12-1-1975

Securities Regulation—Securities as Defined under Securities Act of 1933 and Securities Exchange Act of 1934—Shares of a State Financed and Supervised, Nonprofit Cooperative Housing Corporation Are Not Securities—United Housing Foundation, Inc. v. Forman, 95 S. Ct. 2051 (1975).

David J. Pasternak

Victor O. Tufford

SECURITIES REGULATION—"SECURITIES" AS DEFINED UNDER SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934—SHARES OF A STATE FINANCED AND SUPERVISED, NONPROFIT COOPERATIVE HOUSING CORPORATION ARE NOT "SECURITIES" — *United Housing Foundation, Inc. v. Forman*, 95 S. Ct. 2051 (1975).

Although the Securities Act of 1933[1] and the Securities Exchange Act of 1934[2] provide extensive definitions of the term "security,"[3] the courts still are endeavoring to determine the scope of that term.[4] In

1. 15 U.S.C. § 77a *et seq.* (1970), *as amended*, 15 U.S.C.A. § 77a *et seq.* (Supp. IV, 1975).

2. 15 U.S.C. § 78a *et seq.* (1970), *as amended*, 15 U.S.C.A. § 78a *et seq.* (Supp. IV, 1975).

3. The Securities Act of 1933 defines the term "security" as follows:

> When used in this subchapter, unless the context otherwise requires—
>
> (1) 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.

15 U.S.C. § 77b (1970).

The Securities Exchange Act of 1934 provides the following definition of the term "security":

> (a) When used in this chapter unless the context otherwise requires—
>
> . . . .
>
> (10) The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

15 U.S.C. § 78c (1970).

Although the two definitions of the term "security" contain some minor variations, the United States Supreme Court has observed that they are "virtually identical." Tcherepnin v. Knight, 389 U.S. 332, 336, 342 (1967). For purposes of the *Forman* decision, "the coverage of the two Acts may be considered the same." United Housing Foundation, Inc. v. Forman, 95 S. Ct. 2051, 2058 n.11 (1975).

4. *See, e.g.*, 1050 Tenants Corp v. Jakobson, 503 F.2d 1375 (2d Cir. 1974) (shares of stock in cooperative housing corporation held securities); Safeway Portland Employees' Fed. Credit Union v. C.H. Wagner & Co., 501 F.2d 1120 (9th Cir. 1974) (certificates of deposit purchased by credit union held securities); Bitter v. Hoby's Int'l, Inc., 498 F.2d 183 (9th Cir. 1974) (agreement for restaurant franchise held not a security); Lino v.

United Housing Foundation, Inc. v. Forman,[5] the United States Supreme Court was given its sixth opportunity to construe the definition of "security."[6] Although the Court again focused primarily upon the "investment contract" component of the security definition,[7] for the first time it failed to find a security in the transaction before it. Nevertheless, by its retention of the definition of "investment contract" as enunciated in *SEC v. W.J. Howey Co.*,[8] by its refusal to expand or alter the *Howey* definition,[9] and by its virtual rejection of the "literal approach"[10] to the concept of securities, the Court has offered some guidance to practitioners who must deal in this murky area.

The *Forman* suit was initiated by 57 shareholder-tenants[11] (respondents in the Supreme Court) of Co-Op City,[12] a state subsidized and supervised nonprofit[13] cooperative housing development.[14] The pet-

City Investing Co., 487 F.2d 689 (3d Cir. 1973) (franchise agreements held not securities); SEC v. Glenn W. Turner Ent., Inc., 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973) (pyramid sale of self-improvement courses held securities).

5. 95 S. Ct. 2051 (1975).

6. Hannan & Thomas, *The Importance of Economic Reality and Risk in Defining Federal Securities*, 25 HASTINGS L.J. 219 (1974) [hereinafter cited as Hannan & Thomas]. The issue was previously dealt with in Tcherepnin v. Knight, 389 U.S. 332 (1967); SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967); SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65 (1959); SEC v. W.J. Howey Co., 328 U.S. 293 (1946); SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943).

7. *See* note 3 *supra*.

8. 328 U.S. 293 (1946); *see* notes 41-71 and accompanying text *infra*.

9. *See* notes 47-60 and accompanying text *infra*.

10. *See* notes 28-40 and accompanying text *infra*.

11. "Respondents . . . sued in federal court on behalf of all 15,372 apartment owners, and derivatively on behalf of Riverbay, the owner and operator of Co-Op City, seeking upwards of $30 million in damages, forced rental reductions, and other 'appropriate' relief." 95 S. Ct. at 2056. *See also* note 15 *infra*.

12. Co-Op City, with approximately 50,000 residents residing in 35 high rise buildings and 236 townhouses, is the largest cooperative housing development in the United States. 95 S. Ct. at 2055; REAL ESTATE L. REP., July, 1975, at 1.

13. The Court stated:

> The project was organized, financed, and constructed under the New York State Private Housing Finance Law, commonly known as the Mitchell-Lama Act, enacted to ameliorate a perceived crisis in the availability of decent low-income urban housing. In order to encourage private developers to build low-cost cooperative housing, New York provides them with large long-term, low-interest mortgage loans and substantial tax exemptions. Receipt of such benefits is conditioned on a willingness to have the State review virtually every step in the development of the cooperative. See N.Y. Private Housing Finance Law §§ 11-37, *as amended*, (McKinney's Consol. Laws, c. 44B, Supp. 1974-75). The developer also must agree to operate the facility "on a nonprofit basis," *id.*, at § 11-a(2a), and he may lease apartments only to people whose incomes fall below a certain level and who have been approved by the State.

95 S. Ct. at 2055 (footnote omitted). For a discussion of the eligibility requirements, *see* note 18 *infra*.

14. There are three different forms of cooperative ownership: the trust form, the co-

itoners included the three corporations which were responsible for the construction, promotion and management of the development,[15] several directors of those corporations, the State of New York, and the State Private Housing Finance Agency. Respondents' complaint alleged violations of the fraud provisions of the Securities Act of 1933[16] and of the Securities Exchange Act of 1934.[17] Respondents' claims were based

---

ownership form, and the corporate form. *See generally* N. PENNEY & R. BROUDE, CASES AND MATERIALS ON LAND FINANCING, 113-14 (1970) [hereinafter cited as PENNEY & BROUDE]; 4A POWELL ON REAL PROPERTY, ¶¶ 633.1-33.4 (1974) [hereinafter cited as POWELL]; Castle, *Legal Phases of Co-operative Buildings*, 2 S. CAL. L. REV. 1 (1928); Note, *Co-operative Apartment Housing*, 61 HARV. L. REV. 1407 (1948). *Forman* involved the most common form of cooperative ownership, the corporate form:

> Under this plan a corporation is organized and the land is conveyed to it; then the corporation leases specific apartments to the tenant-stockholders of the corporation. The ownership of corporate shares confers no right of occupancy to an apartment. The execution of "a proprietary lease" from the owning corporation to the stockholder desiring to be a tenant is vital. Such a lease contains the usual clauses of ordinary apartment leases, but it is unique in that its obtaining and its continuance depend upon the lessee being the owner of a specified quantity of the shares of the owning corporation.

POWELL, *supra* ¶ 633.4, at 778 (footnotes omitted).

In contrast to the cooperative form of apartment ownership, a condominium owner possesses title in fee to his individual apartment unit as well as the undivided ownership as a tenant-in-common of the common areas. *See* PENNEY & BROUDE, *supra*, at 138; POWELL, *supra*, ¶ 633.1[2], at 768.

With respect to the investment contract formula, the distinction between the cooperative and condominium forms of ownership is relatively unimportant. *See, e.g., Report of the SEC Real Estate Advisory Committee*, [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,265 (Oct. 12, 1972) [hereinafter cited as *R.E.A.C.*]; REAL ESTATE L. REP., July, 1974, at 1. However, the distinction is crucial with respect to the "literal approach" test of securities. *See* note 29 and accompanying text *infra*.

