ROBERT G. HUTCHINS - LEGAL BULLETINS

July 2007 - When Real Estate Purchase Contracts are Securities

It is commonly assumed that real estate purchase contracts are not "securities" and that offers and sales of real estate can be made using such contracts without complying with the registration and prospectus delivery requirements of the securities laws. For the most part that assumption is accurate, but the statutory definition of a "security" is not limited to stocks and bonds. "Securities" also include both "certificate(s) of interest or participation in any profit-sharing agreement" and "investment contract(s)." Profit sharing agreements and investment contracts can be found when real estate is offered in conjunction with post-closing management, marketing or support services that are provided by the seller or its affiliate and are designed to produce operating profits as opposed to long-term capital appreciation. This frequently occurs when office, agricultural or commercial properties are offered as professionally managed investments or when condominiums or detached homes are offered as recreational properties or second residences in conjunction with a rent management or rental pool arrangement.[1]

If documents labeled real estate purchase contracts are deemed to be securities, but the securities laws have not been observed, the consequences to the seller are serious:

First, to be legal under the Securities Act of 1933, an offering of securities must either be registered or exempt from registration. The preparation of a registration statement, even for a small offering, is a time consuming and extraordinarily expensive process that simply is not feasible for most developers promoting discrete real estate projects.[2]

Second, the primary exemption theoretically available for real estate securities is the "private offering" exemption provided by Section 4(2) of the Securities Act. To qualify for that exemption, the securities cannot be promoted by any form of advertising or "general solicitation." That prohibition alone would frustrate the sales effort for a real estate project. Moreover, a contract treated as a security that has been issued without registration is "restricted." It cannot be assigned by the original purchaser without registration or an exemption.

Third, if an offering is illegal because it is neither registered nor exempt then, for a period of one year after the registration statement should have been filed, purchasers would have the right under Section 12(a)(1) of the Securities Act to rescind their contracts, and receive back their full purchase price plus interest. That right would be based solely on the seller's failure to register. Purchasers would not have to show that they were deceived when making their investment.

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[1] For the definition of a "security," see the Securities Act of 1933, Section 2(a)(1) and the Securities Act of Washington, RCW 21.20.005(12)(a). The Supreme Court first treated real estate contracts as "investment contracts" when confronted by a developer that sold real estate planted with orange groves which the developer itself would manage. See, *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). The *Howey* Court required that the expectation of profit be derived "solely" from the efforts of others. Later decisions cast a wider net by finding an investment contract whenever the profits depended to "an essential degree" on the efforts of others. See, *SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F. 2d 476 (9th Cir. 1973).

[2] By contrast, securities issued by entities that invest in a variety of projects and properties are routinely registered. See, **www.hutchins-law.com/publications/corporate/finance**, *"Raising Capital for Private Real Estate Equity Funds - Disclosure Issues"*

Fourth, the disclosure required for a securities offering vastly exceeds the disclosure required when simply offering real estate. Purchasers who failed to exercise Section 12(a)(1) rescission rights on time could still assert misrepresentation claims under Section 12(a)(2) of the Securities Act without alleging willful fraud, provided they did so within the earlier of one year after they discovered or should reasonably have discovered the underlying misstatement or omission or three years after the sale. Finally, even if all their Securities Act claims were time-barred, purchasers would have an additional window to assert fraud claims under Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934, where the comparable limitations periods are two years and five years, respectively. Thus, on any given project, the seller's exposure to a securities law claim of one kind or another would continue for a full five years after the last sale.

Fifth, in addition to claims by unhappy purchasers, the seller could face SEC enforcement actions not only for failure to register the offering under the Securities Act, but also for failure to register itself or its selling affiliate as a securities broker-dealer under Section 15(b) of the Exchange Act. The consequences could include a substantial fine and a permanent injunction against marketing similar projects. Registration as a real estate broker would not be a defense.[3]

Under current law, a real estate purchase contract will be treated as a security if:

- It documents an investment in a "common enterprise." Typically a common enterprise is found when the buyer and the seller (or the seller's affiliate) continue a contractual relationship after the closing, e.g., because the seller will manage the property or a rental pool.

- The buyer enters the transaction with a reasonable expectation of receiving a profit from the operation of the property, in addition to any long term appreciation in its value; and

- The anticipated profit will be derived primarily from the efforts of others, e.g. the seller or its affiliate, and not from the efforts of the buyer.

All three elements must be present. A real estate contract will not be treated as a security if the buyer's primary motivation is merely to acquire a place to live or a facility from which to conduct business. That showing can be made when any collateral services to be provided by the seller are incidental and it is clear the buyer will be responsible for any operating profits. A classic example of an incidental service is the provision of common area maintenance.

The SEC provided general guidance on this subject in a 1973 Release that has been followed by a number of no-action letters issued by its staff.[4] Unfortunately, the underlying concepts are difficult to apply and neither the release nor the letters are models of clarity. Thus, in 2002 the SEC staff assured Intrawest Corporation, a Canadian developer with extensive US operations, that it would not recommend enforcement to the Commission if Intrawest offered and sold condominium units without registration, even though the units were offered in connection with a

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[3] A sophisticated seller might license an affiliate as a real estate broker then cause the affiliate to engage real estate agents who were dually registered as "associated persons" of a registered broker dealer. The dual registrants would sell the real estate securities in addition to real estate parcels. The securities activities of the dual personnel would be rigidly separated from their real estate activities. That tactic, however, is not for the faint-hearted. See, *Welton Street Investments*, SEC no-action letter, June 27, 2007.

[4] See, Release No. 33-5347 (Jan. 4, 1973)

rental pool managed by an Intrawest affiliate. The rationale was that the Intrawest promotional materials did not tout the financial or tax benefits of the pool, which was mentioned only in the following cryptic sentence: "Ownership may include the opportunity to place your home in a rental arrangement." Prospective purchasers who asked for additional information were referred to a representative of the rental affiliate. The rental and sales facilities were physically separated and operated independently.[5]

On the other hand, on April 25, 2007, the staff denied no-action relief to Vail Resorts, Inc. which also separated the sales and rental facilities associated with its condominium hotel and observed the promotional restrictions required by the Release and the Intrawest letter. However, Vail offered dues reductions and complimentary golf or skiing privileges as participation "incentives" to purchasers who had already signed a binding contract or who affirmatively inquired about a rental pool and the physical layout of the units ensured that prospective purchasers would realize the pool was available.[6]

Under the circumstances, real estate developers offering properties by contracts that include post-closing management services should take extreme care to review their documentary packages, including all marketing, sales and sales training materials, for securities law compliance.

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[5] See, *Intrawest Corporation* no-action letter, November 8, 2002.

[6] See, *Vail Resorts, Inc.* no-action letter, April 25, 2007.