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Betting the Farm: THE TIC Turf War and Why TICs Constitute Investment Contracts Under Federal Securities Laws

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NOTES

BETTING THE FARM: THE TIC TURF WAR AND WHY TICS CONSTITUTE INVESTMENT CONTRACTS UNDER FEDERAL SECURITIES LAWS

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INTRODUCTION

Tenancies-in-common are one of the oldest forms of interests in real estate.¹ Although the traditional tenancy-in-common remains intact, the modern concept based on fractionalized ownership has experienced a controversial evolution.² In the 1990's, investment companies developed the syndicated tenancy-in-common (TIC) structure by packaging tenant-in-common ownership interests together with other arrangements.³ This new TIC investment vehicle offered undivided fractionalized ownership of institutional⁴ grade property with limited management responsibilities.⁵ For the first time, smaller investors who were financially unable to invest in a sizeable, high-quality, income-producing property⁶ on their own could participate as part of a group.⁷

Initially, TICs were offered and sold as securities, not interests in real estate.⁸ At the turn of the twenty-first century,⁹ however, the TIC industry began to experience significant growth,¹⁰ and real estate professionals

1. Early English common law acknowledged three legal forms for the concurrent ownership of property, one of which was the tenancy-in-common. *United States v. Craft*, 535 U.S. 274, 279 (2002).

2. The tenancy-in-common continues to be defined as an undivided joint ownership interest held by two or more persons, each having a possessor right, in the same piece of land. 20 AM. JUR. 2D *Cotenancy and Joint Ownership* § 32 (2008).

3. See KATHY HESHELOW, *EFFORTLESS CASH FLOW: THE ABC'S OF TIC'S (TENANT IN COMMON PROPERTIES)* 9, 10 (iUniverse, Inc. 2006).

4. *Id.* at 1 (noting that TIC properties include sizeable high quality real estate such as office buildings, shopping centers, and apartment complexes).

5. *Id.* at 7 ("TICs are passive income properties with no management and no daily responsibilities or headaches.").

6. *Id.* at 1-2; see also Terence Floyd Cuff, *Avoiding Ticky Tacky TICs: Some Comments on Investing in TICs and Avoiding the Pig in a Poke*, 034 ALI-ABA 795, 797 (2006).

7. Cuff, *supra* note 6, at 797 (stating that TICs provide small investors with access to the market for institutional properties and "provide unsophisticated investors with the illusion of simplicity").

8. See, e.g., 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 (2006).

9. In 2002, the Internal Revenue Service issued a revenue ruling clarifying the conditions under which real estate owners can defer capital gains and other tax liabilities by exchanging TICs as like-kind property under I.R.C. § 1031. Rev. Rul. 2002-22, 2002-1 C.B. 733 (setting forth guidelines for obtaining a ruling that TIC interest will not be treated as a security for federal income tax purposes); see also I.R.C. § 1031(a)(1) (2000) (establishing that under special circumstances, a taxpayer can defer tax liability that would otherwise be imposed as a result of the capital gains from real property).

10. The issuance of Revenue Ruling 2002-22 caused an explosion in the TIC

seized the opportunity to get a “slice of the pie” and garner extensive profit by selling TICs as real estate rather than securities.¹¹ To that end, a heated debate arose involving the question of under what circumstances, if any, the offer and sale of TIC interests will not constitute the offer and sale of a security under federal securities laws.¹² This debate fueled a turf war¹³ between those who “bet the farm” by offering and selling TICs as investments in real estate, and those who properly sell TICs as securities subject to the regulatory regime of the Securities and Exchange Commission (SEC).¹⁴

Offering and selling TICs as real estate is a sponsor-focused approach, designed to benefit and protect the sponsor, *not* the investor.¹⁵ The sponsor disregards protections that were enacted for the benefit of investors in return for a chance to gain more profit.¹⁶ This strategy is counterintuitive: the notion that TICs can simply be structured as real estate embraces a “bet the farm,” all-or-nothing approach that circumvents statutory purpose and congressional intent and deprives investors of the disclosure requirements and anti-fraud provisions that were enacted for their benefit.¹⁷

industry. See HESHELOW, *supra* note 3, at 9 (indicating that in the aftermath of the issuance of Revenue Ruling 2002-22, the TIC industry exploded); see also Alan J. Berkeley, *Real Estate Interests in Securities: TICs/DSTS, in Regulation D Offerings and Private Placements* 75 ALI-ABA 727, 729 (2006) (explaining that 2003 witnessed \$150 million in sales of TIC interests; 2004 witnessed \$2 billion in sales; 2005 witnessed \$4 billion in sales; and the sales numbers may “reach \$40-50 billion annually by 2010”).

11. Thorup, *supra* note 8, at 426 (articulating an investment structure under which TICs are allegedly offered and sold as real estate and not securities).

12. See, e.g., HESHELOW, *supra* note 3, at 32 (noting that the question of whether TICs are securities or real estate has been hotly debated in the TIC industry since 2002).

13. See generally Todd Snyder, *TICs as Real Estate or Securities: Insignificant Sponsors?*, TIC TALK, 4th Quarter 2007, available at <http://www.snyderkearney.com/Portals/0/TICs%20as%20Real%20Estate%20or%20Securities.pdf>.

14. The Securities and Exchange Commission is an autonomous regulatory body charged with administering and enforcing federal securities laws. See generally RICHARD W. JENNINGS ET AL., *SECURITIES REGULATION* 98 (7th ed. 1992 & Supp. 1996) (explaining the authority possessed and the obligations undertaken by the SEC).

15. For the purposes of this Note, the term “sponsors” refers to those persons and entities that offer and sell TICs.

16. See generally Stephanie Ann Miranda, *Can Pre-Purchase Entrepreneurial Efforts Satisfy the Fourth Prong of the Howey Test? A Critique of SEC v. Life Partners, Inc.*, 38 SANTA CLARA L. REV. 269, 274 (1997) (stating three principles underlying federal securities law).

17. See, e.g., Securities Act of 1933, 15 U.S.C. §§ 77a-77b, 77s-77t (2000) (setting forth the statutory definitions and other requirements that govern the offer and sale of securities); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a, 78c(16), 78d (2000) (defining a security and setting forth the comprehensive remedies for statutory violations of securities laws).

This Note contends that TICs are securities under federal law because investors depend upon the entrepreneurial and managerial efforts of the TIC sponsor or third-parties for the profitability of their investments.¹⁸ Part I of this Note introduces the federal securities laws, their underlying principles, and the definition of the term “security.” Part II explains why TICs are securities rather than investments in real estate under existing legal precedent. Part III proposes that the Supreme Court abolish the bright line rules that defy the principles underlying the federal securities laws by recognizing the flexible approach and liberal construction articulated in this Note. Finally, the conclusion provides a brief summary and invites the SEC to offer new guidance in the TIC investment arena.

I. WHAT IS A SECURITY UNDER FEDERAL LAW?: THE SECURITIES ACTS IN THE CONTEXT OF TIC TRANSACTIONS

In order to determine whether TICs constitute securities under federal law, the inquiry necessarily starts with a historical introduction of the securities laws and the underlying principles.¹⁹ It is also necessary to engage in a brief discussion of the definition of the term “security”²⁰ under the relevant portions of the Securities Acts²¹ as applied by the United States Supreme Court.²²

A. *The Federal Securities Acts*

Before Congress enacted the Securities Act of 1933, securities regulation did not exist outside the regime of state “blue sky laws.”²³ “Blue sky laws” are state-adopted statutes that regulate securities and require that offerings comply with certain standards; if an offering fails to meet the standards set forth by a State’s blue sky laws, the securities cannot be sold in that state.²⁴ Congress enacted the 1933 and 1934 Acts in the aftermath of the stock market crash of 1929 as remedial legislation designed to

18. See *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-300 (1946).

19. See generally *Miranda*, *supra* note 16, at 273-74 (discussing the principles underlying Congress’s decision to enact the securities laws).

20. 15 U.S.C. § 77b(a)(1) (2006).

21. *Id.* § 77a, 78a (naming each of the Acts).

22. See *Howey*, 328 U.S. at 293 (defining the term “investment contract” under the federal securities laws).

23. *Miranda*, *supra* note 16, at 273 (citing *SEC v. W.J. Howey Co.*, 246 U.S. 293, 298-99 (1946), and adopting the definition of “investment contract” as had been uniformly applied by the state courts).

24. *Id.* at 273 & n.35.

eliminate widespread abuses in a largely unregulated securities market.²⁵ The 1933 Act regulates the offer and sale of public offerings of securities by requiring the disclosure of material information through a statement of registration submitted to the SEC.²⁶ The 1933 Act is basically a “coherent and unified” statute aimed toward promoting disclosure and preventing fraud in the offer and sale of securities.²⁷

These Securities Acts also created the SEC to aid in the regulation of the securities markets and the pursuit of violators.²⁸ Although the SEC has not issued a definitive ruling regarding whether TICs are securities, it has issued guidance implicitly stating that TICs are securities.²⁹ This is significant because the SEC has considerable expertise in interpreting both the Securities Acts and the novel, complex investment schemes that fall within the scope of federal statutory provisions.³⁰ Thus, considerable

25. *Id.* at 273 (citing *United Hous. Found. v. Forman*, 421 U.S. 837, 849 (1975)). See generally James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 30 (1959) (explaining the history behind the securities laws).

26. Section 5 of the 1933 Act requires new issues of securities to be registered with the SEC pursuant to 15 U.S.C. § 77e. See also 15 U.S.C. § 77g (2006). See generally JENNINGS ET AL., *supra* note 14, at 98 (exploring the boundaries of the registration statement required under federal securities laws).

27. *Miranda*, *supra* note 16, at 275.

28. 15 U.S.C. § 78d (establishing a Securities and Exchange Commission).

29. On January 14, 2009, the SEC issued a response to a “no-action” request that supports the view that TIC investments are securities versus real estate. The no-action request to the SEC was submitted in February 2006 and described two common TIC business models being utilized by sponsors that were syndicating TIC offerings as real estate and who were compensating real estate agents. The request asked the SEC to agree to take “no action” if the companies were to syndicate offerings utilizing either the real estate model or the securities model and were to compensate licensed real estate agents, a practice prohibited for securities. Nearly three years later, the SEC issued its brief response. Specifically, the SEC response stated that “based on the facts presented” the SEC views the sale of undivided tenant-in-common interests as securities, per the Securities Act of 1933. OMNI Brokerage, Inc. Argus Realty Investors, L.P. PASSCO Companies, LLC, SEC No-Action Letter, 2009 WL 153818 (Jan. 14, 2009) [hereinafter OMNI Brokerage No-Action Letter] (rejecting Triple Leases’ claim that TIC’s were not securities). It should be emphasized, however, that the SEC response to the no-action letter does not put an end to the securities versus real estate debate. The SEC response was a concise letter that made it clear that their decision was based only on the facts presented within the specific no-action request and may not be representative of other situations or the industry as a whole. *Id.*; see also *infra* note 292 and accompanying text.

