REAL ESTATE JOINT VENTURES

IS MY JOINT VENTURE A SECURITY?

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OVERVIEW

I often get asked about joint ventures for the purpose of investing in real estate. Most frequently, the conversation involves one party with capital and one party with the know-how. A joint venture is generally understood to be an undertaking between two individuals or entities to carry out a particular project. A joint venture can take many forms, such as a general partnership, a limited partnership, a limited liability company (member managed or manager managed), a note and deed of trust or a joint venture agreement. Sometimes a joint venture (regardless of its form) can be considered a security under federal and state securities laws.

This white paper is intended to help you understand the term “investment contract,” which is a security, as well as provide general information regarding the structure that a joint venture may take. In looking at the joint venture structures, this white paper also provides insight into whether the particular structure is an investment contract and thus a security. This white paper is not meant to nor does it provide legal advice.

IS MY JOINT VENTURE A SECURITY?

Before jumping in and looking at joint venture structures, it is important to know if that particular joint venture is a security. This requires an analysis of the term "investment contract."

The definitions of what constitutes a security under both the Securities Act of 1933 ("**Securities Act**") and the Securities Exchange Act of 1934 ("**Exchange Act**") are substantially similar and are not applied differently. The definition of security is very broad, encompassing all forms of investment instruments and contracts that may be used in the commercial world. The definition of security under the Securities Act and the Exchange Act specifically includes the term "investment contract," which can be interpreted in many different ways.

The landmark U.S. Supreme Court case interpreting the definition of an "investment contract" as a security is *SEC v. W. J. Howey Co.,* 328 U.S. 293 (1946).

In that case the Supreme Court created the "Howey Test," which requires courts to consider an investment's substance, rather than its form, as the determining factor for whether it is a security. Even when an investment is not labeled a "stock" or "bond," it may very well be a security under the law. An investment contract can take many different forms and its underlying character may not be as easily recognizable.

The Supreme Court when formulating the Howey Test defined an investment contract as follows: "an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party…. Such a definition…permits the fulfillment of the statutory purpose of compelling full and fair disclosure relative to the issuance of the many types of instruments that in our commercial world fall within the ordinary concept of a security…. It embodies 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."

The Howey Test is a four-part test. An investment contract exists where there is:

1. An investment of money;
2. An expectation of profits from the investment;
3. The investment of money is in a common enterprise; and
4. Any profit comes from the efforts of a promoter or third party.

All four of the above elements must be present for a transaction to be deemed to involve a security under the Howey Test. Here is a quick look at each part of the test in a little more detail:

1. **An investment of money.** In spite of the use of the term "money," subsequent case law has expanded this concept to include any form of consideration with value.

2. **There is an expectation of profits from the investment.** Profits can take the form of capital appreciation, cash return on investment or other earnings, such as dividends or interest. For purposes of the Howey Test, profits refer particularly to a return to the investor and not necessarily the success of the enterprise as a whole. The expectation of profits analysis turns on a finding that the investor is motivated by a return on investment. For example, the Supreme Court in a later case found that the sale of shares in a housing cooperative—which, importantly, were bundled with the cost of the apartment itself and used for common operating expenses and upkeep of the building—did not give rise to a securities transaction where the investors were attracted by the prospect of acquiring a place to live, not by financial returns on their investments. Alternatively, courts have found that the sale of a condominium unit itself may be a security where (i) the offer of the unit is accompanied with an opportunity to participate in a rental pool; (ii) the offer of the unit requires use of an exclusive rental agent; (iii) the offer of the unit limits time of use of the owner or involves shared ownership (time share arrangements); or (iv) the unit is advertised with an emphasis on economic benefit, such as rental income or tax benefits.

3. **The investment of money in a common enterprise.** The term common enterprise is not precisely defined and courts have used different interpretations. The majority of federal courts define a common enterprise as involving "horizontal commonality," which involves the pooling of money or assets from multiple investors whereby the investors share in the profits and risk in some proportion. Other federal courts, however, define a common enterprise as involving "vertical commonality," which focuses on the relationship between the investor and the promoter. The vertical test defines a common enterprise as one in which the investor is dependent on the promoter's efforts or expertise for the investor's returns. Broad and narrow versions of the vertical commonality test exist. The broad version requires that the investor's fortunes be tied to the efficacy of the promoter's efforts. The narrow version requires that the investor's profits be tied to the promoter's profits, meaning they must rise and fall together. The bottom line is that if a commonality of enterprise is found, regardless of the form it has taken, this factor will be satisfied.

4. **Any profit comes from the efforts of a promoter or third party.** The efforts of the promoter or third party must be undeniably significant in the success or failure of the enterprise. The analysis hinges on whether any profit that comes from the investment is largely or wholly outside of the investor's control. If so, the investment might be a security.

If, however, the investor's own actions dictate whether an investment will be profitable, that investment is probably not a security.

