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Real Estate and Unconventional Securities under the Arkansas Securities Act

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REAL ESTATE AND UNCONVENTIONAL SECURITIES CONCEPTS UNDER THE ARKANSAS SECURITIES ACT

*Harvey L. Bell**

I. Introduction

The definition of a "security" is a concept. In applying this concept, the final determination of whether a given transaction falls within the scope of a "security" is simplified when traditional labels of common stock, preferred stock, limited partnership or bond are utilized; however, businessmen, lawyers, promoters, and others, even confidence artists, who are skilled in financing techniques, can design numerous arrangements which avoid the use of traditional investment documents and yet provide risk capital for a venture or scheme. When unconventional arrangements are employed, the substance of the whole transaction must be analyzed to determine whether all of the elements together constitute a security.

One investment area where nontraditional financing arrangements are frequently used is real estate, which can be marketed and sold as an investment. Real estate ventures, like other enterprises, have developed many conventional and unconventional techniques to obtain financing. Risk of loss in the over-all real estate venture may be spread among large numbers of investors through fractional ownership in the real property or the project, or by other means. The owners may manage their enterprise or arrange for others to manage their property. Sales marketing techniques often emphasize profits to be made on the resale of the real property. Some real estate venture financing techniques involve the creation of a security.

The courts, the law professors and the regulatory agencies have espoused varying views on the proper elements to be utilized in making the determination whether a particular real estate financing venture is a security. This article will explore this area of the law in its current posture and hopefully provide some guidance

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on its possible evolution. The author inserts the *caveat* that the article is being written solely by the author as a licensed attorney and not in any official capacity. The views, interpretations or other analyses set forth herein are solely the views of the individual writer and not an opinion of the Arkansas Securities Department nor of the Commissioner in an official capacity.

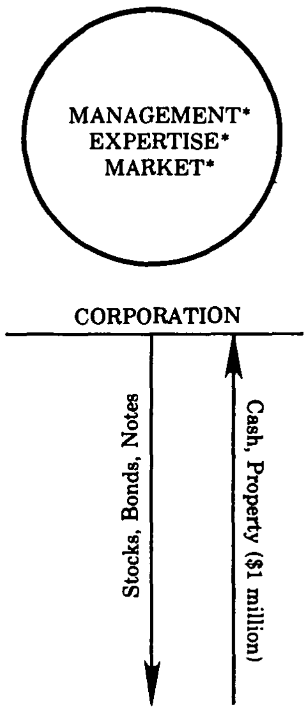
II. *An Overview of Some Real Estate Venture Financing Techniques*

The statutory definition of a security was intended to include all types of transactions which in economic reality are investments in a venture, enterprise, or investment scheme. In an unconventional arrangement, the securities laws basically require one to look at the substance of the whole transaction and not the labels on the face of the individual documents which represent the transaction. A visual display of some real estate venture financing techniques and related securities conceptual problems is illustrated as follows:

> Assume that a promoter has decided that one hundred rental units could be successfully constructed and rented on a one hundred acre tract. He could call the rental units condominiums, chalets or vacation homes. His analysis indicates that the project could be financed with one million dollars, based on a unit cost of approximately ten thousand dollars for one hundred units. The promoter does not have the one million dollars and desires financing in whole or in part from the public or from financial institutions. The promoter desires to retain managerial control of the venture. He recognizes that he has many alternatives he can use to raise the risk capital. Some of the following alternatives involve the creation of a security:

FIGURE A. STOCK, BOND, OR NOTE SALE

PROMOTER(S)



100 INVESTORS
$10,000 Each (Cash or other property)

*Management represents the conduct of the daily business affairs of the venture.

*Expertise represents the technical ability required for the venture.

*Market represents the development or existence of demand for the purpose(s) of the enterprise.

Figure A. illustrates a typical for-profit corporation which sells each of one hundred persons ten thousand dollars worth of stock, bonds, notes or a combination thereof. A promoter would lose the ability to control the project unless he personally contributed controlling amounts of voting capital. The risk of loss in case of whole or partial failure of the venture would fall squarely on the investors.

FIGURE B. MEMBERSHIPS, LICENSES AND USE AGREEMENTS

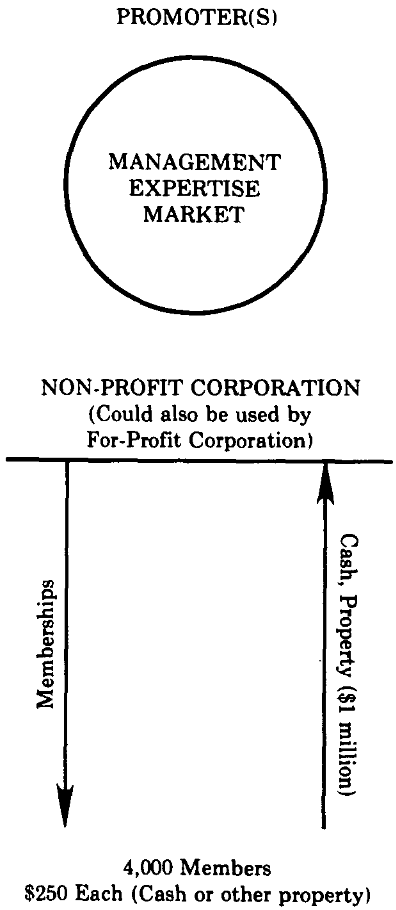


Figure B. illustrates that a non-profit corporation can sell each of four thousand people a two hundred and fifty dollar "membership" whereby each member would have the right to use the facilities when (and if) completed. This alternative has a number of variables such as requiring certain fees for initial membership and perhaps additional periodic assessments or dues. The promoter could retain control of the venture by acquiring the voting documents with his contribution amounting to only a small portion of the entire venture. Development, management, or other affiliated contracts could yield the promoter substantial fees, commissions, or remuneration. Risk of loss in case of whole or partial failure of the venture would fall squarely on the members.

