GETTING RID OF THE SECURITY BLANKET: WHY THE LIMITED PARTNERSHIP UNITS IN *LIBERTY PROPERTY TRUST V. REPUBLIC PROPERTIES CORP.*, 577 F.3D 335 (D.C. CIR. 2009), ARE NOT "SECURITIES"

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I. INTRODUCTION

Did you ever think you would be liable for fraud because you did not tell yourself something you already knew? In *Liberty Property Trust v. Republic Properties Corp.*, the same parties were present on both sides of a transaction, and one attempted to bring a securities fraud action against the other for failing to disclose a material fact.[1] While corporations are viewed only as legal entities, partnerships have traditionally been viewed in light of the individual partners themselves, and not in terms of their legal form.[2]

The *Liberty Property Trust* court found, however, that limited partnership units were "securities" within the meaning of federal security statutes and regulation rules. The court looked at the legal form of the entities in the transaction but ignored the actual substance of the limited partnership in deciding whether one entity owed a duty of disclosure to the other. The court also failed to correctly apply the Supreme Court's test for determining whether a limited partnership interest is a "security." The court's decision was incorrect, and the implications it presents will lead to an increase in future federal securities fraud litigation, which is contrary to Congress' intent in enacting security regulation legislation. The holding could lead to a blanket generalization of what a "security" is, and the term could be applied not only to future limited partnerships but also to other entities such as limited liability companies. The majority's holding was incorrect because the court misused precedent in erroneously finding a limited partnership interest to be a "security."

Section II of this Note will provide an overview and background of securities law and business formation, including a discussion of prior cases

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1. Liberty Prop. Trust v. Republic Props. Corp., 577 F.3d 335 (D.C. Cir. 2009).
2. Williamson v. Tucker, 645 F.2d 404 (5th Cir. 1981).

having conflicting holdings of determining when a limited partnership interest is a "security." Next, Section III will discuss the facts of *Liberty Property Trust* and the conflicting reasoning between the majority opinion and the dissenting opinion. Finally, Section IV will analyze why the majority was incorrect in holding the limited partnership interests were "securities" and how the court should have properly analyzed the facts of the case to come to the opposite conclusion.

II. EXISTING LAW AND LEGAL BACKGROUND

To thoroughly understand the analysis of this case, it is crucial to examine the background and application of the relevant laws and regulations surrounding the definition of a "security." It is also helpful to understand the entities involved in the transaction and the structure of each business organization. Finally, an examination of prior cases illustrates applications of the term "security" as it pertains to a limited partnership and explains the implications of those holdings.

A. The Securities and Exchange Act of 1934

The Securities and Exchange Act of 1934 ("the Act") declares it "unlawful for any person to use or employ any manipulative or deceptive device or contrivance in contravention of rules promulgated by the Securities and Exchange Commission in connection with the purchase or sale of any security not registered on a national securities exchange."[3] The purpose of the Act was "to provide for the regulation of securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets."[4] Prior to the Act, the securities market was highly unregulated, leading to large scale abuse.[5] The Act was intended primarily to eliminate the abuse by requiring disclosures to investors who were purchasing a "security."[6] Congress intended for the economic realities of the underlying transaction to be the basis of determination of a "security," and not merely the terminology used.[7] Section 2(1) of the Act defines the term "security" as any:

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3. 15. U.S.C. § 78j(b) (2006).
4. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 728 (1975).
5. *Id.*
6. *Id.*
7. United Hous. Found., Inc. v. Forman, 421 U.S. 837, 849 (1975); Tcherepnin v. Knight, 389 U.S. 332, 336 (1967).

> 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 subscriptions, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, 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, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the forgoing.[8]

Furthermore, the Supreme Court interpreted the Act in *SEC v. W.J. Howey Co.*, and announced a test to determine if an asset was a "security."[9] The Act's definition of a "security" includes the term "investment contract."[10] If an interest does not fit squarely within one of the definitions, it is appropriate to analyze the interest as an "investment contract."[11]

Therefore, the *Howey* Court announced a test for defining a "security" by determining whether something is an "investment contract."[12] Something is an "investment contract" if it is "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*."[13] The goal of this test is to ensure investors in a company who rely on the management of the entity are given full and fair disclosure with regard to the securities they purchase.[14] It does not matter if the shares in the enterprise have formal certificates or if they are only small interests in physical assets used by the enterprise.[15]

B. Securities and Exchange Commission Rule 10b-5

Congress defined the term "security" in a broad and general manner to include several different kinds of instruments that would ordinarily be within the concept of a security.[16] Therefore, it became the responsibility of the regulatory agency, the Securities and Exchange Commission (SEC)

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8. 15 U.S.C. § 78c(a)(10) (2006).
9. SEC v. W.J. Howey Co., 328 U.S. 293, 298–99 (1946).
10. *Id.*
11. *See* Maura K. Monaghan, *An Uncommon State of Confusion: The Common Enterprise Element of Investment Contract Analysis*, 63 FORDHAM L. REV. 2135, 2136 (1995) (discussing the several catch-all categories covering interests not enumerated in the statute.).
12. *Howey,* 328 U.S. at 298–99.
13. *Id.* (emphasis added).
14. *Id.*
15. *Id.*
16. H.R.REP. NO. 73–85, at 11 (1933); Marine Bank v. Weaver, 455 U.S. 551, 555–56 (1982).