30. Lewis D. Lowenfels & Alan R. Bromberg, *What Is A Security Under Federal Securities Laws?*, 56 ALB. L. REV. 473, 477 (1993) (discussing Congress’s intent to define “security” broadly, to encompass any instruments).

weight should be given to the fact that the SEC has implicitly stated that TICs are securities.³¹

B. Three General Principles Underlying the Federal Securities Acts

Three principles underlying the securities laws are gravely significant.³² First, Congress's purpose in enacting the securities laws was to prevent those who offer and sell securities from exploiting investors.³³ Congress intended to carry out this goal by requiring that sponsors provide investors with information that would be otherwise unavailable.³⁴ The Supreme Court has consistently remarked that the Acts are designed to protect investors through the promotion of full disclosure.³⁵ With many different types of securities, investors do not actively participate in the venture and, therefore, do not have access to the kind of information that registration under the Securities Acts would disclose.³⁶ Yet much of the information surrounding novel investment schemes, such as the potential benefits of investing as weighed against the risk, is undoubtedly necessary for a person to make informed investment decisions.³⁷ Thus, the idea that information is the best form of investor protection is paramount to the purpose underlying the securities laws.³⁸

Second, courts should refrain from imposing formal limitations on what constitutes a security and should instead apply flexible approaches

31. See generally Reuel E. Schiller, *The Era of Deference: Courts Expertise, and the Emergence of New Deal Administrative Law*, 106 MICH. L. REV. 399 (2007) (citing MORTON J. HORWITZ, *THE TRANSFORMATION OF AMERICAN LAW, 1870-1960: THE CRISIS OF LEGAL ORTHODOXY* 222-25 (1992)) (discussing how courts' deference to administrative agencies in administrative matters was a result of President Franklin D. Roosevelt appointing federal judges to the bench).

32. See *Miranda*, *supra* note 16, at 274-75.

33. *Id.*; see also *SEC v. Ralston Purina Co.*, 346 U.S. 119, 124-26 (1953).

34. See *Ralston Purina Co.*, 346 U.S. at 124-26 (discussing three principles that have recurred in the Supreme Court's definition of a "security").

35. *Miranda*, *supra* note 16, at 275-76 (stating that the prospectus and registration statutes, which are required in the issuance in the new securities, are at the core of the Securities Exchange Act (citing, among others, *SEC v. Variable Annuity Life Ins. Co. of Am.*, 359 U.S. 65, 76 (1959))).

36. See *Lowenfels & Bromberg*, *supra* note 30, at 477.

37. See *SEC v. Life Partners, Inc.*, 87 F.3d 536, 552 (D.C. Cir. 1996) (Wald J., dissenting) (arguing that to control its concerns, Congress, when enacting the Security Act, ensured that investors received adequate information before they commit their money).

38. *Id.*

and liberal construction.³⁹ Such an approach is necessary in order to achieve the remedial nature of the statutory purpose.⁴⁰ In determining whether a particular arrangement or instrument constitutes a security, the Supreme Court broadly interprets the 1933 and 1934 Acts to encompass “novel, uncommon, or irregular devices, whatever they appear to be”⁴¹ This preservation of judicial flexibility is necessary “to ensure that those who market investments are not able to avoid coverage of the Securities Acts by creating new instruments that would not be covered by a more determinable definition.”⁴²

Third, the Supreme Court consistently reinforces the underlying policy that “form (theory) should be disregarded for substance (reality), and that emphasis should be on economic reality.”⁴³ Accordingly, the “task has fallen to the SEC and ultimately to the federal courts to decide which of the myriad financial transactions in our society come within the coverage of these statutes.”⁴⁴ The congressional purpose in enacting the securities laws was to regulate investments, regardless of the form and structure of the instrument.⁴⁵ Thus, the type of investment and its external form are insignificant, and the securities laws should apply whenever it would be appropriate for the protection of investors.⁴⁶

C. *The Statutory Definition of a “Security”*

To determine whether the offer and sale of TIC interests constitute the offer and sale of a security or an investment in real estate, it is necessary to start with the statutory definition of a “security” under the Securities Acts.⁴⁷ Courts routinely observe that the definition of a security is essentially the same under section 2(a)(1) of the 1933 Act⁴⁸ and section 3(a)(10) of the 1934 Act.⁴⁹ Under the 1933 Act, a “security” includes “any note,

39. *Miranda*, *supra* note 16, at 277-78.

40. *Id.* at 305; *see also Life Partners, Inc.*, 87 F.3d at 552-53 (Wald J., dissenting).

41. *SEC v. C. M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943).

42. *See Reves v. Ernst & Young*, 494 U.S. 56, 63 n.2 (1990); *see also SEC v. Aqua-Sonic Prods. Corp.*, 687 F.2d 577 (2d. Cir. 1982).

43. *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967).

44. *United Hous. Found. v. Forman*, 421 U.S. 837, 848 (1975).

45. *See Reves*, 494 U.S. at 61.

46. *See generally Miranda*, *supra* note 16.

47. 15 U.S.C. §§ 77a -77mm,78(c)(10) (2006).

48. *Id.* § 77b(a)(1).

49. *Id.* § 78c(a)(10); *see Reves*, 494 U.S. at 61 n.1 (following the Supreme Court’s ruling in *United Housing Foundation* and holding that the slightly different definitions of the term “security” in the 1933 and 1934 Acts should be treated as essentially identical

stock, treasury stock, security future, 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 contract⁵⁰

Although neither TICs nor real property are specifically included in the statutory list, this does not mean that TICs are not securities under the Acts.⁵¹ Recognizing the “virtually limitless scope of human ingenuity,” Congress acted with vast authority⁵² when it enacted a definition of the term security that is sufficient to include almost any device or scheme that might be offered or sold as an investment.⁵³ Thus, Congress included “investment contracts” in its definition of “securities” in order to encompass complex and creative investment schemes.⁵⁴

The term “investment contract” is undefined by the Securities Act or relevant legislative reports.⁵⁵ The concept, however, was well-known in many state blue sky laws that existed before the Securities Acts.⁵⁶ Though the term was also undefined by the state laws, it had “been broadly construed by state courts so as to afford the investing public a full measure of protection.”⁵⁷ By including “investment contracts” within the statutory scope of the Securities Acts, Congress used a term well-defined in state case law.⁵⁸ The Supreme Court, therefore, thought it reasonable to attach that meaning to the term, especially since that definition was consistent with the spirit and statutory purpose of the Securities Acts.⁵⁹ As a result, in 1946, the Supreme Court articulated the quintessential four-part test to determine whether a certain device or scheme constitutes an investment contract, and therefore a security, under the Securities Acts.⁶⁰

in meaning).

50. *Id.* § 77b(a)(1).

51. *See Reves*, 494 U.S. at 61 (holding that Congress provided a broad definition of the term security so as to encompass “virtually any instruments that might be sold as an investment”).

52. *Id.* at 60-61.

53. *Id.* at 61.

54. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298 (1946).

55. *See id.*

56. *See id.*

57. *Id.* (citing *People v. White*, 12 P.2d 1078 (Cal. 1932); *State v. Evans*, 154 Minn. 95 (1922); *Stevens v. Liberty Packing Corp.*, 111 N.J. Eq. 61 (1932); *State v. Health*, 199 N.C. 135 (1930); *Klatt v. Guaranteed Bond Co.*, 213 Wis. 12 (1933); *Prohaska v. Hemmer-Miller Dev. Co.*, 256 Ill. App. 331 (1930)).

58. *See Howey*, 328 U.S. at 298-99.

59. *See id.*

60. *See id.* (establishing the leading test for investment contracts in the federal system).

D. Investment Contracts Under the Howey Test

In *SEC v. W.J. Howey Co.*, the Supreme Court carefully considered the general principles and congressional intent set forth above and articulated a markedly broad definition of an investment contract.⁶¹ *Howey* involved the offer and sale of land sales contracts in the form of citrus grove acreage, along with a service contract for harvesting.⁶² Although the service contract was optional and investors were free to enter into service agreements with any third-party, most of the investors opted for purchase with the affiliate of the Howey Company.⁶³ The service contract gave the Howey Company a leasehold interest and covered cultivation of the groves and other harvesting services.⁶⁴ Upon full payment of the purchase price, each of the approximately forty purchasers of the citrus grove became fractional owners of the citrus grove acreage.⁶⁵ The Howey Company did not register the interests as securities.

Consequently, the SEC brought an action to enjoin the sale of the citrus grove interests. Because the interest at issue did not constitute any of the specific, traditional kinds of securities enumerated in section 2(a)(1) of the Securities Act of 1933, the SEC argued that the interests were "investment contracts."⁶⁶ The *Howey* Court found that the arrangements together constituted an "investment contract."⁶⁷

The *Howey* Court pointed out that the purchasers were investors with general business experience, but no particular experience with citrus crops.⁶⁸ They were lured into the investment not by the prospect of mere undivided ownership in land, but rather by the prospects of a return on their investment from the pooling of assets and sharing in the profits of the enterprise.⁶⁹ The *Howey* Court reasoned that because the inexperienced investors resided in distant locales and were not interested in cultivating the plots for themselves, they had to rely on the efforts of others to help

61. *See generally id.* at 293.

62. *Id.* at 295.

63. *Id.*

64. *Id.* at 296.

65. *Id.* at 295.

66. *See id.* at 297 (explaining the different positions on the legal issue taken by the parties).

67. *Id.* at 300.

68. *Id.* at 296.

69. *Id.* at 300.

them realize their profits.⁷⁰ Thus, fee ownership of packaged real estate was treated as a security.⁷¹

In reaching its conclusion, the Court adopted a four-part test to determine whether the arrangements constituted an investment contract.⁷² Under the adopted test, for purposes of the 1933 Act, an investment contract is “a contract, transaction or scheme whereby a person (1) invests his or her money, (2) in a common enterprise, and (3) is led to expect profits, (4) solely from the efforts of the promoter or a third party.”⁷³ The *Howey* Court did not adopt this test as a bright line rule.⁷⁴ To the contrary, the *Howey* test is 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.”⁷⁵

Although the plain language of the *Howey* decision, the underlying principles of the Securities Acts, and the regulatory guidance espoused by industry professionals⁷⁶ are all persuasive, TICs must be analyzed under the *Howey* test in order to end the TIC turf war once and for all.

