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The Real Estate Investment Trust: State Law Problems

COMMENTS

THE REAL ESTATE INVESTMENT TRUST: STATE LAW PROBLEMS

I. INTRODUCTION

The real estate investment trust, by reason of a 1960 amendment to the Internal Revenue Code,[1] now receives conduit tax treatment, *i.e.*, it is not taxed at the entity level as is a corporation. Basically, the real estate investment trust is a Massachusetts or business trust which has complied with the rigid requirements of the federal tax law.[2]

The Massachusetts trust[3] has been subjected to varied tax treatment in the past. Early tax statutes treated associations and corporations alike.[4] A question arose as to whether such statutes required a business trust to be treated as an association. In *Crocker v. Malley*,[5] the Supreme Court held that trustees were not liable for taxes on dividends received. This decision involved the Income Tax Act of 1913 which imposed a corporate tax on associations[6] but exempted trustees and associations acting in a fiduciary capacity.[7] Subsequently, the Treasury Department construed *Crocker* to mean that a trust was not to be taxed as an association if the trustees were not subject to the beneficiaries' control.[8] The next decision of any significance, *Hecht v. Malley*,[9] questioned the validity of the *Crocker* rule and suggested an active conduct test. After this case, the Treasury Department amended its regulations to provide that a trust would be considered an association if the functions of the trustees were not limited to collecting rents, and if the trustees were really associated in the same manner as the directors of a corporation.[10] In 1935, in *Morrissey v. Commissioner*,[11] a "corporate attributes test" was promulgated. Under this rule, if a trust resembled a corporation, it was taxed as one.[12] After *Morrissey*, the business trust,

1. Int. Rev. Code of 1954, §§ 856-58.

2. For an excellent discussion of the tax aspects of real estate investment trusts see Lynn, Real Estate Investment Trusts: Problems and Prospects, 31 Fordham L. Rev. 73 (1962).

3. The Massachusetts trust has been called various names, e.g., "Business Trust," "Common-Law Trust," and "Joint Stock Company."

4. Income Tax Act of 1913, ch. 16, § 2, 38 Stat. 172 imposed a tax on "every corporation, joint stock company or association."

5. 249 U.S. 223 (1919).

6. Income Tax Act of 1913, ch. 16, § 2, 38 Stat. 172.

7. Income Tax Act of 1913, ch. 16, § 2, 38 Stat. 168.

8. See Morrissey v. Commissioner, 296 U.S. 344, 350-51 (1935).

9. 265 U.S. 144 (1924).

10. See IV-2 Cum. Bull. 7 (1925). See also discussion in Morrissey v. Commissioner, 296 U.S. 344, 353-54 (1935).

11. 296 U.S. 344 (1935).

12. "'Association' implies associates. It implies the entering into a joint enterprise . . . for the transaction of business." Id. at 356. The Court went on to say that "the inclusion of associations with corporations implies resemblance. . . ." Id. at 357. The features of a

at least for tax purposes, became an unfavorable entity and, therefore, was seldom used by real estate syndicates.[13] Today, the Real Estate Investment Trust Act removes, to some extent, the possibility of corporate tax treatment. This special tax consideration, however, is afforded only to those realty trusts which comply with certain requirements relating to organization,[14] transferability of shares,[15] assets,[16] activities[17] and management or control.[18] But mere compliance with these federal provisions does not guarantee, at the state level, the limited liability benefits ordinarily accorded to such trusts. Some states, in effect, do not permit the formation of realty trusts.[19] In others, while no statutory prohibitions exist, liability may be imposed upon the trustees and shareholder-beneficiaries. Accordingly, a Massachusetts court has held that an organization could be a trust for income tax purposes and yet, under the common law of the state, be treated as a partnership, with the attendant liabilities.[20] Finally, additional difficulties may result due to conflicts between various state securities regulations.

II. Formation

Montana,[21] North Dakota[22] and South Dakota[23] have statutes which are possibly too narrow in scope to permit the formation of a real estate investment trust. They allow real property to be held in trust only for certain enumerated purposes.[24] None of the purposes enumerated is broad enough to include a real estate investment trust. In fact, even foreign real estate investment trusts are precluded from holding property in these states, since the pertinent

corporation could be listed as: 1) Title in the entity; 2) Centralization of management; 3) Continuity of life; 4) Limitation of liability; 5) Free transferability of interest. Id. at 359.

13. See Janin, Tax Aspects of Real Estate Syndication, 14 Record of N.Y.C.B.A. 60, 61-62 (1959).

14. Int. Rev. Code of 1954, § 856(a).

15. Int. Rev. Code of 1954, §§ 856(a)(2), 856(a)(5).

16. Int. Rev. Code of 1954, §§ 856(c)(2)-(6).

17. Int. Rev. Code of 1954, §§ 856(a)(4), 856(c)(1).

18. Int. Rev. Code of 1954, §§ 856(a)(1); see also Int. Rev. Code of 1954, § 856(a)(6).

19. See notes 21-23 infra.

20. State St. Trust Co. v. Hall, 311 Mass. 299, 41 N.E.2d 30 (1942).

21. Mont. Rev. Codes Ann. § 86-105 (1947).

22. N.D. Cent. Code § 59-03-02 (1960).

23. S.D. Code § 59.0301 (1939).

24. E.g., the North Dakota statute provides: "Purposes for which express trusts created. —Express trusts may be created for any of the following purposes: 1. To sell real property and apply or dispose of the proceeds in accordance with the instrument creating the trust; 2. To mortgage or lease real property for the benefit of annuitants or other legatees or for the purpose of satisfying any charge thereon; 3. To receive the rents and profits of real property and pay or apply them to the use of any person, whether ascertained at the time of the creation of the trust or not, for himself or for his family during the life of such person or for any shorter term, subject to the rules of title 47, Property; or 4. To receive the rents and profits of real property and to accumulate the same for the purposes and within the limits prescribed by chapter 3 of title 47, Property." N.D. Cent. Code § 59-03-02 (1960).

statutes regulate the ownership of real property within the state and do not purport to regulate the trust as an entity.[25] Other states, as a matter of public policy, disfavor the trust as a form of doing business, thus making its use impractical. Since the passage of the Real Estate Investment Trust Act, however, several states have attempted to eliminate formation problems by passing enabling statutes.[26] In Texas, for example, investors in a trust formerly were not entitled to limited liability unless it had complied with the state corporation or limited partnership law.[27] This made it foolhardy, if not impossible, for a real estate investment trust to operate in that state. Earlier New York statutes, while recognizing business trusts and affording shareholders limited liability, were not broad enough to include realty trusts, and thus, amendment was necessary.[28] Washington, even before the Real Estate Investment Trust Act, passed what would today be called an enabling statute.[29] Prior to this enactment, its courts treated business trusts as irregularly formed corporations and, hence, violative of the state constitution.[30] Even now, however, the constitutionality of this statute would appear to be questionable.[31]

III. Liability of Shareholders

The Real Estate Investment Trust Act requires that a realty trust be "managed by one or more trustees."[32] This provision was originally construed by the Treasury Department to mean that the trustees must have "absolute and exclusive control . . . free from any power of control on the part of its shareholders other than the right to elect trustees. . . ."[33] Under the original interpretation, the beneficiaries of a qualified real estate investment trust would necessarily enjoy the limited liability of corporate shareholders since it is an established rule in states which recognize business trusts that the liability of investors depends on the amount of control they exercise over the trust and trustees.[34] Thus, where investors possess excessive control, partnership liability

25. Ibid.

26. Cal. Corp. Code §§ 23000-03; Kan. Gen. Stat. Ann. §§ 17-2027 to -2033 (Supp. 1961); N.Y. Real Prop. Law § 96; Tenn. Code Ann. §§ 48-1801 to -1804 (Supp. 1962); Tex. Rev. Civ. Stat. art. 6138A (1962).