The recent upsurge in cooperative and condominium home ownership has specifically presented the courts with the task of determining the circumstances under which such interests may be "securities." *See generally* Parness, *Stock in Cooperative Apartment Corporation as a Security Under Federal Securities Laws*, 9 REAL. PROP., PROBATE & TRUST J. 259, 260 (1974) [hereinafter cited as Parness]. The absence of clear guidelines has presented the real estate industry with a major problem: when must real estate projects register with the Securities and Exchange Commission? *See* Kuklin, *Government Regulation of Real Estate Securities—An Overview*, 9 REAL PROP., PROBATE & TRUST J. 11, 13 (1974) [hereinafter cited as Kuklin].

15. United Housing Foundation (UHF), a nonprofit membership corporation consisting of labor unions, housing cooperatives and civic groups, was established for the purpose of "aiding and encouraging" the creation of "adequate, safe and sanitary housing accommodations for wage earners and other persons of low and moderate income." 95 S. Ct. at 2055. Community Services, Inc. (CSI), a wholly owned subsidiary of UHF, was the general contractor and sales agent of Co-Op City. Riverbay Corporation (Riverbay), a nonprofit cooperative housing corporation, was formed by UHF for the purpose of owning and operating Co-Op City. For a discussion of corporate housing cooperatives, *see generally* note 14 *supra*.

16. 15 U.S.C. § 77q(a) (1970).

17. 15 U.S.C. § 78j(b) (1970); 17 C.F.R. § 240.10b-5 (1975). In addition to the

upon an Information Bulletin which had been disseminated by Riverbay, one of the petitioner corporations, in 1965, prior to the completion of the project. The purpose of the Bulletin was to induce eligible prospective tenants[18] to purchase shares of stock in Riverbay, thereby permitting the purchasers to occupy apartments in Co-Op City. For every eighteen shares of stock purchased at $25.00 per share, the shareholder acquired the right to occupy one room in the development.[19] In addition to the initial stock expenditure, each tenant was required to make a monthly rental payment which served to satisfy the project's underlying mortgage obligations and current operating expenses. The 1965 Information Bulletin estimated, on the basis of projected construction costs,[20] that the average monthly rental payment would be $23.02 per room. In fact, increased construction costs eventually resulted in an average monthly rental charge, as of July, 1974, of $39.68 per room.[21] These increased monthly rental obligations formed the basis of the fraud allegations in *Forman*. In addition, the *Forman*

---

fraud allegations under the securities acts, respondents charged that the New York State Financing Agency violated 42 U.S.C. § 1983 (1970), as well as presenting ten pendent state law claims. 95 S. Ct. at 2057.

18. "Eligibility is limited to families whose monthly income does not exceed six times the monthly rental charge (or for families of four or more, seven times the rental charge)." 95 S. Ct. at 2055 n.1, citing N.Y. PRIV. HOUS. FIN. LAW § 31(2)(a) (McKinney Supp. 1974-75).

19. The sole purpose of acquiring these shares is to enable the purchaser to occupy an apartment in Co-Op City; in effect, their purchase is a recoverable deposit on an apartment. The shares are explicitly tied to the apartment; they cannot be transferred to a nontenant; nor can they be pledged or encumbered; and they descend, along with the apartment, only to a surviving spouse. No voting rights attach to the shares as such: participation in the affairs of the cooperative appertains to the apartment, with the residents of each apartment being entitled to one vote irrespective of the number of shares owned.

95 S. Ct. at 2055.

Upon termination of occupancy a tenant shareholder is obligated to offer the stock to Riverbay at its initial selling price of $25.00 per share. Should Riverbay decline to repurchase the stock the sales price of the stock is limited to the initial purchase price plus a percentage of the portion of the mortgage which the tenant has paid off. In addition, the tenant is also restricted to selling only to an "eligible" purchaser. *See* N.Y. PRIV. HOUS. FIN. LAW § 31-a (McKinney Supp. 1974-75). *See also* note 18 *supra*.

20. The 1965 Information Bulletin estimated the total construction cost of the project to be $283,695,550. Of this total, $32,795,550 was to be obtained through the sale of the Riverbay stock to the tenants. A 40-year low-interest mortgage loan from the New York Private Housing Finance Agency was to provide the remaining $250,900,000. 95 S. Ct. at 2056.

21. Ultimately the construction loan was $125,000,000 more than the $250,900,000 estimate contained in the 1965 Bulletin. *Id.* The increased costs were allocated solely to the monthly rental charges, while the cost of Riverbay stock remained static. The increased monthly rental charges caused a corresponding increase in Co-Op City's income eligibility requirements. *Id.* at 2056 n.6; *see* note 18 *supra*.

respondents alleged that the petitioners failed to disclose several material facts to the prospective stock purchasers.[22]

Arguing that the shares of Riverbay stock were not securities within the context of the federal securities acts, the petitioners moved to dismiss the complaint for lack of federal jurisdiction. Commenting that "the question before this court is not whether the plaintiffs *should* be protected; rather . . . whether or not they *are* protected by the federal securities laws,"[23] District Judge Pierce granted petitioners' motion to dismiss. In so ruling, the District Court rejected the literal approach under which any instrument labeled stock is mechanically deemed a security within the ambit of the federal securities laws. Additionally, by stressing the nonprofit nature of the transaction, the court foreclosed the possibility of finding that the shares were securities through the application of the alternative approach of the *Howey* investment contract formula.

The United States Court of Appeals for the Second Circuit disagreed with the District Court on both issues and reversed.[24] Holding that stock certificates are securities, the Circuit Court explicitly adopted the literal approach.[25] In addition, noting that "[p]rofit . . . need not be realized only in capital appreciation,"[26] the court found that an expectation of profit existed in the immediate transaction, thus satisfying the *Howey* investment contract test.

The Supreme Court reversed the Second Circuit and dismissed respondents' complaint for lack of federal jurisdiction on the grounds that neither the literal test nor the investment contract test was fulfilled. Disagreeing with both facets of the majority opinion, Justice Brennan, in

---

22. Respondents maintained that the following material facts were omitted: (i) the original estimated cost had never been adhered to in any of the previous Mitchell-Lama projects sponsored by UHF and built by CSI; (ii) petitioners knew that the initial estimate would not be followed in the present project; (iii) CSI was a wholly owned subsidiary of UHF; (iv) CSI's net worth was so small that it could not have been legally held to complete the contract within the original estimated costs; (v) the State Housing Commissioner had waived his own rule regarding liquidity requirements in approving CSI as the contractor; and (vi) there was an additional undisclosed contract between CSI and Riverbay.
95 S. Ct. at 2056-57 n.7.

23. Forman v. Community Services, Inc., 366 F. Supp. 1117, 1125 (S.D.N.Y. 1973), *rev'd*, 500 F.2d 1246 (2d Cir. 1974), *rev'd sub nom.*, United Housing Foundation, Inc. v. Forman, 95 S. Ct. 2051 (1975).

24. Forman v. Community Services, Inc., 500 F.2d 1246 (2d Cir. 1974), *rev'd sub nom.*, United Housing Foundation, Inc. v. Forman, 95 S. Ct. 2051 (1975).

25. 500 F.2d at 1252.

26. *Id.* at 1254. *Compare* notes 47-60 and accompanying text *infra*.

his dissenting opinion,[27] argued for both the adoption of the literal approach and the expansion of the *Howey* investment contract doctrine.

I. THE LITERAL APPROACH

The literal approach classifies transactions as being subject to the federal securities laws solely upon the basis of the labels used by the offeror.[28] This approach is viable only in those transactions in which the offeror transfers interests which are expressly held out as stock or other forms of securities.[29]

The problem inherent in the literal approach is that it ignores com-

27. Justices Douglas and White joined in Justice Brennan's dissenting opinion. 95 S. Ct. at 2064.

28. "According to this approach the fact that 'stock' certificates are used in a 'stock' corporation is sufficient in itself to bring transactions in the 'stock' within the literal definition of the Acts." Forman v. Community Services, Inc., 500 F.2d 1246, 1252 (2d Cir. 1974), *rev'd sub nom.*, United Housing Foundation, Inc. v. Forman, 95 S. Ct. 2051 (1975), *quoting* R. JENNINGS & H. MARSH, SECURITIES REGULATION 299-300 (3d ed. 1972), wherein it is stated that "when a stock corporation is used, the securities acts literally apply . . . ." *See also* 1050 Tenants Corp. v. Jakobson, 503 F.2d 1375, 1377-78 (2d Cir. 1974). *Compare* Movielab, Inc. v. Berkey Photo, Inc., 321 F. Supp. 806 (S.D.N.Y. 1970), *aff'd*, 452 F.2d 662 (2d Cir. 1971); Milnarik v. M-S Commodities, Inc., 457 F.2d 274, 275-76 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972).