FIGURE C. GALA OF PARTNERSHIP, LIMITED PARTNERSHIP JOINT VENTURE OR TENANT-IN-COMMON FRACTIONAL UNITS

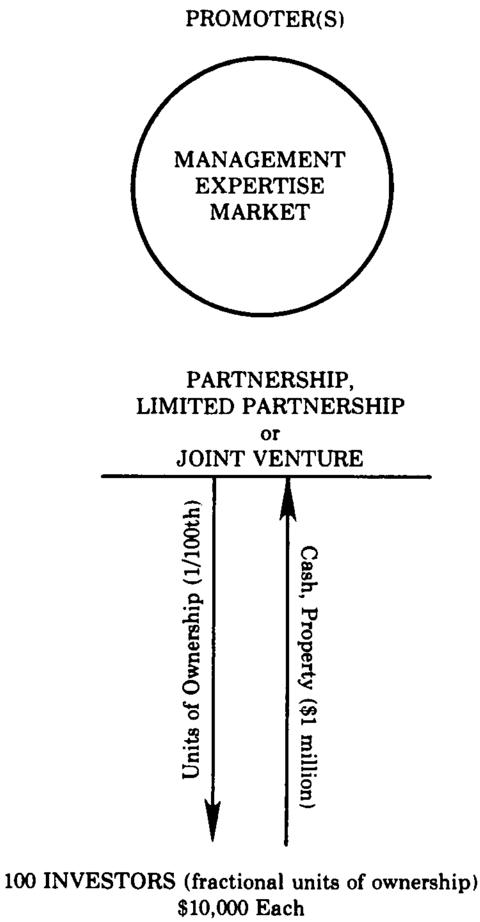


Figure C. illustrates how the promoter could organize a partnership (general, limited or joint venture) and sell each of the one hundred partners a ten thousand dollar unit of ownership. If properly structured, the promoter could contractually be the managing partner and specify his fees, commissions or other remunerations. The promoter could retain control with his contribution being only a small portion of the entire venture. The promoter could also arrange for each of one hundred persons to contribute ten thousand dollars for which the investor would receive a one/one-hundredth unit of ownership as a tenant-in-common. The promoter would agree to enter into a construction and management arrangement. While the tenant-in-common arrangement resembles a partnership, it is distinguishable. The risk of loss in the tenant-in-common structure in case of whole or partial failure of the venture would fall squarely on the tenant-in-common owners.

FIGURE D. SALE OF FRACTIONAL OWNERSHIP BY WARRANTY DEED, CONTRACT OF SALE, TENANT-IN-COMMON, CONDOMINIUM AND OTHERS (MANAGEMENT AGREEMENTS)

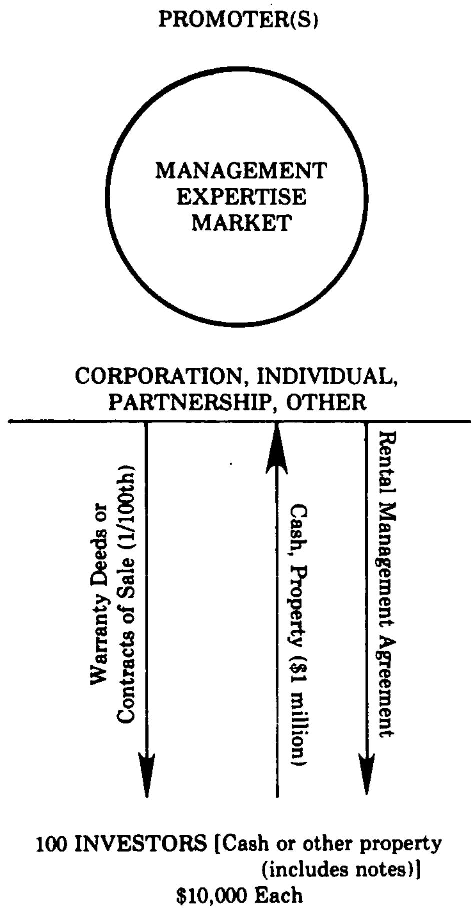


Figure D. illustrates how the promoter could (before groundbreaking) sell each of one hundred persons a "rental unit." Each person would receive either a warranty deed or contract of sale for the approximate one acre of real estate upon which the rental unit would be constructed (also, a tenant-in-common concept could be used). For enhanced marketability, the rental units could be called condominiums, chalets or villas. Concurrently, or as an integral part of the financing technique, each of the one hundred persons would enter into a management contract, lease-back or rental pool whereby the promoter would rent, manage, oversee, and pay over to each purchaser those amounts of rental income not otherwise needed to pay debt service or maintain the unit. The promoter could retain control with his contribution accounting for only a small portion of the entire venture. The risk of loss in case of whole or partial failure of the venture would fall squarely on the investors.

FIGURE E. VACATION TIME-SHARING LEASE, LEASES, LICENSES

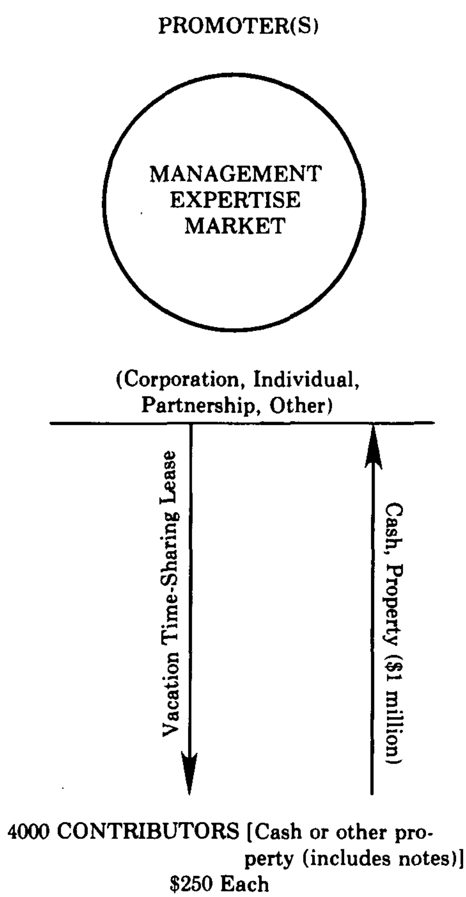


Figure E. illustrates how the promoter could sell four thousand vacationers or potential users the right to use the planned facilities for one week each year for two hundred and fifty dollars each. Under such an approach, the promoter would raise the one million dollars to build the facilities and each contributor would receive the right to use his designated facility for one week each year for a given number of years. This plan could be called a vacation time-sharing lease, a use agreement, or another similar name. The contract could provide that each contributer would receive any profits from the rental of his unit if he did not use the facility during the time period allotted to him. The promoter could retain control with his contribution accounting for only a small portion of the entire venture. The risk of loss in case of whole or partial failure of the venture would fall squarely on the lessees.

FIGURE F. BUY-BACK

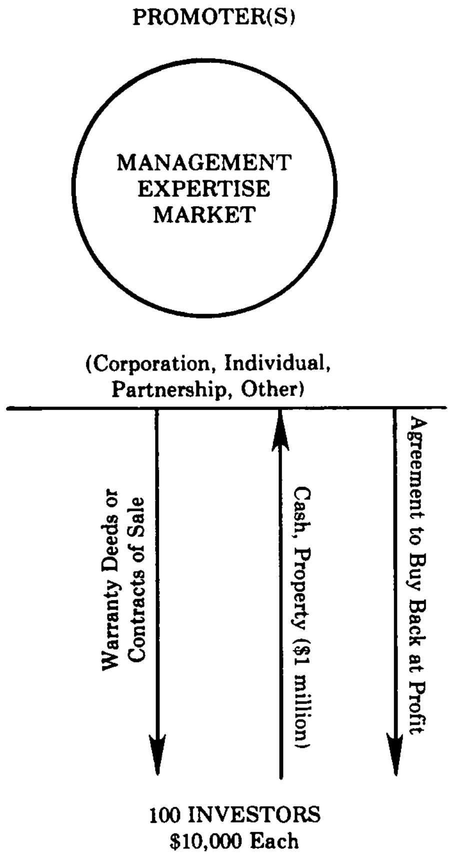


Figure F. illustrates how the promoter could offer to each of one hundred persons a "buy-back" arrangement whereby each investor would contribute ten thousand dollars, and the promoter represents that after a given period of time, five years for example, he would buy back the property for twenty thousand dollars. The promoter could retain control with his contribution accounting for only a small portion of the entire venture. The risk of loss in case of whole or partial failure of the venture would fall squarely on the investors.