27. See Thompson v. Schmitt, 115 Tex. 53, 274 S.W. 554 (1925).

28. N.Y. Real Prop. Law § 96.

29. Wash. Rev. Code Ann. §§ 23.90.010 to .90.900 (1961).

30. See State ex rel. Colvin v. Paine, 137 Wash. 566, 243 Pac. 2 (1926); State ex rel. Range v. Hinkle, 126 Wash. 581, 219 Pac. 41 (1923).

31. See Note, 34 Wash. L. Rev. 305, 306 (1959) and cases cited therein; see also, Committee on Partnerships and Unincorporated Business Associations, ABA Report on Real Estate Investment Trusts, 16 Bus. Law. 900, 904 (1961) [hereinafter cited as ABA Report].

32. Int. Rev. Code 1954, § 856(a)(1).

33. Proposed Treas. Reg. § 1.856-1(d)(1), 26 Fed. Reg. 604 (1961).

34. See Williams v. Inhabitants of Milton, 215 Mass. 1, 102 N.E. 355 (1913), where the so-called control test is fully discussed. This case did not deal directly with the liability of shareholders to creditors, but was a taxation case. The court, however, said: "The right to tax property as trust or as partnership property depends upon what the character of the property taxed really is." Id. at 6, 102 N.E. at 356.

arises.[35] However, to meet objections by state securities commissioners that the granting of absolute control to the trustees denied adequate protection to shareholders and invited fraud,[36] the treasury regulation, as finally promulgated, states:

> The term trustee means a person who holds legal title to the property of the real estate investment trust. . . . [T]he trustee must have continuing exclusive authority over the management of the trust, the conduct of its affairs, and the management and disposition of the trust property. For example, such authority will be considered to exist even though the trust instrument grants to the shareholders *any or all* of the following rights and powers: To elect or remove trustees, to terminate the trust; and to ratify amendments to the trust instrument proposed by the trustees. . . .[37]

Inherent in this provision is the danger that the control powers granted to the beneficiaries might be deemed excessive under state law. What constitutes excessive control? It is safe to say that investors, unless of course they have contracted with their creditors against the imposition of liability, cannot retain the power to direct trustees in the details of management. The majority of states, applying the "control test," hold that a true trust frees the beneficiaries from individual liability,[38] while a partnership does not.[39] This test was formulated by a Massachusetts court thus:

> A declaration of trust or other instrument providing for the holding of property by trustees for the benefit of the owners of assignable certificates representing the beneficial interest in the property may create a trust or it may create a partnership. Whether it is one or the other depends upon the way in which the trustees are to conduct the affairs committed to their charge. If they act as principals and are free from the control of the certificate holders, a trust is created. . . .[40]

It is axiomatic that the nature of a business trust will be determined by the terms of the trust instrument, for normally this agreement will give an accurate reflection of the rights and duties of all concerned.[41] Control by the shareholders

35. See, e.g., Betts v. Hackathorn, 159 Ark. 621, 252 S.W. 602 (1923); Goldwater v. Oltman, 210 Cal. 408, 292 Pac. 624 (1930); Schumann-Heink v. Folsom, 328 Ill. 321, 159 N.E. 250 (1927); Rossman v. Marsh, 287 Mich. 580, 283 N.W. 696, aff'd on rehearing, 287 Mich. 720, 286 N.W. 83 (1939); Darling v. Buddy, 318 Mo. 784, 1 S.W.2d 163 (1927); Rhode Island Hosp. Trust Co. v. Copeland, 39 R.I. 193, 98 Atl. 273 (1916).

36. See Sobieski, State Securities Regulation of Real Estate Investment Trusts—The Midwest Position, 48 Va. L. Rev. 1069 (1962).

37. Treas. Reg. § 1.856-1(d)(1) (1962).

38. See note 35 supra.

39. See, e.g., Bank of America Nat'l Trust & Sav. Ass'n v. Scully, 92 F.2d 97 (10th Cir. 1937); In re Conover, 295 Ill. App. 443, 14 N.E.2d 980 (1938); First Nat'l Bank v. Chartier, 305 Mass. 316, 25 N.E.2d 733 (1940); Brown v. Bedell, 263 N.Y. 177, 188 N.E. 641 (1934); Liquid Carbonic Co. v. Sullivan, 103 Okla. 78, 229 Pac. 561 (1924).

40. Frost v. Thompson, 219 Mass. 360, 365, 106 N.E. 1009, 1010 (1914). The control test, as such, was originally enunciated in Williams v. Inhabitants of Milton, 215 Mass. 1, 102 N.E. 355 (1913).

41. Koenig v. Johnson, 71 Cal. App. 2d 739, 163 P.2d 746 (Dist. Ct. App. 1945); Morriss v. Finkelstein, 127 S.W.2d 46 (Mo. App. 1939).

need not be actually exercised. It is enough that the power exists.[42]

Certainly where the trustees and beneficiaries are one and the same, the latter would be subject to liability regardless of the provisions in the trust instrument.[43] The mere power of the beneficiaries to hold meetings[44] or to demand occasional conferences[45] with the trustees to discuss the affairs of the trust will not, per se, make them liable. Nor does the appointment by the trustees of an advisory board from among the beneficiaries automatically impose liability provided, however, that the trustees retain actual control of the trust affairs.[46] The right of the beneficiaries (vested by the declaration of trust) to fix or control the minimum sale price of lots has also been found inconclusive.[47] However, this right, coupled with any additional supervisory or management powers, might be critical.[48] Correspondingly, where the declaration of trust provided for annual meetings of the beneficiaries and authorized them to join with the trustees in transacting trust business, to elect trustees annually, to amend the trust instrument, to terminate the trust, and to restrict the power of the trustees with respect to the issuance of additional shares under specified circumstances, the organization was held to be a partnership and not a trust.[49]

In general, "passive" privileges given to the beneficiaries have been found not to conflict with the trustees' control. But what of the power to elect trustees at stated intervals and the power to fill vacancies?[50] *Levy v. Nellis*,[51] a leading Illinois case, held that the ability to elect trustees, even where coupled with additional powers,[52] did not impose personal liability on the investors. *Rhode*

42. Simson v. Klipstein, 262 Fed. 823 (D.N.J. 1920); In re Associated Trust, 222 Fed. 1012 (D. Mass. 1914).

43. Enochs & Flowers, Ltd. v. Roell, 170 Miss. 44, 154 So. 299 (1934). Where the shareholders and trustees are not identical, of course, a number of other factors would have to be considered as to whether or not a true trust existed.