The statutory bases of this approach are the specific provisions in the Federal Securities Acts which state: "[T]he term 'security' means any . . . stock, . . . or in general, any instrument commonly known as a 'security' . . . ." 15 U.S.C. § 77b(1) (1970); 15 U.S.C. § 78c(a)(10) (1970); *see* note 3 *supra.*

Courts which had adopted the literal approach found support for its use in the United States Supreme Court decision in SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943), wherein the Court stated:

> In the Securities Act the term "security" was defined to include by name or description many documents in which there is a common trading for speculation or investment. Some, such as notes, bonds, *and stocks*, are pretty much standardized and the name alone carries a well settled meaning. Others are of more variable character and were necessarily designated by more descriptive terms, such as "transferable share," "investment contract," and "in general any interest or instrument commonly known as a security." . . . Instruments may be included within any of these definitions, as matter of law, if on their face they answer to the name or description.

Id. at 351 (emphasis added). *See* Forman v. Community Services, Inc., 500 F.2d 1246, 1252 (2d Cir. 1974), *rev'd sub nom.*, United Housing Foundation, Inc. v. Forman, 95 S. Ct. 2051 (1975); 1050 Tenants Corp. v. Jakobson, 365 F. Supp. 1171, 1174 (S.D.N.Y. 1973), *aff'd*, 503 F.2d 1375 (2d Cir. 1974); Movielab, Inc. v. Berkey Photo, Inc., 321 F. Supp. 806, 808-10 (S.D.N.Y. 1970), *aff'd*, 452 F.2d 662 (2d Cir. 1971); *cf.* United Housing Foundation, Inc. v. Forman, 95 S. Ct. at 2059.

29. Prior to *Forman*, the literal approach was always a viable possibility in transactions involving the corporate form of cooperative home ownership. This was true because stock is an indispensible element in corporate cooperatives. *See* POWELL, note 14 *supra*, ¶ 633.4, at 778. However, because of the absence of any interest labeled stock, the literal approach generally is not applicable to transactions involving the other three forms of cooperative and condominium ownership. *See generally* note 14 *supra.*

mercial reality by disregarding the substance of the particular transaction before it, and instead focuses upon the form in which that transaction has been framed.[30] Cases which have rejected the literal approach have detected this problem of exalting form over substance.[31] Such a test fails to recognize the Congressional intent behind the 1933 and 1934 Securities Acts. In passing these Acts, Congress intended to protect investors in all securities transactions, whatever the form, through registration and full disclosure.[32] These statutes delineated comprehensive lists of various forms of securities[33] in order to ensure coverage of every conceivable form of investment.[34] Since the list of securities defi-

30. *See* United Housing Foundation, Inc. v. Forman, 95 S. Ct. 2051, 2059 (1975); Tcherepnin v. Knight, 389 U.S. 332, 336 (1967).

31. 95 S. Ct. at 2059. *Compare* Milnarik v. M-S Commodities, Inc., 457 F.2d 274, 275-76 (7th Cir.), *cert. denied,* 409 U.S. 887 (1972).

32. H.R. REP. No. 85, 73d Cong., 1st Sess. 2-4 (1933). *See also* SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 352-53 (1943); Movielab, Inc. v. Berkey Photo, Inc., 321 F. Supp. 806, 808 (S.D.N.Y. 1970), *aff'd,* 452 F.2d 662 (2d Cir. 1971); Securities Act Release No. 5211, [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,446 (Nov. 30, 1971); Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation,* 24 OKLA. L. REV. 135, 138 (1971) [hereinafter cited as *Mainstream of Securities Regulation*]. Congress "define[d] the term 'security' in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security." H.R. REP. No. 85, *supra* at 11. Relying upon this Congressional intent, courts generally note that the remedial securities legislation "should be construed broadly to effectuate its purposes." Tcherepnin v. Knight, 389 U.S. 332, 336 (1967). *See also* United Housing Foundation, Inc. v. Forman, 95 S. Ct. 2051, 2067 (1975) (Brennan, J., dissenting); Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972); Superintendent of Insurance v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971); SEC v. Capital Gains Bureau, 375 U.S. 180, 195 (1963); 1050 Tenants Corp. v. Jakobson, 365 F. Supp. 1171, 1174 (S.D.N.Y. 1973), *aff'd,* 503 F.2d 1375 (2d Cir. 1974); Note, *Cooperative Housing Corporations and the Federal Securities Law,* 71 COLUM. L. REV. 118, 127 (1971) [hereinafter cited as *Cooperative Housing Corporations*].

While the *Forman* court acknowledged the above Congressional declaration, it held that the nonprofit Riverbay stock had none of the characteristics "that in our commercial world would fall within the ordinary concept of a security." H.R. REP. No. 85, *supra* at 11; United Housing Foundation, Inc. v. Forman, *supra* at 2060.

In contrast, the California Corporate Securities Law expresses a broader sweep than the Federal Securities Acts, and does more than merely protect investors. "The required [California] administrative review is undertaken for the purpose of determining whether . . . the proposed issuance of securities if 'fair, just, and equitable.'" Hoisington, *Condominiums and the Corporate Securities Law,* 14 HASTINGS L.J. 241, 243 (1963). California cases have uniformly adopted the substance over form approach. *See, e.g.,* People v. Davenport, 13 Cal. 2d 681, 91 P.2d 892 (1939); Oil Lease Service, Inc. v. W.H. Stephenson, 162 Cal. App. 2d 100, 107-08, 327 P.2d 628 (1958); People v. Yant, 26 Cal. App. 2d 725, 736, 80 P.2d 506, 511 (1938).

33. *See* note 3 *supra.*

34. Mofsky, *Some Comments on the Expanding Definition of "Security,"* 27 U. MIAMI L. REV. 395, 397 (1973) [hereinafter cited as Mofsky].

nitions in each of the Securities Acts is prefaced with the phrase "unless the context otherwise requires,"[35] the purpose of the list is not to emphasize the form, but rather the substance of the transaction.[36]

Although the *Forman* majority failed to accept the literal approach, the Court did clarify its status in current law,[37] setting out a specific criterion to be met in order for this test to apply. The literal approach is now viable only in those cases in which the plaintiff is able to prove a justifiable reliance upon the label given to the instrument purchased, and a reasonable belief, based on the label affixed, that the instrument was subject to the federal securities laws.[38] Thus, in future cases, application of the literal approach will depend upon the reasonableness of the plaintiff's reliance upon the label affixed to the interest acquired. The *Forman* Court proclaimed that the reasonableness of such reliance

---

35. Securities Act of 1933, 15 U.S.C. § 77b (1970); Securities Exchange Act of 1934, 15 U.S.C. § 78(a)(10) (1970); *see* note 3 *supra*. *See also* SEC v. Nat'l Sec., Inc., 393 U.S. 453, 466 (1969).

36. Most authorities in discussing the issue of "how to determine what is a security" have noted that the substance of the transaction predominates over its form. *See, e.g.*, Tcherepnin v. Knight, 389 U.S. 332, 336 (1967); SEC v. Universal Serv. Ass'n, 106 F.2d 232, 237 (7th Cir. 1939); L. LOSS, SECURITIES REGULATION 493 (2d ed. 1961). *See also* note 32 *supra*. Such a conclusion is in accordance with the observation of the United States Supreme Court in Church of the Holy Trinity v. United States, 143 U.S. 457, 459 (1892):

> [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 . . . . This is not the substitution of the will of the judge for that of the legislator, for frequently words of general meaning are used in a statute, words broad enough to include an act in question, and yet a consideration of the whole legislation, or of the circumstances surrounding its enactment, or of the absurd results which follow from giving such broad meaning to the words, makes it unreasonable to believe that the legislator intended to include the particular act.