II. TICs ARE INVESTMENT CONTRACTS UNDER THE *HOWEY* TEST AND ARE THEREFORE SECURITIES UNDER FEDERAL LAW

Over sixty years after the Supreme Court’s decision in *Howey*, its analysis test remains the leading test for investment contracts in the federal system.⁷⁷ The test remains flexible and continues to fulfill “the statutory purpose of compelling full and fair disclosure relative to” the

70. *Id.*

71. *See id.*

72. *Id.* at 298-99.

73. *Id.*

74. *See id.*

75. *Id.* at 299.

76. On March 2, 2005, the National Association of Securities Brokers (NASD) published Notice to Members 05-18, in an attempt to provide guidance concerning the classification of TICs as an investment in real estate versus securities. The notice states that TIC interests standing alone generally are not securities, but that when sponsors offer and sell TICs together with other arrangements, such as management agreements, the scheme generally would constitute an investment contract, and would therefore be securities under federal law. The NASD takes the position that just because an investor in a particular TIC transaction might have the power to terminate a management contract or maintain and repair the property, it does not necessarily follow that a TIC interest is a security. National Association of Securities Dealers, *Notice to Members 05-18*, Fin. Indus. Regulatory Auth., Mar. 2005, <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p013455.pdf> [hereinafter NASD, *Notice to Members*].

77. SEC v. Edwards, 540 U.S. 389, 390 (2004).

issuance of the wide variety of unique investment mechanisms that “fall within the ordinary concept of a security.”⁷⁸ While some syndicated⁷⁹ real estate investment schemes may fall outside the purview of the federal securities laws, syndicated TICs do not.⁸⁰ In general, in order to convince those who continue to “bet the farm” by selling TICs as real estate that TICs are in fact securities, there are two different TIC structures that must be analyzed.⁸¹

The first structure is known as the master lease, or affiliate TIC structure.⁸² Under this structure, the TIC investors purchase the property subject to a long-term leaseback agreement with the sponsor or an affiliate of the sponsor.⁸³ The sponsor or its affiliate leases the whole property from the TIC owners in exchange for an agreed upon amount of monthly income or rent payable to the TIC owners.⁸⁴ Under this master lease, the sponsor or its affiliate is the only tenant.⁸⁵ As the master lessee, the sponsor or its affiliate is ultimately responsible for all maintenance, leasing, and management-related obligations that arise in the operation of syndicated TIC investments.⁸⁶ The master lease TIC structure requires little or no management on the part of the TIC owners.⁸⁷ Because those who invest in an affiliated TIC depend on the undeniably significant entrepreneurial and managerial efforts of the sponsor or its affiliate for the profitability of their investment, players on both sides of the turf war generally agree that this structure is inherently a security.⁸⁸

78. *Howey*, 428 U.S. at 299.

79. See Alex R. Pederson, *The Rejuvenation of the Tenancy-In-Common Form for Like-Kind Exchanges and Its Impact on Lenders*, 24 ANN. REV. BANKING & FIN. L. 467, 473 (2005) (explaining that syndication is “the elegant term for group participation in the ownership or development of an idea, product or tangible asset”).

80. See, e.g., Snyder, *supra* note 13; Darryl Steinhouse, *You Can Take the Security Out of TIC but You Can't Take the TIC Out of Security*, TIC TALK, 1st Quarter 2007, available at <http://www.1031propertywatch.com/articles/shArt.pdf>.

81. See generally Elizabeth Ayres Whitman, *A “TIC”ing Time Bomb: Rule 506 Meets Section 1031*, 12 FORDHAM J. CORP. & FIN. L. 121, 128 (2007).

82. See, e.g., Richard M. Lipton, *DSTs and § 1031: A Marriage Made in Heaven, or Just a Pipe Dream?*, 646 PRAC. L. INST/TAX 911, 931 (2005).

83. *Id.*

84. *Id.*

85. *What is a Master Lease*, <http://www.tenantincommon1031.com/master-lease.php> (last visited Mar. 13, 2010).

86. *Id.*

87. *Id.*; see also Richard Lipton, *TICs as Real Estate (and not Securities)*, TIC TALK, 4th Quarter 2006, available at <http://www.omni1031corp.com/tictalk/ticTalk Archive/ticTalk4Qtr06.pdf>.

88. See, e.g., Lipton, *supra* note 87; Steinhouse, *supra* note 80.

The second structure is known as the property management, or non-affiliate structure.⁸⁹ This structure is commonly characterized as a syndicated TIC transaction coupled with a property management agreement, where the property management is not carried out by the sponsor or an affiliate of the sponsor.⁹⁰ Thus, instead of buying the fractionalized interests subject to a leaseback agreement with the sponsor or an affiliate of the sponsor, the TIC investors rely on third-party property and asset managers to operate the investment.⁹¹ Because players on both sides of the debate generally agree that the master lease TIC structure constitutes a security under federal law, the analysis below will focus on the reasons why non-affiliate TICs satisfy the four-pronged *Howey* test.⁹²

A. TICs Satisfy All Four Prongs of the *Howey* Test

To this point, it is generally agreed upon that all syndicated TICs easily satisfy the first three prongs of the *Howey* test.⁹³ The industry debate is largely confined to the fourth prong.⁹⁴ As a result, the analysis below briefly shows why syndicated TIC investments satisfy the first three prongs of the *Howey* test, but it focuses primarily on the reasons why “the efforts of others”⁹⁵ under the fourth prong of the *Howey* test are sufficient to bring TICs within the purview of federal securities laws.⁹⁶

1. Investment of Money

The first prong of the *Howey* test, an investment of money, is rarely an issue when the courts attempt to identify investment contracts.⁹⁷ Courts apply a broad interpretation to this prong and have not limited it to cash.⁹⁸ In every decision made by the Supreme Court that recognizes the presence of an investment contract under the Securities Acts, the person found to have been an investor voluntarily chose to give up specific consideration

89. See Thorup, *supra* note 8, at 426 (analyzing the property management style TIC structure under the *Howey* test).

90. *Id.*

91. *Id.*

92. See Lipton, *supra* note 87 (conceding that master-lease TICs are securities).

93. See, e.g., *id.*; Steinhouse, *supra* note 80.

94. Snyder, *supra* note 13.

95. See generally 15 U.S.C. §§ 77a, 78a.

96. *Id.*

97. SEC v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946).

98. See, e.g., *Int'l Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 559-60 (1979).

in return for a separable financial interest.⁹⁹ In TIC transactions, the investors, even those acting in connection with like-kind exchanges,¹⁰⁰ purchase their TIC interests in exchange for cash or other consideration.¹⁰¹ Thus, the tangible consideration in the form of cash or like-kind credit given by TIC investors in exchange for their interests satisfies the first prong of the *Howey* test.

2. Common Enterprise

The second prong of the *Howey* test requires the existence of a common enterprise.¹⁰² There is currently a split among the circuits as to the requirements of the second prong of the *Howey* test.¹⁰³ This split gives rise to two different versions of commonality: horizontal and vertical. Most circuits that have considered the issue find that the common enterprise requirement is satisfied through horizontal commonality. Horizontal commonality requires a pooling of interests of two or more investors who share the investment risks and benefits of the venture with one another.¹⁰⁴ On the other hand, the Fifth,¹⁰⁵ Ninth,¹⁰⁶ and Eleventh Circuits¹⁰⁷ have

99. *Id.* at 559; *see, e.g.*, *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967) (money paid for bank capital stock); *SEC v. Variable Annuity Life Ins. Co. of Am.*, 359 U.S. 65, 76 (1959) (premium paid for variable-annuity contract); *Howey*, 328 U.S. at 293 (money paid for purchase, maintenance, and harvesting of orange grove); *SEC v. C. M. Joiner Leasing Corp.*, 320 U.S. 344, 345-46 (1943) (money paid for land and oil exploration).

100. *See* I.R.C. § 1031(a)(1) (2000) (establishing that under special circumstances, a taxpayer can defer tax liability that would otherwise be imposed as a result of the capital gains from real property).

101. *See* Thorup, *supra* note 8.

102. *Howey*, 328 U.S. at 298-99.

103. *See, e.g.*, Shawn Hill Crook, Comment, *What is a Common Enterprise? Horizontal and Vertical Commonality in an Investment Contract Analysis*, 19 CUMB. L. REV. 323 (1989).

104. *See, e.g.*, *SEC v. Infinity Group Co.*, 212 F.3d 180, 188 (3d Cir. 2000); *SEC v. Banner Fund Int'l*, 211 F.3d 602, 614-15 (D.C. Cir. 2000); *Teague v. Bakker*, 35 F.3d 978, 986 n.8 (4th Cir. 1994); *Wals v. Fox Hills Dev. Corp.*, 24 F.3d 1016, 1018-19 (7th Cir. 1994); *Revak v. SEC Realty*, 18 F.3d 81, 87-89 (2d Cir. 1994); *Newmyer v. Philatelic Leasing, Ltd.*, 888 F.2d 385, 391-93 (6th Cir. 1989) (applying horizontal commonality as the requirement that investors share or pool their funds in order to succeed in the venture).

105. *See, e.g.*, *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 478-79 (5th Cir. 1974).

106. *See, e.g.*, *SEC v. Glenn W. Turner Enter., Inc.*, 474 F.2d 476, 481-82 (9th Cir. 1973).

107. *See, e.g.*, *SEC v. ETS Payphones, Inc.*, 300 F.3d 1281, 1283-84 (11th Cir. 2002) (recognizing "horizontal commonality" as the majority test in the circuit courts, but

adopted *some*¹⁰⁸ version of vertical commonality. Vertical commonality requires the fortunes of the investor to be “interwoven with and dependent on the efforts and success of those seeking the investment or of third parties.”¹⁰⁹ Vertical commonality focuses on the relationship between the investors and the promoter, not on the relationship between the individual investors.¹¹⁰ While it is not clear whether the Supreme Court believes horizontal or vertical commonality should control the analysis for the second prong of *Howey*,¹¹¹ this does not present an issue because TICs satisfy both interpretations.

In the typical TIC transaction, at least two investors purchase undivided interests and share in common ownership of the property on a pro-rata basis in accordance with the percent interest held by each respective investor.¹¹² TIC investors pool their assets and share in the venture’s profits and losses on a pro rata basis.¹¹³ The sharing of the risks and benefits of the investment, as well as the pooling of assets, constitutes horizontal commonality for the purposes of the *Howey* test.¹¹⁴

TIC transactions also satisfy vertical commonality.¹¹⁵ In the typical non-affiliate TIC transaction, the sponsor or managing third party does not gain profits or suffer losses independent of action exercised by investors.¹¹⁶ Thus, investor fortunes and profits are adequately interwoven with, and dependent on the efforts of the sponsor and third parties to the extent necessary to satisfy vertical commonality.¹¹⁷

applying precedent that broad vertical commonality is the controlling test in the Eleventh Circuit), *rev’d. on unrelated grounds by SEC v. Edwards*, 540 U.S. 389, 393-97 (2004).