44. Levy v. Nellis, 284 Ill. App. 228, 1 N.E.2d 251 (1936); Rhode Island Hosp. Trust Co. v. Copeland, 39 R.I. 193, 98 Atl. 273 (1916).

45. Greco v. Hubbard, 252 Mass. 37, 147 N.E. 272 (1925).

46. Krey Packing Co. v. Hitchings, 18 S.W.2d 123 (Mo. App. 1929).

47. Rossman v. Marsh, 287 Mich. 580, 283 N.W. 696, aff'd on rehearing, 287 Mich. 720, 286 N.W. 83 (1939).

48. Bank of America Nat'l Trust & Sav. Ass'n v. Scully, 92 F.2d 97 (10th Cir. 1937).

49. Liquid Carbonic Co. v. Sullivan, 103 Okla. 78, 229 Pac. 561 (1924); Marchulonis v. Adams, 97 W. Va. 517, 125 S.E. 340 (1924).

50. E.g., such vacancies resulting from death, expiration of their term of office, or their resignation. See Gutelius v. Stanbon, 39 F.2d 621 (D. Fla. 1929); Levy v. Nellis, 284 Ill. App. 228, 1 N.E.2d 251 (1936); Hamilton v. Young, 116 Kan. 128, 225 Pac. 1045 (1924); Home Lumber Co. v. Hopkins, 107 Kan. 153, 190 Pac. 601 (1920); ABA Report, 16 Bus. Law. 900, 907-10 (1961); see also Magruder, The Position of Shareholders in Business Trusts, 23 Colum. L. Rev. 423, 436 (1923).

51. 284 Ill. App. 228, 1 N.E.2d 251 (1936).

52. Ibid. The trust instrument provided that in addition to the shareholders' power of election, the trustees had a five year term of office with the right to fill any vacancy for the unexpired term. The shareholders also had the power to amend the trust instrument by a two-thirds vote and to hold regular and special meetings.

Island Hosp. Trust Co. v. Copeland[53] reached the same conclusion in a case where the shareholders had the power to amend the trust instrument, to remove and replace trustees by majority vote, to call shareholders' meetings and to terminate the business of the trust. There are, however, decisions to the contrary.[54]

Thus, in states which have not passed enabling statutes, it is not certain whether the shareholder powers permitted in the treasury regulations[55] and required by some state statutes will be considered excessive. On the other hand, where enabling statutes have been enacted, the control problem is minimized, especially where the statute has been constructed to conform to the Internal Revenue Code.[56]

A. *Effect of Nonliability Provisions*

A nonliability clause, quite commonly found in trust instruments,[57] usually provides: that the beneficiaries are not to be personally or individually liable for debts of the trust; that third persons dealing with the trustees shall look solely to the assets of the trust for satisfaction of their claims; and that every contract made by the trustees shall likewise contain a provision relieving the beneficiaries of personal liability.[58] Such a clause has been effective to preclude beneficiary liability even in jurisdictions where the beneficiaries would otherwise be liable under the control test or where the limited liability of business trusts would not otherwise be recognized.[59] In these states, nonliability provisions are not contrary to public policy,[60] but even so, the creditor must have knowledge of their existence.[61]

B. *Denial of Limited Liability for Reasons Other Than Control*

Arizona, in a leading case,[62] has held that business trusts operating in that state are nothing more than organizations seeking corporate benefits without

53. 39 R.I. 193, 98 Atl. 273 (1916).

54. See Goldwater v. Oltman, 210 Cal. 408, 292 Pac. 624 (1930); First Nat'l Bank v. Chartier, 305 Mass. 316, 25 N.E.2d 733 (1940); Neville v. Gifford, 242 Mass. 124, 136 N.E. 160 (1922) (the trustees here were also the shareholders). See also Liquid Carbonic Co. v. Sullivan, 103 Okla. 78, 229 Pac. 561 (1924).

55. Treas. Reg. § 1.856-1(d)(1) (1962).

56. See, e.g., Cal. Corp. Code §§ 23000-03.

57. For an example of such a form see Hemphill v. Orloff, 277 U.S. 537 (1928).

58. Hemphill v. Orloff, 277 U.S. 537 (1928); Betts v. Hackathorn, 159 Ark. 621, 252 S.W. 602 (1923); Krey Packing Co. v. Hitchings, 18 S.W.2d 123 (Mo. App. 1929).

59. Farmers' State Bank & Trust Co. v. Gorman Home Refinery, 3 S.W.2d 65 (Tex. Com. App. 1942); Shelton v. Montoya Oil & Gas Co., 292 S.W. 165 (Tex. Com. App. 1927).

60. Schumann-Heink v. Folsom, 328 Ill. 321, 159 N.E. 250 (1927); McCarthy v. Parker, 243 Mass. 465, 138 N.E. 8 (1923); Darling v. Buddy, 318 Mo. 784, 1 S.W.2d 163 (1927).

61. Hunter v. Winter, 268 Ill. App. 487 (1932); Ing v. Liberty Nat'l Bank, 216 Ky. 467, 287 S.W. 960 (1926); Graham Hotel Corp. v. Leader, 241 S.W. 700 (Tex. Civ. App. 1922); see also RFC v. Goldberg, 143 F.2d 752 (7th Cir.), cert. denied, 323 U.S. 770, rehearing denied, 323 U.S. 817 (1944).

62. Rubens v. Costello, 75 Ariz. 5, 251 P.2d 306 (1952); see also Reilly v. Clyne, 27 Ariz. 432, 234 Pac. 35 (1925).

incorporation and, therefore, should be treated as corporations which have failed to comply with the state corporation statute. Kansas[63] and Texas[64] likewise, prior to enacting enabling acts, required a business trust to comply with state corporation or limited partnership laws.[65] A similar problem may exist in Washington, where the constitutionality of the "enabling" act is doubtful.[66]

C. *Compliance With Enabling Acts and Possible Conflicts*

Some states, in accord with their public policy, insist that certain powers, greater than those permitted by the treasury regulations, be granted the shareholders of realty trusts. The Washington statute requires the trust to give beneficiaries the right to: call special meetings,[67] vote cumulatively,[68] remove directors,[69] *approve* sales, leases or exchanges of corporate assets,[70] *approve* mergers or consolidations,[71] and institute voluntary dissolutions.[72]

Certainly the right to call a special meeting or to vote cumulatively does not interfere with the trustee's power of control, but it is arguable that the investor's right to approve specified acts of the trustee does. Actually, however, the approval provisions of the Washington law are quite similar to the provision in the treasury regulations affording shareholders the right to ratify trust amendments proposed by the trustee. Although approval connotes agreement prior to execution and ratification agreement thereafter, both terms here are, in effect, synonymous in that they provide the beneficiaries with a passive rather than an active power of control, *i.e.*, in neither case can they initiate the act approved or ratified. Nevertheless, a situation can be foreseen where, because of arbitrary beneficiary action in refusing to approve a sale, the trustee might be severely hampered in performing his duties and would in fact be subject to shareholder control. Hence, a real estate investment trust should exercise care in transacting business in those states with beneficiary requirements similar to Washington's, for depending upon the interpretation given to these powers, compliance with the particular state provision could prove disastrous.