As can be seen in each of these illustrations, the investors are risking their capital in the promoter's ventures. In certain examples, a layman would recognize he was subject to losing his money; in other cases, the structure may camouflage the risk of loss. It is clear that if the securities laws were restricted solely to stocks, bonds, or notes, those promoters marketing other investment programs would not be required to disclose the whole truth concerning the investment and its inherent risk of loss as required by the securities laws. A clever draftsman, promoter or flim-flam could seemingly avoid the anti-fraud provisions of the securities acts simply by changing the names at the top of the documents. Such is not the case. Section 13 of the Arkansas Securities Act defines a security to encompass both the conventional and unconventional means of financing a venture or a promotional scheme:

> When used in this Act, unless the context otherwise requires:
> (1) "Security" means any note; stock; treasury stock; bond; debenture; evidence of indebtedness; certificate of interest or participation in any profit-sharing agreement; collateral-trust certificate; pre-organization certificate or subscription; transferable share; investment contract; variable annuity contract; voting-trust certificate; certificate of deposit for a security; certificate of interest or participation in an oil, gas or mining title or lease or in payments out of production under such a title or lease; or, in general, any interest or instrument commonly known as a "security" or any certificate of interest or participation in, temporary or interim certificate for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing. "Security" does not include any insurance or endowment policy or annuity contract or variable annuity contract issued by any insurance company.[1]

An "investment contract," "certificate of interest or participation in a profit-sharing agreement" or an "evidence of indebtedness" security frequently include those unconventional means utilized by promoters to finance their ventures and by confidence men to consummate their fraudulent investment schemes. While these terms have been used in both state and federal statutes, the

1. ARK. STAT. ANN. § 67-1247(1) (1966).

judicial interpretations have established different points of view as to how to determine whether a given transaction constitutes an unconventional security. The determination often hinges on a fact-finding process. The Arkansas courts have recently clarified Arkansas' position in determining when an unconventional financing device constitutes a security.

III. The Arkansas Approach

The statutory definition of a security under the original Blue Sky laws varied from state to state because investment schemes varied from state to state.[2] The tendency of the state legislatures through the 1920's was to expand the definition of a security by adding additional categories to cover new investment vehicles as they appeared.[3] Unfortunately, the art of developing new and innovative investment arrangements exceeded the speed with which the legislatures could respond. Investors' funds were frequently in the promoter's pockets before the statutory change could be implemented. The federal and state solution was to adopt terms in the statutory definition of a security which were broad enough to encompass both new and innovative as well as old and tried promotional investments.[4] By so defining a security, the legislatures clearly intended that regardless of the labels on the documents, virtually all such investment arrangements were to come within the purview of the securities laws. The courts were empowered with the flexibility to review all the facts surrounding the sale of an investment arrangement in order to determine if the investment fell within the remedial purposes of the securities laws. Under that broad grant of power, the courts in turn have used various approaches ranging from conservative to ingenious, to determine whether a given financing technique or promoter's scheme constitutes a security.

Arkansas adopted its first "Blue Sky law" on March 28, 1913, and the following year the first Arkansas case to address the unconventional investment arose in *Standard Home Company v. Da-*

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2. J. LONG, CASES AND MATERIALS ON STATE SECURITIES (BLUE SKY) REGULATION 1 (3rd ed. 1978).

3. *Id.*

4. *Id.* The terms "investment contract," "evidence of indebtedness," "certificate of interest or participation in an oil, gas or mining title or lease" or "certificate of interest or participation in any profit sharing agreement" are examples of securities definitions to cover those unconventional investment arrangements not otherwise specified.

vis.[5] In *Davis*, the Standard Home Company planned to market documents styled "investment home purchasing conracts." Basically, the contracts provided that the purchaser who contributed $6.00 a month for eighty months could become eligible for a $1,000 loan, participate in profits on loans made by the company and receive interest and other benefits. The purchaser would forfeit his contributions under certain conditions and his money was subject to risk of loss. Standard Home Company attacked the Arkansas Blue Sky law as unconstitutional. The district court rejected the company's position and in dicta recognized that "investment home purchasing contracts" were securities within the scope of the 1913 Blue Sky law.[6]

More than fifty years later, in 1977, the Arkansas Supreme Court rendered its principal definitive opinion concerning what constitutes an investment contract in *Schultz v. Rector-Phillips-Morse, Inc.*[7] Rector-Phillips-Morse, Inc. ("RPM") was principally in the business of real estate sales which included locating, developing, constructing and managing real estate ventures. RPM structured some of its enterprises so that the company retained control by the use of affiliated corporations or persons, or through officers, directors and employees associated with the RPM enterprises. RPM located a parcel of real property, later known as "Stuttgart 221," which it deemed suitable for a federal housing project. RPM elected not to finance the entire apartment house project alone, but chose instead to associate some of its subsidiary corporations in the construction, insuring and managing of the apartments. Four persons were sold fractional units of ownership in a joint venture to finance the project. RPM arranged for the organization of a new corporation whose principal purpose was to take title in trust for the joint venture owners. The joint venture owners were merely investors who were not expected to contribute management, effort or skill toward the construction, development or management of the apartments. The officers of the corporate trustee were also officers of RPM or RPM's affiliates. The corporate trustee was given full power by contract to develop, manage, mortgage or sell the apartments belonging to the joint venture and to enter into contracts with third parties upon such terms as the trustee deemed

5. 217 F. 904 (E.D. Ark. 1914).
6. *Id.*
7. 261 Ark. 769, 552 S.W.2d 4 (1977).

reasonable. In substance, the several contractual documents were structured so that the investor/joint venturers were mere risk capital contributors to an apartment complex that RPM would plan, construct and manage. The Arkansas Supreme Court, in analyzing the arrangement, observed:

> [W]e are convinced that the so-called joint venture interests purchased by the Appellants constituted securities within the meaning of the Arkansas Securities Act. This transaction simply cannot be characterized as the sale of an interest in real estate. The entire scheme for marketing and managing the apartment complex was put together in one single package by Rector-Phillips-Morse. That corporation and its affiliates organized, constructed, managed and controlled the properties of the joint venture. The "units" were sold to investors as a "tax shelter" and upon the basis that the entire project would be constructed, managed and controlled by Rector-Phillips-Morse or its affiliated companies. *However, the risk of loss of money actually invested was placed squarely on the investors,* not only for their capital contributions, but also for the additional cash that would be required to make the payments to keep the property from going into foreclosure. In no sense was this a partnership in which a number of persons expected to pool their talents and capital and reap the benefits from their own expertise and abilities. The Stuttgart 221 investors were mere passive contributors of *risk capital* who placed their money in an investment program labeled a "joint venture."[8]

While the court specifically recognized that not all units of ownership in a general partnership or joint venture constitute securities, *Schulz* clearly holds that units of ownership in a general partnership or joint venture in a real estate enterprise constitute a security if the arrangement as a whole is structured so as to procure mere passive contributors of risk capital who are not expected to manage their investment.[9] The Arkansas Supreme Court, in order to establish judicial guidepost as to what constitutes an unconventional security, reviewed various federal[10] and[11] ap-

8. *Id.* at 781-82, 552 S.W.2d at 10-11 (emphasis added).