108. Within the circuits that have adopted vertical commonality under the second prong of the *Howey* test, two variations exist: (1) narrow vertical commonality and (2) broad vertical commonality. *Compare Mordaunt v. Incomco*, 686 F.2d 815 (9th Cir. 1992), *with Long v. Shultz Cattle Co.*, 881 F.2d 129 (5th Cir. 1989).

109. *Villeneuve v. Advanced Bus. Concepts Corp.*, 698 F.2d 1121, 1124 (11th Cir. 1983).

110. *See SEC v. Unique Fin. Concepts, Inc.*, 196 F.3d 1195, 1199-1200 (11th Cir. 1999).

111. The Supreme Court has never decided which form of commonality is required. *See McGill v. Am. Land & Exploration Co.*, 776 F.2d 923, 925 (10th Cir. 1985).

112. *See Marilyn B. Cane & Jennifer C. Erdelyi, 1031 Tenant In Common Exchanges: A “TIC”king Time Bomb at the Intersection of Real Estate, Securities, and Tax Law?*, 14 U. MIAMI BUS. L. REV. 273, 283-85 (2006).

113. *Id.*

114. *Id.*

115. *See Long v. Shultz Cattle Co.*, 881 F.2d 129, 140-41 (5th Cir. 1989); Jonathan E. Shook, Note, *The Common Enterprise Test: Getting Horizontal or Going Vertical in Wals v. Fox Hills Development Corp.*, 30 TULSA L.J. 727, 728-34 (1995).

116. *See Cane & Erdelyi, supra note 112.*

117. *Id.*

3. *Expectation of Profits*

The third prong of the *Howey* test requires an “expectation of profits.”¹¹⁸ For the purposes of *Howey*, the term “profits” means merely a financial return on an investment.¹¹⁹ In its 2004 decision in *SEC v. Edwards*, the Supreme Court re-articulated this position.¹²⁰ The Court emphasized that when it held that “profits” must “come solely from the efforts of others,” it was “speaking of the profits that investors seek on their investment.”¹²¹ The Court used “profits” in the “sense of income or return, to include, for example, dividends, other periodic payments, or the increased value of the investment.”¹²² In addition, the enticement of tax deferral may also constitute profits under the third prong of *Howey*.¹²³

In the typical non-affiliate transaction, investors purchase TICs with the expectation that the property will not only produce monthly income through rentals and leasing, but that the value of the property will appreciate.¹²⁴ Additionally, many investors purchase TICs in order to defer taxes through 1031 exchanges.¹²⁵ Thus, TIC investors have an expectation of profits for the purposes of the *Howey* test.¹²⁶

4. *Reliance on the Efforts of Others*

The fourth prong of the *Howey* test requires that the expectation of profits come “solely from the efforts of [others].”¹²⁷ While the Supreme Court used the word “solely” in its articulation of the fourth prong of *Howey* test, the lower courts have essentially disregarded the word “solely,” instead requiring that the third-party efforts be “undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.”¹²⁸ The Ninth Circuit’s interpretation has been

118. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946).

119. *United Hous. Found. v. Forman*, 421 U.S. 837, 853 (1975).

120. *SEC v. Edwards*, 540 U.S. 389, 393-97 (2004).

121. *Id.* at 394.

122. *Id.*

123. *Long v. Shultz Cattle Co.*, 881 F.2d 129, 132-34 (5th Cir. 1989).

124. *See Cane & Erdelyi*, *supra* note 112, at 283-84.

125. 26 U.S.C. § 1031 (2000); *see also* Bradford Updike, *Exploring the Frontier of Non-Traditional Real Estate Investments: A Closer Look at 1031 Tenancy-In-Common Arrangements*, 40 CREIGHTON L. REV. 271 (2007).

126. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946).

127. *Id.*

128. *SEC v. Glenn W. Turner Enter., Inc.*, 474 F.2d 476, 482 (9th Cir. 1973), *cert. denied*, 414 U.S. 821 (1973).

adopted by ten additional circuits.¹²⁹ Additionally, while the Supreme Court has not espoused a position on the issue, it expressly recognized the Ninth Circuit's liberal view.¹³⁰ Moreover, the Supreme Court altogether omitted the word "solely" in its most recent formulation of the *Howey* test.¹³¹ In *SEC v. Edwards*, the Supreme Court quoted the investment contract definition from *Howey* and restated the four-part test as "an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others."¹³² Thus, in determining whether non-affiliate TICs are securities, the language of *Howey* should not be applied literally.¹³³

In addition, the "efforts of others," as described in the fourth prong should be broken down into two categories when analyzing TIC transactions: pre-purchase and post-purchase.¹³⁴ Pre-purchase efforts are defined as those carried out by the TIC sponsor prior to the close of the investment.¹³⁵ Post-purchase efforts are those carried out by the third-party property and asset managers after the close of the investment.¹³⁶ In order to determine whether TICs are securities, it is necessary to consider the pre-purchase and post-purchase circumstances that exist in the typical non-affiliate TIC transaction.¹³⁷

129. *See, e.g.*, *SEC v. Unique Fin. Concepts, Inc.*, 196 F.3d 1195, 1201 (11th Cir. 1999) (adopting the Ninth Circuit's liberal interpretation of the word "solely" as used in the *Howey* test); *SEC v. Int'l Loan Network, Inc.*, 968 F.2d 1304, 1308 (D.C. Cir. 1992); *Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.*, 840 F.2d 236, 240 n.4 (4th Cir. 1988); *Goodwin v. Elkins & Co.*, 730 F.2d 99, 103 (3d Cir. 1984), *cert. denied*, 469 U.S. 831 (1984); *SEC v. Prof. Assocs.*, 731 F.2d 349, 357 (6th Cir. 1984); *Kim v. Cochenour*, 687 F.2d 210, 213 n.7 (7th Cir. 1982); *SEC v. Aqua-Sonic Prods. Corp.*, 687 F.2d 577, 582 (2d Cir. 1982), *cert. denied*, 459 U.S. 1086, (1982); *Williamson v. Tucker*, 645 F.2d 404, 418 (5th Cir. 1981), *cert. denied*, 454 U.S. 897 (1981); *Aldrich v. McCulloch Prop., Inc.*, 627 F.2d 1036, 1040 n. 3 (10th Cir. 1980); *Fargo Partners v. Dain Corp.*, 540 F.2d 912, 914-15 (8th Cir. 1976).

130. *United Hous. Found. v. Forman*, 421 U.S. 837, 852 n.16 (1975).

131. *See SEC v. Edwards*, 540 U.S. 389, 395 (2004).

132. *Id.* at 395 (citing *United Housing Foundation*, 421 U.S. at 852).

133. While the Supreme Court has not expressly stated whether the language from *Howey* is to be interpreted literally, the majority of courts have taken the position that if the Supreme Court was faced with the question, it would not insist on applying the word "solely" literally. *Aqua-Sonic*, 687 F.2d at 582.

134. *See SEC v. Mut. Benefits Corp.*, 408 F.3d 737 (11th Cir. 2005); *SEC v. Life Partners, Inc.*, 87 F.3d 536 (D.C. Cir. 1996).

135. *Mutual Benefits Corp.*, 408 F.3d at 743-44.

136. *See generally* *Miranda*, *supra* note 16.

137. 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) (discussing the

a. Pre-Purchase Efforts

The Supreme Court has only dealt with investment contracts in a piecemeal fashion and has not offered clear guidance concerning the effect of a sponsor's pre-purchase efforts on the fourth prong of the *Howey* test.¹³⁸ To fill the gap, the Federal Circuit Courts of Appeals have come to surprisingly different conclusions.¹³⁹

i. A Bright Line Distinction: SEC v. Life Partners, Inc.

Those who argue that TICs can be offered and sold as real estate rely on a controversial and widely-criticized decision by the D.C. Circuit which stands for the proposition that a sponsor's pre-purchase efforts are insignificant and, therefore, cannot satisfy the fourth prong of *Howey*.¹⁴⁰ In *SEC v. Life Partners, Inc.*, the D.C. Circuit Court of Appeals considered whether fractionalized ownership interests in viatical settlements were investment contracts under the *Howey* test.¹⁴¹ As is the case with the analysis of TICs, the court's decision in *Life Partners* hinged on the fourth prong of *Howey*.¹⁴² The SEC argued that although the defendant sponsor, Life-Partners, Inc. (LPI), did not perform substantial post-purchase efforts, the court could nonetheless find that the viatical settlements at issue were investment contracts based on the pre-purchase efforts carried out by LPI.¹⁴³ The court, however, did not agree with the SEC's position that the time of sale is an *artificial* dividing line.¹⁴⁴ Rather, the court interpreted the dividing line as a significant legal construction that should be recog-

distinction between pre-purchase and post-purchase efforts).

138. The Supreme Court has rarely considered investment contracts since espousing the *Howey* test in 1946. *See, e.g.*, *SEC v. Edwards*, 540 U.S. 389, 389 (2004); *Reves v. Ernst & Young*, 494 U.S. 56, 56 (1990); *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 684 (1985); *Marine Bank v. Weaver*, 455 U.S. 551, 552 (1982); *Daniel v. Int'l Bhd. of Teamsters*, 439 U.S. 551, 552 (1979); *United Hous. Found. v. Forman*, 421 U.S. 837, 845 (1975); *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967); *SEC v. Variable Annuity Life Ins. Co. of Am.*, 359 U.S. 65, 76 (1959) (analyzing investment contracts under the *Howey* test).

139. *Compare Life Partners, Inc.*, 87 F.3d 536, with *Mutual Benefits Corp.*, 408 F.3d 737 (declining to follow the bright line rule espoused in *Life Partners*). *Compare Williamson v. Tucker*, 645 F.2d 404 (5th Cir. 1981), with *SEC v. Aqua-Sonic Prods. Corp.*, 687 F.2d 577 (2d Cir. 1982).

140. *See, e.g.*, Levin, *supra* note 137.

141. *Life Partners, Inc.*, 87 F.3d at 538.

142. *Id.* at 545-49.

143. *See id.* at 546-49.

144. *Id.* at 547.

nized by the courts when analyzing a particular instrument under the fourth prong of *Howey*.¹⁴⁵

In rationalizing its unprecedented conclusion, the *Life Partners* court reasoned that if the investor's profits depend primarily upon the promoter's efforts after closing, then the investor may benefit from the disclosure and other requirements of the federal securities laws.¹⁴⁶ On the other hand, however, the court stated that (1) if the value of the sponsor's efforts had already been factored into the promotional fees or the purchase price of the investment, and (2) if neither the sponsor nor any other third-party was expected to make additional efforts that would have had an impact on the failure or success of the enterprise, then the need for investor protection under the Securities Acts is cognizably reduced.¹⁴⁷ Thus, according to *Life Partners*, absent substantial post-purchase efforts undertaken by the sponsor or a third-party, the fourth prong of *Howey* cannot be satisfied.¹⁴⁸

ii. A Flexible Approach: SEC v. Mutual Benefits Corp.