The California Enabling Act of 1961[73] authorized the formation of a real estate investment trust provided it complied with the provisions of the Internal Revenue Code,[74] hence making the possibility of conflict remote. However, the California securities law requires annual beneficiary meetings, limits

63. Kan. Gen. Stat. Ann. §§ 17-2027 to -2038 (Supp. 1961).
64. Tex. Rev. Civ. Stat. Ann. art. 6138A (1962).
65. Linn v. Houston, 123 Kan. 409, 255 Pac. 1105 (1927); Weber Engine Co. v. Alter, 120 Kan. 557, 245 Pac. 143 (1926); Thompson v. Schmitt, 115 Tex. 53, 274 S.W. 554 (1925).
66. See note 31 supra.
67. Wash. Rev. Code Ann. § 23.01.280 (1961).
68. Wash. Rev. Code Ann. § 23.01.290 (1961).
69. Wash. Rev. Code Ann. § 23.01.320 (1961).
70. Wash. Rev. Code Ann. § 23.01.390 (1961).
71. Wash. Rev. Code Ann. § 23.01.470 (1961).
72. Wash. Rev. Code Ann. § 23.01.530 (1961).
73. Cal. Corp. Code §§ 23000-03.
74. Cal. Corp. Code § 23000.

election of trustees to one year terms[75] and stipulates that trust records must be available for inspection by the shareholders.[76] How this affects the trust's status for tax purposes is undetermined. It would appear that the shareholder powers here are passive in nature and will not alter the trust's tax status.[77]

A section in the Texas statute provides that "the declaration of trust may be amended upon receipt of the affirmative vote of the holders of at least two-thirds (2/3) of the outstanding shares of the trust. . . ."[78] If by this language the Texas legislature intended to vest in shareholders the right to initiate amendments to the trust instrument, a serious conflict with the treasury regulations might arise. The tax status of the trust would be jeopardized, for the beneficiaries would possess an active control power.

New York, on the other hand, has taken perhaps the safest route by providing the beneficiaries only with the power to terminate the trust by a majority vote.[79] In other words, not only does the real estate investment trust face no control problem, but there is also no possibility of conflict with the treasury regulations.

In those states where there is presently a conflict, it would seem reasonable to assume that the situation will be ameliorated by future judicial decisions. However, until favorable decisions are rendered, a real estate investment trust will have to weigh the advisability of avoiding business in that state against altering its trust instrument to meet the more stringent state requirements, thereby risking loss of its favored tax status.

IV. Liability of Trustees

A. *Beneficiaries*

Whether or not a real estate investment trust is determined by a court to be a "trust or a partnership, the trustees are in a fiduciary relationship with the shareholders of the trust."[80] Therefore, the trustees must act in the interest of the trust's beneficiaries and not their own.[81] As a general rule, however, the trustee is not an insurer, but rather is liable only for the lack of ordinary care.[82]

75. Cal. Admin. Code tit. 10, § 549.6(e), 1 Blue Sky L. Rep. ¶ 8629-1. Note that this one provision is actually a combination of three rights: (a) the annual meeting, (b) the election of trustees, and (c) the term of office for trustees to be one year. The election of trustees is provided for in the regulations, whereas the other two are not. This section forms part of the California securities regulations.

76. Cal. Admin. Code tit. 10, § 549.6(g), 1 Blue Sky L. Rep. ¶ 8629-1.

77. See notes 67-72 supra and accompanying text.

78. Tex. Rev. Civ. Stat. Ann. art. 6138A, § 23 (1962). If the Texas legislature meant that the beneficiaries shall have a mere right to ratify amendments proposed by the trustees, there is no problem, since it would be completely in accord with the treasury regulations.

79. N.Y. Real Prop. Law § 42-d. This section also provides the trustees with a right of termination of the trust.

80. Haskell v. Patterson, 165 Ark. 65, 262 S.W. 1002 (1924); Culp v. Robey, 299 S.W. 846 (Tex. Com. App.), reversing 294 S.W. 647 (Tex. Civ. App. 1927).

81. Page v. Natural Gas & Fuel Co., 35 F.2d 462 (8th Cir. 1929).

82. R.C.L. Trusts §§ 130, 160 (1929).

B. *Third Parties*

It is a general rule in the law of trusts that trustees are personally liable[83] for both the contracts[84] and torts[85] of the enterprise, unless they have specifically contracted against such liability.[86] What constitutes "contracting against liability" is a problem on which courts have differed.[87] The inclusion of an express disclaimer clause in the contract will certainly accomplish this.[88] A mere oral stipulation, though the contract be in writing, also has been held sufficient to exempt the trustees from liability.[89] A disclaimer clause in the trust instrument alone, however, without a similar clause in the contract, may leave the trustees personally liable even where the contracting party is aware of it. For example, the clause in the trust instrument may provide that all trust contracts must contain a similar disclaimer.[90] At least one court has held that a promise not to hold the trustees personally liable need not always be express, but can be implied.[91] On the other hand, if the trust instrument does not obligate the trustees to provide a similar clause in their contracts, the trustee may very well be liable.[92] In this situation, however, where the third party is aware of the

83. To insure against personal loss it is usually necessary for trustees to obtain comprehensive liability insurance, since contracts designed to exempt them from liability are, because of the doctrine of respondeat superior, generally held to be violations of public policy. Fisheries Co. v. McCoy, 202 S.W. 343 (Tex. Civ. App. 1918). However, where the tortious act is not that of the trustee personally, he is entitled to reimbursement from the trust, Smith v. Rizzuto, 133 Neb. 655, 276 N.W. 406 (1937); In re Lathers, 137 Misc. 226, 243 N.Y. Supp. 366 (Surr. Ct. 1930); and, therefore, such insurance, although practical, may not be absolutely necessary.

84. See Taylor v. Davis, 110 U.S. 330 (1884); Betts v. Harkathorn, 159 Ark. 621, 252 S.W. 602 (1923); Goldwater v. Oltman, 210 Cal. 408, 292 Pac. 624 (1930); Review Printing & Stationery Co. v. McCoy, 276 Ill. App. 580 (1934); Darling v. Buddy, 318 Mo. 784, 1 S.W.2d 163 (1927).

85. Alphonso E. Bell Corp. v. Bell View Oil Syndicate, 46 Cal. App. 2d 684, 116 P.2d 786 (Dist. Ct. App. 1941); Piff v. Berresheim, 405 Ill. 617, 92 N.E.2d 113 (1950).