9. *Id.* at 782-83, 552 S.W.2d at 11.

10. SEC v. W.J. Howey Co., 328 U.S. 293 (1946); SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943).

11. State v. Hawaii Market Centers, Inc., 52 Hawaii 642, 485 P.2d 105 (1971); State v. Investors Security Corp., 297 Minn. 1, 209 N.W. 2d 405 (1973); State v. Gopher Tire Rubber Co., 146 Minn. 52, 177 N.W. 937 (1920).

proaches, and adopted the general approach used by Minnesota.[12] Under the Minnesota cases, notes secured with a real estate mortgage or contract for deed,[13] contracts for the sale of land,[14] units of ownership in a joint venture,[15] multiple real estate lot sales in a cemetery,[16] undivided interests in land,[17] and options for the sale of land[18] have been held to constitute securities under certain factual circumstances.

The recent Arkansas Court of Appeals case of *Smith v. State*[19] added some judicial gloss to *Schultz*. The court of appeals noted that the test to determine whether a given transaction constituted a security hinged upon the following five elements: (1) the investment of money or money's worth; (2) the investment in a venture; (3) the expectation of some benefit to the investor as a result of the investment; (4) the contribution towards the risk capital of the venture; and (5) the absence of direct control over the investment or policy decisions concerning the venture.[20]

IV. Real Estate as an Investment

Real restate ventures may be packaged and sold as an investment and not fall within the concept of a security. This occurs when the structure chosen does not fall within the guidelines established by the general assembly and the courts. For example, many seasoned, independently established and sophisticated businessmen, corporations, partnerships and other investment groups purchase both developed and undeveloped real properties with the expectation of obtaining economic benefit from their management and ownership of the property. Because of their sophistication, these buyers are not normally induced to purchase the properties in reliance on the seller's sales pitch, but customarily conduct their own independent market analysis of the economic prospects of each particular investment in real property. The success or failure of the venture hinges upon the new owner's ability—not a third

12. Schultz v. Rector-Phillips-Morse, Inc. 261 Ark. 769, 781, 552 S.W.2d 4, 10 (1977).
13. State v. Investors Security Corp., 297 Minn. 1, 209 N.W.2d 405 (1973).
14. *Id.*
15. Virnig v. Smith, 252 Minn. 363, 90 N.W.2d 241 (1958).
16. State v. Lorentz, 221 Minn. 366, 22 N.W.2d 313 (1946).
17. Busch v. Noerenberg, 202 Minn. 290, 278 N.W. 34 (1938).
18. Webster v. U.S.I. Realty Co., 170 Minn. 360, 212 N.W. 806 (1927).
19. 266 Ark. App. 85, 587 S.W.2d 50 (1979).
20. Id. at 89, 587 S.W.2d 52 (1979); *See also*, Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135 (1971).

person who has structured the venture so that the over-all risks falls on the owner(s), while retaining for himself the managerial powers over the principal enterprise, or who has overly represented his expertise or the property's profitability.

Real estate may also be packaged and sold as an investment in such a manner as to constitute a security. Promoters who represent that they have the expertise, management ability and knowledge of the market frequently solicit investment dollars from the public. It is not uncommon during the promotion of a typical real estate development to emphasize to investors the profits to be made on resale. In may cases, the investors are unsophisticated in real estate matters and must rely on the promoter's representations. Partnership, joint venture, tenancy-in-common, condominium, managment agreement, common stock, warranty deed, contract of sale, option, note and other such labels can be used as part of the over-all structure to market the real estate as an investment commodity, but the underlying economic substance of the arrangement is that the investor is a mere passive contributor of risk capital to a venture in which he has no direct managerial control.

A review of the various labels used by promoters to market real estate as an investment may shed light on when the arrangement or circumstances will constitute a security. In following this review, the reader should constantly look to see if the contractual arrangement as a whole is structured so that the purchaser is acquiring real property which he can manage and supervise, or if he is instead acquiring a parcel for which other persons control the managerial decisions and influence the success or failure of the venture.

A. Partnerships, Joint Ventures and Limited Partnerships

(1) General Partnerships

Arkansas has adopted the Uniform Partnership Act which contemplates that each partner has a right in the management and in the making of business decisions of the partnership—*i.e.*, each partner has a right to participate in the active daily management of the partnership.[21] In reality, however, the articles of partnership combined with other contractual relationships can result in a gen-

21. ARK. STAT. ANN. § 65-101 to -143 (1966); ARK STAT. ANN. § 65-124 (1966); ARK. STAT. ANN. § 65-126 (1966); ARK. STAT. ANN. § 67-108 (1966).

eral partnership venture in which persons other than all of the general partners make the management decisions of the venture.[22] For example, a general partnership can be designed so that it purchases investment properties which are an integral part of someone else's financing scheme, or the partnership can be structured so that there are two or more classes of partners, one of which is prohibited from management participation.

Any arrangement which restricts the participation in the actual management of the partnership enterprise raises the question of whether such an arrangement creates an investment security in a non-participating partner who only contributes risk capital. In other words, restriction of management participation by a general partner can create a mere passive investor if that non-participating partner contributes risk capital to the venture. This issue can arise in a large general partnership where the control of the partnership enterprise is totally vested in a management committee or otherwise restricted to certain senior partners. Passive partners may be mere employees or have other non-managerial relationship within the partnership. In economic reality, if he is only required to contribute risk capital to the partnership, then the passive general partner is no more than an investor in the managing partner's enterprise.[23] If the law did not recognize this result, then promoters could avoid the securities laws by simply selling numerous units of ownership in a partnership to the public in which the promoter retained for himself the management and control of the enterprise while limiting the investor-partner's ability to influence the success or failure of his investment. The courts, however, have recognized that certain types of units of ownership in a general partnership can constitute a security.[24]

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22. ARK. STAT. ANN. § 65-118 (1966). Note that the relationship of general partners can be subject to agreements between the partners and that the partnership itself can be structured to allow third persons (non-partners) to manage the principal activity of the partnership.

23. *See* Long, *Partnership, Limited Partnership, and Joint Venture Interests as Securities*, 37 Mo. L. REV. 581 (1972).