37. Prior to *Forman*, the cases had exhibited judicial confusion as to the viability of the literal approach. *See, e.g.*, Milnarik v. M-S Commodities, Inc., 457 F.2d 274 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972); Avenue State Bank v. Tourtelot, 379 F. Supp. 250 (N.D. Ill. 1974); Forman v. Community Services, Inc., 366 F. Supp. 1117 S.D.N.Y. 1973), *rev'd*, 500 F.2d 1246 (2d Cir. 1974), *rev'd sub nom.*, United Housing Foundation, Inc. v. Forman, 95 S. Ct. 2051 (1975); 1050 Tenants Corp. v. Jakobson, 365 F. Supp. 1171 (S.D.N.Y. 1973), *aff'd*, 503 F.2d 1375 (2d Cir. 1974). This confusion may be traced to dicta in the Court's opinions. For example, in Tcherepnin v. Knight, 386 U.S. 332 (1967) (dicta), two conflicting principles are expounded. First, relying upon the Congressional intent, the Court noted that the definitions of "security" are to be broadly construed. *Id.* at 336. *See* note 32 *supra*. However, the *Tcherepnin* Court also stated that the substance of the transaction should prevail over its form and the emphasis should be on the economic reality. 386 U.S. at 336. As one court has recently stated, "each of [the preceding statements] suggest[s] a different resolution" to the determination of what is a security. Avenue State Bank v. Tourtelot, *supra* at 253.

38. 95 S. Ct. at 2059-60. *Compare* Davis v. Rio Rancho Estates, Inc., CCH FED. SEC. L. REP. ¶ 95,249, at 98,291 (S.D.N.Y. July 28, 1975), in which the District Court misconstrued the viability of the literal approach in the wake of *Forman*.

will be easier to prove if the instrument has many of the traditional characteristics normally attributed to a "stock" or "bond."[39] It should be noted that the practical effect of the *Forman* analysis is to diminish the usefulness of the literal approach, because an instrument with many of those characteristics probably satisfies one of the alternative "security" tests. Thus, if the presence of those common characteristics are the primary indicia of the reasonableness of one's reliance, the literal test will be satisfied only in those cases in which one of the other tests also is satisfied, thereby rendering the literal approach virtually meaningless.[40]

II. THE HOWEY INVESTMENT CONTRACT FORMULA[41]

In *SEC v. W.J. Howey Co.*,[42] the Supreme Court confronted the question of whether an offering of an orange grove parcel, together with a contract providing for the cultivation and marketing of the produce, constituted a "security" as defined by the federal securities acts. In holding that such interests were subject to the provisions of the federal securities laws, the Court formulated the investment contract test[43] which is currently applied:

---

39. 95 S. Ct. at 2060. The *Forman* Court observed that the Riverbay stock lacked many common attributes of stock. These included the right to receive "dividends contingent upon an apportionment of profits" (which the *Tcherepnin* Court declared to be the most common characteristic of stock, 389 U.S. at 339), common negotiability, the ability to be pledged or hypothecated, voting rights proportionate to the number of shares owned and the capability to appreciate in value. 95 S. Ct. at 2060.

40. Other tests, each based upon a separate listing contained within the statutory definition of the term security, are also available. Especially notable is the investment contract approach. *See* notes 42-71 and accompanying text *infra*.

41. The first statutory use of the term "investment contract" as a definition of "security" appeared in Minnesota. MINN. GEN. LAWS ch. 429, § 3 (1917). *See also* Mofsky, *supra* note 34, at 397. The first case to define the term was State v. Gopher Tire & Rubber Co., 177 N.W. 937 (Minn. 1920), in which the court defined investment contract as "[t]he placing of capital or laying out of money in a way intended to secure income or profit from its employment. . . ." *Id.* at 938.

While SEC v. W.J. Howey Co., 328 U.S. 293 (1946) established the current investment contract formula, SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943), the first Supreme Court case to use the investment contract concept, enumerated the principles which were later formulated into the *Howey* test. *Joiner* held that assignment in oil and gas leases were investment contracts within the sphere of the federal securities laws.

42. 328 U.S. 293 (1946).

43. In both *Howey* and *Joiner* the Court was called upon to determine whether a real property interest was a security. Hannan & Thomas, *supra* note 6, at 274; *see* note 41 *supra*. By emphasizing the investment contract qualities of the transactions in question, rather than distinguishing a real property interest from an investment contract, the Supreme Court, in these two landmark cases, held that a real property interest may be a security. *Cf.* State v. Hirsch, 131 N.E.2d 419 (Ohio 1956); Note, *Legal Characterization*

of the Individual's Interest in a Cooperative Apartment: Realty or Personalty, 73 COLUM. L. REV. 250 (1973) (arguing that a cooperative interest should be recognized as a distinct legal entity). While these two cases clearly established that a real property interest may be a security, recent courts have been pressed to determine *what* real property interests are securities. *See* note 4 *supra*.

The SEC has acknowledged that not all real property interests are securities. Paul Gonson, Associate General Counsel for the SEC (*see* Brief for SEC as Amicus Curiae, United Housing Foundation, Inc. v. Forman, 95 S. Ct. 2051 (1975)), assured the Court that the SEC was not contending that all multiple housing projects are subject to the securities laws, but that the SEC merely was asking the Court "not to diminish the scope of the securities laws." BNA SEC. REG. & L. REP. (No. 299) A-12 (April 23, 1975). Ray Garrett, Jr., Chairman of the SEC, recently has voiced a similar view:

> Interests in [real] property are not ordinarily securities. We have nothing to do with the normal buying and selling of interests in [real] property, and we don't want to have anything to do with it.

Address by Ray Garrett, Jr., San Diego Mortgage Bankers Ass'n, July 2, 1974, *cited in* Berman & Stone, *Federal Securities Law and the Sale of Condominiums, Homes, and Homesites*, 30 BUS. LAW. 411, 425 (1975) [hereinafter cited as Berman & Stone]. The reluctance of the SEC to regulate all real property transactions stems partially from its lack of expertise in real estate matters. Comment, *Condominium Regulation: Beyond Disclosure*, 123 U. PA. L. REV. 639, 653 (1975) [hereinafter cited as *Beyond Disclosure*]. *See also Cooperative Housing Corporations, supra* note 32, at 123-24.

The *Forman* majority noted what it deemed to be a conflict between the SEC's position in the *Forman* case and its prior statements regarding the applicability of the securities laws to condominium and cooperative developments. 95 S. Ct. at 2063 n.24. In Securities Act Release No. 5347, *supra*, at 82,539-40. The release added, however, ¶ 79,163 (Jan. 4, 1973), which adopted the recommendations of the SEC Real Estate Advisory Committee Report (*see* R.E.A.C., *supra* note 14) the SEC provided guidelines concerning the applicability of the federal securities acts to condominiums and other offerings of all types of real estate units which have similar characteristics. The SEC there listed three specific situations, in any one of which an offering would be viewed as an offering of a security:

> 1. The condominiums [or other type of similar real estate units], which any rental arrangement or other similar service, are offered and sold with emphasis on the economic benefits to the purchaser to be derived from the managerial efforts of the promoter, or a third party designated or arranged for the promoter, from rental of the units.
>
> 2. The offering of participation in a rental pool arrangement; and
>
> 3. The offering of a rental or similar arrangement whereby the purchaser must hold his unit available for rental for any part of the year, must use an exclusive rental agent or is otherwise materially restricted in his occupancy or rental of his unit.

Securities Act Release No. 5347, *supra* at 82,539-40. The release added, however,

> there may be situations, not referred to in this release, in which the offering of the [condominium type] interests constitutes an offering of securities. *Whether an offering of securities is involved necessarily depends on the facts and circumstances of each particular case.*

Id. 82,540 (emphasis added). In apparent disregard of the latter SEC statement, the *Forman* Court found an "unexplained contradiction in the Commission's position," thus enabling the Court to "accord no special weight to [the SEC's] views." 95 S. Ct. at 2064 n.24. *Compare* 1050 Tenants Corp. v. Jakobson, 365 F. Supp. 1171, 1174-75 (S.D.N.Y. 1973), *aff'd*, 503 F.2d 1375 (2d Cir. 1974).