to determine what types of instruments are covered by the Act.[17] SEC Rule 10b-5 declares it unlawful "to omit to state a material fact necessary in order to make statements made, in the light of the circumstances under which they were made."[18] The Supreme Court inferred from SEC Rule 10b-5 a private cause of action for securities fraud in *Superintendent of Insurance v. Bankers Life & Casualty*.[19]

The Supreme Court also stated that Congress intended the SEC to have broad discretionary powers, and that SEC Rule 10(b) should be read flexibly, not technically and restrictively.[20] The Court further stated Congress did not intend to regulate transactions dealing with simple corporate mismanagement but sought to "bar deceptive devices and contrivances in the purchase or sale of securities."[21] The Fifth Circuit articulated the rationale of having a private right of action under SEC Rule 10b-5, stating that if someone denies access to known material information, the investor is unable to make an informed judgment regarding the value of the transaction.[22]

C. Business Organizations Overview

The complex set of transactions in *Liberty Property Trust* involved several different business entities including a real estate investment trust, a limited partnership, and a corporation. It is essential to the case to know the distinctions between the different business organizations and how they operate. Further, it is helpful to understand why one particular entity would be advantageous over another in forming a business organization.

1. Real Estate Investment Trusts

A "REIT" is a real estate investment trust. A trust can be structured as a REIT for tax avoidance purposes under Section 856 of the Internal Revenue Code (IRC).[23] A corporation, trust, or association must meet several requirements to qualify as a REIT, and Section 856 of the IRC outlines these requirements in depth.[24] REITs allow for diversified investment in real estate and can be compared to a mutual fund, as REITs permit investors to combine resources to achieve a return on their capital

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17. United Hous. Found. v. Forman, 421 U.S. 837, 848 (1975).
18. 17 C.F.R. § 240.10b-5 (2010).
19. Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 (1971).
20. *See* SEC v. Glenn W. Turner Enter., Inc., 474 F.2d 476 (9th Cir. 1973).
21. *Superintendent of Ins.*, 404 U.S. at 12.
22. Shell v. Hensley, 430 F.2d 819, 827 (5th Cir. 1970).
23. 26 U.S.C. § 856 (2006).
24. *Id.*

without having to pay a corporate tax on the capital gain.[25] REITs are similar to partnerships and limited liability companies because they are "pass-through" entities where only the shareholders pay taxes and the entity itself does not.[26] Further, there is a special type of REIT, called an Umbrella Partnership REIT, or UPREIT, that serves as a common tax saving device when the REIT is associated with a limited partnership.[27] In these types of UPREIT entities, investors can add real estate that has appreciated into a limited partnership without realizing any taxable income.[28]

2. Limited Partnerships

Generally, a limited partnership consists of one general partner who is personally liable for the debts and obligations of the partnership and limited partners who are not personally liable, as long as they are not actively participating in the management of the partnership.[29] When interests in the limited partnership are transferred, it is typically required that there is consent of the non-transferring partners.[30] A limited partnership, however, may approve or draft pre-agreements to allow transfers.[31]

3. Corporations

A corporation can register as a C corporation or an S corporation depending upon the number of shareholders.[32] S corporations are referred to as "small business corporations" and require a limited number of shareholders, while there is no shareholder limit for the number of shareholders in C corporations.[33] C corporations are managed by a board of directors and not by the member shareholders themselves.[34] Income to corporations is taxed at both the corporate level when it is earned and the shareholder level when the corporation distributes income to the shareholders.[35]

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25. Liberty Prop. Trust v. Republic Props. Corp., 577 F.3d 335, 337 (D.C. Cir. 2009).
26. Russell Singer, *Understanding REITs, UPREITs, and Down-REITs, and the Tax and Business Decisions Surrounding Them,* 16 VA. TAX. REV. 329, 331 (1996).
27. *Id.*
28. *Id.*
29. Michael J. Garrison & Terry K. Knoepfle, *Limited Liability Company Interests as Securities: A Proposed Framework for Analysis*, 33 AM. BUS. L.J. 577, 585 (1996).
30. *Id.* at 586.
31. *Id.*
32. *Id.* at 583.
33. *Id.*
34. *Id.*
35. *Id.*

D. Prior Case Law Determining When a Limited Partnership Interest is a "Security"

Previous cases have inconsistent holdings in determining whether a limited partnership interest is a "security." While some cases have held the interest is a "security," others have held it is not. Therefore, there is no clear answer or bright line test to determine the status of a limited partnership interest.

1. Cases Finding Limited Partnership Units Are "Securities"

The Second Circuit held in *Mayer v. Oil Field Systems Corp.* that limited partnership units were securities because "such an interest involves investment in a common enterprise with profits to come solely from the efforts of others."[36] The court in *Mayer* held that even though the limited partners had no part in managing the partnership, it did not exonerate the general partner from liability for fraud.[37] The court also stated that, in general, limited partnership interests are securities under the *Howey* test because the investment derives profits from the efforts of others.[38]

Additionally, the U.S. District Court for the Southern District of New York first held in 1975 that limited partnership units were securities because the parties bringing the suit were not general partners at the time of purchase.[39] The court held that the limited partnership interests had to be considered separately from a later purchase of general partnership interests.[40] The court determined the limited partnership interests were securities while the general partnership interests were not.[41]

2. Cases Finding Limited Partnership Units Are Not "Securities"

The Third Circuit determined the limited partnership interests were not securities.[42] In *Steinhardt Group, Inc. v. Citicorp*, the court found the limited partner "retained pervasive control over its investment in the limited partnership such that it cannot be deemed a passive investor" under the

36. Mayer v. Oil Field Sys. Corp., 721 F.2d 59, 65 (2d Cir. 1983).
37. *Id.*
38. *Id.*
39. Hirsch v. DuPont, 396 F.Supp. 1214, 1228 (S.D.N.Y. 1975).
40. *Id.*
41. *Id.*
42. Steinhardt Grp., Inc. v. Citicorp, 126 F.3d 144, 155 (3d Cir. 1997).