24. *See* Andrews v. Blue, 489 F.2d 367 (10th Cir. 1973); Pawagan v. Silverstein, 265 F. Supp. 898 (S.D.N.Y. 1967)(a unit of ownership in a general partnership is a security); Goldberg v. Paramount Oil Co., 55 Cal. 619, 300 P.2d 329 (1956)(a joint venture unit in oil and gas is a security); Rivlin v. Levine, 195 Cal. App. 2d 13, 15 Cal. Rptr. 587 (1961); People v. Smith, 180 Cal. App. 2d 420, 4 Cal. Rptr. 282 (1960)(a contribution made by an employee to an employer is a security where the employee had a menial job with no degree of managerial control. This case did not involve a *bona fide* joint venture). *But see* Polikoff v. Levy, 55 Ill. App. 2d 229, 204 N.E. 2d 807 (1965)(sale of a joint venture interest in land on which a

(2) Joint Ventures

The legal rights, remedies and relationships among joint venturers and among general partners are identical in many contexts; however, there are some historical appendages and unique features that can make a difference.[25] From an investment standpoint, a joint venture is a separate concept from a general partnership if for no other reason than the sales marketability of the label. While the courts have not laid down a firm definition of a joint venture, it can generally be said that a joint venture is an association of persons with intent by way of contract, express or implied, to engage in and carry out a single business venture for joint profit.[26] The joint venture can be used in the promotional venture context to develop a single real estate parcel as an investment project.

Many real estate ventures are marketed and sold as joint ventures. When marketing real estate investments under the joint venture label, the question becomes whether all of the joint venturers have combined their efforts, property, money, skill, talent and knowledge to consummate a business endeavor of their own or whether one or more of the joint venturers is a mere passive contributor of risk capital to someone else's business venture. Joint ventures which include passive contributors of risk captial who are not expected to employ their skills, talents or knowledge toward the active management of the venture have been held to be investments involving the sale of securities.[27] The fact that the joint venture invests in real properties should not influence the determination of whether the over-all structure has created an investment security.

(3) Limited Partnerships

Arkansas has recently adopted the Revised Limited Partnership Act ("RLPA").[28] Under the RLPA, the contributions of a limited partner to a limited partnership may be in the form of cash, property, services rendered or promissory notes.[29] A limited partner does not become liable as a general partner unless, in addition

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motel was to be built was *not* a security).

25. 46 Am. Jur. 2d Joint Ventures §1 (1969).

26. *Id.*

27. *See* cases cited note 24 *supra*.

28. ARK. STAT. ANN. § 65-501 to -566 (Cum. Supp. 1979).

29. ARK. STAT. ANN. § 65-527 (1966).

to the exercise of his rights and powers as a limited partner, he takes part in the control of the business.[30] By statutory mandate, under the RLPA a limited partner is a passive investor in the partnership business venture. Because of this passive role, numerous courts have held a unit of ownership in a limited partnership to be a security.[31] It has also been held that a right to subscribe to or an option to purchase a limited partnership unit is a security.[32] Both the Arkansas Supreme Court[33] and the General Assembly[34] have determined that units of ownership in limited partnerships are securities. While it appears that structurally all limited partnership units are securities, *per se*, the Arkansas Supreme Court has not yet so stated.

The limited partnership is probably the best form of direct tax participation program available for the investor. Investors are able to achieve limited liability while simultaneously receiving the direct tax benefits of the enterprise. In recent years, this feature has brought about public offerings of limited partnerhip units which theoretically could have thousands of partners in a single limited partnership. Neither the common law of partnerships nor statutory partnership law was framed with the concept of large numbers of

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30. ARK. STAT. ANN. § 65-519 (1966).

31. *See* Goodman v. Epstein, 582 F.2d 388 (7th Cir. 1978)(limited partnership is a security as a matter of law); McGreghar Land Co. v. Meguiar, 521 F.2d 822 (9th Cir. 1975); Kroungold v. Triester, 407 F. Supp. 414 (E.D. Pa. 1975)(limited partnership in a real estate venture is a security); Weinberger v. New York Stock Exchange, 403 F. Supp. 1020 (S.D.N.Y. 1975)(limited partnership in a securities brokerage firm is a security); Bayoud v. Ballard, 404 F. Supp. 417 (N.D. Tex. 1975)(limited partnership unit in an oil and gas drilling venture is a security); Hirsch v. duPont, 396 F. Supp. 1214 (S.D.N.Y. 1975)(limited partnership in brokerage firm is a security); People v. Woodson, 78 Cal. 2d 132, 177 P.2d 586 (1947)(certificates of limited partnership and certificates of interest in leases under certain arrangements are securities); Fortier v. Ramsey, 136 Ga. App. 203, 220 S.E.2d 753 (1975)(limited partnership interest in a land syndication are securities as a matter of law); Curtis v. Johnson, 92 Ill. App. 141, 234 N.E.2d 566 (1968)(a right to subscribe to a limited partnership unit is a security); People v. Hoshor, 111 Kan. 205, 206 P.2d 882 (1949)(limited partnership units are securities); Conroy v. Schultz, 80 N.J. Super. 443, 194 A.2d 20 (1963)(participation units in a real estate limited partnership are securities); Reiter v. Greenberg, 21 N.Y.2d 57, 288 N.Y.S.2d 57 (Ct. App. 1968)(limited partnership interest involving syndication in real estate is a security); Pratt v. Kross, 276 Or. 483, 555 P.2d 765 (1976).

32. Curtis v. Johnson, 92 Ill. App. 141, 234 N.E.2d 566 (1968).

33. Graham v. Kane, 264 Ark. 949, 576 S.W.2d 711 (1979); Morton v. Tullgren, 263 Ark. 69, 563 S.W.2d 422 (1978); Schultz v. Rector-Phillips-Morse, Inc., 261 Ark. 769, 552 S.W.2d 4 (1977).

34. 1977 ARK. ACTS. 730, the Investor Protection Take-Over Act codified at ARK. STAT. ANN. § 67-1264 to -1264.14 (Cum. Supp. 1979) refers to a unit of ownership in a limited partnership as an equity security.

partners; however, this is currently an area of rapid development and evolution. Many questions remain unanswered as to the functioning of this relatively new concept in the commercial environment. In the meantime, the real estate industry continues to rely on the limited partnership as a principal tool to raise capital both for new enterprises and for the expansion of existing real estate ventures. Because the limited partnership structure is versatile (there are "income programs," "tax shelter programs," "long term capital gain programs," "oil and gas drilling ventures," "geothermal development programs" and numerous others) it is well suited to our commercial environment. This versatility has produced a growing number of limited partnership ventures which will increase accordingly the number of required judicial interpretations as litigation arises. For now, it seems clear that limited partnership units of ownership fall squarely within the definition of a security. As in general partnerships and joint ventures, the fact that the limited partnership is designed to purchase real property should not influence the outcome of whether the limited partnership units of ownership are investment securities.