The following no-action letters reflect the pre-*Forman* SEC position regarding the application of the investment contract doctrine to specific multi-unit developments: Sunriver Properties, Inc., [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,691

(Dec. 11, 1973) (condominiums with rental management program; salesmen not to initiate conversations regarding economic benefits, held not investment contracts); Culverhouse, Tomlinson, Mills, DeCarion & Anderson, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,612 (Oct. 5, 1973) (retirement condominium, no rental pool arrangement, realtors not to emphasize economic benefits, held not investment contracts); Tahoe Donner Ski Bowl Condominiums, [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,440 (July 18, 1973) (resort condominiums in which prospective purchasers were informed that they had the option to rent their condominiums through developer or other rental agents, resulted in no opinion because certain rental unit selection procedures were left to the discretion of the rental agent, and these procedures may determine the existence of an investment contract); Innisfree Corp., [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,398 (Apr. 5, 1973) (sale of twelve undivided interests in each resort condominium unit with each purchaser entitled to two two-week occupancy periods each year held not investment contracts); Surf Tides Condominiums, [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,686 (Jan. 7, 1972) (resort condominiums, realtors required not to mention to prospective purchasers the investment possibilities of units, held not to be investment contracts); Clemson Properties, Inc., [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,387 (Aug. 13, 1971) (sale of 222 residential condominium units, each of which included an interest in a corporation formed to enter into commercial leases of a portion of the project, held not to be investment contracts where the total estimated value of the project is some $11,750,000 and the estimated value of the portion to be commercially leased is only some $200,000).

Another indication of the SEC's stance toward the application of the federal securities laws to cooperative housing associations is Rule 235, 17 C.F.R. § 230.235 (1975), which exempts some cooperative housing associations from the Acts' registration requirements. *See generally Cooperative Housing Corporations, supra* note 32, at 135-37. The Rule 235 exemption, like other securities laws exemptions, merely obviates the necessity of registration. It does not exempt the transaction from the anti-fraud provisions contained in the federal securities acts. Forman v. Community Services, Inc., 366 F. Supp. 1117, 1132 n.44 (S.D.N.Y. 1973), *rev'd*, 500 F.2d 1246 (2d Cir. 1974), *rev'd sub nom.*, United Housing Foundation, Inc. v. Forman, 95 S. Ct. 2051 (1975); 15 U.S.C. § 77q(c) (1970). To be eligible for this exemption, the aggregate offering price of all the securities offered by the association may not exceed $300,000 during any twelve-month period. This figure is determined by the par value of the stock. *See, e.g.*, Summit House Tenants Corp., [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,611 (Jan. 6, 1972) (offering held exempt from registration under Rule 235 where aggregate offering price of securities was $4,279,293, and par value of all shares did not exceed $300,000); Lynbrook Gardens Tenants Corp., [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,146 (Apr. 27, 1971) (offering held exempt from registration under Rule 235 where aggregate offering price of securities was $1,768,300, and par value of all shares did not exceed $300,000). Thus, while a billion dollars worth of cooperatives may theoretically be sold, this exemption still might be available to the association's stock. *Securities and Real Estate: Where the Twain Meets, A Panel Discussion*, 2 SEC. REG. L.J. 48, 55 (1974). It is also stipulated that the cooperative association may not participate in any business other than that which "is incidental to the ownership, leasing, management or construction of such residential properties." 17 C.F.R. § 230.235(2)(b) (1975). For an analysis of the factors used in determining when such business is "incidental," see Rifkin & Borton, *SEC Registration of Real Estate Interests: An Overview*, 27 BUS. LAW. 649, 659 (1972). The *Forman* respondents argued that the Rule 235 exemption of eligible cooperative stock from the securities acts is an implicit recognition that such stock is normally securities within the purview of the federal acts. BNA SEC. REG. & L. REP. (No. 299) A-12 (Apr. 23, 1975). *See also* 1050 Tenants Corp. v. Jakobson, *supra*, at

> [A]n investment contract . . . means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party. . . .[44]

The *Forman* Court addressed itself solely to the concept of "profit" as enunciated in the *Howey* test, specifically focusing on the requirement that there be an expectation of profit solely[45] from the efforts of a promoter or a third party.[46]

1174. The Court in *Forman* apparently disposed of this argument through its rejection of the SEC's views because of contradictions found in the SEC's position. 95 S. Ct. at 2063-64 n.24.

44. 328 U.S. at 298-99. This *Howey* test has been criticized since its inception. *See id.* at 301, where Justice Frankfurter stated in dissent: " 'Investment contract' is not a term of art; it is a conception dependent upon the circumstances of a particular situation." Recent commentators have subjected the *Howey* formula to a heavy barrage of criticism, often including suggested alternative formulations of an investment contract definition. *See generally* Coffey, *The Economic Realities of a "Security": Is there a More Meaningful Formula?*, 18 W. RES. L. REV. 367 (1967) [hereinafter cited as Coffey]; *Mainstream of Securities Regulation, supra* note 32, at 174; Long, *Interpreting the Statutory Definition of a Security: Some Pragmatic Considerations*, 6 ST. MARY'S L.J. 96, 128 (1974) ("A security is the investment of money or money's worth including goods furnished and/or services performed in the risk capital of a venture with the expectation of some benefit to the investor where the investor has no direct control over the investment or policy decisions of the venture."). Criticism of *Howey* and the interpretation given to it by the courts, has not been limited to commentators, however. *See, e.g.*, SEC v. Glenn W. Turner Ent., 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973); State Comm'r of Securities v. Hawaii Market Center, Inc., 485 P.2d 105, 108-09 (Hawaii 1971).

45. In SEC v. Glenn W. Turner Ent., 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973), the Ninth Circuit Court of Appeals held that "the word 'solely' should not be read as a strict or literal limitation on the definition of an investment contract, but rather must be construed realistically, so as to include within the definition those schemes which involve in substance, if not form, securities." *Id.* at 482. The Supreme Court in *Forman*, noting the Ninth Circuit's interpretation of the word "solely," declined to express any view thereon. 95 S. Ct. at 2060 n.15. *See also* 1050 Tenants Corp. v. Jakobson, 503 F.2d 1375, 1378 n.5 (2d Cir. 1974), and the cases cited therein, in which the courts state that even if the shareholder-tenants of private cooperative housing corporations exercised "some small role in the management of the venture," the *Howey* reliance element still would be satisfied.

46. 95 S. Ct. at 2064-65 (Brennan, J., dissenting). The *Forman* courts did not find it necessary to examine the first element of the *Howey* test, investment in a common enterprise, because this factor is an inherent characteristic of the cooperative form of ownership. Forman v. Community Services, Inc., 366 F. Supp. 1117, 1128 (S.D.N.Y. 1973), *rev'd*, 500 F.2d 1246, 1253-54 (2d Cir. 1974), *rev'd sub nom.*, United Housing Foundation, Inc. v. Forman, 95 S. Ct. 2051, 2064-65 (1975) (Brennan, J., dissenting). *Compare* 1050 Tenants Corp. v. Jakobson, 365 F. Supp. 1171, 1175 (S.D.N.Y. 1973), *aff'd*, 503 F.2d 1375, 1378 (2d Cir. 1974). *See also* Happy Inv. Group v. Lakeworld Properties, Inc., 396 F. Supp. 175 (N.D. Cal. 1975).

Regarding the third element of the *Howey* test, reliance on the efforts of a third party, the *Forman* District Court, while noting that the satisfaction of this element might be

The courts applying the *Howey* test generally have recognized two modes of profit: (1) capital appreciation and (2) income from the investment.[47] Each of these modes stresses the existence of some form of tangible return to the investor. In *Forman*, the Court refused to expand the *Howey* concept of profits to include a return of strictly intangible benefits.