In practice, the first three elements are interpreted broadly and are often easily satisfied. The final determination of whether a transaction involves a security often hinges on the fourth and final element. When a venture's success does not depend on the managerial efforts of the promoter, the interest sold is a not a security. As a general rule, investments in purely real estate are not deemed a security. But when real estate is purchased through a joint venture, a gray area exists as to whether the transaction is deemed to involve a security, in spite of the Howey test and its application. Each transaction requires an analysis of the economic realities of the underlying transaction.

TYPICAL JOINT VENTURE STRUCTURES

Having discussed what constitutes an investment contract, I will now lay out the most common joint venture structures and analyze each in light of the definition of an investment contract.

LIMITED PARTNERSHIPS

Limited partnership interests are generally securities because limited partners rely on the general partners to manage the partnership. Limited partners often only contribute capital to the limited partnership and have minimal control over daily business decisions or operations. The lack of control by limited partners establishes a presumption that limited partnership interests are investment contracts. In order to rebut this presumption, it must be shown that the limited partnership permits the limited partner to have significant legal or actual control over management of the limited partnership. This determination turns on the language of the Limited Partnership Agreement.

LIMITED LIABILITY COMPANY (MEMBER MANAGED)

An LLC interest in a member-managed LLC, which vests management authority with its members, is not as likely to be considered an investment contract. However, courts will look at the economic realities of the relationship at issue to determine whether members, as a practical matter, exercise meaningful control. For instance, an interest in a member-managed LLC may be considered an investment contract under the Howey test if one or more of the following are true:

- the operating agreement vests ultimate control in individuals other than the members;
- the LLC interests are sold to such a large number of people that the LLC interest does not provide any real control;

- the members lack sufficient business experience and knowledge to exercise management rights possessed by such member or members; or
- the members are, in fact, dependent upon the ability of a promoter or manager because of the promoter's or manager's expertise.

While there are numerous court cases across the country regarding LLC interests being a security, a recent court case found that an LLC interest is not a security if an LLC member possesses each of the following:

- the right to manage along with other members;
- the right to vote in proportion to his holdings;
- protection from other members acting individually on behalf of the LLC;
- protection from calls for additional capital without approval of two-thirds of the membership interests;
- the right to participate in a detailed cash flow distribution structure; and
- the right to call meetings.

LIMITED LIABILITY COMPANY (MANAGER MANAGED)

As a general rule, when management of an LLC is vested in a non-member manager or in fewer than all members, LLC interests offered or sold to non-participating members are considered securities, unless the non-participating members retain voting or veto powers over significant events affecting the LLC's business. In general, the LLC Operating Agreement sets forth the rights of the members. And a court will look to that document to determine whether the members have meaningful participation in the management of the company. This issue does not focus solely on whether the members have exercised their rights but, rather, on the rights and powers the members can exercise. In my practice, it is extremely common in a manager managed LLC for the members to have very little if any rights or powers.

GENERAL PARTNERSHIP

General partnership interests are normally not considered investment contracts. This presumption can be rebutted depending on the level of control afforded to partners comprising the general partnership. Unlike a limited partnership, general partnerships involve only general partners, each of whom typically enjoys equal authority and control, or a proportionate level of authority and control to the general partners' contributed capital in the general partnership. Consequently, the presumption is that these general partnership interests do not constitute investment contracts because each general partner possesses the opportunity to significantly influence business endeavors. Because of that, the fourth and final element of the Howey test is not satisfied. This presumption can be rebutted by a general partner who can show that he or she has no capacity to control the general partnership due to inexperience or lack of relevant knowledge, that he or she has no actual legal control (based on the Partnership Agreement) or that the general partnership is dependent on distinct managerial abilities of the promoter or other general partner causing the subject general partner to relinquish actual control.

JOINT VENTURE AGREEMENT

A joint venture, or JV, is a type of business arrangement where two or more parties make an agreement to pool their resources to achieve a specific goal. While a JV is similar to a partnership, there are a few key differences: (i) a JV holds no legal standing, i.e., it is not a legally recognized entity; and (ii) a JV is used for one single business activity and for only a specified period of time.

A JV is typically memorialized in a Joint Venture Agreement or JV Agreement. It is critically important for the parties to a JV that the JV Agreement covers certain essential items to protect the JV parties. Those essential items include: (i) the names of the parties; (ii) the nature of the JV; (iii) the contributions of each party; (iv) a mechanism for settling disputes; (v) a governing law and jurisdiction clause; (vi) details surrounding each party's responsibilities and obligations; (vii) the rights of each party; and (viii) information on how profits from the JV are distributed among the parties; and (ix) other applicable terms and conditions.