Howey test.[43] The limited partner owned a 98.79% interest in the limited partnership and retained proposal and approval rights.[44] The court thoroughly assessed the other limited partners' interests and roles in the partnership and found their involvement was nominal.[45] The limited partner had significant rights and powers and "directly affected the profits it received from the partnership."[46] Therefore, the court found the limited partnership units did not meet the *Howey* test and were not "investment contracts" because the profits were not being derived from the efforts of others.[47]

III. EXPOSITION OF THE CASE

In order to fully comprehend the analysis and implications of *Liberty Property Trust*, the facts of the case, majority opinion, and dissenting opinion must be discussed at length.

A. Facts of the Case and Procedural History

Liberty Property Trust involves a difficult and complex set of facts as several different transactions occurred over a period of time. Further, the majority's opinion explains the transactions with some inconsistencies that make the facts difficult to fully comprehend. The defendants were two real estate developers, Richard Kramer and Steven Grigg, who owned and controlled Republic Properties Corporation ("Corporation").[48] Kramer owned 85% of the Corporation while Grigg owned a minority share of 15%.[49] In January 2005, Kramer and Grigg joined fellow developer Mark Keller to form a REIT called the Republic Property Trust.[50] Later in the opinion, however, the Court states that the REIT was formed in December 2005, demonstrating an inconsistency in the facts.[51] In December 2005, before the REIT's initial public offering, the Republic Property Limited Partnership ("Partnership") was formed.[52] The REIT was the Partnership's

43. *Id.* at 145. *See also* Lino v. City Investing Co., 487 F.2d 689, 692–93 (3d Cir. 1973); SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476, 482 (9th Cir. 1973); Scholarship Counselors, Inc. v. Waddle, 507 S.W.2d 138 (Ky. 1974).
44. *Steinhardt Grp., Inc.,* 126 F.3d at 154.
45. *Id.* at 155.
46. *Id.*
47. *Id.*
48. Liberty Prop. Trust v. Republic Props. Corp., 577 F.3d 335, 336–37 (D.C. Cir. 2009).
49. *Id.* at 337.
50. *Id.*
51. *Id.*
52. *Id.*

sole general partner and owned approximately 88% of the Partnership.[53] This is a common practice as REITs connected with limited partnerships can take advantage of favorable tax treatment and are called Umbrella Partnership REITs or UPREITS.[54] The REIT was formed as a real estate investment trust to gain favorable tax treatment.[55] Kramer and Grigg were the main actors involved in the REIT.[56] Kramer was the chairman of the board of trustees while Grigg was vice chairman, president, and chief development officer.[57] The majority's opinion fails to indicate Keller's participation in the REIT.

In October 2004, prior to establishing the REIT and the Partnership, the Corporation entered into a Professional Services Agreement with the City of West Palm Beach to design, develop, and construct a mixed-use development valued at $100 million in West Palm Beach, Florida.[58] The agreement was made between the Corporation and the West Palm Beach Community Redevelopment Agency.[59] The agreement provided for the Corporation to "at all times conduct business in a reputable manner" and required that it "had not employed or retained any company or person . . . and ha[d] not agreed to pay any person, company, corporation, individual, or firm . . . any fee, commission, percentage, gift, or any other consideration contingent upon or resulting from the award of making of this Agreement."[60]

A month later, in November 2004, the Corporation hired the commissioner of West Palm Beach and member of the Community Redevelopment Agency, Raymond Liberti.[61] Liberti was hired as a consultant to help to obtain a contract for an undergraduate building and teaching hospital at Florida Atlantic University.[62] The Corporation began paying Liberti $5,000 per month and later increased his pay to $8,000 per month between November 15, 2004, and May 2006.[63] Liberti's consulting work was limited to projects that were not within the city limits of the City of West Palm Beach.[64] Liberti, however, voted to approve and amend the

53. *Id.*
54. *Id.*
55. *Id.*
56. *Id.*
57. *Id.*
58. *Id.*
59. *Id.*
60. *Id.*
61. *Id.*
62. *Id.*
63. *Id.*
64. *Id.*

Professional Services Agreement to benefit the Corporation as part of his membership on the Community Redevelopment Agency.[65]

In September 2005, the Corporation and the Partnership signed a "Contribution Agreement" where the Corporation sold its rights in the Professional Services Agreement to the Partnership in exchange for 100,234 units of the Partnership.[66] To summarize, the Corporation bought a portion of the Partnership, and the Partnership bought the Professional Services Agreement that had been entered into by the Corporation with West Palm Beach.

Later in December 2005, the Professional Services Agreement was amended at its closing, and the Corporation's rights to the Professional Services Agreement were transferred to "Republic WPB LLC . . . an indirectly wholly owned subsidiary" of the Partnership.[67] The *Liberty Property Trust* opinion does not expand on the Partnership's subsidiary.