86. See notes 88-90 infra.

87. See, e.g., § 20 of the Uniform Negotiable Instruments Law which provides, that where it appears on the instrument that a duly authorized agent is acting in a representative capacity for a disclosed principal, the signer will not be liable on the instrument. Compliance with this section would relieve trustees from personal liability. Gutelius v. Stanbon, 39 F.2d 621 (D. Fla. 1930); Tebaldi Supply Co. v. Macmillan, 292 Mass. 384, 198 N.E. 651 (1935); Pennsylvania Co. v. Wallace, 346 Pa. 532, 31 A.2d 71 (1943). A similar result might reasonably be anticipated in those states which have adopted the Uniform Commercial Code. ABA Report, 16 Bus. Law. 900, 911 (1961); see Uniform Commercial Code § 3-403.

88. See, e.g., Schumann-Heink v. Folsom, 328 Ill. 321, 159 N.E. 250 (1927); Hamilton v. Young, 116 Kan. 128, 225 Pac. 1045 (1924); Dunning v. Gibbs, 213 Ky. 81, 280 S.W. 483 (1926).

89. Taylor v. Davis, 110 U.S. 330 (1884).

90. Farmers' State Bank & Trust Co. v. Gorman Home Refinery, 3 S.W.2d 65 (Tex Com. App. 1928); Shelton v. Montoya Oil & Gas Co., 292 S.W. 165 (Tex. Civ. App. 1927).

91. Review Printing & Stationery Co. v. McCoy, 291 Ill. App. 524, 10 N.E.2d 506 (1937).

92. Larson v. Sylvester, 282 Mass. 352, 185 N.E. 44 (1933).

original disclaimer, the trustee will be exculpated.[93] At least two states, Pennsylvania[94] and Oklahoma,[95] have provided statutory exemptions from liability for trustees, unless the contracts specifically provide otherwise. Wisconsin[96] and Michigan[97] impose personal liability on the trustees merely for failure to comply with state filing, recording, and reporting requirements.

V. Securities Regulation

Financing the real estate investment trust will, for the most part, be accomplished by sales of securities, and, hence, the whole area of federal and state securities regulation must be considered.

A. *Securities Act of 1933*

There is no doubt that a share of, or beneficial interest in, a real estate investment trust is a security as defined in the Securities Act of 1933.[98] As early as 1935, it was held that a security includes a participating trust certificate.[99] Indeed, the Securities and Exchange Commission has assumed this. It has promulgated regulations specifically aimed at the real estate investment trust,[100] and has devised a special registration form for it.[101] The registration statement requires disclosure of all the pertinent facts concerning the proposed sale. A prospectus containing most of this same information must be distributed to each prospective buyer. In line with its philosophy of full disclosure, the 1933 act prescribes the content and form to be followed in the prospectus[102] and regulates the manner in which the security may be advertised.[103] Violators of the act

93. Goldwater v. Oltman, 210 Cal. 408, 292 Pac. 624 (1930).

94. Fiduciaries Act of 1949, Pa. Stat. Ann. tit. 20, §§ 320.101 to .1401 (1950).

95. Okla. Stat. Ann. tit. 60, § 174 (1949).

96. Wis. Stat. Ann. § 226.14(q) (1957). See also ABA Report, 16 Bus. Law. 900, 903 (1961) and especially note 20 supra and accompanying text.

97. Mich. Stat. Ann. § 21.87 (1948). This section was held to apply to business trusts in Nedeau v. United Petroleum, 251 Mich. 673, 232 N.W. 202 (1930).

98. "The term '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, preorganization certificate or subscription, 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 foregoing." 48 Stat. 74 (1933), as amended, 15 U.S.C. § 77b(1) (1958).

99. SEC v. Jones, 12 F. Supp. 210, 212 (S.D.N.Y.), aff'd, 79 F.2d 617 (2d Cir. 1935), rev'd on other grounds, 298 U.S. 1 (1936).

100. Proposed SEC Rule § 240.106-10, 27 Fed. Reg. 8280 (1962) (rule concerning redemptive securities).

101. Form S-11, 17 C.F.R. § 239.18 (Supp. 1962).

102. 48 Stat. 81 (1933), as amended, 15 U.S.C. § 77j (1958).

103. The term "prospectus" is given such a broad definition that it includes the common

are subject to both civil and penal liability. Jurisdiction of the Securities and Exchange Commission is based on use of the mails or other facility of interstate commerce.

It should be noted that the Securities and Exchange Commission does not favor "open end" real estate investment trusts.[104] Objection stems from the fact that an "open end" real estate investment trust could not have a realistic method of valuing certificates because the majority of its assets would not, in the strict sense, have a market value.[105] Accordingly, the Securities and Exchange Commission recently promulgated a proposed rule limiting the "open end" or redeemable certificate mechanism to those entities whose assets are composed of items which have a ready valuation.[106]

B. *Blue Sky Laws*

After complying with the Securities Act of 1933, the issuing promoters of the real estate investment trust face the task of "blue skying" the issue. Here, the problems are twofold—those applicable to any security issue, and those, by reason of special state regulations, peculiar to real estate investment trusts.

1. Generally

Most state blue sky laws have provisions relating to fraudulent practices. These provisions vary in detail, imposing both affirmative and negative obligations, and for the most part, prohibit fraudulent acts, deceptive practices, and material omissions.[107] Fraud is usually dealt with at three levels: the sale or

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form of advertisements. 48 Stat. 75 (1933), as amended, 15 U.S.C. § 77b(10) (1958). Thus advertisements are regulated because they are included within the definition of "prospectus."

104. "Indeed the first registration statement of a real estate investment trust filed with the SEC was an open-end trust. After considerable study and soul-searching the SEC tentatively decided that it will not clear an open-end trust primarily because there is no way in which a trust could adequately inform the investing public of the trust's limited ability to redeem shares upon demand." Williamson, The Real Estate Investment Trust Act, The Catalyst Which Is Making Real Estate "Go Public," 27 J. Property Management No. 2, at 74 (1961).

105. Ibid.

106. "It shall constitute a 'manipulative or deceptive device or contrivance' as used in section 10(b) of the Act [Securities Exchange Act of 1934] for any person in connection with the offering or sale of any equity security of any issuer to make any representation to the effect that—(a) the offering price of such security is based upon and varies with the current value of its proportionate share of the assets of the issuer represented by such security; or (b) such security is or will be redeemable at the option of the holder at a price which is based upon and varies with the current value of such proportionate share, unless substantially all of the assets of the issuer consist of cash, cash items and securities (other than mortgages and other liens on and interests in real estate) for which market quotations are readily available and which are readily marketable." SEC Rule § 240.10b-10, 27 Fed. Reg. 8280 (1962). "This matter has become of particular interest in connection with proposals by certain real estate investment companies to offer redeemable securities." Ibid.

