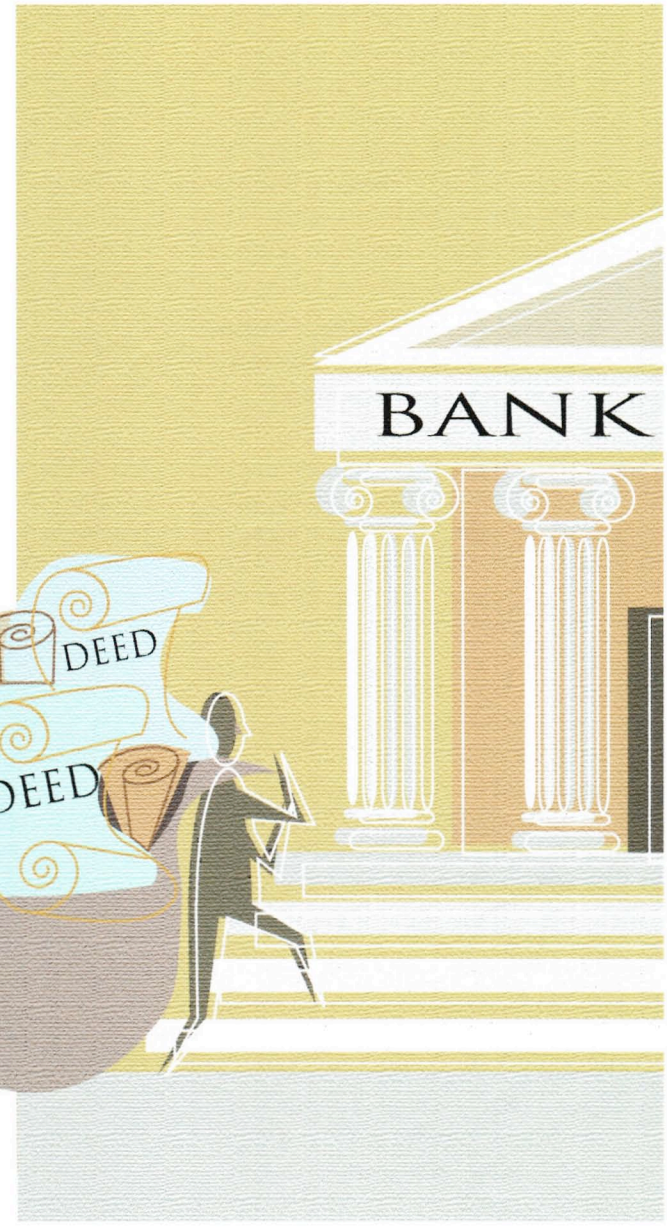

Banking on Appreciation

The Application of Securities Laws to "Landbanking" Transactions

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Current economic conditions create opportunities for investors to purchase undeveloped real estate and hold it for appreciation in a "landbanking" transaction. A "landbank" or "landbanking" transaction involves the purchase of undeveloped land by an investment syndicate for purposes of appreciation with the understanding that no development activities will be undertaken on the land. Although the structures of landbanking transactions can vary widely, ownership of the land is typically held using a tenant-in-common arrangement or by a limited liability company or partnership.

Although numerous legal issues arise in a landbanking transaction, this article is limited to an overview of the application of securities laws to certain landbanking transactions. The most conservative path is to treat every landbanking transaction as a securities offering and either properly register the offering or fall within an exemption from registration. Nonetheless, many promoters wish to avoid the burden and expense of securities compliance, if possible. This article explores the opportunity of structuring a landbanking transaction to avoid the application of state and federal securities laws.