Conversely, in *SEC v. Mutual Benefits Corp.*, the Eleventh Circuit Court of Appeals declined to follow the *Life Partners* decision and rejected the pre-post bright-line distinction.¹⁴⁹ Like *Life Partners*, *Mutual Benefits Corp.* addressed whether fractionalized ownership interest in viatical settlements were investment contracts under the *Howey* test. The decision in *Mutual Benefits Corp.* also hinged on the fourth prong of *Howey*.¹⁵⁰ The defendant, Mutual Benefits Corp. (MBC), relied on the *Life Partners* bright line rule for the proposition that its pre-purchase efforts could not bring the viatical settlements within the purview of the federal securities laws.¹⁵¹ The court found both MBC's argument and the *Life Partners* rationale unpersuasive.¹⁵²

In reaching the conclusion that the fourth prong of *Howey* is not confined to a "forward-looking inquiry" from the point of closing, the court found that while it may be true that the "efforts of others" prong of the

145. *Id.*

146. *See Levin, supra* note 137.

147. *Id.* (citing *Life Partners, Inc.*, 87 F.3d at 547).

148. *Life Partners, Inc.*, 87 F.3d at 546-48.

149. *SEC v. Mut. Benefits Corp.*, 408 F.3d 737, 743 (11th Cir. 2005); *see also Levin, supra* note 137.

150. *Mutual Benefits Corp.*, 408 F.3d at 737, 743.

151. *Id.* at 741.

152. *Id.* at 744-45.

Howey test is more easily satisfied by post-purchase efforts of the sponsor or third-parties, there is no statutory or judicial authority upon which to exclude pre-purchase entrepreneurial or managerial activities from the analysis.¹⁵³ Thus, according to *Mutual Benefits Corp.*, the fourth prong of *Howey* can be satisfied even in the absence of substantial post-purchase activities undertaken by the sponsor or a third-party.¹⁵⁴

iii. The Pre-Purchase Efforts Performed by TIC Sponsors Are Significant and Should Not Be Excluded from the Analysis

While it is true that the securities laws “are not a broad federal remedy for all fraud,”¹⁵⁵ the Supreme Court has never formally distinguished pre-purchase from post-purchase efforts under the fourth prong of *Howey*.¹⁵⁶ Until *Life Partners*, no federal case ever held that pre-purchase efforts cannot satisfy the fourth prong of *Howey*.¹⁵⁷ Although this Note does not contend that *Life Partners* was incorrectly decided, it does contend that the bright-line rule announced in *Life Partners* is neither in line with the general principles underlying the securities laws, nor appropriate for an analysis of TIC transactions.¹⁵⁸ Thus, keeping in mind the need for a fact-sensitive inquiry and case-by-case analysis, courts should recognize that the flexible approach and liberal construction as applied in *Mutual Benefits Corp.* is the proper approach for TIC transactions.¹⁵⁹ The Supreme Court recently reinforced the position that it would not interpret the securities laws in such a way as to undermine the statutory purpose and principles.¹⁶⁰ The threshold question for any inquiry under the fourth prong of *Howey* is not “when” the efforts of “others” take place, but whether those efforts are so undeniably significant that the investor relies upon them for the success of the investment.¹⁶¹

The dying breed of sponsors that market TIC investments as interests in real estate, rather than securities, attempt to minimize the importance of their role by characterizing the efforts they undertake as insignificant in

153. *Id.* at 743-44.

154. *Id.*

155. SEC v. *Life Partners, Inc.*, 87 F.3d 536, 547 (D.C. Cir. 1995).

156. See *Miranda*, *supra* note 16, at 272 (citing *Life Partners, Inc.*, 87 F.3d at 553 (Wald J., dissenting)).

157. *Id.*

158. Levin, *supra* note 137; see also Snyder, *supra* note 13.

159. *Mutual Benefits Corp.*, 408 F.3d at 743-44.

160. SEC v. *Edwards*, 540 U.S. 389, 393 (2004).

161. *Id.*

the context of the investment.¹⁶² However, when considering the flexible approach and liberal construction underlying the Securities Acts, as well as the emphasis that courts place on economic reality, these arguments are without merit.¹⁶³ The position that the pre-purchase efforts carried out by TIC sponsors are insignificant for the purposes of the fourth prong of *Howey* begs this question: If pre-purchase efforts are so insignificant then why do TIC sponsors charge millions of dollars in sponsor fees for their services?¹⁶⁴

TIC sponsors perform substantial pre-purchase efforts prior to the acquisition of the TIC property and the sale of TIC interests to investors.¹⁶⁵ The sponsor initially makes all of the important decisions with respect to the acquisition of the property.¹⁶⁶ Typically, the process begins when the sponsor carefully selects the property to be purchased.¹⁶⁷ After selecting properties that fall within the selected criteria, the sponsor performs due diligence, as well as a more general economic investigation of the market area.¹⁶⁸ TIC sponsors then identify potential investors and arrange favorable financing and insurance for the TIC property.¹⁶⁹ As part of this process, TIC sponsors seek tax-related and legal advice, as well as perform substantial services, such as lender selection and loan negotiation.¹⁷⁰ TIC sponsors also prepare marketing materials and documents, which include descriptions of the property and financial projections for the potential life of the TIC investment.¹⁷¹ The sponsor also provides other significant agreements, such as leases and tenant-in-common agreements which govern the TIC owners' operation of the investment.¹⁷² Finally, TIC sponsors generally choose the initial property manager to maintain the property throughout the transition process.¹⁷³ TIC sellers charge more than substantial fees in return for their organizational, marketing, and transact-

162. See, e.g., Thorup, *supra* note 8, at 422-24 (arguing that the efforts undertaken by TIC sponsors are incidental to the commercial real estate industry and do not affect the fourth prong of *Howey*).

163. See Steinhouse, *supra* note 80.

164. See Snyder, *supra* note 13.

165. See Steinhouse, *supra* note 80.

166. See Snyder, *supra* note 13.

167. See Thorup, *supra* note 8, at 426.

168. Whitman, *supra* note 81, at 128-29.

169. *Id.*; see also Steinhouse, *supra* note 80.

170. See, e.g., Berkeley, *supra* note 10, at 736; Whitman, *supra* note 81, at 128-29.

171. See Thorup, *supra* note 8, at 428.

172. See *id.* at 430.

173. See *id.* at 429; see also Steinhouse, *supra* note 80.

ional efforts, which are of the utmost importance to the success of the investment.¹⁷⁴

In order to satisfy the fourth prong of *Howey*, or at the very least play a significant role in the determination, the sponsor's pre-purchase efforts must significantly impact the profits sought in the return on the investment.¹⁷⁵ From the very beginning through closing, all of the activities undertaken by TIC sponsors are the type of efforts that affect the "failure or success of the enterprise."¹⁷⁶ Finding the property and negotiating the purchase price play an important role in the short- and long-term success of the investment.¹⁷⁷ For instance, overpaying for the property, or choosing a property located in a poor or unreliable market, can seriously hinder investor profits that flow from the investment.¹⁷⁸ In addition, the terms negotiated by the sponsor on behalf of the TIC owners and the decision surrounding the amount of debt that should be placed on the property directly impact both cash flow and the stability of the investment.¹⁷⁹ This is not to say that every pre-packaged commercial real estate deal is a security.¹⁸⁰ The requirement that the other three elements of the *Howey* test must also be met precludes any support for such a conclusion.¹⁸¹

Looking at the pre-closing process in its entirety shows that TIC sponsors often organize and supervise a geographically diverse group of unrelated and inexperienced investors from step one through closing. These efforts have a crucial impact on the failure or success of the enterprise.¹⁸² While courts must remember the need for flexibility in identifying those who need protection under the securities laws,¹⁸³ courts should find

174. See, e.g., Thorup, *supra* note 8, at 426; Whitman, *supra* note 81, at 128-29.

175. SEC v. *Howey*, 328 U.S. 293, 298-99 (1945); SEC v. Mut. Benefits Corp., 408 F.3d 737, 743-44 (11th Cir. 2005).

176. See Steinhouse, *supra* note 80; see also Snyder, *supra* note 13.

177. Snyder, *supra* note 13.

178. *Id.*

179. *Id.*

180. See Thorup, *supra* note 8.

181. SEC v. *Howey*, 328 U.S. 293, 298-99 (1945).

182. See, e.g., SEC v. Glenn W. Turner Enter., Inc., 474 F.2d 476 (9th Cir. 1973).

183. Any offer and sale of a security must either be *registered* or *exempt* from registration under applicable state and federal securities laws. One of the most common exemptions is the non-public or limited offering exemption. See 17 C.F.R. §§ 230.501-230.508 (2008). In *SEC v. Ralston Purina Co.*, the Supreme Court established that the non-public offering exemption will be available in offerings made exclusively to investors who are able to "fend for themselves." 346 U.S. 119, 124-26 (1953). In the eyes of the *Ralston* Court, certain investors, such as experienced and wealthy individuals or investors with a prior business relationship with the sponsor, do not need the protections afforded by full registration under the securities laws. *Id.*

that the pre-purchase efforts of TIC sponsors can alone satisfy the fourth prong of *Howey*.¹⁸⁴ At the very least, when combined with the insubstantial and illusory investor control that exists after closing, these pre-purchase efforts are sufficient to bring TICs within coverage of the federal securities laws.¹⁸⁵

b. Post-Purchase Efforts

In determining whether TIC investors have a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others, the post-closing inquiry is largely confined to the degree of actual control given to and exercised by TIC owners, versus the degree to which this purported control is insubstantial and illusory.¹⁸⁶ Those who argue that TICs can be structured as real estate rely on another line of cases and bright line rules that are collectively referred to as the “written agreements” test.¹⁸⁷ Under this test, the actual control exercised by the TIC owner after closing is irrelevant—as long as the investor has the right to control the purchased asset, the fourth prong of *Howey* is not satisfied.¹⁸⁸

i. A Pre-Cursor to the Written Agreements Test: Williamson v. Tucker

In *Williamson v. Tucker*,¹⁸⁹ the Fifth Circuit determined whether general partnership interests in a real estate development scheme were securities.¹⁹⁰ The *Williamson* court began with the presumption that general partnerships are not securities, stating that investor-plaintiffs will “have a difficult factual burden if they are to establish that the [general partnership] interests they purchased are securities.”¹⁹¹ In dictum, the court applied a three-part test to determine whether a general partnership interest that on its face creates a true partnership is a security.¹⁹² Under the

184. *Howey*, 328 U.S. at 298.