107. See, e.g., Ariz. Rev. Stat. Ann. § 44-1991 (1956), 1 Blue Sky L. Rep. ¶ 6261; Conn. Gen. Stat. Ann. § 36-287 (1960), 1 Blue Sky L. Rep. ¶ 10124.

offer,[108] the registration statement,[109] and misrepresentations that registration of the security constitutes approval or endorsement of the issue by the particular state official charged with enforcing the applicable statute.[110] It is generally agreed, however, that enforcement of state blue sky laws is virtually impossible where the guilty party was never subject to the jurisdiction of a particular state.[111]

2. Specific Provisions in the Blue Sky Laws

The activities of those dealing with securities of real estate investment trusts have been thoroughly regulated by the various state securities commissioners. Whether or not the public needs the ample protection afforded by these regulations has been the subject of comment.[112] Perhaps this stringent attitude is based on the realty trust's similarity to the regulated investment company, which has been the subject of extensive regulation.[113] On the other hand, this attitude might merely be based on the fear that the real estate investment trust provides a fertile ground for unscrupulous promoters.[114] Whatever be the case, some sort of uniformity seems to be emerging as more and more states formally or informally adopt the policies enunciated by the Midwest Securities Commissioners' Association.[115]

3. Midwest Securities Commissioners' Association Statement of Policy

a. The Trust Structure

Under the Midwest regulations there must be a minimum of three trustees who can serve for not more than three years.[116] This term is not absolute, however, for the trust instrument must provide that a trustee can be removed by a two-thirds vote of the trust's outstanding beneficiaries.[117] Further, the trustees

108. See, e.g., Ala. Code tit. 53, § 28 (Supp. 1961), 1 Blue Sky L. Rep. ¶ 5201; Conn. Gen. Stat. Ann. § 36-287 (1960), 1 Blue Sky L. Rep. ¶ 10124; Ga. Code tit. 97, § 11 (1933), 1 Blue Sky L. Rep. ¶ 14111.

109. See, e.g., Ill. Ann. Stat. ch. 121½, § 137.12(E) (Smith-Hurd 1960), 1 Blue Sky L. Rep. ¶ 16212; Kan. Gen. Stat. Ann. § 17-1264 (Supp. 1959), 1 Blue Sky L. Rep. ¶ 19213.

110. See, e.g., Ariz. Rev. Stat. Ann. § 44-1993 (1956), 1 Blue Sky L. Rep. ¶ 6263; Ala. Code tit. 53, § 41 (Supp. 1961), 1 Blue Sky L. Rep. ¶ 5214; Ark. Stat. Ann. § 67-1251 (Supp. 1961), 1 Blue Sky L. Rep. ¶ 7117.

111. See 1 Loss, Securities Regulation 84-85 (2d ed. 1961).

112. See Sobieski, State Securities Regulation of Real Estate Investment Trusts—The Midwest Position, 48 Va. L. Rev. 1069, 1075 (1962); Armstrong, State Securities Regulation of Real Estate Investment Trusts—An Attorney's Viewpoint, 48 Va. L. Rev. 1082, 1103 (1962).

113. Investment Company Act of 1940, 54 Stat. 789, as amended, 15 U.S.C. §§ 80a-1 to -52 (Supp. III, 1959-1961).

114. See Sobieski, supra note 112, at 1075.

115. Revised Midwest Securities Commissioners Association Statement of Policy Regarding Real Estate Investment Trusts, Illinois Securities Division Bull., No. 101, § B(1)(a) (Supp., Oct. 27, 1961), 1 Blue Sky L. Rep. ¶ 4754 [hereinafter cited as Midwest Rules].

116. California requires that the trustees be elected annually. Cal. Admin. Code tit. 10, § 549.2, 1 Blue Sky L. Rep. ¶ 8629-1.

117. Midwest Rules § B(1)(d), 1 Blue Sky L. Rep. ¶ 4754.

cannot limit any liability arising by reason of bad faith, wilful malfeasance, gross negligence, or reckless disregard of duty.[118] The regulations also require that the trustees have absolute and exclusive control over the management of the trust and its property.[119] This provision seems paradoxical in light of the many restrictions placed on the trustees' power and the fact that they may be removed by a vote of the beneficiaries. Notwithstanding their right to absolute and exclusive control, the trustees are permitted initially only to enter into advisory contracts for a period up to three years. Moreover, such agreements must be terminable on sixty days notice and subsequent contracts may not exceed one year.[120] The expenses which the trustees may incur in promotion,[121] annual operations,[122] and purchasing real property[123] are also limited, while the compensation of investment advisors may not exceed one half of one per cent of the net value of the trust assets managed by the trustees.[124]

The regulations require that the investing policy of the trust be stated "with reasonable particularity."[125] Furthermore, disclaimers of liability must be placed in all of the trust's contracts and adequate liability insurance must be acquired.[126] Specified information is required to be made available to beneficiaries. This would be accomplished by annual reports,[127] annual meetings,[128] special meetings (called by a written request of twenty-five per cent of the beneficiaries),[129] and distribution statements disclosing the source of the funds allocated.[130]

The declaration of trust may not be amended except by a written consent of two-thirds of the beneficiaries.[131] This, however, does not apply to initiating amendments, but only to ratification of those made or initiated by the trustees. The trust can be terminated in the same fashion, *i.e.*, by written consent of two-thirds of the beneficiaries.[132] The beneficiaries are further protected from possible conflicts of interest on the part of the trustees, employees, advisors, or officers, in that the trust is prohibited from acquiring property from them, except in the formation process or immediately thereafter.[133] Finally, the trust must have a minimum capital of $100,000.[134]

118. Midwest Rules § B(1)(c), 1 Blue Sky L. Rep. ¶ 4754.
119. Midwest Rules § B(11), 1 Blue Sky L. Rep. ¶ 4754.
120. Ibid.
121. Midwest Rules § B(12)(a), 1 Blue Sky L. Rep. ¶ 4754.
122. Midwest Rules § B(12)(b), 1 Blue Sky L. Rep. ¶ 4754.
123. Ibid.
124. Ibid.
125. Midwest Rules § B(2), 1 Blue Sky L. Rep. ¶ 4754.
126. Midwest Rules § B(3), 1 Blue Sky L. Rep. ¶ 4754.
127. Midwest Rules § B(4), 1 Blue Sky L. Rep. ¶ 4754.
128. Midwest Rules § B(5), 1 Blue Sky L. Rep. ¶ 4754.
129. Midwest Rules § B(6), 1 Blue Sky L. Rep. ¶ 4754.
130. Midwest Rules § B(8), 1 Blue Sky L. Rep. ¶ 4754.
131. Midwest Rules § B(9), 1 Blue Sky L. Rep. ¶ 4754.
132. Midwest Rules § B(10), 1 Blue Sky L. Rep. ¶ 4754.
133. Midwest Rules § B(1)(b), 1 Blue Sky L. Rep. ¶ 4754.
134. Midwest Rules § C, 1 Blue Sky L. Rep. ¶ 4754.