Months later, on May 5, 2006, the United States Attorney for the Southern District of Florida charged Liberti with "accepting bribes and otherwise abusing his elected position" in connection with transactions that were not between either the Corporation or the REIT.[68] Liberti pled guilty to the charges.[69] After these events occurred, the City of West Palm Beach notified the Corporation that it intended to terminate the Professional Services Agreement.[70] Again, this displays an inconsistency in the opinion because by this time, the Corporation had sold its rights in the Professional Services Agreement to the Partnership. The opinion does not indicate why the city notified the Corporation and not the Partnership. The Partnership then entered into an "assignment agreement with mutual releases" and terminated the Professional Services Agreement, ceasing all involvement with the City of West Palm Beach project.[71]

Consequently, the Partnership brought nine causes of action, including securities fraud and state law infractions, against the Corporation claiming that the relationship between the Corporation and Liberti was "material information affecting the value of the Contribution Agreement."[72] The Partnership further alleged that the Corporation, Kramer, and Grigg "failed to disclose that relationship before assigning the Contribution Agreement" to the Partnership.[73]

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65. *Id.*
66. *Id.*
67. *Id.* at 338.
68. *Id.*
69. *Id.*
70. *Id.*
71. *Id.*
72. *Id.*
73. *Id.*

In the district court, the Corporation, Kramer and Grigg, filed a motion to dismiss the Partnership's claims under the Securities Exchange Act of 1934 and SEC Rule 10b-5 for failure to state a claim.[74] The district court granted the motion to dismiss and held that the limited partnership interests sold were not "investment contracts," and therefore, were not securities under the *Howey* test.[75] The Partnership then appealed to the United States Court of Appeals, District of Columbia Circuit.[76] A divided panel of the appellate court reversed the district court's order and found the limited partnership units were "securities" and remanded the case for further proceedings.[77]

B. The Majority Opinion

The main issue in the case was whether the units of the Partnership were "securities" under the definition in the Securities Exchange Act of 1934 and SEC Rule 10b-5.[78] The majority held that the Partnership units were "securities" under the Act and SEC rules, reversing the district court's grant of dismissal.[79] The majority also held that because the Partnership units were "securities" under the Act, the Partnership had standing to bring the suit.[80]

Because the issue was a matter of first impression in the District of Columbia Circuit, the majority looked to the Supreme Court's *Howey* test to determine whether the limited partnership units were "securities."[81] The definition of a "security" under the Act includes "investment contracts" along with other types of securities.[82] The majority was further guided by *Goodwin v. Elkins & Co.*, which stated "the *legal* rights and powers enjoyed by the investor" are the main focus in determining whether the limited partnership interests were "securities."[83] While the Corporation argued that the interests should not be securities because the same people were on both sides of the transaction and that Kramer and Grigg should not be liable for failing to disclose information to themselves, the Court disagreed.[84] The Corporation argued that the *Howey* test was "flexible" and

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74. *Id.*
75. *Id.*
76. *Id.*
77. *Id.*
78. *Id.*
79. *Id.*
80, *Id.* at 339.
81, *Id.*
82. *Id.*
83. Goodwin v. Elkins & Co., 730 F.2d 99, 107 (3d Cir. 1984).
84. *Liberty Prop. Trust*, 577 F.3d at 339.

that "emphasis should be on economic reality."[85] The Court reasoned that because defendants took advantage of the corporate form to buy the units, they cannot turn around and disregard the corporate structure to avoid liability in the same transaction.[86]

The Court further stated that even if they accepted the Corporation's arguments to disregard the corporate form, Kramer and Grigg did not have enough control of the Partnership to exclude the interests from being "securities."[87] The REIT had six trustees and ten executive officers, but Kramer and Grigg only had two votes on that panel of trustees.[88] Previously in the opinion, however, the Court stated that the REIT was owned only by Kramer, Grigg, and Keller.[89] The Court stated that even if they accepted the Partnership's structure at the time the "Contribution Agreement" was signed, Kramer and Grigg were only two out of the three votes.[90] Again, the opinion does not specify who held the third vote. It is never stated exactly how the Partnership was controlled, and the opinion only provided that the REIT controlled approximately 88% of the Partnership. The Court reasoned that regardless of whether Kramer and Grigg were then the majority players, the test in *Howey* only examines whether profits are expected to rise from the "efforts of others."[91] The Court reasoned that if Kramer and Grigg expected additional trustees to be added before the transaction was completed, then they "expected" the profits to come from the efforts of others.[92] Once again, however, the opinion fails to articulate any expectancy by Kramer and Grigg that additional trustees would be involved before the exchange was completed. It is unclear from the opinion where the notion of these additional votes or trustees came from. Without further explanation, the opinion concludes by simply stating, "disregarding the corporate form, Kramer and Grigg still appear to have been dealing in securities."[93]

C. The Dissenting Opinion

Senior Circuit Judge A. Raymond Randolph, author of the dissenting opinion, believed the district court was correct in holding that the

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85. *Id.*
86. *Id.*
87. *Id.* at 340–41.
88. *Id.*
89. *Id.* at 341.
90. *Id.*
91. SEC v. Life Partners Inc., 87 F.3d 536, 545 (D.C. Cir. 1996).
92. *Liberty Prop. Trust*, 577 F.3d at 341.
93. *Id.*