B. Warranty Deeds and Installment Contracts for the Sale of Real Estate

Numerous real estate financing transactions involve the transfer of title to ownership in real property by warranty deeds and installment sales contracts. Because the primary function of these documents is merely to transfer title, warranty deeds and installment sales contracts are not normally considered to represent investment units of ownership, but the spreading of the risk of loss in a real estate venture into fractional portions can be accomplished through the use of these instruments. This concept can be illustrated by the enterprise structure, where the warranty deed represents the fractional portion of real estate venture for which an investor is entitled to the profits (or losses). The determination of whether a warranty deed or installment contract for the sale of real estate is being used as a financing tool in an investment scheme or as an integral part of a financing plan requires an analysis of the economic realities connected with the creation of the documents, as well as any economic inducements presented as an incentive to the purchase of the real property. The warranty deed or installment contract of sale itself is not the security in these arrangements, but is merely one element in the over-all design. Warranty deeds and installment contracts for the sale of real estate are "hat racks" upon which promoters can hang an investment security.

(1) Tenants-in-Common

Co-ownership in a real estate venture may be achieved through the use of tenancy-in-common ownership. While tenant-in-common ownership is not normally thought of as an investment or capital formation device, it can be used by a promoter to assemble investors into a real estate venture.[35] The fact that the promoter himself buys a fractional portion of the venture does not eliminate the economic reality that other tenant-in-common investors are mere passive contributors of risk capital where the promoter or some third party by rigid design is to manage the venture.

Tenancy-in-common ownership is not *per se* indicative of the creation of an investment security. Individual investors may, without the participation of a promoter and of their own volition, form their venture and choose to use the tenancy-in-common alternative as their means of fractionalizing ownership and determining profits or losses. In the non-securities context, the owners manage or have the immediate right to manage their property; the individual investors independently decide for themselves to contract a manager for the venture separately from the promoter's design. The determination of whether the venture is a security hinges on the five-part test cited by the Arkansas courts in *Smith v. State* and in *Schultz.*[36]

(2) Condominiums, Chalets, Shelter Units and Others ("Rental Units")

Real estate investments in the non-residential rental unit market are subject to variable risks of loss, variable qualities of investment and variable quality of management. Our mobile society has brought about the development of hotels, motels, resorts, inns and

35. Mary Pickford Co. v. Bayly Bros. Inc., 12 Cal. 2d 501, 86 P.2d 102 (1939)(an individual fractional interest in trust for financing real estate subdivision is a security); D. K. Properties, Inc. v. Osborne, 143 Ga. App. 832, 240 S.E.2d 293 (1977)(units of ownership sold to sixteen tenants-in-common are securities); Sire Plan Portfolios v. Carpentier, 8 Ill. App. 2d 354, 132 N.E.2d 78 (1956); Bergquist v. Int'l Realty, Ltd., 272 Or. 416, 537 P.2d 553 (1975)(fractional interest with a lease-back is a security).

36. *See* cases cited, notes 7 & 19 *supra*.

other rental units designed to accommodate the market. The relocation of highways, the dislocation of industry, the weather, the facility itself—the degree of cleanliness, the quality of food, the services—and any one of a number of variable aspects can affect the economic soundness of a rental unit enterprise. As can be quickly observed, this facet of the real estate income property business is subject to complex factors which can materially influence the success or failure of the enterprise.

The design, construction and management of a resort development as well as the expansion of an existing facility frequently entails the need to raise substantial amounts of risk capital. Many developers, whether by choice or under economic pressure, have used the risk capital financing technique of marketing units of real properties to the public as a part of their over-all financing plan. Under this concept, members of the public purchase as an investment a condominium, a chalet or a shelter unit. The developer (or an affiliate) agrees to manage the property and return any income to the investor after debt services and expenses. The purchaser frequently will have the right to use the unit himself for a short period of time each year under specified terms; however, the principal motive for the purchase under such an arrangement is investment and not personal use. Such a technique allows the resort enterprise to have shelter unit facilities for the resort's tourist trade while simultaneously shifting the risk of total or partial loss of the venture to the rental unit investor. While this technique is particularly suited to a resort enterprise, it is by no means restricted solely to resorts.

The sale of a single rental unit in a rental unit project may constitute an investment security, although the purchase of a dwelling exclusively for personal use has never been so categorized.[37] On the other hand, when collateral agreements, an over-all financing arrangement, or other economic inducements are added to the naked purchase of a rental unit, these additions can create an investment security.[38] For the real estate promoter, the labels of condominium, villa, townhouse, chalet and other similar labels do not insulate him from the reach of the securities laws.

37. United Hous. Foundation, Inc. v. Forman, 421 U.S. 837 (1975).

38. *See* Lowery v. Ford Hill Inv. Co., 192 Colo. 25, 556 P.2d 1201 (1976)(condominium sold by an installment sales contract together with a management contract and economic inducements to invest is a security); *see also* Offers and Sales of Condominiums or Units in a Real Estate Development, SEC Release No. 33-5347 (Jan. 4, 1973).

(3) Lots

Fruit trees,[39] chinchillas,[40] beavers,[41] race horses,[42] cemetery burial lots,[43] inventions,[44] condominiums,[45] scholarships,[46] cosmetics[47] and whiskey[48] are just some of the items of real and personal property which can be hat racks upon which promoters hang an investment arrangement. While these items are not normally sold

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39. Securities and Exchange Commission v. W.J. Howey Co., 328 U.S. 293, (1946)(warranty deeds with lease-backs are securities); Ferland v. Orange Groves, Inc., 377 F. Supp. 690 (M.D. Fla. 1974)(one-acre orange grove tract package is a security); SEC v. Orange Grove Tracts, 210 F. Supp. 81 (D. Mass. 1962)(sales of citrus grove acreage for development coupled with management contract are securities); SEC v. Bailey, 41 F. Supp. 647 (S.D. Fla. 1941)(contracts for sale of small tracts of land for cultivation and development of tung trees with management agreement are securities); SEC v. Tung Corp. of America, 32 F. Supp. 371 (N.D. Ill. 1940)(tung tree contracts for development, care and management of small tracts are security). *Contra*, State v. Hemphill, 142 Fla. 728, 195 So. 915 (1940)(tung tree management contract with land sale for cultivation, care and planting is *not* a security).

40. Hollywood State Bank v. Wilde, 70 Cal. App. 2d 103, 160 P.2d 846 (1945)(chinchilla growing arrangement in which investor was passive is a security); Miller v. Centeral Chincilla Group, Inc., 494 F.2d 414 (8th Cir. 1974)(chinchilla growing arrangement is a security); SEC v. Payne, 35 F. Supp. 873 (S.D.N.Y. 1940)(silver fox sale with management agreement to care and breed is an investment contract); Gracchi v. Friedlander, 93 Cal. App. 770, 270 P. 235 (1928)(arrangement for the growing and sale of rabbits is a security); *see* State v. Robbins, 185 Minn. 202, 240 N.W. 456 (1932)(muskrat farming arrangement can be a security); Stevens v. Liberty Packing Corp., 111 N.J. Eq. 61, 161 A. 193 (1932)(rabbit-growing arrangement can be a security).

