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Securities Regulation--Securities Covered--Shares in Cooperative Housing Corporation as Securities under the Federal Securities Acts

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SECURITIES REGULATION — SECURITIES COVERED — SHARES IN COOPERATIVE HOUSING CORPORATION AS SECURITIES UNDER THE FEDERAL SECURITIES ACTS.


I. INTRODUCTION

Co-op City is located in the Bronx, New York, and is the largest cooperative housing project in the United States. The project was conceived, built, and promoted by the United Housing Foundation (UHF), a nonprofit corporation composed of housing cooperatives, labor unions, and civic groups. UHF organized Community Services, Inc. (CSI) as a wholly-owned subsidiary and made CSI the project's sales agent and general contractor. In addition, UHF established Riverbay Corp. pursuant to New York's Mitchell-Lama Act to own and operate the land and buildings of the project. Riverbay subsequently employed a stock subscription, which made the corporation eligible for state financial assistance, to raise the capital necessary to finance the project. The Co-op City project is thus a subsidized housing cooperative owned by the shareholders of Riverbay Corp.

All tenants of Co-op City's residential units must be shareholders of Riverbay. The Riverbay stock owned by tenants cannot be transferred to a nontenant, pledged, or otherwise encumbered. Riverbay by-laws provide that when a tenant wishes to terminate his occupancy, he must first offer his stock to Riverbay at its initial selling price. In the event Riverbay declines to repurchase the stock, the tenant-shareholder may attempt to sell...
elsewhere; however, he may not sell at a price higher than the initial purchase price and may sell only to a prospective tenant who meets the statutory income requirements.

Subsequent to the development's initial planning, Riverbay circulated an Information Bulletin through the mails designed to attract prospective tenant-shareholders. While the subscription price stated in the Bulletin remained unchanged, inflationary pressures forced the average monthly assessments to increase in excess of 70 percent above the figure estimated in the 1965 Information Bulletin. As a result of this increase, 57 residents sued UHF, CSI, and Riverbay on behalf of all the residents of Co-op City, alleging that the 1965 Bulletin falsely represented that CSI would bear all subsequent cost increases due to such factors as inflation, and that it failed to disclose other material facts.

Plaintiffs charged that defendants violated section 17(a) of the Securities Act of 1933 (Securities Act), section 10(b) of the Securities Exchange Act of 1934 (Exchange Act), and SEC rule 10b-5.

The District Court for the Southern District of New York granted defendants' motion to dismiss for lack of subject matter

8. The selling shareholder may also recapture his pro rata share of the amortized mortgage during his period of ownership. N.Y. PRIV. HOUS. FIN. LAW § 31-a (McKinney Supp. 1975). A tenant-shareholder does not pay rent during his occupancy of a Co-op City residential unit. Instead, he is charged a monthly assessment which represents a proportionate share of both mortgage amortization and corporation operating expenses, based upon the size, location, and type of unit occupied. United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 843 (1975).

9. The Bulletin estimated that the average monthly assessment would be $23.02 per room. Id. Thus, the typical four-room apartment in Co-op City would require a cash outlay of $1800 to purchase the requisite 72 shares of Riverbay stock, plus an estimated monthly assessment of $92.08.

10. The increase was due primarily to a construction loan which cost $125 million more than the $250 million figure used in the 1965 Bulletin as a basis for estimating costs. Id. at 844.

11. Also named as defendants were the individual directors of the corporations, the State of New York, and the New York Private Housing Agency. Id.

