



You Can Take the Security Out of TIC but You Can't Take the TIC Out of Security

Darryl Steinhouse
Luce, Forward, Hamilton & Scripps, LLP

Despite the opinion expressed by my esteemed colleague, syndicated tenant in common interests ("TICs") are securities. Is it theoretically possible to structure the purchase of real estate by tenants in common in a way that would not classify the undivided interests as a security? Yes, but a syndicated TIC transaction is not that structure.

Federal Law

The applicable test was established by the United States Supreme Court in *SEC v. Howey*, 328 US 293 (1946) ("Howey"). The Supreme Court held that an "investment contract", and thus a security, will be found to exist if there is (i) an investment in money, (ii) in a common enterprise, (iii) with the expectation of profits, (iv) solely from the efforts of others. There does not seem to be any disagreement that the first three prongs of the Howey test are satisfied in a syndicated TIC transaction. Thus, the key element is whether investors are expecting profits solely from the efforts of others.

First, I believe that we all agree that a TIC transaction that includes a master lease is a security. See, *SEC v. Edwards*, 540 U.S. 389 (2004) and *Triple Net Leasing, LLC*, SEC No-Action Letter, SEC No-Act. LEXIS 824 (Aug. 23, 2000). There is also no argument that a syndicated TIC structure where the property manager is an affiliate of the sponsor would meet the "solely on the efforts of others" element of the Howey test. Thus, we are left to determine whether a syndicated TIC transaction structured with a property management agreement where the property manager is not an affiliate of the sponsor meets the "solely from the efforts of others" prong of the Howey test.

The courts acknowledge that Congress intended to make the definition of "security" as broad as possible. In *SEC v. Paul S. Rubera*, 350 F.3d 1084 (9th Cir. 2003), the Ninth Circuit stated "Congress did not intend the definition of 'security' in the Securities Acts to be restrictive. Rather, it defined 'security' sufficiently broadly to encompass virtually any instrument that might be sold as an investment." Although the Federal courts do have varying methods for determining what exactly is meant by "solely from the efforts of others," "the courts of appeal have been unanimous in declining to give literal meaning to the word 'solely' in this context, instead holding the requirement satisfied so long as 'the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.'" *SEC v. SG Ltd., et al.*, 265 F.3d 42 (1st Cir. 2001). In *SEC v. Aqua-Sonic Products, et al.*, 687 F.2d 577 (2nd Cir. 1982), the Second Circuit stated "we think that if faced with the question the [United States Supreme] Court would not insist on applying that language literally

but would consider whether, under all circumstances, the scheme was being promoted primarily as an investment or as a means whereby participants could pool their own activities, their money and the promoter's contribution in a meaningful way." In *SEC v. Glenn W. Turner Enters.*, 474 F. 2d 476 (9th Cir. 1973), the Ninth Circuit stated that "in light of the remedial nature of the legislation, the statutory policy of affording broad protection to the public, and the Supreme Court's admonitions that the definition of securities should be a flexible one, the word 'solely' should not be read as a strict or literal limitation on the definition of an investment contract, but rather must be construed realistically, so as to include within the definition those schemes which involve substance, if not form, securities." Similar interpretations can be found in the other Circuits' court decisions.

In addition, on March 2005, the NASD issued Notice to Members 05-18, which states that "when TICs are offered and sold together with other arrangements, they generally would constitute investment contracts and thus securities under the federal securities laws." The NASD indicated that syndicated TICs are investment contracts because TIC investments derive their profit "predominantly from the efforts of others, such as through contracts concerning leasing, management and operation of the acquired property," and that "TIC sponsors typically structure the TIC and negotiate the sale price and loan."

Activities of Real Estate TIC Sponsors

As a result of the applicable law, we need to determine the activities of a real estate sponsor. If, in fact, the real estate TIC sponsor did not engage in any activities for the benefit of the investors, do we really believe that investors would purchase these TIC interests? Is it also realistic to believe that the real estate broker who is selling the TIC interests actually tells the investors that the sponsor has nothing to do with the ongoing operations at the property and that the investors are now entirely on their own, like 30 people adrift in a row boat in the middle of the ocean? To the contrary, significant efforts are undertaken by all real estate TIC sponsors which are sufficient to cause a syndicated real estate TIC to be classified as a security.