Federal Securities Laws—Overview

The applicability of both the Securities Act of 1933 (establishing federal regulation of the registration of securities), 15 U.S.C. § 77a et seq., and the Securities Exchange Act of 1934 (establishing federal regulation of trading securities), 15 U.S.C. § 78a et seq., to an offering of interests in a landbank depends on whether the offering is an "investment contract," and therefore a security under federal law. The seminal case on whether interests offered are investment contracts is *Securities & Exchange Commission v. W.J. Howey Co.*, 328 U.S. 293 (1946). *Howey* analyzed the application of the Securities Act of 1933 to an offering of units of a citrus grove development coupled with a contract for cultivating and marketing the citrus products and remitting the net proceeds to the investors. The U.S. Supreme Court set forth a three-factor test to determine whether an offering is an "investment contract" under federal law (and thereby deserving of the protection of federal securities laws). The first two *Howey* factors—whether an investment has occurred and whether the investment was made in a common enterprise—are typically straightforward inquiries. The third *Howey* factor—whether an investor has an expectation of profit derived solely from the efforts of a promoter or a third party—is an inquiry that typically is heavily dependent on the circumstances of each case. Lower federal courts have modified the third *Howey* factor to an investor's expectation of profit based significantly (rather than solely) on the efforts of others. See, e.g., *Securities & Exch. Comm'n v. Glenn W. Turner Enters.*, 472 F.2d 476 (9th Cir. 1973). Although this modification has never been expressly endorsed by the U.S. Supreme Court, most securities practitioners proceed as if this modification is the relevant and applicable test. The focus in this inquiry is on the investor's dependence on the entrepreneurial or managerial skills of a promoter or third party.

In applying the *Howey* test to landbanks, it is clear that an investment in land solely for the purpose of profit *from appreciation* should not be a security. This is black letter securities law. See *Gordon v. Terry*, 684 F.2d 736 (11th Cir. 1982) (applying Securities Act of 1933 to interests in a real estate

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syndicate); I. L. Loss, *Securities Regulation* 491–92 (1962). To determine whether the profit from an investment in undeveloped land is derived substantially from the efforts of others (and not simply from appreciation), it is necessary to understand the most typical types of landbank investment structures and to analyze applicable case law.

General Partnerships, Limited Partnerships, and Limited Liability Companies

An interest in a general partnership is generally not considered to be a security, because the general partners usually control its management. An interest in a limited partnership is generally considered to be a security, because a limited partner does not usually have the legal ability to participate in the limited partnership's management. Few federal cases have addressed the application of federal securities laws to a landbank structured as a limited liability company (LLC). A court applying a *Howey* analysis to a landbank structured as a multi-member LLC is likely to analyze the LLC like a partnership, given the functional similarities between partnerships and multi-member LLCs. Consequently, the outcome of the application of a *Howey* analysis to a landbank structured as an LLC will likely depend on whether the LLC functions more like a general partnership or more like a limited partnership.

Williamson v. Tucker, 645 F.2d 404 (5th Cir. 1981), is the leading case on when interests in a real estate general partnership are securities. The *Williamson* case involved a general partnership's purchase of undivided interests in a 160-acre parcel of land. The Fifth Circuit held that interests in a general partnership can be "investment contracts" in two circumstances. The first circumstance is when the partners are so dependent on a particular manager that the manager cannot be replaced, such as when the manager has some particular expertise. The second circumstance is when the partners for practical purposes are unable to exercise ultimate control over the decisions of the partnership. This second circumstance is likely to occur when the business of the general partnership involves so many decisions that passive, nonmanagerial general partners cannot realistically exercise management control. An attorney structuring a landbanking transaction should consider carefully the responsibility, control, and expertise of the manager in analyzing the applicability of federal securities laws.

The *Williamson* court also recognized that, although a partner may choose to delegate his day-to-day managerial responsibilities to a committee or manager, any such delegation does not diminish the partner's legal right to a voice in partnership matters. In stressing function over form, however, the court held that a general partnership agreement giving controlling power to certain managing partners allocates control in a manner similar to a limited partnership, a structure historically more likely to be deemed subject to securities laws.