Partnership units were not securities under the Act.[94] Judge Randolph pointed out that while circuits are split in determining whether limited partnership interests should be recognized as "securities," the main factor to consider is "whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others."[95] Additionally, the test has now been extended from "solely" to "predominantly" from the efforts of others.[96] Judge Randolph noted that the deeply experienced securities law judge, Judge Henry Friendly, has stated that in determining whether an interest is a security, courts should not "attach decisive significance to mere legal formality . . . [and should] disregard form for substance placing emphasis upon economic reality."[97]

Here, Kramer and Grigg were the major players in the Partnership and there was even a provision in the Limited Partnership Agreement that stated "No Limited Partner (*other than any officer, director, or trustee of the General Partner*) shall take part in the operation, management, or control of the Partnership's business."[98] The dissenting opinion stated that the profits yielded by the Partnership "depended on the efforts of Kramer and Grigg," and Kramer and Grigg were the owners of the Corporation selling the Professional Services Agreement to the Partnership.[99] The dissenting opinion reasoned that the test in *Howey* was to further the purpose of the Act by ensuring that investors who rely on an entity's management will receive full and fair disclosure about the securities.[100] Judge Randolph stated that holding the limited partnership interests here as "securities" would completely disregard the main purpose of the Act.[101] Accordingly, Judge Randolph felt that to find the limited partnership units were "securities" would render the laws "senseless" and that the only justification the majority offered was to avoid "piercing the corporate veil."[102] The dissenting opinion respectfully disagreed and saw no reason why this concept applied.[103] Simply stated, "if the selling corporation is owned and managed by two individuals . . . and if those same individuals control and manage the entity investing in that corporation, the investor cannot be relying on the efforts of others' to make a profit."[104]

94. *Id.*
95. *Id.* at 342.
96. *Life Partners, Inc.*, 87 F.3d at 548.
97. S.E.C. v. Aqua-Sonic Prod. Corp., 687 F.2d 577, 584 (2d Cir. 1982).
98. *Liberty Prop. Trust*, 577 F.3d at 343.
99. *Id.*
100. *Id.*
101. *Id.*
102. *Id.*
103. *Id.*
104. *Id.*

IV. ANALYSIS

The dissenting opinion in *Liberty Property Trust* was correct in its reasoning that the limited partnership units were *not* securities under the test announced in *SEC v. J. Howey Co.* Prior case law supports that the substance of the transaction is more important than the form of the entity. The majority opinion did not review the record in enough detail to determine the actual participation of the individuals involved in the Partnership. The Court incorrectly applied the *Howey* test by not looking further into the substance of the Partnership and determining who was actually involved in making decisions and operating the Partnership.

Further, if courts continue to apply the term "security" without respect to identifying the individuals who control the various entities, this will lead to every limited partnership interest, along with limited liability company interests, being considered as "securities" from the onset of the transaction and will increase federal securities regulation litigation. Neither Congress nor the SEC intended for a limited partnership interest to be a "security" when enacting the Securities Exchange Act of 1934 and the subsequent SEC Rule 10b-5. Given the present struggling economy, holding limited partnership interests as "securities" could lead to numerous lawsuits being filed under the federal regulation when they could be properly litigated in other less expensive, state forums. Holding that a limited partnership interest is not a "security" is not the same as saying the buyer has no available remedy. Buyers can still seek recourse by filing state law fraud claims, and buyers may have adequate remedies even if the interest is not determined a "security."

A. Substance Reigns Over Form When Determining if an Interest is a "Security"

In determining if an interest is a security, there are several elements to consider aside from the legal form of the entity. The actual substance of the interest should be reviewed in-depth, and the mere form should be ignored. Further, the "economic reality" of the entity and the individuals in control must be considered as well. Finally, a court must review which individuals had control of the investment during the transaction.

1. Substance of the Entity Can Defeat Form

The Supreme Court held in *United Housing Foundation v. Forman* that shares of stock allowing purchasers to lease apartments in a state

subsidized and supervised nonprofit housing cooperative were not "securities" within the meaning of the Act.[105] The Court articulated that in determining the meaning of a "security" *form should be disregarded for substance* and the analysis should be based on *economic reality*.[106] The Court noted that when applying the Act, the background must be considered to determine the purpose of the Act.[107] The Court used a traditional canon of statutory construction that "a thing may be within the letter of the statute and yet not within the statute, because not within its spirit nor within the intention of its makers" to interpret the Act.[108] Even though the term "stock" was listed in the statue, the economic reality and substance of the transaction did not make the stock a "security" in the case because it would have gone against the intent of Congress to hold it as one.

The present case involved a limited partnership, a REIT, and a corporation. The majority merely looked at the form of the entities, and saw three separate organizations engaging in multiple transactions. The Court found the interests in the entities were "securities" because, in the transaction, the Partnership and Corporation exchanged interests between two forms of legal entities. Nevertheless, such a simple analysis is ill-founded. If a court establishes its reasoning in this simplistic manner, it would go against prior Supreme Court precedent as stated in *United Housing Foundation*.

2. The "Economic Reality" of the Entity Must Also be Considered

Additionally, in *Landreth Timber Co. v. Landreth*, the Supreme Court stated that simply labeling an interest as a "security" is not sufficient to determine its status as a "security."[109] Instead, courts must determine "whether those instruments possess 'some of the significant characteristics typically associated with' stocks, recognizing that when an instrument is both called stock *and* bears stock's usual characteristics, a purchaser may justifiably assume that federal securities laws apply."[110] The Court illustrated that the legal form is not controlling but rather, the usual characteristics of the investment must also be considered.