"...investors do not actually manage their investment; that is reality."

First, the sponsor makes all of the important decisions with respect to the acquisition of the property, including:

- choosing the property to be purchased
- investigating the property and performing the due diligence on the property

- seeking and negotiating the loan, including deciding how much debt to place on the property, which lender to engage, whether to buy down the interest rate, the amount of reserves to be established, forming special purpose entities to acquire the property, engaging legal counsel for the acquisition and financing, and determining how and when the investors will have personal liability
- obtaining property insurance for the property
- choosing the initial property manager
- providing offering documents describing the property to be acquired by the investor
- providing financial projections to the investors for the property

Second, the sponsor provides the TICs with the names of a few, select property managers that the TICs will “hire” for the ongoing property management of the property. The TICs do not know if these property managers are qualified to manage the property and rely on the sponsor’s recommendation. In addition, the sponsors choose the property managers from a small group of companies with which the sponsor has completed numerous deals. Are these really independent property managers?

Third, after acquisition of the property, the sponsor is still much more influential than the TICs in making decisions regarding the property. The sponsor typically retains an interest in the property and interacts with the property manager. In addition, because a unanimous vote is required to hire a property manager, the sponsor has the ability, both legally and practically, to control the ultimate decisions being made by the TICs.

Further, when problems have developed at the properties, the real estate sponsors have been there to help solve the problem.

Theory versus Reality

When I was in college and went out on a Saturday night, there was a “theoretical” possibility that I could date any of the women at the bar that I met that night. However, there was also reality (enough said). The same applies here. Is it theoretically possible that all of the TICs actually manage a piece of real estate? Yes. However, these investors do not actually manage their investment; that is reality. It does not matter how many times they are required to represent that they will actually manage or how many times it is assumed that they will actually manage; they do not. If you put together 20 investors from all over the country, with limited knowledge of the property, its operations and the market in the property’s location, there cannot actually be any meaningful management. If you ask most TICs, they will not even know the tenants in the building. It is also clear that real estate TICs and securities TICs are sold to the same type of investors and that the sales process for the “real estate TICs” is remarkably similar to that of TICs sold in the securities market. Offering memorandums and purchaser questionnaires with suitability representations are used by the “real estate” TIC sponsors in their offerings of TIC interests. The documentation used to structure the transaction is also identical to the securities TIC, including the TIC Agreements and loan documents. There is no real difference other than the distribution channel.



California Law

Even if it is somehow possible to make the argument that TICs are not securities for Federal law purposes, each state has its own rules with respect to what constitutes a security. There is clear authority in California that a syndicated TIC interest is a security in California. Currently, California is one of the states where the greatest number of TIC interests are sold.

Release No. 62-C. The Commissioner indicated “[i]f title to the property is vested in the individual purchasers coupled with a management agreement designed to confer upon them proceeds or income from the activities of the manager, the security is an investment contract.”

California Department of Corporations Commissioner’s Opinion 70/166C. The sale of tenant in common interests with respect to a 25-unit apartment building where the sponsor represented that the owners would have no management responsibilities and that the property would be professionally managed, was found to be a security. The Commissioner concluded “these arrangements proposed by you are investment contracts because the purchasers invest their money with the expectation of realizing profits solely or at least primarily, from your efforts.”

California Department of Corporations Commissioner’s Opinion 74/28C. The sponsor was offering 20 acre parcels of land tied to a management contract with the purchasers. The Commissioner indicated that “the offering of parcels of land without the availability of management contracts would be an offering of real estate only and would not constitute an offering of securities. However, agreements for the sale of parcels when offered with the requirement or opportunity to enter into a management contract presents a different problem.” The Commissioner also considered that the sponsor had projected cash flow for the property and, as a result, treated the sale of land tied to a management contract as a security under California law.