185. *See, e.g.*, *SEC v. Mut. Benefits Corp.*, 408 F.3d 737, 743-45 (11th Cir. 2005).

186. *Albanese v. Fla. Nat’l Bank of Orlando*, 823 F.2d 408, 410 (11th Cir. 1987); *Williamson v. Tucker*, 645 F.2d 404, 419-24 (5th Cir. 1981).

187. *See, e.g.*, *Albanese*, 823 F.2d at 410.

188. *Gordon v. Terry*, 684 F.2d 736, 741-42 (11th Cir. 1982) (adopting *Williamson* and holding that if the investor retains the ability to control the profitability of his investment, the agreement is not a security).

189. 645 F.2d at 404.

190. *Id.* at 406-07.

191. *Id.* at 416.

192. *Id.* at 424.

test, a general partnership or joint venture interest can be designated a security if: (1) the agreement among the parties leaves so little power in the hands of the partner that the arrangement-in-fact distributes power as would a limited partnership; or (2) the partner is so inexperienced and unknowledgeable in business affairs that he or she is incapable of intelligently exercising his or her partnership powers; or (3) the partner is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he or she cannot replace the manager of the enterprise or otherwise exercise meaningful partnership powers.¹⁹³ The first prong of *Williamson* is the main focus of the analysis and has widely become known as the written agreements test.¹⁹⁴ Under this test, the *Williamson* court declared that “[i]n each case the actual control exercised by the purchaser is irrelevant.”¹⁹⁵ As long as the investor “has the right to control the asset he has purchased, he is not dependent on the promoter or on a third party for ‘those essential managerial efforts which affect the failure or success of the enterprise.’”¹⁹⁶

ii. The Bright Line Written Agreements Test: Albanese v. Florida National Bank of Orlando

The written agreements test has been re-articulated and embraced in other Federal Circuit Courts of Appeal as well.¹⁹⁷ For instance, in *Albanese v. Florida National Bank of Orlando*,¹⁹⁸ the Eleventh Circuit examined claims from plaintiffs-investors that invested capital in an ice machine

193. *Id.*; see also *Matek v. Murat*, 862 F.2d 720, 729 (9th Cir. 1988) (declining to adopt *Williamson* with respect to the second and third prongs due to a finding that the second two prongs of *Williamson* create uncertainty in the area of business investing). *Williamson* did not hold that the partnership interests were securities; rather the appellate court reviewed the lower court’s dismissal for lack of subject matter jurisdiction as a dismissal based on the pleadings. *Williamson*, 645 F.2d at 406-07. The court was thus compelled to apply the strict standard of *Bell v. Hood*, 327 U.S. 678, 682-83 (1946), to the lower court’s decision. *Id.* at 415-17.

194. See, e.g., *SEC v. Aqua-Sonic Prods. Corp.*, 687 F.2d 577 (2d Cir. 1982), cert. denied, 452 U.S. 1086 (1982) (citing *Williamson*, 645 F.2d at 418-19).

195. *Williamson*, 645 F.2d at 421.

196. *Id.*

197. See, e.g., *SEC v. Merchant Capital, LLC*, 483 F.3d 747, 756 (11th Cir. 2007) (stating that in *Williamson*, the Eleventh Circuit defines the conditions under which a general partnership interest may qualify as an investment contract, as well as the scope of the investment contract analysis); *Albanese v. Fla. Nat’l Bank of Orlando*, 823 F.2d 408, 410 (11th Cir. 1987); *Fargo Partners v. Dain Corp.*, 540 F.2d 912, 914-15 (8th Cir. 1976).

198. *Albanese*, 823 F.2d at 409-10.

leaseback program.¹⁹⁹ The sponsor in *Albanese* agreed to place the ice machine in various hotels and motels and contracted to service and collect money from the machines.²⁰⁰ In concluding that profits were derived solely from the efforts of the corporation and, therefore, the fourth prong of *Howey* was satisfied, the court stated that “the crucial inquiry [for the fourth prong] is the amount of control that the investors retain under their written agreements.”²⁰¹ The *Albanese* court reasoned that if the investor retains the ability to control the profitability of his or her investment through power expressly articulated in the written agreements, then the purchaser is not dependent on the sponsor or a third-party for the “undeniably significant efforts” that affect the “failure or success of the enterprise and the fourth prong of the *Howey* test is not satisfied.”²⁰²

iii. *The Target Audience Approach: SEC v. Aqua-Sonic Products Corp. and United States v. Leonard*

In *SEC v. Aqua-Sonic Products Corp.*,²⁰³ the Second Circuit considered an SEC enforcement action brought under the federal securities laws where the sponsor offered licenses to sell dental products, while an affiliate of the sponsor was described to potential investor-licensees as an optional sales agent.²⁰⁴ Under that optional agreement, the investor retained the right to terminate it at any time upon 90 days written notice and also retained ultimate control over pricing and other conditions relating to the offer and sale of the dental products, including the right to sell the dental products within the specified territory himself.²⁰⁵ The court ultim-

199. *Id.*

200. *Id.*

201. *Id.* at 410 (citing *Williamson*, 645 F.2d at 423-24).

202. *Id.* (citing *Gordon v. Terry*, 684 F.2d 736 (11th Cir. 1982)). *SEC v. Merchant Capital* is the most recent Eleventh circuit case to consider the written agreements test. 483 F.3d 747 (11th Cir. 2007). In that case, the Eleventh Circuit found that interests owned by registered limited liability partnerships (RLLPs) were “investment contracts” covered by the federal securities laws. *Id.* at 765-66. When considering the fourth prong of *Howey*, the court found that the partners had the powers of limited partners because they had no authority to remove the managing general partner (MGP) and the purported authority to approve purchases was illusory. *Id.* at 763-65. The court further found that (1) the partners were inexperienced in the debt purchasing industry, and (2) even if they could have removed the MGP, they had no realistic alternative as manager, because their debt pools were in fractional form with a company whose only contractual relationship was with the MGP. *Id.* at 764.

203. *SEC v. Aqua-Sonic Prods. Corp.*, 687 F.2d 577 (2d. Cir. 1982).

204. *Id.* at 577-78.

205. *Id.* at 579-80.

ely held that the arrangements were investment contracts and therefore securities.²⁰⁶

The lynchpin of the Second Circuit's approach is the "target" audience, rather than the amount of investor control provided in the written agreements governing the investment.²⁰⁷ The Second Circuit emphasized that the *Howey* Court did not focus on whether it was somehow possible for an investor to profit without the efforts of others, or whether the investor had a *theoretical* right to reject the efforts of others.²⁰⁸ Rather, the *Howey* Court focused on whether the typical investor who was being solicited would be expected under all the circumstances to accept the efforts of others and be passive, or reject the efforts of others and be active.²⁰⁹

Like the *Howey* Court, the *Aqua-Sonic* court properly focused its inquiry when it stated that the sponsors "sought to attract the passive investor for whose benefit the securities laws were enacted."²¹⁰ The court further stated that the fact that an investor *might* retain "some legal rights over distribution does not render it unnecessary for him to have the benefits of the disclosures provided in registration statements or the protection of the antifraud provisions."²¹¹ The Court explained that "[i]f, by contrast, the reasonable expectation was one of significant investor control, a reasonable purchaser could be expected to make his own investigation of the new business he planned to undertake and the protection of the 1933 and 1934 Acts would be unnecessary."²¹²

More recently, in *United States v. Leonard*, a Second Circuit case relying on *Aqua-Sonic Products Corp.*, "criminal charges were brought against twenty-five individuals involved in the marketing of investment interests in two limited liability companies."²¹³ The defendants argued that disclosure was not mandatory because the LLC interests were not securities.²¹⁴ The *Leonard* court revisited the target audience approach from *Aqua-Sonic Products Corp.* and upheld a jury finding that membership interests in the LLCs constituted "investment contracts," because defendants sought out passive investors who did not actively participate in the

206. *Id.* at 585.

207. *Id.* at 582-85.

208. *Id.* at 582-83.

209. *Id.*

210. *Id.* at 585.

211. *Id.*

212. *Id.*

213. *United States v. Leonard*, 529 F.3d 83 (2d. Cir. 2008).

214. *Id.* at 85.

venture.²¹⁵ Although the LLC's organizational documents gave significant managerial authority to members, little such authority was exercised in practice. Therefore, "the jury could reasonably have found the managerial rights contained in the organizational documents were hollow and illusory."²¹⁶

In reaching its conclusion, the *Leonard* court silently acknowledged the written agreements rationale and rejected such a limited inquiry when it reasoned that if the court confined itself to "a review of the organizational documents," it would "likely conclude that the interests ... could not constitute securities because the documents would lead us to believe that members were expected to play an active role in the management of the companies."²¹⁷ Thus, rather than confining the inquiry to the theoretical authority given to investors in the written agreements, *Leonard* recognized the importance of "*the factual circumstances*" and the written agreements, as well as the actual exercise of control surrounding the investment.²¹⁸

iv. Applying the Written Agreements Test to TICs Would Circumvent Statutory Purpose

Although numerous courts embrace the written agreements test under *Albanese*²¹⁹ and the general partnership approach espoused by the *Williamson* court,²²⁰ the target audience approach applied by the Second Circuit in *Aqua-Sonic* and *Leonard* is a more realistic analysis for TICs and is designed to benefit the investor, not the sponsor.²²¹ While the

215. *Id.* at 88-89; see Darryl Steinhouse, *TICs As Real Estate: Another Nail In The Coffin*, TIC TALK, 3rd Quarter 2008, available at <http://www.vojodesign.com/websites/omniCR/2008Qtr3/article04.html> (discussing the Second Circuit's decision in *United States v. Leonard*, and arguing that any position that a syndicated TIC interest is not a security ignores reality).

216. *Leonard*, 529 F.3d at 90.

217. *Id.* at 89.

218. *Id.* (emphasis added).

219. See *supra* note 197.

220. See, e.g., *Banghart v. Hollywood Gen. P'ship*, 902 F.2d 805, 807-08 (10th Cir. 1990); *Hocking v. Dubois*, 885 F.2d 1449, 1460-61 (9th Cir. 1989), *cert. denied*, 494 U.S. 1078 (1990); *Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.*, 840 F.2d 236, 240-42 (4th Cir. 1988); *Odom v. Slavik*, 703 F.2d 212, 214-16 (6th Cir. 1983) (adopting the Fifth Circuit's dicta from *Williamson*); *Gordon v. Terry*, 684 F.2d 736, 740-41 (11th Cir. 1982).