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105. United Hous. Found., Inc. v. Forman, 421 U.S. 837 (1975).
106. *Id.* at 848 (emphasis added); *See* SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 483 n. 14 (5th Cir. 1974); Local 705, Int'l Bhd. of Teamsters v. Daniel, 439 U.S. 551 (1979); Tcherepnin v. Knight, 389 U.S. 332, 336 (1967); SEC v. W.J. Howey Co., 328 U.S. 293, 298 (1946).
107. *United Hous. Found.*, 421 U.S. 837 (1975).
108. Church of the Holy Trinity v. United States, 143 U.S. 457, 459 (1892).
109. Landreth Timber Co. v. Landreth, 471 U.S. 681, 686 (1985) (citing *United Hous. Found*., 421 U.S. at 850–51 (1975)).
110. *Landreth Timber Co.*, 471 U.S. at 687.

Further, the *Landreath* Court also discussed the importance of applying the "economic-reality" test in determining if an interest is a "security."[111] This requires looking beyond the form of an interest and looking further into the material substance and the realities of the situation.[112] This "economic-reality" test was "designed to determine whether a particular instrument is an investment contract, not whether it fits within any of the examples listed in statutory definition of a "security."[113] Therefore, the economic reality test must be used in the present situation where the interest does *not* fit within the examples enumerated in the statute.

Consequently, in deciding whether limited partnership interests are "securities," the Court should have analyzed the parties actually involved in the transactions. Kramer and Grigg were the only actors in the corporation and the main actors in the Partnership. The Court did not even discuss Keller's degree of involvement or his knowledge of the Professional Services Agreement. The reality of the situation is that there were no other parties involved that needed to rely upon disclosure. If both sides of the transaction had the same information, then there is no disclosure dispute.

Still, the majority merely looked at the two legal entities, the Partnership and the Corporation, and determined from this alone that the interests are "securities" because the parties cannot disregard the organizational forms. The majority stated that "having taken advantage of the corporate form to purchase the limited partnership units, the defendants may not disregard that form to avoid liability for the same transaction."[114] This type of reasoning is directly contrary to the Supreme Court's reasoning in *Landreth* and is, therefore, incorrect because it simply looks at the form—and not the economic realities—of the transaction, thereby ignoring who was actually participating in the transaction.

Further, the Court also stated that even if it did "disregard the corporate form," the reality was that Kramer and Grigg did not have enough control over the Partnership. First, the Court incorrectly stated the facts by stating it would disregard the "corporate" form when it should have been the "partnership" form. Second, the Court neither established, nor attempted to inquire about who else may have had control of the Partnership. At first, the Court stated the REIT comprised of Kramer, Grigg, and Keller held approximately 88% of the Partnership, but later said Kramer and Grigg only have two-sixths of the votes. This is a major discrepancy that goes to the crux of the issue to appropriately determine the

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111. *Id.*
112. *Id.*
113. *Id.*
114. Liberty Prop. Trust v. Republic Props. Corp., 577 F.3d 335, 340 (D.C. Cir. 2009).

economic reality of the transaction. There should have been further inquiry as to who was actually in control of the Partnership and who actually depended on the disclosure. The majority opinion never makes this point clear, which is important to the determination of the interest as a "security."

3. Considering Control Over the Investment

The present case is more analogous to *Steninhardt* where the limited partnership interests were found not to be "securities." Similar to *Steinhardt,* Kramer and Grigg retained pervasive control over the investment in the Partnership and were not passive investors as they held the majority (two-thirds) of the vote at the time the Contribution Agreement was signed. Kramer and Grigg had significant rights and powers that directly affected profits they received from the Partnership as the Limited Partnership Agreement even specified that no limited partner could be active in the management of the Partnership.

B. The Court Misconstrued Precedent by Failing to Correctly Apply the Term "Others"

The Court misapplied the *Howey* test in determining the limited partnership units were securities. Specifically, the majority failed to see that the profits of the limited partnership were *not* being derived from the "efforts of others." The issue here is whether "others" means simply a separate legal entity or individuals who actually *control* the legal entities involved. It is inappropriate for the majority opinion to disregard precedent, and the Court may have had an alternative option in resolving the issue.

1. Why the Term "Others" Refers to Individuals and Not to Entities

Legal entities are nothing more than a legal fiction in business organization law. Artificial legal entities cannot actually disclose information to others. It is the individuals who act as agents for the entities who must actually disclose the information by written or spoken words. Therefore, to determine if an entity has an obligation to disclose certain information, it would be absurd to conclude that Individual A, acting as an agent of an entity X, has a duty to disclose information to Individual A while acting as an agent of entity Y.

Here, it appears Kramer and Grigg were in charge of both the Corporation and the Partnership. It is impossible for the profits to have been derived from "others" as the parties were the same on both sides of the transaction. The disclosure at issue is the fact that Kramer and Grigg hired

Liberti as a consultant for the Corporation. For the Court to ask Kramer and Grigg to formally disclose to themselves the fact that they hired Liberti as a consultant would be irrational.[115] A clear reading of the *Howey* test determines that the interests did not involve separate individuals.