Because of the general requirement that any stock in Co-Op City be resold at its initial purchase price there was no possibility that the purchases in *Forman* could result in profit in the form of capital appreciation.[48] Presumably, in a case presenting a fact situation such as that found in *1050 Tenants Corp. v. Jakobson*,[49] in which there were no such restrictions on the sale of the cooperative stock, the Court would find the profit element to be satisfied.[50] However, the *Forman* majority opinion does not guarantee that such a result would follow.[51]

Relying upon the alternate mode of profit, the shareholder-tenants in *Forman* contended that three different types of income resulted from their investment. First, they argued that the tax deductions permitted for

questionable where the development is a small cooperative, observed that "it would be specious" to question the fulfillment of this element in the case of the huge Co-Op City Cooperative. 366 F. Supp. at 1128. The Second Circuit disposed of the issue simply by stating that this element of the *Howey* test definitely was established under the particular circumstances of the case before it. 500 F.2d at 1253-54. The Supreme Court, in emphasizing the absence of the profit element of the *Howey* test, did not find it necessary to expressly reach the issue of the absence or presence of the third element. *Compare* 1050 Tenants Corp. v. Jakobson, *supra*, in which the court found that the sale of shares of stock in a private cooperative housing corporation satisfied the *Howey* criteria. The District Court found the reliance element fulfilled by the following three factors: (1) the project's "sponsors had complete control over initial financial arrangements and the general guidelines under which the Corporation [continues to operate]"; (2) in the event of occurrence of certain contingencies (which did not here occur), the project's sponsors would be represented on the Board of Directors; and (3) the project's sponsors obligated "the Corporation to at least nine contracts, including one . . . which extended for three years past the time the shareholders were supposedly in complete control." *Id.* at 1176-77.

47. 95 S. Ct. at 2060.

48. *See* Forman v. Community Services, Inc., 366 F. Supp. 1117, 1129 (S.D.N.Y. 1973), *rev'd*, 500 F.2d 1246 (2d Cir. 1974), *rev'd sub nom.*, United Housing Foundation, Inc. v. Forman, 95 S. Ct. 2051 (1975). *See also* notes 13, 15 & 19 *supra*.

49. 365 F. Supp. 1171 (S.D.N.Y. 1973), *aff'd*, 503 F.2d 1375 (2d Cir. 1974).

50. In *1050 Tenants*, the District Court, distinguishing the *Forman* fact situation, held that there was a possibility of profit on the transfer of partially restricted shares. Even though the 1050 Tenants Corporation shares could not be severed from the lease and could not be transferred without the consent of the Corporation, the absence of any restrictions prohibiting the transfer of the shares at a price higher than that originally paid by the shareholder resulted in a possibility of profit realization. 365 F. Supp. at 1172, 1175.

51. *See* note 74 and accompanying text *infra*.

that portion of the monthly rental charge which applied to interest on the Co-Op City mortgage[52] constituted a return of income on the shareholders' investments. Noting that "[t]hese tax benefits are nothing more than that which is available to any homeowner who pays interest on his mortgage," the Court refused to hold that such tax deductions constitute income.[53]

The Court also refused to recognize that rental charges which were substantially below that which was charged for comparable housing constituted income on an investment, saying:

> The low rent derives from the substantial financial subsidies provided by the State of New York. This benefit cannot be liquidated into cash; nor does it result from the managerial efforts of others. In a real sense, it no more embodies the attributes of income or profit than do welfare benefits, food stamps or other governmental subsidies.[54]

The Court similarly rejected the respondents' third income contention, "the possibility of net income derived from the leasing by Co-Op City of commercial facilities, professional offices and parking spaces, and its operation of community washing machines,"[55] holding that these essential services were provided as a convenience for the tenants rather than as a means of producing income.[56]

---

52. *See* INT. REV. CODE OF 1954, § 216.

53. 95 S. Ct. at 2062. *Compare id.* at 2065 (Brennan, J., dissenting); 1050 Tenants Corp. v. Jakobson, 365 F. Supp. 1171, 1176 (S.D.N.Y. 1973), *aff'd*, 503 F.2d 1275, 1375 (2d Cir. 1974); Pine Grove Manor, Section No. 1, Inc. v. Director, Div. of Taxation, 171 A.2d 676, 685 (N.J. Super. 1961); Commonwealth v. 2101 Cooperative, Inc., 27 Pa. D. & C.2d 405, 414-20 (C.P. 1961), *aff'd*, 183 A.2d 325 (Pa. 1962).

The *Forman* majority opinion also stated that even if these tax deductions constituted profits, they would not fulfill the *Howey* requirements because they did not result from the efforts of third parties. 95 S. Ct. at 2062 n.19. *Compare id.* at 2065-66 (Brennan, J., dissenting).

54. 95 S. Ct. at 2062. *Compare id.* at 2065 (Brennan, J., dissenting); Forman v. Community Services, Inc., 500 F.2d 1246, 1254-55 (2d Cir. 1974), *rev'd sub nom.*, United Housing Foundation, Inc. v. Forman, 95 S. Ct. 2051 (1975); Pine Grove Manor, Section No. 1, Inc. v. Director, Div. of Taxation, 171 A.2d 676, 685 (N.J. Super. 1961); State *ex rel.* Troy v. Lumberman's Clinic, Inc., 58 P.2d 812, 816 (Wash. 1936), in which the court stated:

> Profit does not necessarily mean a direct return by way of dividends, interest, capital account, or salaries. A saving of expense which would otherwise necessarily be incurred is also a profit to the person benefited. If respondent renders to its incorporators or members or to businesses in which they are interested and in whose profits they share, a service at a cost lower than that which would otherwise be paid for such service, then respondent's operations result in a profit to its members.

See also Berman & Stone, *supra* note 43, at 422-24.

55. 95 S. Ct. at 2062.

56. *Id.* at 2062-63. *Compare id.* at 2065 (Brennan, J., dissenting); 1050 Tenants Corp. v. Jakobson, 365 F. Supp. 1171, 1176 (S.D.N.Y. 1973), *aff'd*, 503 F.2d 1375, 1378 (2d

In refusing to recognize any of these three items as income derived from an investment, the Court highlighted the distinction between a benefit and profit.[57] The Court viewed the preceding three items as benefits which resulted from the respondents' purchase of housing, a commodity.[58] In contrast, under the Court's analysis, profit stems from an investment. The *Forman* majority's initial determination that the respondents had failed to make an investment in the immediate transactions automatically foreclosed any finding of profit within the context of the *Howey* formula. While the majority could have extended the concept of profit to include the return of purely intangible benefits such as those present in *Forman*, it specifically refused to do so.[59] Herein lies the major distinction between the majority and dissenting *Forman* opinions. The majority perceived the transactions in question as solely the pur-

---

Cir. 1974); Pine Grove Manor, Section No. 1, Inc. v. Director, Div. of Taxation, 171 A.2d 676, 685-86 (N.J. Super. 1961); Commonwealth v. 2101 Cooperative, Inc., 27 Pa. D. & C.2d 405, 414-20 (C.P. 1961), *aff'd*, 183 A.2d 325 (Pa. 1962).

The *Forman* majority also relied upon two other factors in rejecting the respondent's argument: (1) the 1965 Information Bulletin did not mention the use of such income to offset rental costs; and (2) the lack of any proof that these services in fact returned a profit. 95 S. Ct. at 2062.

The Internal Revenue Code, which permits a cooperative housing corporation tenant stockholder to take the same tax deductions allowed an individual homeowner, conditions this right upon the corporation having at least 80% of its gross income derived from the tenant stockholders. INT. REV. CODE OF 1954 § 216(b)(1)(D). Because of this requirement, it is unlikely that any cooperative corporation would maintain commercial facilities from which it would derive a substantial portion of its gross income. Berman & Stone, *supra* note 43, at 423.