California Department of Corporations Commissioner's Opinion 73/42C. The sponsor sold parcels of real estate and required the investor to engage any one of 10 third party management companies to manage the property. The investor could select its own manager and negotiate its own fees. The Commissioner concluded that "the sale of property is not the sale of a security even though the purchaser employs a management company to operate the property where the seller does not assist the purchaser in obtaining the management." The Commissioner continued, "In the instant case, we would conclude that neither the sale of a parcel of orchard acreage nor a management contract for the parcel in and of itself would constitute a security, if the two transactions were separate, the manager not affiliated with the seller of the parcel, and the help provided by seller enabling a purchaser to enter into the management contract, not a material inducement for the purchase of the acreage." The Commissioner also looked at whether the sponsor included financial projections in the offering and concluded that this structure was a security.

California Department of Corporations Commissioner's Opinion 79/15C. A general partnership sold general partnership interests after the partnership had acquired a property. The partnership had a property manager and a management corporation. However, management could not bind the partnership absent a majority vote of the partners. The Commissioner, in determining whether there was an investment contract, stated "It appears that the most significant initial decision for the partnership is to be made before the partnership is even formed – the decision regarding the property to be purchased for the partnership's initial real estate investment and, apparently, the approximate price of the property, e.g., at a profit to Mr. Johnson [the sponsor]. The most significant initial managerial decisions for the partnership will have been made and the prospective partners' decision will be whether they wish to be a partner in a partnership." As a result of the fact that the investment was pre-assembled for the investors, even though the investors had managerial control, the partnership interests were considered investment contracts and thus a security.

California Department of Corporations Commissioner's Opinion 72/138C. The sponsor selected property and transferred it to the tenants in common, which consisted of approximately 15 specified individuals (the "Parties"). Prior to the transfer, the sponsor was going to construct a building. The sponsor and all of the Parties would mutually select a property manager with voting to be in proportion to their percentage interests. The Commissioner concluded that if the sponsor (i) had not sold any of the parcels to the Parties and (ii) was not instrumental in the acquisition of the parcels, the arrangement between the parties would not be a security. The Commissioner stated that the agreement of the Parties contemplated the pooling of their parcels, the operation of the pooled parcels in proportionate expense of the Parties and the sharing of profits and losses from the operation of the parcels in proportion to their undivided interests. As a result the interests in the properties constituted an investment contract.

Oil Lease Service, Inc. v. W. H. Stephenson, 162 Cal. App. 2d 100 (9th Cir. 1958). The sponsor's sole activity in this case was the purchase of

oil and gas leases. The sponsor would purchase 640 acre leases and sell them in smaller sections. The sponsor provided no other services except for the selection of the property. The court indicated that this was a security because (i) the sponsor did the work necessary for the acquisition of the property and (i) suggested that the investors could make profits or cash bonuses from the property. This case was appealed by the sponsor to the California supreme court and review was denied.

First, there are no TIC structures that meet the three part test set forth in Commissioner Opinion 73/42C. Second, all TICs are pre-assembled as discussed in Commissioner Opinion 79/15C. Third, the sponsor in all syndicated TIC transactions sells the property to the investor and the provides information about the potential profits or cash flow from the property. Thus, under California law, all syndicated TICs will be securities.

"...when the sale of the real estate is packaged by a TIC sponsor and sold to third party investors who are looking for economic gain, you have a security..."

Conclusion

Is it possible to have multiple parties own real property as TICs so that it is not a security? Yes, but that would be Dick and me selecting the property and actively managing the property together. Is there actual active management in a syndicated TIC transaction sold on the "real estate" platform? Do these "real estate TIC" investors have more control over the project than their securities counterparts? Do the investors actively select the property or complete their own analysis regarding the projected economic return from the property? No. While the sponsor may put together a conference call once a month, the TICs still do not actively participate in management decisions regarding the property. Even if someone could argue that, under Federal law, a once-a-month conference call is enough to treat a TIC interest as real estate and not a security (which I do not believe), that structure will not work in California.

Clearly, the mere ownership of real estate by more than one person does not mean that the real estate has become a security. However, when the sale of the real estate is packaged by a TIC sponsor and sold to third party investors who are looking for economic gain, you have a security, especially in California. ✖