Also, in *Williamson v. Tucker*, the Fifth Circuit stated that an investor who has some type of control over the investment has not expected profit to be derived from the efforts of others "even if he has contracted with the vendor for the management of the property."[116] The court further stated "[i]t is not enough that partners in fact rely on others for the management of their investment; a partnership can be an investment contract only when the partners are so dependent on a particular manager that they cannot replace him or otherwise exercise ultimate control."[117] If an interest is to be deemed a "security," then the investor must show that "he was so dependent on the promoter or on a third party that he was in fact unable to exercise meaningful partnership powers."[118]

In the present case, the majority should be guided by *Williamson* to determine that limited partnership interests cannot possibly be "securities" because they are in no way expecting profits to be "derived from the efforts of others."[119] As the main players in the Partnership, Kramer and Grigg certainly were not depending on anyone besides themselves in purchasing the Professional Services Agreement, and as the owners of the Corporation, they were not depending on anyone besides themselves in the Partnership. As stated above, simply summarizing the transaction to appear as two separate parties is confusing because it is clear that Kramer and Grigg were involved on both sides of the transaction and knew the material information. Kramer and Grigg were not relying on anyone else in exercising their managerial judgment in the transaction. They were in control of the two entities, and it would, therefore, be absurd to hold the two liable for failing to disclose information to themselves.

2. *The Court Incorrectly Applied the Fourth Prong of the* Howey *Test*

The *Howey* test looks at "whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others."[120] This requires examining four matters in the case at hand. First, there was an investment scheme as the Partnership and

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115. *See* Polikoff v. Levy, 382 U.S. 903 (1965).
116. Williamson v. Tucker, 645 F.2d 404, 424 (5th Cir. 1981).
117. *Id.*
118. *Id.*
119. *Id.* at 423.
120. *See Williamson*, 645 F.2d at 404 (1981).

Corporation entered into business transactions together. Second, there was an investment of money by the Corporation to purchase the limited partnership interests. Third, the common enterprise was the limited partnership units, which became the focus on the transaction. At this point, it looks as though the limited partnership interests have met the first three factors of the *Howey* test. The crux of the test thus falls on the fourth and final factor to determine whether the interests were "securities."

However, the fourth factor clearly fails in the present case. The test states that profits are "to come solely from the efforts of others," and here, the only actors in charge of the transaction were Kramer and Grigg. The Corporation was compromised of only Kramer and Grigg. The REIT was controlled by Kramer, Grigg, and Keller. The Partnership was owned approximately 88% by the REIT, and the REIT was the Partnership's sole general partner. The majority's opinion fails to identify who held the remaining 12% interest in the Partnership. The Court here failed to review the record deeply enough to determine Keller's involvement and only refers to Keller's one other time in the opinion as "one other colleague." Also, the Court failed to determine his involvement in the entity and neglected to see if he were aware of the relationship with Liberti.

3. The Majority Cannot Disregard Controlling Precedent and Adopt Its Own Reasoning

The majority may have had reasonable arguments to conclude that "others" should be interpreted to mean simply a separate legal entity. Also, the majority may have had difficulty allowing individuals who choose a particular legal form of ownership to receive tax advantages by structuring transactions utilizing multiple entities to later come to court and ask a judge to ignore the legal form in order to avoid certain non-tax consequences when unexpected or unfortunate events occur. The majority may have felt that if people wish to utilize multiple entities to their advantage, then they must also take the consequences when it comes to liability for compliance with securities regulations. Nevertheless, the Court may not simply disregard Supreme Court precedent that holds the substance must be analyzed and that the profits must be derived from "others." Also, while multiple entities were utilized in the case at hand, there was no real difference in the management of the entities involved in the case. That is the complexity of the case. The bottom line is that one should not be held liable to disclose information to oneself, even if there are two separate entities by their legal definition.

4. An Alternative Resolution

Both the district court and appellate court of the District of Columbia Circuit debated the meaning of an "investment contract." Both courts failed, however, to look at the actual statements in question, given the interrelationship between the parties. The district court did not thoroughly review the complicated and intertwining relationships between the parties. The appellate court simply relied on the district court's review and did not address the relationships at all. If the Court took a more in-depth, detailed review of the record, there may not even be a need to debate the definition of the term "investment contract."

Therefore, the true issue of the case is reliance. The Court should have asked, "Who would have relied on these disclosures?" Because both sides of the transaction had the same information regarding the Corporation's relationship with Liberti, there can be no disclosure issue. The real issue is not whether the Court reached the right conclusion but whether it asked the right questions. In discussing the minor causation issue, the majority opinion even states that on remand the Court needs to determine the relationships between the entities on a more developed record. How is it possible for this Court to determine that the interests are "securities" with profits being derived from the efforts "of others" if it does not even have a developed record of the relationships between the entities? It is clear that the Court is not certain as to who was directly and indirectly involved in each entity at the time the alleged fraud occurred. While this is a complex set of facts, the Court was grossly inadequate in its determination of the facts or, at best, its articulation of the facts.

D. Expanding Regulation and the Definition of a "Security" Will Increase Litigation

Congress did not intend to allow every investment to be controlled by federal securities regulation. Expanding the term "security" allows more investments to adhere to federal regulation, which increases potential lawsuits in the federal forum when a state forum would be appropriate. Further, requiring disclosure for more investments may not serve the main goal of disclosure. Finally, the effect of holding a limited partnership interest as a "security" may impact similar interests such as limited liability company interests. This could potentially further increase the reach of securities regulation.