b. Prohibited Activities

The Midwest Commissioners would also limit the investment activities of the trust in the manner that banks and insurance companies are regulated under investment laws. Investment in commodities is prohibited entirely,[135] while speculation in unimproved lands is prohibited to the extent that it exceeds five per cent of the value of the trust.[136] Investment in mortgages on unimproved land or with other than first priority is also curtailed.[137] The percentage allowable is governed by local law applicable to savings and loan associations.[138] The trust may not invest in real property which is already mortgaged, unless the mortgage is held by a bank or other institutional lender.[139] However, if the mortgage involved is a purchase money mortgage, the restriction does not apply.[140] The total encumbrance for property must not exceed two-thirds of its fair market value.[141] Investment in unsecured loans and short sales may not exceed eight per cent of the net value of the trust.[142] The trust may not trade[143] or underwrite the securities of others,[144] nor issue redeemable securities,[145] stock of more than one class,[146] warrants, or options.[147] In addition, it may not hold securities in any company or other real estate investment trust which is actively violating any of the Midwest regulations.[148] Finally, there is a saving clause to eliminate possible conflicts with the Internal Revenue Code.[149]

4. States With Regulations Other Than the Midwest Policy

Alabama has adopted regulations which are not as extensive as those of the Midwest policy.[150] There, the trust must have a stated capital and a specific number of shares available for sale.[151] This excludes the "open end" trust. A corporate trustee, once appointed, must be retained.[152] To protect shareholders, a surety bond, conditioned upon faithful application of the funds received from security sales and inuring to the benefit of the trust and trustees, must be obtained.[153]

135. Midwest Rules § B(14)(b), 1 Blue Sky L. Rep. ¶ 4754.
136. Midwest Rules § B(14)(a), 1 Blue Sky L. Rep. ¶ 4754.
137. Midwest Rules § B(14)(c), 1 Blue Sky L. Rep. ¶ 4754.
138. Ibid.
139. Midwest Rules § B(14)(e), 1 Blue Sky L. Rep. ¶ 4754.
140. Ibid.
141. Midwest Rules § B(14)(f), 1 Blue Sky L. Rep. ¶ 4754.
142. Ibid.
143. Midwest Rules § B(14)(h), 1 Blue Sky L. Rep. ¶ 4754.
144. Midwest Rules § B(14)(l), 1 Blue Sky L. Rep. ¶ 4754.
145. Midwest Rules § B(14)(j), 1 Blue Sky L. Rep. ¶ 4754.
146. Midwest Rules § B(14)(i), 1 Blue Sky L. Rep. ¶ 4754.
147. Midwest Rules § B(14)(m), 1 Blue Sky L. Rep. ¶ 4754.
148. Midwest Rules § B(14)(k), 1 Blue Sky L. Rep. ¶ 4754.
149. Midwest Rules § B(15), 1 Blue Sky L. Rep. ¶ 4754.
150. Alabama Sec. Comm'n, Rule 15, 1 Blue Sky L. Rep. ¶ 5625.
151. Alabama Sec. Comm'n, Rule 15 § 1, 1 Blue Sky L. Rep. ¶ 5625.
152. Alabama Sec. Comm'n, Rule 15 § 2, 1 Blue Sky L. Rep. ¶ 5625.
153. Alabama Sec. Comm'n, Rule 15 § 3, 1 Blue Sky L. Rep. ¶ 5625.

The trust manager is held to the same degree of accountability as the trustees and he may not accept bonuses from third persons, nor gain, directly or indirectly, from trust contracts.[154] Any contract in which the trustee or trust manager has a private interest is conclusively deemed fraudulent, and is voidable at the election of any of the beneficiaries.[155] Furthermore, no transaction can be made with trusts or companies which have interlocking trustees, directors, or managers.[156] No commissions are allowed on the sale or exchange of securities or real estate in the same transaction.[157] All of the trust properties are required to be held in the name of the trustee[158] and the legal or equitable rights of the beneficiaries cannot be limited by any provision in the declaration of trust.[159] In addition, commissions or discounts on shares cannot exceed ten per cent.[160] To insure policing of these provisions, the books of the trust must be kept open for inspection by the beneficiaries.[161]

In Nebraska, the issuer must sign an agreement which provides in part that:

> No applicant receiving an authorization order [for the sale of securities] . . . shall declare or distribute a dividend of any kind or in any amount whatsoever until such a dividend has been actually earned and received by the applicant through the medium of net profits earned and received by the applicant from its business at the time such dividend is declared.[162]

It is, therefore, impossible to take advantage of accelerated depreciation to give the investor a tax-free return of capital, a result which may well discourage a company from registering its securities in Nebraska.

Several states follow the Midwest policy informally; that is to say, because state securities commissioners are given discretion to prohibit the sale of, or to attach conditions to, an issue,[163] they can impose the Midwest policy even in the absence of specific regulations. When a real estate investment trust seeks to sell its securities in such states, the securities commissioner can attach the condition that the issuer comply with the rules promulgated by the Midwest Commissioners.

The Midwest rules have been adopted or used as a guide even by states which are not members of the Midwest Association. A recent survey indicates that many states have specific regulations for the securities of a real estate investment trust, or that they have adopted part of the Midwest policy. Other

154. Alabama Sec. Comm'n, Rule 15 § 4(a), 1 Blue Sky L. Rep. ¶ 5625.
155. Alabama Sec. Comm'n, Rule 15 § 4(c), 1 Blue Sky L. Rep. ¶ 5625.
156. Alabama Sec. Comm'n, Rule 15 § 4(d), 1 Blue Sky L. Rep. ¶ 5625.
157. Alabama Sec. Comm'n, Rule 15 § 4(e), 1 Blue Sky L. Rep. ¶ 5625.
158. Alabama Sec. Comm'n, Rule 15 § 4(f), 1 Blue Sky L. Rep. ¶ 5625. This provision narrows the three possible ways of holding title to property as specified in the treasury regulations, i.e., title in the trust, trustee, or nominee. Treas. Reg. § 1.856-1(d)(1) (1962).
159. Alabama Sec. Comm'n, Rule 15 § 5, 1 Blue Sky L. Rep. ¶ 5625.
160. Alabama Sec. Comm'n, Rule 15 § 7, 1 Blue Sky L. Rep. ¶ 5625.
161. Alabama Sec. Comm'n, Rule 15 § 6, 1 Blue Sky L. Rep. ¶ 5625.
162. Neb. Rev. Stat. § 81-319 (Supp. 1962), 1 Blue Sky L. Rep. ¶ 30603.
163. See, e.g., Iowa Code Ann. § 502.7(9) (1946), 1 Blue Sky L. Rep. ¶ 18107.

states indicated that while they were studying the matter, they had not passed any specific regulations.[164] New Hampshire said that it refuses to qualify real estate investment trust securities.[165] In some of these states, since no rules appear either in the statutes or regulations, the only way to uncover a definite policy would seem to be by actual experience.