The holding and reasoning in *Williamson* was reinforced in *Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.,* 650 F. Supp. 1378 (W.D. Va. 1986). The *Rivanna* case involved the application of the Securities Act of 1933 and the Securities Exchange Act of 1934 to interests in a general partnership that invested in the ownership and operation of commercial fishing vessels. The *Rivanna* court held that general partnerships are ordinarily not considered investment contracts under *Howey* because the partners have control over significant decisions of the enterprise. The court affirmed the *Williamson* holding that a partnership can be an investment contract under *Howey* only when the partners are dependent on an irreplaceable manager or cannot otherwise exercise ultimate control. Further, the *Rivanna* court stated that the critical inquiry in applying the *Howey* analysis to a general partnership is "whether the powers possessed by the [partners are] so significant that, regardless of the degree to which such powers were exercised, [the investors do not have] a reasonable expectation of profits [based on] the management efforts of others." Id. at 1383 (quoting *Howey*). In making this inquiry, a court must examine the partnership agreement and circumstances of a particular partnership to determine the reality of the contractual rights of the general partners. The *Rivanna* court went on to create a rebuttable presumption that interests in general partnerships are not securities in certain circumstances. Specifically, the *Rivanna* court held that when a partnership agreement allocates powers to the general partners that are sufficient to allow the general partners to exercise ultimate control, as a majority, over the partnership and its business, then the presumption that interests in the general partnership are not securities can be rebutted only by evidence that it is not possible for the partners to exercise such powers.

Given the holdings in *Williamson* and *Rivanna,* a promoter can diminish the risk that interests in a landbank will be deemed securities by affording the investors the ultimate right to control the key management functions of the landbank and ensuring that the profitability of the entity is not dependent on a nonreplaceable manager. A landbank's all-cash purchase of undeveloped land to be held for appreciation should not be considered a security under federal law if the only major decision to be made is whether to sell the property. In this investment, the profitability of the landbank depends on market forces, economic conditions, and the timing of a decision to sell, which is controlled by a majority of the landbank's investors. No substantive management is needed, only the coordination of such ministerial and administrative tasks relating to the payment of taxes and insurance.

As noted above, the Eleventh Circuit Court of Appeals has held that an investment in land solely for the purpose of profits *from appreciation* cannot be a security under a *Howey* analysis. *Gordon v. Terry,* 684 F.2d 736 (11th Cir. 1982). In *Gordon,* the court analyzed the application of the Securities Act of 1933 to interests in real estate syndicates that purchased large tracts of undeveloped land. This land was to be held passively and eventually sold by the syndicates if they received the consent of a majority of the investors. In a simple all cash landbanking transaction, the question of whether an investment in the landbank is a security depends, in large part, on who has the authority to decide to sell the property. Under *Howey, Williamson,* and *Rivanna,* if the decision to sell is made by a nonreplaceable expert manager, or if the manager has the authority to sell the property regardless of the opinion of the investors, then the transaction resembles a limited partnership and will likely be deemed a security. But, if the decision to sell is ultimately made by a majority of the investors or is recommended by a manager but must be

approved by the investors, then the structure resembles a general partnership and should not be deemed a security.

Although this analysis is simple and straightforward, it can be argued that the efforts to locate the investment property must be considered in determining whether the transaction is considered a security. If the venture involves a simple purchase of undeveloped land, the efforts of a promoter to locate the property should not cause the investment to be considered a security because such efforts are equivalent to the non-unique efforts provided by most real estate brokers in locating an investment tract. This reasoning can be bolstered if the offering materials provide sufficient information to allow potential investors to make an informed and independent decision on the profit potential of the land.