221. See *SEC v. Aqua-Sonic Prods. Corp.*, 687 F.2d 577, 584 (2d. Cir. 1982) (reasoning that an application of *Williamson* would deprive investors of the laws that were enacted for their benefit).

Second Circuit's disapproval of the bright line written agreements test is implicit in *Leonard* and *Aqua-Sonic*, the Second Circuit expressly rejected *Williamson*'s authority as an accurate statement of the law.²²² The Second Circuit criticized *Williamson* and its progeny for focusing the *Howey* analysis on the degree of control provided to investors in the written agreements governing the investment.²²³ Instead, the *Aqua-Sonic* and *Leonard* courts distinguished between companies that seek the "passive investor" and situations where there is a reasonable *expectation and significant exercise* of real (not illusory), investor control.²²⁴

Applying the written agreements test as set forth in *Williamson*, *Albanese*, and their progeny to TIC transactions is in direct contravention of the statutory purpose and principles underlying the federal securities laws.²²⁵ The target audience approach as articulated by the Second Circuit is the proper approach for TIC transactions given that inexperienced investors, baby boomers, and senior retirees are all attracted to TICs by the prospect of an opportunity to gain wealth through passive investment.²²⁶ If the written agreements test were applied to TICs, and the actual control exercised by the investor was found to be irrelevant to the analysis, then TIC sponsors could evade coverage of the securities laws simply by giving investors hollow power in the written agreements, even when the sponsor is aware that such powers will not in fact be exercised.²²⁷

Because TIC sponsors arrange the agreements that govern the investment, the documents could be purposely structured so as to theoretically avoid the securities laws.²²⁸ When documents are so structured, as the court pointed out in *Leonard*, it would be easy for a jury to support the *improper* conclusion that a certain investment interest or scheme cannot, by the terms set forth in the written agreements, be a security.²²⁹ Sponsors should not be permitted to deprive expectedly passive investors of their rights, provided by applicable securities laws by simply drafting agreements that act as an obstacle.²³⁰ As the Second Circuit cautioned in *Aqua-*

222. *Id.*

223. *Id.* (rejecting *Williamson*'s authority as an accurate statement of the law).

224. *Id.* at 585; *United States v. Leonard*, 529 F.3d 83, 88 (2d Cir. 2008).

225. *See Aqua-Sonic*, 687 F.2d at 584.

226. *See HESHELOW*, *supra* note 3, at 4 (emphasizing that inexperienced baby boomers, retirees, and even younger investors who simply want to enjoy passive income are attracted to TICs, because, as investors, they can allow managers to run the investment while they gain cash flow with tax benefits).

227. *See Aqua-Sonic*, 687 F.2d at 584-85.

228. *Steinhaus*, *supra* note 215.

229. *See United States v. Leonard*, 529 F.3d 83, 89 (2d Cir. 2008) (emphasis added).

230. *See Aqua-Sonic*, 687 F.2d at 584.

Sonic, “it would circumvent the purposes of the securities laws to exonerate defendants who had the guile to insert the requirement that the buyer contribute a modicum of effort.”²³¹

Moreover, in *Leonard*, the Second Circuit emphasized that one of the original promoters of the investment interests at issue in that case testified at trial that the interests were structured to minimize the possibility that the investment units would constitute securities—“to get into ... the gray areas of the securities laws.”²³² This is a similar approach to the one taken by those who offer and sell TICs as securities.²³³ Consequently, the written agreements test equates to a mere legal formality when applied to TIC transactions.²³⁴ The heart of the inquiry under *Williamson* and *Albanese* is whether the investor *theoretically* retains substantial control over the investment on the face of the written agreements.²³⁵ The problem with this approach is the emphasis on the word *theoretical*. Under a theoretical interpretation, TICs would not constitute investment contracts as long as the investor has control in theory under the written agreements, even where the honest expectation and ultimate reality is one of passive investment.²³⁶ While it is true that the land service contracts in *Howey* were generally for a ten-year period and some investor rights were limited in other respects,²³⁷ the investors in *Howey* retained theoretical control.²³⁸ Additionally, the Supreme Court did not directly rely upon these factors in reaching its conclusion.²³⁹ While some inquiry into the written agreements may be necessary to prevent investors from purposely choosing not to exercise their powers, which would transform a non-security into a security after the fact, the bright line written agreements test is not proper for the TIC analysis.²⁴⁰

231. *Id.*

232. *Leonard*, 529 F.3d at 89.

233. Steinhouse, *supra* note 215.

234. See *SEC v. W.J. Howey Co.*, 328 U.S. 293, 300 (1946).

235. *Holden v. Hagopian*, 978 F.2d 1115, 1119 (9th Cir. 1992) (citing *Williamson v. Tucker*, 645 F.2d 404 (5th Cir. 1981)).

236. *But see Leonard*, 529 F.3d at 89-90.

237. *Howey*, 328 U.S. at 296.

238. *Id.* at 299-300.

239. See *id.* at 298-300.

240. See *Williamson*, 645 F.2d at 424 (denying that investments were securities where sophisticated investors had both contractual power and the ability to exercise power).

v. The Written Agreements Test Does Not Take TICs Outside the Purview of Federal Securities Laws

Even if the written agreements test was applied to TIC transactions, the courts should still find that TICs satisfy the fourth prong of the *Howey* test. The focus under *Williamson* and *Albanese* is on the investors' expectations under the written agreements at the time of investment and "is not directed at what actually transpires after the investment was made"²⁴¹ Prior to the close of a TIC property, the sponsor puts in place the agreements that govern the investment, such as the purchase agreement, TIC agreement, property management agreement, and asset management agreement.²⁴² The documents used by TIC real estate sponsors are the same as those used by sponsors that sell TICs as securities.²⁴³ The only difference between the offer and sale of TICs as security versus real estate is the channel of distribution.²⁴⁴ Ironically, the agreements governing the operation of securitized TICs are structurally designed for purchasers with an expectation of passive investment that do not intend to exercise meaningful control.²⁴⁵ Therefore, even under the agreements governing TICs sold as real estate, courts could find that the interests constitute securities under the *Howey* test.

Furthermore, even *Williamson* and *Albanese* recognize that if the power to control an investment is merely illusory, then actual control will be deemed not to exist.²⁴⁶ If actual control is found not to exist after closing, then the owners clearly rely on the essential managerial efforts of others, thus satisfying the fourth prong of *Howey*.²⁴⁷ Those who sell TICs as real estate argue that if TIC investors can vote to hire and fire a third-party property manager, to partition the property, or to sell the property, then the investors are actually in control of the investment.²⁴⁸ However, the mere fact that an investor may have the ability to hire or fire a property manager or sell his or her interest in the TIC property, in and of itself, is

241. *Holden v. Hagopian*, 978 F.2d 1115, 1119 n.6 (9th Cir. 1992) (citing *Koch v. Hankins*, 928 F.2d 1471 (9th Cir. 1991)).

242. See *Thorup*, *supra* note 8, at 426.

243. *Steinhouse*, *supra* note 80.

244. *Id.*

245. *Id.*

246. *Albanese v. Fla. Int'l Bank of Orlando*, 823 F.2d 408, 412 (11th Cir. 1987); *Williamson v. Tucker*, 645 F.2d 404, 424 (5th Cir. 1981); see also *SEC v. Aqua-Sonic Prods. Corp.*, 687 F.2d 577, 583-84 (2d Cir. 1982).

247. See *Albanese*, 823 F.2d at 412.

248. See, e.g., *Lipton*, *supra* note 87 (arguing that TICs can be structured as real estate investments and not securities).

not sufficient to bring an otherwise securitized transaction outside the purview of the federal securities laws.²⁴⁹

Unless investors go out and select the property, perform the significant pre-purchase functions, and then actively manage or exercise control over the property, TIC investments constitute a security, not an investment in real estate.²⁵⁰ This position is bolstered by the fact that TIC investors are lured in by representations touting the experience and expertise of the sponsor and the prospect of receiving monthly income with no management responsibilities.²⁵¹ As it stands now, TIC investors do virtually nothing, while third-party property and asset managers approve leases, collect and distribute the pro-rata gain and loss to investors, undertake maintenance and improvements, and carry out all other day-to-day management responsibilities.²⁵² The insignificant control exercised by investors as compared to the post-purchase efforts exerted by third-parties, affiliated with the seller or not, is insubstantial for the purposes of the fourth prong of the *Howey* test.²⁵³

Moreover, not only is the control set forth in the written agreements governing TIC investments insubstantial, it is merely illusory²⁵⁴ in that investors are in fact, unable to exercise such powers.²⁵⁵ Many TIC arrangements involve a geographically diverse group of investors.²⁵⁶ While the written agreements governing the investment may individually give investors certain powers, a group of inexperienced and unknowledgeable investors cannot realistically come together and actively exercise meaningful control over the investment.²⁵⁷ As one prominent industry authority points out, the concept of illusory control is most easily understood through an illustration of theory versus reality.²⁵⁸ Here is the idea:

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

249. See NASD, *Notice to Members*, *supra* note 76 (noting that TICs “generally are securities for the purposes of the federal securities exchange laws and NASD rules”).

250. Steinhouse, *supra* note 80.

251. *Id.*

252. *Id.*

253. See *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946).

254. See *Albanese v. Fla. Int’l Bank of Orlando*, 823 F.2d 408, 412 (11th Cir. 1987); *Williamson v. Tucker*, 645 F.2d 404, 424 (5th Cir. 1981).