41. Kemmerer v. Weaver, 445 F.2d 76 (7th Cir. 1971)(beaver growing, care and marketing arrangement is a security); Continential Marketing Corp. v. SEC, 387 F.2d 466 (10th Cir. 1967)(beaver investment arrangement is a security).

42. Marshall v. Harris, 276 Or. 447, 555 P.2d 756 (1976)(fractional interest in a race horse constitutes a security).

43. State v. Lorentz, 221 Minn. 366, 22 N.W.2d 313 (1946)(multiple cemetery lots sold for investment are securities); *In re* Waldstein, 160 Misc. 763, 291 N.Y.S. 697 (1970)(certain type of burial arrangement is a security). *Contra*, Memorial Gardens of the Valley, Inc. v. Love, 5 Utah 2d 270, 300 P.2d 628 (1956)(burial lots are *not* a security).

44. People v. Shafer, 130 Cal. App. 74, 19 P.2d 861 (1933)(sale of 1/100 interest in a patent with ties to future enterprises is a security).

45. Lowery v. Ford Hill Inv. Co., 192 Colo. 25, 556 P.2d 1201 (1976).

46. Scholarship Counselors, Inc. v. Waddle, 507 S.W.2d 138 (Ky. 1974) (scholarship plan or program held to be an investment contract).

47. SEC v. Koscot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974)(marketing plan for cosmetic held to be a security). *Contra*, Koscot Interplanetary, Inc. v. King 452 S.W.2d 531 (Tex. Civ. App. 1970)(marketing plans for cosmetics are *not* securities).

48. Glen-Arden Commodities, Inc. v. Costantino, 493 F.2d 1027 (2d Cir. 1974)(scotch whiskey warehouse investment arrangement held to be a security); SEC v. Haffenden-Rimar Int'l, Inc., 496 F.2d 1192 (4th Cir. 1974); Penfield v. SEC, 143 F.2d 746 (9th Cir. 1944)(bottling contracts exchanged for whiskey warehouse receipts are securities); SEC v. Bourbon Sales Corp., 47 F. Supp. 70 (W.D. Ky. 1942)(whiskey warehouse receipt investment arrangement held to be security); State v. Unger, 237 Wis. 318, 296 N.W. 629 (1941)(whiskey warehouse receipt held a security where no delivery of whiskey expected or contemplated).

pursuant to an investment arrangement, the method of offering, the economic realities and other attendant factors can cause what would otherwise be a plain purchase of real or personal property to become an investment security. Real estate lots are not exempt from this concept. The development of real estate into subdivisions, resorts, housing projects and other endeavors is a complex and risk-ridden business. In the last two decades, there has been an evolving emphasis on the sale of real estate lots for investment purposes. Some of these new arrangements appear to involve the offer and sale of an investment security.

(a) The Single Isolated Real Estate Lot

The offer and sale of a single isolated lot for personal use, rather than as an integral part of an over-all investment venture, is not a security. It is the sale of real estate in its purest form. The buyer takes title to the property and the seller departs, never to be heard from again. The buyer has total control over use of the property. The appreciation (or depreciation) in value is not influenced by the departed seller or by an affiliate of the seller but by true market conditions. The buyer may purchase the lot as an investment, but if he does so it is not with the principal expectation that the seller or an affiliate of the seller will continue affirmative acts which will materially influence the price of the lot. The owner has the absolute right to determine when he will resell the property, under what conditions and to whom. The sale of a real estate lot which is not part of a promoter's investment package or an over-all financing scheme is not a security. This consequence can change, however, when a lot is in a real estate development, is only one of numerous related lots, is an integral part of an over-all financing scheme, is sold with a buy-back arrangement or is sold with undue emphasis on investment.

(b) The Single Lot in a Completed Real Estate Development

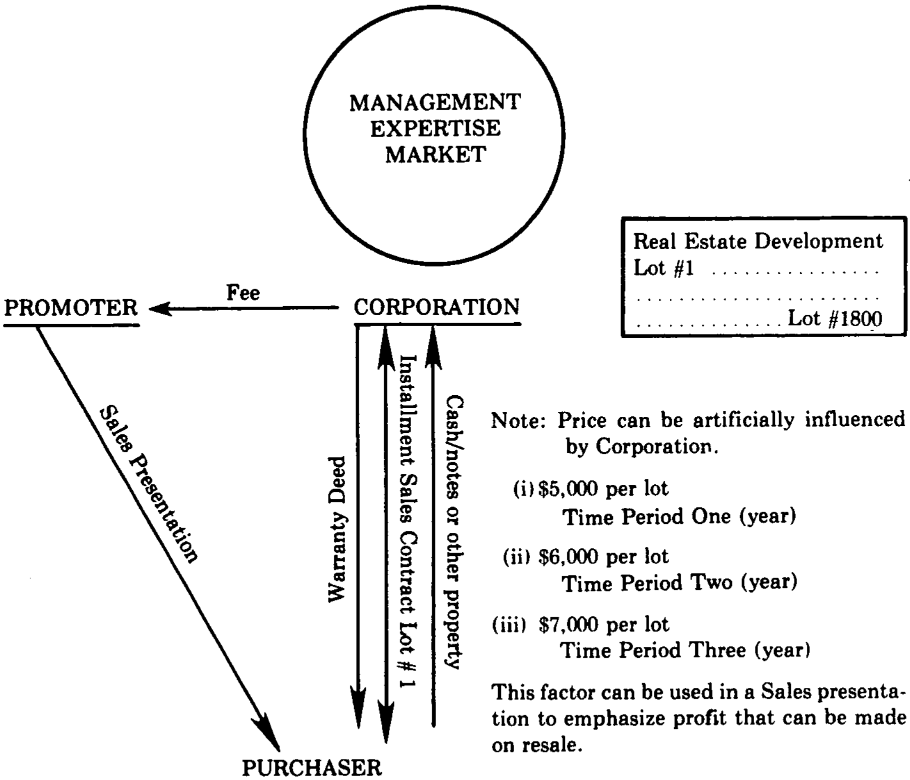
A completed real estate development has finished streets and utilities as well as unencumbered common use facilities. The sale of a real estate lot in a completed development without overriding additional investment factors does not appear to be security. The buyer is not risking his money with the anticipation that the seller will complete the development project. The capital appreciation (or depreciation) of the lot is not influenced by the seller's completion of the development. The buyer gets what he purchases. He determines whether to build on the property and decides on the timing and conditions of any resale of the property. The buyer has no future ties with the seller. The sale of a lot under such circumstances does not appear to be an investment security partly because his purchase price is not subject to the risk of the entire enterprise. This conclusion can change, however, when other economic inducements are attached to the sale, such as a representation that the seller will buy back the lot at a specified future date at a profit or where there is undue emphasis on resale at a profit.