1. The Unwarranted Increase of Litigation in the Federal Forum

The purpose of the anti-fraud and disclosure provisions in the Act was to provide a basis for national litigation.[121] Traditional securities such as stocks and bonds are nationally marketed and traded, and thus the investors can be spread throughout the nation or even internationally.[122] In these traditional "securities" if fraud were to occur there would need to be one place where the dispute could be litigated in order to resolve the dispute in an efficient manner.[123]

On the other hand, when it comes to other interests such as limited partnership interests, it is more likely that the investors in the partnership are similarly located, and the interests are not marketed and traded on a large-scale, nationwide basis. Therefore, it is much less important that there be one nationwide forum in which disputes may be litigated. The Supreme Court also held in *Landreth* that "Congress did not intend by adopting federal securities laws to provide a comprehensive federal remedy for all fraud in the sale of securities."[124] While it may be convenient to have one forum in which the claims could be brought, the costs of the convenience outweigh the potential benefits of national regulation because expanding the required regulation to securities that Congress did not intend to protect would increase costs of disclosure. Although it is obvious that stricter regulation would be beneficial to potential investors, the costs of required regulation would be a barrier to the advantages. Because an interest is not defined as a "security" does not mean that buyers will not have an adequate remedy available to them in other venues. Buyers of interests will continue to have state fraud and non-disclosure rules to provide a proper remedy. These state-law remedies may be entirely adequate for limited partnership interests which are typically sold locally to a small group of investors, whereas an individual purchasing a large amount of an international stock will not likely have an adequate state-law remedy for fraud.

2. Increasing Disclosure Regulation is Not the Solution

Even highly regulated disclosure laws enacted by Congress such as the Truth in Lending Act (TILA) and the Real Estate Settlement Procedures

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121. Carol R. Goforth, *Why Limited Liability Company Membership Interests Should Not be Treated as Securities and Possible Steps to Encourage this Result*, 45 HASTINGS L.J.1223, 1271–72 (1994).
122. *Id.*
123. *Id.*
124. Landreth Timber Co. v. Landreth, 471 U.S. 681, 685 (1985).

Act (RESPA) in the mortgage industry have done little to curtail the current massive detriments to the mortgage industry from the collapse of the sub-prime mortgage market.[125] Indeed, even the drafters of TILA regulation were aware that disclosures were inadequate for most of the population.[126] Disclosure in securities law diminishes in effectiveness as complexity of the security increases.[127] Even if full disclosure is made, it can be insufficient if investors cannot fully comprehend what they purchased.[128] Disclosure alone may not fully fix the imbalance of information between two parties.[129] The mortgage industry has become so complex that current disclosure is inadequate and is demanding massive reform.[130]

Likewise, expanding the definition of a "security" to include limited partnerships will not increase the probative effects of disclosure but will, in fact, complicate them. As shown in the mortgage industry, many investors cannot even comprehend disclosures because they are not directly involved with the security—the mortgage—they have purchased and cannot understand the investment itself. Disclosure's effectiveness and value is fairly low despite intervention from the federal government. With limited partnerships, however, there are typically a small number of individuals involved who normally have detailed knowledge of the actual investment. Limited partnerships would not benefit from federal regulation requirements to provided detailed disclosures. Therefore, more regulation by stricter application of the term "security" will fail in providing the most effective way to protect potential investors from fraud due to the high costs that regulation carries.

3. The Effects on Other Business Entities

Additionally, newly created business entities may be included by broadening the term "security." There is already much debate as to how courts will treat limited liability companies, a hybrid of a limited partnership and a corporation, and whether those interests will be considered "securities." If the term "security" continues to be expanded, federal courts can expect to see increased security regulation litigation as the forum will become more inclusive.

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125. *See* Elizabeth Renuart & Diane E. Thompson, *The Truth, The Whole Truth, and Nothing but the Truth: Fulfilling the Promise of Truth in Lending,* 25 YALE J. ON REG. 181 (2008).
126. *Id.*
127. *See* Steven Schwarcz, *Disclosure's Failure in the Sub-prime Mortgage Crisis*, 2008 UTAH L. REV. 1109, 1121 (2008).
128. *Id.* at 1110.
129. *Id.*
130. *See* Patricia A. McCoy, *Rethinking Disclosure in a World of Risk-Based Pricing*, 44 HARV. J. ON LEGIS. 123, 150 (2007).

In the current recessionary economy, where not only have stocks crashed, but also entire markets such as the real estate sector, courts can expect securities fraud suits to be filed on an increasing basis with a more expansive definition of the term "security." If the definition is broadened, federal courts could potentially be flooded with increased security regulation litigation, even when Congress did not intend for such suits to be brought in federal court. Congress intended to define the term "security" in a broad manner, but did so in order to delegate to the SEC (a regulatory agency with an arguably better knowledge of securities) the application of terms and laws Congress enacted. Congress did not define the term broadly so that it could be applied broadly, allowing almost any type of interest to qualify as a "security" and allowing a fraud claim to be litigated at a federal level.

V. CONCLUSION

The majority was incorrect in holding the limited partnership interests were "securities" and allowing the plaintiffs to proceed in *Liberty Property Trust*. The Court failed to distinguish between the form of the entities involved and the actual substance of the businesses. Further, the Court incorrectly applied the *Howey* test, as the profits to be expected were not derived from the efforts of others. The same parties were present on both sides of the transaction and disclosure of the relationship with Liberti should not have been required because the parties already had knowledge of the information. Holding that the limited partnership interests at issue are "securities" only invites future litigation of limited partnership interests and other interests Congress did not intend to be covered, thereby increasing both the cost of both federal regulation and federal litigation. In conclusion, the limited partnership interests in *Liberty Property Trust* should not have been determined to be "securities."