255. See *Williamson*, 645 F.2d at 424.

256. Steinhouse, *supra* note 80.

257. *Id.*

258. *Id.*

actually manage a piece of real estate? Yes. However, these investors do not actually manage their investment; that is reality.²⁵⁹

In the typical non-affiliate TIC transaction, many of the specific powers given to investors are truly illusory.²⁶⁰ For instance, since mortgage loans obtained by the sponsor on behalf of the owners are typically securitized later, the loan documents often require investors to obtain lender approval before selling or transferring their TIC interests.²⁶¹ Loan documents may also require TICs to hold their interests through a LLC that qualifies as a special purpose entity.²⁶² Furthermore, sponsors are often required to execute standard guaranties, which prohibit investors from terminating the property and asset management agreements.²⁶³ Thus, while the agreements governing the investment may give the TIC power to vote to sell or transfer the property or terminate the property management agreements, such control is merely illusory in that it does not actually exist.²⁶⁴ As a result, even the nominal control that investors are given exists only in theory because TIC owners are realistically precluded from exercising their powers.²⁶⁵

In light of the above legal precedent, the significant pre-purchase efforts carried out by TIC sponsors, and the degree to which investor control is both insignificant and illusory, the efforts carried out by the sponsor and third-parties constitute the “undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.”²⁶⁶ Thus, for the reasons stated above, TICs constitute investment contracts under the *Howey* test and should, therefore, only be offered and sold as securities under federal law.²⁶⁷

259. *Id.*

260. *Id.*

261. Whitman, *supra* note 81, at 128-29.

262. *Id.*

263. *Id.*

264. *Id.*

265. See Steinhouse, *supra* note 80.

266. SEC v. Glenn W. Turner Enters, Inc., 474 F.2d 476, 482 (9th Cir. 1973).

267. See SEC v. W.J. Howey Co., 328 U.S. 283, 298-99 (1946).

III. THE SUPREME COURT SHOULD ADOPT THE APPROACH USED IN THIS NOTE WHEN ANALYZING TIC TRANSACTIONS

The bright line rule adopted in *SEC v. Life Partners* has no place in the federal securities laws.²⁶⁸ On the other hand, the flexible approach and liberal construction articulated in *SEC v. Mutual Benefits Corp.* equitably balances the competing interests of both the sponsor and the investor.²⁶⁹ While it may be true that a TIC sponsor's post-purchase efforts more easily satisfy the fourth prong of *Howey*, there is no basis for excluding efforts carried out by the TIC sponsor or others that significantly affect the profitability of the enterprise.²⁷⁰ Thus, the Supreme Court should adopt the flexible approach and liberal construction as applied to pre-purchase efforts in *Mutual Benefits Corp.*²⁷¹

This Note does not dispute that the written agreements test may be appropriate for the analysis of certain investment devices, including general partnerships. However, when applied to TIC transactions, the written agreements test amounts to no more than a bright line rule that directly contradicts all three of the principles underlying the securities laws as set forth above.²⁷² Like most investors that purchase securities, the passive nature of TIC investors must be considered when analyzing TICs under the fourth prong of *Howey*.²⁷³ Rather than deprive inexperienced, passive investors of the benefits and protections of the laws that were enacted for their benefit, the Supreme Court should adopt the target audience approach as articulated in *SEC v. Aqua-Sonic Products Corp.* and *United States v. Leonard*.²⁷⁴ The target audience approach is flexible and provides for a liberal construction that considers substance (reality) over form (theory), as well as the investor need for disclosure and anti-fraud protection.²⁷⁵

In addition to the traditional analysis under the *Howey* test, when deciding whether an instrument should properly fall within the scope of

268. See *SEC v. Life Partners, Inc.*, 87 F.3d 536 (D.C. Cir. 1995).

269. *SEC v. Mut. Benefits Corp.*, 408 F.3d 737, 743-44 (11th Cir. 2005).

270. *Id.*

271. *Id.*

272. Compare *Albanese v. Fla. Nat'l Bank of Orlando*, 823 F.2d 408, 410 (11th Cir. 1987), and *Williamson v. Tucker*, 645 F.2d 404, 419-24 (5th Cir. 1981), with *SEC v. Aqua-Sonic Prods. Corp.*, 687 F.2d 577, 584 (2d. Cir. 1982).

273. See, e.g., *Steinhaus*, *supra* note 80 (discussing the passive nature of TIC investors).

274. *United States v. Leonard*, 529 F.3d 83, 88 (2d. Cir. 2008); *Aqua-Sonic*, 687 F.2d at 584.

275. *Aqua-Sonic*, 687 F.2d at 584.

the Securities Acts, the Supreme Court has applied the “context” clause²⁷⁶ it adopted in *SEC v. National Securities, Inc.*²⁷⁷ The “context” clause analysis considers the existence of other regulatory schemes that would govern a particular investment instrument in the event that such an instrument was found not to be a security.²⁷⁸ For instance, in *International Brotherhood of Teamsters v. Daniel*, the Supreme Court held that a compulsory pension plan was not a security.²⁷⁹ One of the main reasons for the holding in *Daniel* was that the employee pension plan was regulated by the Employee Retirement Income Security Act of 1974 (ERISA).²⁸⁰ The *Daniel* Court emphasized that the existence of far-reaching legislation “governing the use and terms of employee pension plans severely undercuts all arguments for extending the Securities Acts to noncontributory, compulsory pension plans.”²⁸¹ Since ERISA regulates employee pension plans and also requires certain disclosures, it was unnecessary to subject pension plans to the requirements of the Securities Acts as well.²⁸²

Furthermore, in *Marine Bank v. Weaver*, the Supreme Court considered whether certificates of deposit were securities within the meaning of the Securities Acts.²⁸³ Citing the *Daniel* Court’s factual application of the “context” clause, the *Marine Bank* Court focused its analysis not on the particular characteristics of the investment instrument, but rather, on the existence of comprehensive and pervasive federal regulation governing the banking industry.²⁸⁴ Ultimately, the Court concluded that “[it] is unnecessary to subject issuers of bank certificates of deposit to liability under the anti-fraud provisions of the federal securities laws since the holders of bank certificates of deposit are abundantly protected under federal banking law.”²⁸⁵

276. Congress prefaced the list of securities defined in the Securities Acts with the phrase “unless the context otherwise requires.” *Marine Bank v. Weaver*, 455 U.S. 551, 555, 558-59 (1982) (citing 15 U.S.C. § 78c(a)(10)).

277. *SEC v. Nat’l Sec., Inc.*, 393 U.S. 453, 466 (1969); see also MARC I. STEINBERG, *SECURITIES REGULATION: LIABILITIES AND REMEDIES* §§ 4A-23, 4A-24 (Law Journal Press 1984 & Supp. 2009).

278. See, e.g., *Marine Bank*, 455 U.S. at 556-59; *Int’l Bd. of Teamsters v. Daniel*, 439 U.S. 551, 569-70 (1979).

279. *Daniel*, 439 U.S. at 569-70.

280. *Id.* at 569 (citing 29 U.S.C. §§ 1021-1030 (2000)).

281. *Id.* at 569-70.

282. *Id.*

283. *Marine Bank*, 455 U.S. at 558-59.

284. *Id.* at 558 (citing federal regulations that govern various aspects of the banking industry).

285. STEINBERG, *supra* note 277, §§ 4A-23, 4A-24 (citing *Marine Bank*, 455 U.S. at 559).

By analogy, the regulatory scheme governing real estate is neither as comprehensive nor as pervasive as the legislation governing the pension plans in *Daniel* or the banking industry in *Marine Bank*.²⁸⁶ The federal regulations governing real property transactions provide neither the registration and disclosure requirements nor the anti-fraud provisions that are necessary to protect the average TIC investor.²⁸⁷ Even if the Supreme Court were to find that some comprehensive scheme governs the TIC industry, the “context” clause does not dictate that the anti-fraud provisions are unnecessary if a comprehensive federal scheme exists elsewhere.²⁸⁸ Thus, the Supreme Court should find that TICs are securities and adopt the approach used in this Note to clarify the characteristics of securitization within the framework of the *Howey* test.

CONCLUSION

TICs constitute investment contracts under the *Howey* test and are therefore “securities” subject to regulation under the Securities Act of 1933 and the Securities and Exchange Act of 1934.²⁸⁹ Offering and selling TICs as investments in real estate circumvents statutory purpose and imposes unnecessary risk on investors. The Securities Acts were enacted as remedial legislation designed to protect those who purchase investment interests, not those who sell them.²⁹⁰ Sponsors that offer and sell TICs as real estate rely on controversial legal conclusions and theoretical factual circumstances.²⁹¹ This practice is in direct contravention of the principles underlying the Securities Acts.²⁹² Those who endorse and exercise this counterintuitive, illogical approach should no longer remain free to embrace theory and ignore reality.²⁹³

286. See *Marine Bank*, 455 U.S. at 558-59; *Daniel*, 439 U.S. at 569.

287. See, e.g., Thorup, *supra* note 8, at 426 (arguing that there are numerous benefits to investors when TICs are sold as real estate).

288. See, e.g., STEINBERG, *supra* note 277, §§ 4A-23, 4A-24.

289. See Securities Act of 1933, 15 U.S.C. §§ 77a-77mm. (2000); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78oo (2000).

290. See generally Landis, *supra* note 25 (exploring the legislative history behind the securities laws).

291. See *supra* Part II.

292. See *supra* Part I.B.

293. Steinhouse, *supra* note 80.

The TIC turf war will continue to be a hotly contested issue and remain of the utmost importance because TICs currently make-up a multi-billion dollar sector of the domestic investment landscape and are an increasingly attractive global alternative to traditional securitized arrangements.²⁹⁴ TICs will also undoubtedly increase in popularity among smaller investors, baby boomers, and senior retirees in the near future.²⁹⁵ The need for investor protection is greater now than ever.²⁹⁶ Thus, in addition to recognizing the importance of adhering to the approach used in this Note, the SEC should also provide new guidance in the TIC investment arena.²⁹⁷ For instance, instead of forcing the federal courts to split hairs in order to protect investors, the SEC could promulgate a rule providing that TICs sold to five or more persons must be registered or be otherwise exempt under the Securities Acts. Instead, the SEC could simply flex its muscles and issue a definitive ruling stating that all syndicated TICs are securities. These types of rules or guidance would restore a full-measure of protection to investors who need it, without interfering with the flow and stability of the TIC market. If TIC sponsors are actually exercising the degree of care warranted under the circumstances, then forcing sponsors to register TICs, file an exemption, or face the consequences would not be

294. See Berkeley, *supra* note 10, at 729.

295. See Pederson, *supra* note 79, at 469.

296. On January 15, 2009, the Idaho State Department of Finance filed a \$9.75 million civil suit against Idaho-based TIC sponsor DBSI Inc. Beth Mattson-Teig, *SEC Confirms TICs as Securities*, NAT'L REAL EST. INVESTOR, Jan. 28, 2009, http://nreionline.com/news/SEC_TICs_security/. Although DBSI filed for Chapter 11 bankruptcy last fall, the suit claims that the defendants engaged in a scheme to defraud thousands of investors through the sale of unregistered securities by unregistered broker-dealers. *Id.*

297. See OMNI Brokerage No-Action Letter, *supra* note 29.

difficult.²⁹⁸ With further guidance clarifying the boundaries of securitization for investment contracts, the SEC and the Supreme Court can protect investors, promote success, and preserve the integrity of the TIC investment market for decades to come.

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298. See 17 C.F.R. § 230.144 (2006) (permitting the sale of restricted and controlled securities without registration under limited circumstances); *id.* § 230.144A (providing a “safe harbor” from the registration requirements of the Securities Act of 1933 for certain private re-sales of restricted securities to qualified institutional buyers, which are generally large institutional investors with over \$100 million in investable assets); see also *id.* § 230.505 (providing a “safe harbor” from the general requirement that all offerings of securities be registered with the SEC and exempting certain offerings totaling less than \$5 million from the SEC’s registration requirement).

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