12. The tenant-shareholders claimed that the following material facts were omitted: (1) UHF-sponsored and CSI-built projects under the Mitchell-Lama Act had never adhered to original cost estimates; (2) defendants knew that the initial cost estimate would not be followed in the Co-op City project; (3) CSI was a wholly-owned subsidiary of UHF; (4) CSI's net worth was so small that it legally could not have been held to complete the contract within the original cost estimates; (5) the New York Housing Commissioner had waived his own liquidity requirements when CSI was approved as contractor; and (6) there was an additional undisclosed contract between CSI and Riverbay. Id. n.8.


jurisdiction, holding that the shares of stock in question did not fall within the definitions of a security contained in section 2(1) of the Securities Act and section 3(a)(10) of the Exchange Act.\textsuperscript{16} The court stated that even though the word "stock" is contained within the definitional provisions of the Acts, the mere denomination of the shares in Riverbay as "stock" did not conclusively render them securities for the purposes of the federal securities laws.\textsuperscript{17} The district court viewed "the fundamental nonprofit nature of this transaction" as an insurmountable barrier to qualification as a security transaction.\textsuperscript{18} The Court of Appeals for the Second Circuit reversed, finding that the Riverbay shares were securities under alternative rationales.\textsuperscript{19} Since the shares were actually characterized in the Co-op City Information Bulletin as stock, the court of appeals reasoned that the securities laws were literally applicable.\textsuperscript{20} Alternatively, the court found that the relationship fell within the "investment contract" language of section 2(1).\textsuperscript{21} Applying the traditional test for an investment contract,\textsuperscript{22} the court held that the tenant-shareholders acquired an expectation of profits derived from three sources: rental reductions made due to income produced from on-site commercial facilities; tax deductions allowable for a tenant's pro rata share of the interest payment on the


Although the definitional sections of the Securities Act and the Exchange Act do not coincide exactly, precedential authority construing one Act is equally applicable to the other. Tcherepnin v. Knight, 389 U.S. 322, 335-36 (1967). Yet full equivalence does not necessarily follow. For example, a broader interpretation may be given when antifraud considerations are involved. See I A. Bromberg, Securities Law: Fraud § 4.6(312), at 82.2 (1975). For a comparison of the definitional provisions of the two Acts, see Hannan & Thomas, The Importance of Economic Reality and Risk in Defining Federal Securities, 25 Hastings L.J. 219, 221 n.13 (1974).

\textsuperscript{17} Forman v. Community Servs., Inc., 366 F. Supp. at 1127.

\textsuperscript{18} Id. at 1128.


\textsuperscript{20} Id. at 1252.

\textsuperscript{21} Id.

\textsuperscript{22} For a discussion of the test, see note 69 infra and accompanying text.
mortgage; and housing expense savings due to the substantially lower costs of residential units in Co-op City compared with similar nonsubsidized housing.\(^{23}\)

The Supreme Court reversed the Second Circuit in *United Housing Foundation, Inc. v. Forman.*\(^{24}\) Justice Powell, speaking for six members of the Court, stated that the substance rather than the form of the transaction should control. The "any stock" language of the Acts was discounted since no right existed in the shareholders to receive dividends based on profit, the stock could not be pledged or hypothecated, voting rights were not in proportion to the number of shares owned, and the shares could not appreciate in value.\(^{25}\) Addressing the respondents' alternative argument that the shares came within the "investment contract" language of the Acts, the Court pointed out that profits of the kind traditionally associated with investment securities were not offered to them. Specifically, the Court held that gain from rental reductions, tax deductions, and housing expense savings did not constitute profit expectation.\(^{26}\) In a vigorous dissent, Justice Brennan, speaking for three members of the Court, found the reasoning of the Second Circuit more persuasive. He indicated that he would have held both the "stock" and "investment contract" language to have been directly applicable.\(^{27}\)

*Forman* involved the unique housing alternative known as the cooperative.\(^{28}\) Cooperative housing has been aptly described as the "child of a marriage of a long-term lease with a stock certificate."\(^{29}\) Even though this form of property ownership dates back to the Civil War, it was never common. Indeed, it became virtually extinct during the Depression.\(^{30}\) Only when the provision of the