57. *Compare* Berman & Stone, *supra* note 43, at 422 (benefits are not profit), *with* Pine Grove Manor, Section No. 1, Inc. v. Director, Div. of Taxation, 171 A.2d 676, 685-86 (N.J. Super. 1961); Commonwealth v. 2101 Cooperative, Inc., 27 Pa. D. & C.2d 405, 414-20 (C.P. 1961), *aff'd*, 183 A.2d 325 (Pa. 1962); Coffey, *supra* note 44, at 403; and *Mainstream of Securities Regulation*, *supra* note 33, at 165-67 (all contending that benefit is profit). *See also* Miller, *Cooperative Apartments: Real Estate or Securities?*, 45 B.U.L. REV. 465, 496-97 (1965) [hereinafter cited as Miller].

In refusing to equate the concept of benefit with that of profit, the Supreme Court rejected the expansive interpretation which the Second Circuit had given to the *Howey* test. The Court thus has shielded against the following alarmist possibility:

> A misguided extension of the Second Circuit's broadly drawn and somewhat contorted reasoning with respect to the investment contract concept . . . could be advanced whereby the profit motivation required under *Howey* would be found whenever a purchaser has the possibility of anticipating any type of advantage from a particular purchase. Hence, an unwary court could be prevailed upon to rule that the second circuit decisions support an interpretation of *Howey* which covers virtually any real estate unit sale, for practically every purchase of a real estate unit involves an anticipation of some form of financial benefit or advantage, whether it be in the nature of a future sale, tax saving, or the like.

Berman & Stone, *supra* note 43, at 424.

58. *See* note 64 and accompanying text *infra*.

59. *See* notes 52-56 and accompanying text *supra*.

chase of housing; the dissent viewed the transactions as both the purchase of housing and the making of an investment.[60]

In concluding that respondents had purchased only a commodity, and had not also made an investment, the majority placed considerable importance upon the 1965 Information Bulletin[61] which had been circulated to the respondents prior to their purchases of their cooperative interests. The Court utilized the Bulletin as the foremost indication of the respondents' intent at the time that they entered into those purchase transactions.[62] Because the Bulletin referred only to the residential nature of those purchases, and failed to make any reference to the purchase of these cooperative interests as investments entered into for profit,[63] the majority determined that "the inducement to purchase was solely to acquire subsidized low-cost living space; it was not to invest for profit."[64] In so holding, the Court expressly reserved deciding whether the federal securities laws would govern a different transaction, one in which the purchaser is clearly induced by the offer of both a commodity and an expectation of profit.[65] Thus, the Court failed to determine whether the *Howey* expectation-of-profit element is present in the typical condominium or cooperative purchase in which the seller induces the purchaser to buy by stressing both the commodity aspects and the profit potential of the investment.[66]

60. *Compare* 95 S. Ct. at 2063, *with id.* at 2066-67 (Brennan, J., dissenting).

61. 95 S. Ct. at 2061, 2062. *See also id.* at 2066 (Brennan, J., dissenting).

62. Compare Davis v. Rio Rancho Estates, Inc., CCH FED. SEC. L. REP. ¶ 95,249 (S.D.N.Y. July 28, 1975), a post-*Forman* decision in which the court also emphasized the importance of the promoters' advertising brochures as the primary indication of the purchaser's intent. *Id.* ¶ 98,290-91. *See also* Happy Inv. Group v. Lakeworld Properties, Inc., 396 F. Supp. 175, 180 (N.D. Cal. 1975), in which the court tempered the importance of the purchaser's intent, saying, "[b]uying land with expectations of profit does not make the transaction a security."

63. 95 S. Ct. at 2061.

64. *Id.* at 2060. *See also id.* at 2061, 2063, 2064.

65. *Id.* at 2061 n.16. *See also id.* at 2064; Parness, *supra* note 14, at 265.

66. Several articles which were written before the Court's opinion in *Forman* sought to warn real estate salespersons of potential security law hazards if inducements to purchasers were phrased in terms of profit potential. One such article made the following suggestions:

> In order to minimize the possibility of application of the securities acts, developers should carefully structure their sales and marketing programs to eliminate inducements to purchase based upon the expectation of profit through the developers' efforts. Mere reference by salesmen to the general application of land values would not appear to make the sale of real estate units constitute a sale of securities; but the establishment of rental pools, resale arrangements managed by developers, guarantees of investment return based upon increases in the value of completed developments, or encouragement of multi-unit lot purchases could well result in security status. . . . [S]uch sales should not constitute a sale of securities in the absence of inducements which emphasize the profitability of the investment.

Forman also provided the Supreme Court with an opportunity to adopt the "risk capital" approach as a replacement or an alternative to the profit element of the *Howey* investment contract test.[67] This approach, first adopted by the California Supreme Court in *Silver Hills Country Club v. Sobieski*,[68] provides that an investment is subject to the federal securities laws if the investor risks capital, regardless of whether or not the investment is made with an expectation of profit.[69] The effect of the risk capital approach is to expand the scope of the securities laws by extending their coverage to some transactions which fail to satisfy the three-pronged *Howey* test. The *Forman* majority, refusing to abandon the profit requirement, stated that the case was not an appropriate one in which to adopt the risk capital approach because "[p]urchasers of apartments in Co-Op City [took] no risk in any significant sense."[70]

Berman & Stone, *supra* note 43, at 413. *See also id.* at 429-31; Parness, *supra* note 14, at 265-66. The primary impetus behind these warnings appears to be the SEC pronouncements regarding the applicability of the federal securities laws to condominiums and cooperatives, and the subsequent SEC no-action letters. *See* note 43 *supra*. In the wake of the Court's failure to definitively resolve the issue of the applicability of the federal securities laws to the typical condominium or cooperative sales transaction, the aforementioned suggestions should be given careful consideration.

67. The Ninth Circuit recently refused to expressly adopt the risk capital approach in a case in which the District Court opinion seemingly embraced this expansive test. SEC v. Glenn W. Turner Ent., 474 F.2d 476 (9th Cir. 1973), *aff'g*, 348 F. Supp. 766 (D. Ore. 1972). In endorsing the use of the risk capital approach, the *Turner* District Court relied upon the Congressional intent that the federal securities laws be given a liberal interpretation, with emphasis on the economic realities, so as to effectuate their remedial purposes. 348 F. Supp. at 771-74; *see* note 32 *supra*. By relying upon the Congressional intent, as well as the fact that the three-pronged *Howey* test is not expressly mandated by statute, the Court could, if it so chose, adopt the risk capital approach to enlarge the sweep of the federal securities laws. However, the restrictive interpretation of "security" which the Court established in *Forman* suggests that the present Court would not be inclined to adopt the expansive risk capital approach. *See generally* note 74 and accompanying text *infra*.

68. 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961).

69. *Id.* at 815. *See, e.g.*, Forman v. Community Services, Inc., 366 F. Supp. 1117, 1130 (S.D.N.Y. 1973), *rev'd*, 500 F.2d 1246 (2d Cir. 1974), *rev'd sub nom.*, United Housing Foundation, Inc. v. Forman, 95 S. Ct. 2051 (1975); Sobieski, *Securities Regulation in California: Recent Developments*, 11 U.C.L.A.L. REV. 1, 5-7 (1963); Tew & Freedman, *In Support of SEC v. W.J. Howey Co.: A Critical Analysis of the Parameters of the Economic Relationship Between an Issuer of Securities and the Securities Purchaser*, 27 U. MIAMI L. REV. 407 (1973) [hereinafter cited as Tew & Freeman]; Comment, *Community Apartments: Condominium or Stock Cooperative?*, 50 CALIF. L. REV. 299, 339 (1962) [hereinafter cited as *Community Apartments*]. *See also* Hannan & Thomas, *supra* note 6, at 284-85.

70. 95 S. Ct. at 2063 n.23. Because of the pervasive New York State supervision of the Co-Op City project, the court reasoned that purchasers therein were subject to no capital risk. Hannan & Thomas, *supra* note 6, at 248 n.114. *But see* N.Y. Times, Nov. 15, 1975 at 1, col. 1. The Supreme Court observed that "[t]o date every family that has with-

Thus, the *Forman* Court failed to resolve the question of whether real estate developers and sellers whose transactions satisfy the risk capital standard, but fail to satisfy the *Howey* expectation-of-profit requirement are subject to the federal securities laws. The prudent developer or seller who falls within such a classification must consider the potential consequences of a failure to either register with the Securities and Exchange Commission or qualify for one of the registration exemptions.[71]

III. CONCLUSION

In *Forman*, the Court manifested its reluctance to extend the protective umbrella of the federal securities laws to persons who are essentially mere purchasers of a commodity.[72] While the direct effect of the Court's holding is to generally preclude purchasers of real property interests

---

drawn from Co-Op City has received back its initial payment in full." 95 S. Ct. at 2056 n.5.