The determination of whether a party's interest in a JV is a security will be determined based on to what extent each party has a right to meaningfully participate in the JV's activities and operations. If one party does nothing more than contribute capital to the JV and the other party holds all of the power and control, the JV interests are likely to be considered investment contracts. If both parties to the JV have meaningful control and can participate in decision making (like in a general partnership), the JV interests are likely to not be considered investment contracts.

This type of structure is often pitched to real estate investors by real estate education seminars and workshops conducted across the United States. But just because that structure is pitched doesn't mean it has been properly vetted and/or doesn't violate securities laws. If you are a real estate investor, and you have heard this pitch from one of the many seminars, before using a JV structure to raise capital from investors, you should consult an experienced securities attorney.

In my experience, many small real estate investors (especially those buying and selling notes or investing in single family residences) use a JV structure where one party brings all of the capital to the JV and the other party has all of the control and does all of the work. In this JV structure, the JV interest will be considered an investment contract.

NOTE AND DEED OF TRUST/MORTGAGE

I have included this structure because I know many small real estate investors fix and flip single family residences or smaller multifamily residences and fund the acquisition and rehabilitation with an investor who loans money secured by a first position lien (through a mortgage or deed of trust) on the subject property.

The definitions of security under both the Securities Act and the Exchange Act include a promissory note. The famous Supreme Court case, *Reves v. Ernst & Young*, 494 U.S. 56 (1990), sets forth the framework for determining whether a note is or is not a security. The *Reves* decision established certain judicially crafted exemptions. If a promissory note falls into one of the below categories, it is not considered a security:

- A note delivered in consumer financing.
- A note secured by a mortgage or deed of trust.
- A note secured by a lien on a small business or some of its assets.
- A note relating to a "character" loan to a bank customer.
- A note which formalizes an open-account indebtedness incurred in the ordinary course of business.
- A short-term note secured by an assignment of accounts receivables.
- A note given in connection with loans by a commercial bank to a business for current operations.

The Court in *Reves* also provided additional guidance to help courts analyze whether a note fits into one of the above enumerated exemptions by establishing a four-part test, called the family resemblance test. The test looks at these four factors: (i) the motivation of the parties; (ii) the plan of distribution; (iii) the reasonable expectation of the public; and (iv) whether another regulatory scheme applies

In general, where a real estate investor has obtained a single loan in the form of a promissory note from a single investor whose position is secured by a mortgage or deed of trust on the applicable property, the promissory note will not be considered a security. However, if the real estate investor is obtaining multiple promissory notes for a single property or the single note is fractionalized (e.g., the note is funded by multiple investors), the analysis is more complex and is not covered by this white paper.

WHAT DOES THIS MEAN FOR MY BUSINESS?

When using other peoples' money and structuring joint ventures, it doesn't matter how you label the arrangement. What matters is the reality of the situation and whether the investor providing the capital is actively involved or is merely a passive investor.

Many real estate investors try to skirt federal and state securities laws by arguing that their joint venture is not a security. Doing so is a mistake that could prove very costly. Federal and state securities laws require that any offering of securities either: (i) be registered with the appropriate regulatory department; or (ii) fall within an exemption from such registration.

To obtain a securities exemption, the first decision is determining the applicable exemption and drafting the appropriate documentation to follow the rules for such exemption. Some typical rules for securities exemptions may include advertising restrictions, limits on who can invest (financial or geographic) or limits on the number of investors, and they usually require disclosure of the risks of the investment.

Under securities laws, there exists an obligation to provide all material facts (anything that could influence an investor's decision to invest, such as whether the issuer has criminal convictions, a recent bankruptcy or other failed investments) so investors can make an informed decision. Omissions or misrepresentations of material facts can lead to charges of fraud.

Failure to adhere to federal or state securities laws or regulations can result in civil or criminal penalties and provide investors a right of rescission (i.e., a right to demand back their investment). Further, any person connected with the offer or sale of a security may be subject to federal and state securities anti-fraud provisions.

When structuring joint ventures of any kind, I strongly encourage you to spend the time and money to find and work with an experienced securities attorney to avoid the pitfalls that exist, which otherwise could lead to civil or criminal penalties for you.

ABOUT THE AUTHOR

As a results-oriented dealmaker, Jason enjoys creating solutions that bring together great people, projects and capital.

When working on sophisticated business and financing transactions, Jason focuses on the big picture to ascertain his clients' strategic business direction and formulate risk mitigation strategies to protect corporate capital and profitability. His extensive experience includes advising businesses, lenders, investors, startups, and real estate investment companies and developers across the United States, on business transactions from formation to exit, acquisition, due diligence, real estate securities offerings, joint ventures, disposition and financing of real estate.

Passionate about real estate investing, Jason frequently speaks, writes and teaches on the topic, and is also a real estate investor himself. He has authored two books about private money lenders and is working on an eBook focusing on real estate syndication. Jason leads Foster Garvey's Real Estate Funds & Syndications Team.

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