Application of Federal Securities Laws to Tenant-in-Common Structures

A tenant-in-common landbanking structure should not be considered a security as long as the tenants-in-common control management decisions and the manager (if any) can be replaced. Although not binding authority, however, the Securities and Exchange Commission (SEC) on two occasions refused to issue no-action letters on tenant-in-common interests in land that were subject to a master lease structure, implying that the SEC was taking the position that such a structure was a security. See Triple Net Leasing, LLC, SEC No-Action Letter, 2000 WL 1221859 (Aug. 23, 2000); Omni Brokerage, Inc., SEC No-Action Letter, 2009 WL 153818 (Jan. 14, 2009). The investments in *Triple Net Leasing* and *Omni*, however, involved investments in real estate and leaseback arrangements. *Triple Net Leasing* and *Omni*, like *Howey*, both involved an investment in land *plus* an additional factor. In *Howey*, the additional factor was a contract for cultivating and marketing the fruit that was grown on the citrus grove development (in which interests were offered to investors); in *Triple Net Leasing* and *Omni*, the additional factor was the master leaseback arrangement. It is also interesting to note that, notwithstanding its refusal to issue no action letters in *Triple Net Leasing* and *Omni*, the SEC has never taken any enforcement action against any of the numerous tenant-in-common arrangements that have been structured like the *Triple Net Leasing* and *Omni* arrangements and sold to passive investors. To the authors' knowledge, no authority provides that a simple tenant-in-common purchase of undeveloped property will be a security under federal law when set up in a manner similar to the general partnership structure contemplated in *Williamson* and *Rivanna* (so long as the structure does not rely on irreplaceable management). It may also help if pre-acquisition costs are built into and reflected in the investors' purchase price of interests in the landbank.

Application of Blue Sky Laws (State Securities Laws)

An attorney counseling clients on landbanking transactions also should be cognizant of applicable state securities laws, known as "blue sky" laws. States have adopted various tests and presumptions regarding interests in limited liability companies as well as tenant-in-common arrangements, some of which impose more stringent standards than federal securities laws. For example, some states apply the risk-based test developed in *State v. Hawaii Market Center, Inc.*, 485 P.2d 105 (Haw. 1971), rather than the *Howey* test. The *Hawaii Market* court, in applying securities laws to an offering of interests in a retail operation, deemed *Howey* inadequate to protect the public. But an offering of interests in undeveloped real estate in a landbanking transaction as described above should not be securities under the *Hawaii Market* test. It is possible, however, that interests in a landbanking transaction may not (in certain circumstances) be deemed securities under federal securities laws yet be deemed securities under state law, and state securities law registration requirements (or an applicable exemption) therefore must be satisfied for these interests.

Conclusions and Drafting Considerations

As set forth above, whether interests in a landbank are deemed to be securities is largely dependent on the terms and structure of the offering, including the relevant limited liability company operating agreement, partnership agreement, or tenant-in-common agreement, as the case may be. Therefore, an attorney should consider certain principles when drafting these documents as well as any other offering materials associated with a landbanking transaction.

A landbanking transaction should be structured to functionally resemble a general partnership. The controlling documents should provide that the investment property can be sold, transferred, or encumbered only with the consent of a majority of the investors. Such provisions support the position that the investors, rather than the manager, retain substantive control of the entity and its assets and cause the transaction to be similar to the general partnership structure contemplated in *Williamson* and *Rivanna*. In addition, the manager's duties should be ministerial and administrative in nature and should not include the exercise of any special or exclusive skills, reinforcing the position that the profitability of the investments in the landbank is not dependent on the retention or involvement of a particular individual. If the manager's duties are ministerial in nature, it should not matter whether the manager can be removed, as long as the investors have the ability to hire an independent real estate professional if they so choose.

Finally, if entitlements intended to increase the value of the property are to occur, the attorney documenting the landbanking transaction should carefully analyze the value of the entitlements, as well as who has the power to authorize and seek such entitlements. A landbanking transaction that is structured to avoid classification as a security should be a simple land investment, the success of which is not dependent on specialized, complex, and time-intensive land planning and rezoning that must be undertaken by the manager. If possible, a promoter should obtain entitlements before offering interests in the landbank to investors. The price of the interests can then reflect the efforts of the promoter. It is also generally ideal if entitlements and additional land planning are undertaken by purchasers of the property from the landbank after placing the property under contract. In this case the potential purchaser would agree that the sales price is contingent on the purchaser applying for and obtaining the rezoning of the property necessary to support the price of the land being sold by the landbank. ■