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23. 500 F.2d at 1254-55.
25. Id. at 851.
26. Id. at 855-57.
27. Id. at 860-65.
28. The cooperative has been defined for the purposes of Federal Housing Administration insurance as "a nonprofit . . . corporation . . . or trust, the permanent occupancy of the dwellings of which is restricted to members of such corporation or to beneficiaries of such trust." National Housing Act, 12 U.S.C. § 1715(e)(a)(1) (1970). The Internal Revenue Code defines a cooperative housing corporation as a corporation where "each of the stockholders . . . is entitled, solely by reason of his ownership of stock in the corporation, to occupy for dwelling purposes a house, or apartment in a building, owned or leased by such corporation . . . ." Int. Rev. Code of 1954, § 216(b)(1)(B). Accord, N.Y. Tax Law § 360(12) (McKinney 1975).
30. See 2 P. Rohan & M. Reskin, Cooperative Housing Law and Practice § 3A.02[1], at 3A-3 (1975).
Internal Revenue Code allowing tenant-shareholders to deduct their proportionate share of the cooperative's mortgage interest expense was adopted did cooperative housing experience a revival.31

The vehicle commonly used to establish a cooperative housing arrangement is the corporation. Once created, the corporation will generally purchase land or an apartment building and enter into the mortgage itself.32 Then shares of stock are allocated to each apartment and sold to prospective tenants. Apartments are leased to tenant-shareholders, who in turn elect a board of directors to manage the property. It is the lease and not the stock which creates the right of possession.33 The stock, however, is a necessary prerequisite to entrance into the lease agreement, and therefore becomes the practical determinant of the right of possession.

A housing cooperative in its purest form is a joint venture by many individuals working together to accomplish the goal of home ownership.34 Yet, in practice the cooperative housing corporation usually arises in one of two ways. In one, the owner of an existing apartment building converts to a cooperative, thereby achieving a result similar to the outright sale of the building. In the other, one or more individuals construct a multi-unit building and then market the structure as a cooperative.35 In either case the attempt to provide cooperative ownership often takes the form of "an investment in a highly complex corporate enterprise whose purpose often combines home ownership with profit, an investment where shareholder-tenants are dependent on third parties not only to initiate the venture but even to operate it for a substantial period of time after they have moved into their apartments."36 As a result, the

31. INT. REV. CODE OF 1954, § 216. An additional potential tax advantage to the tenant-shareholder is provided by allowing the deferral of recognition of capital gain from the sale of a principal residence if the proceeds of the sale are invested in a new residence. Cooperatives are specifically included as principal residences. Id. § 1034.

32. Cf. text accompanying notes 4-5 supra. There is thus only one mortgage for the entire project. This differs from the condominium form of community housing where, since the resident is the owner in fee of the airspace between the common walls, each individual unit usually will be mortgaged by its owner. The difference results in a greater degree of interdependence among the residents of a cooperative, and a greater possibility that a resident's entire investment may be lost if enough other shareholders default on their monthly assessments. See 2 P. ROHAN & M. RESKIN, supra note 30, § 2.01[4][e], at 2-10. See also Isaacs, supra note 29, at 210.

33. 2 P. ROHAN & M. RESKIN, supra note 30, § 2.02[4], at 2-16.

34. See Miller, Cooperative Apartments: Real Estate or Securities, 45 BOSTON U.L. REV. 465, 469 (1965).

35. See 2 P. ROHAN & M. RESKIN, supra note 30, § 2.02[2], at 2-14.

36. Miller, supra note 34, at 474. Once effective management by the tenants is lost due to the large scale of the venture, the condominium form of ownership would
potential for abuse is great. Typical examples of abuse include binding management agreements made by a promoter to assure himself a place on the board of directors for either a stated period of time or as long as a certain percentage of the shares remain unsold;^7 "flip sales," whereby a promoter reaps windfall profits by purchasing a building one day and transforming it into a co-op the next, obtaining a greater aggregate price through co-opting than through a straight sales transaction;^8 and underestimation of shareholder costs in order to attract prospective tenants.^9