71. The penalties for a failure to comply with the registration requirements can be harsh. *See, e.g.*, Securities Act of 1933 §§ 12, 15, 15 U.S.C. §§ 77*l* 77o (1970); Securities Act of 1933 § 24, 15 U.S.C.A. § 77x (Supp. IV, 1975), *amending* 15 U.S.C. § 77 (1970). The imposition of these penalties can also extend to the offeror's attorney. *See generally* Small, *An Attorney's Responsibilities Under Federal and State Securities Laws: Private Counselor or Public Servant?*, 61 CALIF. L. REV. 1189 (1973).

A project may avoid the registration requirements through any one of three exemptions. First, a private offering, Securities Act of 1933 § 4(2), 15 U.S.C. § 77d(2) (1970), and Rule 146, 17 C.F.R. § 230.146 (1975), is exempted. *See generally* Erwin, *Marketing Investment Condominiums and Real Estate Syndications "Without" Securities Registration: SEC Rule 146*, 3 REAL ESTATE L.J. 119 (1974); Grimes & King, *A Look at Condominium Offerings Under the Federal Securities Laws—For the Idaho Lawyer*, 9 IDAHO L. REV. 149, 159-61 (1973); Note, *SEC Rule 146—The Private Placement Exemption*, 58 MINN. L. REV. 1123 (1974). Second, an offering made exclusively intrastate, Securities Act of 1933 § 3(a)(11), 15 U.S.C. § 77c(a)(11) (1970), and Rule 147, 17 C.F.R. § 230.147 (1975), is exempted. *See generally* Grimes & King, *supra*, at 161-64; Kant, *SEC Rule 147—A Further Narrowing of the Intrastate Offering Exemption*, 30 BUS. LAW. 73 (1974); Olson & Fein, *The Single-State Condominium Offering*, 4 REAL ESTATE REV. 78 (1974); *Cooperative Housing Corporations, supra* note 32, at 132-34; Comment, *SEC Rule 147—Distilling Substance From the Spirit of the Intrastate Exemption*, 79 DICK. L. REV. 18 (1974). Third, a limited or small offering, Securities Act of 1933 § 3(b), 15 U.S.C. § 77b(3) (1970), and Rule 235, 17 C.F.R. § 230.235 (1975), is exempted. *See generally* Grimes & King, *supra*, at 164-66.

The primary reason for avoiding registration via one of the aforementioned exemptions is to avoid the great expenditures of time and money which are necessary for the completion and filing of an SEC registration. Ellsworth, *Condominiums Are Securities?*, 2 REAL ESTATE L.J. 694, 699 (1974); Emens & Thomas, *The Intrastate Exemption of the Securities Act of 1933 in 1971*, 40 U. CIN. L. REV. 779, 783 (1971). *See also* Klein, *Preparation of an SEC Registration Statement for an Offering of Condominium Units*, 2 REAL ESTATE L.J. 461 (1974).

72. *But cf.* Imperial Towers Condominium, Inc. v. Brown, 38 Fla. Supp. 123 (Broward County Cir. Ct. 1973).

from utilizing the anti-fraud provisions of the securities acts, the indirect effect of *Forman* is to encourage the establishment of a more appropriate mode of regulation.[73]

By its virtual rejection of the literal approach and its refusal to expand the parameters of the *Howey* investment contract formula, *Forman* typifies the retrenchment of the Burger Court from the activist stances of

---

73. It is generally agreed that there is a definite need for some type of federal regulation of the rapidly proliferating modes of community home ownership. *See, e.g., R.E.A.C., supra* note 14, at ¶ 82,772; Kuklin, *supra* note 14, at 13; Miller, *supra* note 57, at 468; *Cooperative Housing Corporations, supra* note 32, at 122, 139; Wall Street J., Oct. 6, 1975, at 22, cols. 1-3; *cf.* Wenig & Schulz, *Government Regulation of Condominium in California*, 14 HASTINGS L.J. 222, 226-37 (1963). While its form is yet to be determined, "increased regulation appears to be inevitable." Kuklin, *supra* note 14, at 16.

Most commentators who addressed the issue prior to *Forman* concluded that the SEC is not the proper agency for the regulation of the sale of residential real estate. *See, e.g.*, Rosenbaum, *The Resort Condominium and the Federal Securities Laws—A Case Study in Government Inflexibility*, 60 VA. L. REV. 785, 789-90 (1974); Tew & Freedman, *supra* note 69, at 407-08; *Beyond Disclosure, supra* note 43, at 665-69; Note, 41 BROOKLYN L. REV. 1283 (1975); Note, 53 TEXAS L. REV. 623, 634-35 (1975); *cf. Community Apartments, supra* note 69, at 341. *Contra, Cooperative Housing Corporations, supra* note 32, at 139. *See also* note 43 *supra.*

Ten separate bills have been introduced in the first session of the 94th Congress dealing with the regulation of these interests. S. 2273, 94th Cong., 1st Sess. (1975); H.R. 10150, 94th Cong., 1st Sess. (1975); H.R. 7966, 94th Cong., 1st Sess. (1975); H.R. 7752, 94th Cong., 1st Sess. 1975); H.R. 4748, 94th Cong., 1st Sess. (1975); H.R. 3763, 94th Cong., 1st Sess. 1975); H.R. 3586, 94th Cong., 1st Sess. (1975); H.R. 2348, 94th Cong., 1st Sess. (1975); H.R. 2347, 94th Cong., 1st Sess. (1975); H.R. 228, 94th Cong., 1st Sess. (1975). All of these bills are specifically applicable only to condominiums. Most of these bills provide for regulation by the Department of Housing and Urban Development (HUD). The most prominent of the aforementioned bills, S. 2273, 94th Cong., 1st Sess. (1975) (The Condominium Consumer Protection Act of 1975), "is designed to give the maximum protection to the condominium buyer with the minimum amount of expense and red tape for the developer." 121 CONG. REC. S 14,967 (daily ed. Aug. 1, 1975) (remarks of Senator William Proxmire co-sponsor of S. 2273). The bill, which establishes federal condominium requirements to be enforced by the states or through private lawsuits, has recently received the endorsement of the Ford Administration. Wall Street J., Oct. 7, 1975, at 40, col. 2. While this recent congressional concern about the protection of condominium purchasers is encouraging, it would be advisable for Congress to expressly provide that any such remedial legislation extend to other types of community home ownership, particularly to cooperatives.

Federal regulation is also available through two other existing government agencies: the Federal Housing Administration (FHA) and the Federal Trade Commission (FTC). However, under existing law, the scope of any protection which may be provided by these two agencies is limited. *See generally* Berman & Stone, *supra* note 44, at 429; Ingersol, *A Landmark Ruling Hits the Land Developers*, 4 REAL ESTATE REV. 100 (Fall 1974); *Cooperative Housing Corporations, supra* note 32, at 122-23; *Beyond Disclosure, supra* note 43, at 650.

the Warren Court.[74] *Forman* suggests that in a future case the present Court might be inclined to further restrict the application of the *Howey* formula by emphasizing the importance of the distinction between the purchase of a commodity and the making of an investment. Such emphasis might result in the Court holding that even when the three elements of the *Howey* test are satisfied, an investment contract within the penumbra of the federal securities laws is not established if the primary motivation of the purchaser is to obtain a commodity.

David J. Pasternak
Victor O. Tufford

74. *See generally* Green, *Supreme Court Shows Pro-Business Tilt in Series of Rulings,* Wall Street J., July 1, 1975, at 1, col. 6; Wall Street J., Dec. 9, 1975, at 4, cols. 2-4.