(c) The Single Lot in an Uncompleted or Ongoing Real Estate Development

Other sections of this article have dealt with the concept of how a business venture involving a single parcel of real estate can be divided into fractional units through partnerships, joint ventures, limited partnerships, tenancy-in-common and by other means. The use of these various structures for apartment houses, shopping centers, housing developments, buildings, warehouses and other real properties can allow the venture to be broken into fractional risk of loss units of ownership. The real estate lot sale in an uncompleted or ongoing real estate development offers a relatively new and innovative means by which a real estate project can be broken down into fractional risk of loss units. This financing technique can be illustrated as follows:

Assume a developer who owns or has access to 800 acres allocates 600 acres to a lot development plan which he has determined would take $6,000,000 to develop. Once fully developed, the market value for the tract would be $18,000,000 based upon sales of 1,800 one-third acre lots at $10,000 per lot (adjustments in lots made for streets and roads). The developer considers retaining 200 acres for commercial properties and other facilities for additional profits. The developer has many alternatives to choose from with which to finance the $6,000,000. A typical structure appears in Figure G.

FIGURE G



(1) Is there investment of money or money's worth?

(2) Is there investment in a venture?

(3) Is there the expectation of some benefit to the investor as a result of the investment?

(4) Is there contribution towards the risk capital of the venture?

(5) Is there the absence of direct control over the investment or policy decisions concerning the venture?

Is the purchaser of a real estate lot in this development in substance taking a fractional risk in the promoter's real estate project? If the lots are initially sold for $5,000 in time period one, $6,000 in time period two and $7,000 in time period three, should this plan of sales marketing be a factor in determining if the lot is an investment security? What effect should be given if it is emphasized that prospective buyers can resell the lot for a profit? Is the lot owner similar to a stockholder in a corporation in that the developer has the managerial supervision over the real enterprise and the lot holder owns a fraction of the true venture? Is it relevant if on the date of sale the buyer is purchasing for investment and not with a view toward personal use? Does it matter if the property owners' association for the development is controlled by the seller or promoter?

Courts are presently answering these questions. Lots in uncompleted or ongoing real estate developments can constitute securities under the federal and state securities act.[49] The courts have recognized that in some real estate development sales practices the marketing technique can contribute to the creation of an

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49. *See* Tober v. Charnita, Inc., 58 F.R.D. 74 (M.D. Pa. 1973)(cause of action exists under securities acts for sale of recreational or investment lots); McCown v. Heidler, 527 F.2d 204 (10th Cir. 1975)(lot in a real estate development can be sold in a manner which creates an investment security); *In re* Los Angeles Land & Invs., Ltd., 282 F. Supp. 448 (D. Hawaii 1968)(parcels of real estate in an ongoing development can be used to create an investment security arrangement); United States v. Brown, 578 F.2d 1280 (9th Cir. 1978)(contract assignments, promissory notes, mortgages and land sales contracts can be sold as investment securities in land developments); Anderson v. Grand Bahama Dev. Co., 24 Ill. 114, 384 N.E.2d 981 (1978)(land installment contracts used to sell unimproved land, with representations land would increase in value as a result of promoter's effort, stated a claim under the securities laws); Timmreck v. Munn, 433 F. Supp. 396 (N.D. Ill. 1977)(lots in a devlopment can be marketed and have such economic substance as to create an investment security); Fogel v. Sellamerica, Ltd. 455 F. Supp. 1269 (S.D.N.Y. 1978)(lot is a development which may or may not be a security); Fuls v. Shastina Properties, Inc., 448 F. Supp. 983 (N.D. Cal. 1978)(sale of lots in a recreational subdivision creates a cause of action under federal securities laws); Jenne v. Amrep Corp., [1978] Fed. Sec. L. Rep. (CCH) ¶ 96.343 (D.N.J. Feb. 14, 1978)(court must look to more than the four corners of a land sale contract to see if the arrangement is an investment security); State v. Evans, 154 Minn. 95, 191 N.W. 425 (1922)(sale of multiple lots in an ongoing cemetery for investment and speculation is an investment security); Holloway v. Thompson, 112 Ind. App. 229, 42 N.E.2d 421 (1942)(sale of cemetery lots with representations of numerous improvements on the cemetery properties and with representation that the lots would be bought back at a profit is a security); State v. Lorentz, 221 Minn. 366, 22 N.W. 2d 313 (1946)(cemetery lots sold in multiple numbers with emphasis on investment, speculation and profits on resale constitutes a security); SEC v. Lake Havasu Estates, 340 F. Supp. 1318 (D. Minn. 1972)(land purchase contracts with management agreement are investment contracts). *But see* Happy Inv. Group v. Lakeworld Properties, Inc., 396 F. Supp. 175 (N.D. Cal 1975)(lots purchased in a recreational subdivision are *not* securities); Van Arsdale v. Claxton, 391 F. Supp. 538 (S.D. Cal. 1975)(land investment *not* a security where mere general increase in market is profit expectation); Memorial Gardens v. Love, 5 Utah 2d 270, 300 P.2d 628 (1956)(cemetery lots purely for burial and not for resale are *not* a security).

investment security.[50] As illustrated by Figure G, the sale of a lot in certain land development financing structures involves more than the sale of real property. The question becomes how many factors can be attached to naked real estate before an investment security is created. Perhaps the investment image, created through representations of an artificial increase in price, is not enough, but regardless of the sales pitch, if the over-all plan is to finance the venture through lot sales, this one factor may be sufficient to denominate the purchase as a risk capital contribution to the venture.

Under the Arkansas Securities Act, it appears that when the purchaser is sold a lot with emphasis on the investment aspects including profits to be made on resale and when his investment dollars are subject to risk of loss in the over-all development of the project, for which he cannot participate as a manager, then an investment security has been created.[51]

(d) Multiple Real Estate Lot Sales

The sale of multiple lots in a cemetery as an investment and for speculation has been held to constitute a security.[52] This concept would by analogy apply to the sale of the multiple lots in a real estate development as an investment and for speculation. Thus, the sale of multiple rather than single lots would be evidence of the investment intent necessary to constitute an investment security.

CONCLUSION

Many alternatives are available to finance a new profit-seeking venture or to expand an existing enterprise. Regardless of the route taken, when risk capital is solicited or acquired, the Arkansas Securities Act requires proper disclosure of the risk of loss to the investors. This requirement is accomplished through the broad definition of a security and the adjunct civil and criminal penalties for failure to comply.

The fact that certain investments are hinged upon the expected value of real estate does not make them exempt from the Act simply because the underlying profit-making source is real es-

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50. *See generally* cases citied note 49 *supra*.
51. *See* cases cited notes 7 & 19 *supra*.
52. State v. Lorentz, 221 Minn. 366, 22 N.W.2d 313 (1946).

tate, an interest in real estate or connected to real estate. The courts are increasingly recognizing clever financing techniques as risk capital raising devices. As inflation, high taxes and lack of confidence in other investment markets continues, real estate will offer both opportunities and pit-falls for the investor. The courts will be left to trumpet repeatedly the call that one cannot avoid the disclosure, regulatory, and anti-fraud remedies of the Arkansas Securities Act simply by using unconventional or creative labels in a risk capital financing technique.