5. New York

In New York, before securities of a real estate investment trust can be sold, a statement must be filed with the Department of Law.[166] The Attorney General then has fifteen days in which to issue a letter stating that the issue has been filed, thereby making the statement effective.[167] Offers, advertisements and sales are prohibited prior to this letter. Dissemination of preliminary prospectuses and circulation of nonfirm offers are permitted, however, and in fact, are allowed even before an offering statement is filed.[168] In addition, all money raised must be held in a trust fund until it is actually used.[169] Since registration is only required of real estate securities, realty trusts receive careful scrutiny. In this connection, it has been observed that "several R.E.I.T.'s, which have survived the Midwest Rules and SEC, decided to stay out of New York after an initial conference with an examiner from the New York Attorney General's office."[170]

164. Six states have formal regulations governing the registration of real estate investment trusts: Alabama, 1 Blue Sky L. Rep. ¶ 5625; California, 1 Blue Sky L. Rep. ¶ 8629-1; Kansas, 1 Blue Sky L. Rep. ¶ 19612; Oklahoma, 2 Blue Sky L. Rep. ¶ 39632; Tennessee, 2 Blue Sky L. Rep. ¶ 45626.

Arkansas, Idaho, Illinois, Indiana, Iowa, Kentucky, Michigan, Minnesota, Missouri, Nebraska, New Mexico, North Dakota, Oregon, South Carolina, Vermont and Wisconsin have indicated either a formal adoption of the Midwest policy or an informal attempt to follow it. See Address by David Clurman, Special Assistant Attorney General of New York, to the Nat'l Ass'n of Real Estate Inv. Funds, May 25, 1962 at 16-22 [hereinafter cited as Address to the Nat'l Ass'n]. Florida and Texas follow part of the Midwest rules. Id. at 17, 21. "Maine has indicated that it has no special rules . . . but . . . it is working on the matter. . . ." Id. at 18. "New Hampshire . . . wrote . . . 'we do not qualify the securities of any real estate investment trust for sale. . . .'" Id. at 20. "Ohio . . . is reserving action in this area until they can observe what abuses or contingencies may arise." Ibid. "Virginia reported that it had no special rules . . . other than the requirement that the following legend appear in all prospectuses used in Virginia: 'This investment trust is not a corporation and, therefore, the holders of the shares may be liable for debts or other liabilities of the trust.'" Id. at 22. "Washington stated that it will not accept any filings of real estate investment trusts until such time as the legality or constitutionality of this matter has been settled. . . ." Ibid.

165. Id. at 20.

166. N.Y. Gen. Bus. Law § 352-e(a), 2 Blue Sky L. Rep. ¶ 35102-4.

167. N.Y. Gen. Bus. Law § 352-e(2), 2 Blue Sky L. Rep. ¶ 35102-4.

168. N.Y. Gen. Bus. Law § 352-e(1)(a), 2 Blue Sky L. Rep. ¶ 35102-4.

169. N.Y. Gen. Bus. Law § 352-h, 2 Blue Sky L. Rep. ¶ 35102-7.

170. Address to the Nat'l Ass'n at 5-6. "[M]ost of those R.E.I.T.s eventually had to come to New York, the financial capital of the world, to sell. But only after they made important disclosures and clarifications we thought were lacking." Id. at 6.

In placing emphasis on "full disclosure," rather than on the quality of the securities,[171] the New York approach is similar to that of the Securities and Exchange Commission. The adequacy and accuracy of the information disseminated is the primary concern. It is safe to say that if a trust is newly formed or its principals have little or no experience, that fact should appear in the prospectus.[172] It should also be stated that the investor will be relying solely on the ability of the trustees to invest the proceeds.[173] Factors such as limitations on voting rights, restrictions on the trustee in buying and selling and other areas of unusual risk should be clearly brought to the attention of the investor.[174] The investment policy should be clearly expressed and should, in fact, be that which the promoters are intending to pursue. In this connection, specific returns should not be promised where there are too many unpredictable conditions. Of course, where the property or properties are specified and they do have a record of prior earnings on which to base anticipated distributions, then the promise of a specified return is permissible.[175] The use of terms such as "tax free" should be avoided and it should be made clear to the investor that the tax treatment can be affected by changes in the tax law or in the treasury regulations.[176]

The amount of time the trustees are going to devote to their duties should be indicated.[177] Furthermore, if the trustees' salaries are in some way based on variable factors, it should be pointed out that in some instances they may have the power to increase their own compensation.[178] In addition to these registration requirements, New York, unlike other states, investigates the background of the trust's principals and has experts examine the property involved.[179]

6. Enforcement of Midwest and Quasi-Midwest Rules

It is to be noted that the Midwest Commissioners concentrated on the activity and the internal structure of the issuer, rather than sales of securities and the contemplated enforcement of blue sky laws, to insure full disclosure and eliminate deceptive practices. Where do the commissioners get such broad powers? Usually the state statutes give them the power to promulgate regulations and attach conditions to registration necessary to the enforcement of the

171. Id. at 5.

172. Id. at 6.

173. Ibid.

174. Id. at 6-7.

175. Id. at 9. "In this area, each offering circular must be judged on its own merits with respect to full disclosure and unwarranted use of imagination." Ibid.

176. Id. at 10-11.

177. Id. at 13.

178. E.g., "In the event . . . compensation is determined on the basis of total gross assets of the trust . . . the trustees can themselves increase their compensation by simply increasing the mortgage indebtedness of the trust. . . ." Ibid.

179. Id. at 15.

act.[180] What is necessary for enforcement would probably be resolved in favor of the commissioners. Such sweeping power, however, can easily be extended to regulate any form of business, provided that the business is seeking to register for permission to sell securities. The Midwest policy seems to contemplate achieving enforcement at the outset, with the sanction that if the trust does not comply with the securities provisions, it will not be permitted to sell. Consider the case where after permission has been granted and all the securities sold, the trust engages in prohibited activities by amending the trust instrument. What could be done to stop it? Could the trustees be enjoined? Would they be civilly liable? This would depend on the manner in which the commissioner treated the rules at the outset. If, for example, they were adopted as regulations, they would have the force and effect of legislation and, hence, the particular state statute must be examined to determine the consequences of violating the regulation.[181] If the rules were attached as conditions to registration, the same result would probably follow.[182] As a practical matter, however, enforcement of the securities regulation might be difficult where the trust, although within the jurisdiction of a particular state, is in fact operating in another state and, thus, is not physically present in the state in question.

VI. Conclusion

The Real Estate Investment Trust Act has been described as a "catalyst" to public holdings in real estate.[183] There are, as noted however, many problems at the state level involving formation, investors' and trustees' liability and securities regulation. The "catalyst," itself, if the Treasury formula be given precise application, may, instead of producing success for the realty trust, precipitate conditions which invite its abandonment.

180. See, e.g., Ala. Code tit. 53, § 29A (Supp. 1961), 1 Blue Sky L. Rep. ¶ 5202.

181. See, e.g., N.D. Cent. Code § 10-04-08.1 (Supp. 1961), 2 Blue Sky L. Rep. ¶ 37209.

182. See, e.g., Cal. Corp. Code § 26100, 1 Blue Sky L. Rep. ¶ 8391.

183. Williamson, The Real Estate Investment Trust Act, The Catalyst Which Is Making Real Estate "Go Public," 27 J. Property Management No. 2, at 68 (1961).