Few states have adopted adequate measures to guard against these abuses. The provision enacted by New York, for example, provides little protection for tenant-shareholders due to its inadequate and incomplete disclosure requirements. A Historically, land sale agreements, especially noninstallment agreements, have not fallen within the scope of state blue sky regulation unless specifically included. Even when covered, the few state cases dealing with cooperative housing projects provide little effective protection to the tenant-shareholder. Where the primary motivation for the purchase of the shares in the cooperative housing corporation is "home ownership," the purchase is not primarily for profit expectation and therefore not subject to blue sky regulation.\[Vol. 26:735

result in better organization. The characteristic of joint venture is lost and "realty in a corporate mold" becomes more akin to an "investment in securities." Id. at 505. See also Hoisington, Condominiums and the Corporate Securities Law, 14 Hastings L.J. 241, 248-50 (1963).

42. See Miller, supra note 34, at 468. For example, in State v. Silberberg, 166 Ohio St. 101, 139 N.E.2d 342 (1956), cooperative apartments were sold to shareholders. The Supreme Court of Ohio held that the Ohio Blue Sky Law specifically exempted the sale of real estate and therefore the purchase in question was not subject to state securities regulation. When juxtaposed with Justus v. Bowers, 167 Ohio St. 384, 148 N.E.2d 917 (1958), however, "an apparent inconsistency in viewpoint . . . result[s] in uncertainty as to whether registration of stock in cooperative apartment corporations is required in Ohio." Miller, supra, at 476. In Willmont v. Tellone, 137 So.2d 610 (Fla. Dist. Ct. App. 1962), sale of stock in a housing cooperative was held not to violate the Florida Securities Act. The case is questionable authority because it was decided in a conclusory fashion with little analysis. Brothers v. McMahon, 351 Ill. App. 321, 115 N.E.2d 116 (1953), held cooperative housing shares outside the coverage of Illinois' Blue Sky legislation. However, the case was decided prior to the Illinois Security Act of 1953, and the subsequent deci-
Federal protection of tenant-shareholders has not been fully developed. Although the Interstate Land Sales Full Disclosure Act has been applied to safeguard the public against fraud in certain real estate unit sales, the Act is primarily directed toward property-by-mail schemes. Given the limited scope of the Land Sales Act, a more potent weapon for correcting abuses might be available through application of federal securities laws. This approach to the problem would present several advantages.

New legislation would be unnecessary, since the disclosure provisions of the federal securities laws are readily adaptable to the cooperative situation. In addition, the present mode of enforcement is strong enough to ensure compliance and provide an adequate remedy to defrauded purchasers. Of course, the coextensive coverage of the Land Sales Act would cause certain developers to face double compliance requirements, thereby increasing dramatically the costs of promotion and sale. Many developers, however, already prepare similar materials either for their own purposes or to comply with various state provisions.


44. See Berman & Stone, Federal Securities Law and the Sale of Condominiums, Homes, and Homosites, 30 BUS. LAWYER 411, 412 (1975).

45. Legislative history indicates that the Land Sales Act was enacted to regulate "an industry, ambitious and adolescent, actively engaged in marketing raw and semi-developed subdivided land to the 'sunset set' by means of the mails, magazines, newspapers, and personal or telephone solicitations." Coffey & Welch, supra note 43, at 6.

The original bill envisioned a tough Act enforced by the SEC and was supported by HEW, HUD, the FTC, and the Bureau of Land Management. "Despite such support for SEC control . . . strong lobbying pressure brought by the National Association of Real Estate Boards and the National Association of Home Builders resulted in HUD control." Berman & Stone, supra note 44, at 427. The result is a "relatively innocuous" statute, at least with respect to the problem of cooperative housing abuses. Note, Cooperative Housing Corporations and the Federal Securities Laws, 71 COLUM. L. REV. 118, 123 (1971).

46. Id.

47. The counterargument, though, is that the Securities Act of 1933 is primarily concerned with the disclosure of facts concerning the issuer-developer, whereas the Land Sales Act is aimed at disclosure of facts concerning the land being marketed. They thus involve conflicting goals. 3 H. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW § 2.14, at 2-63 to 2-64 (1975). This conflict may remain even though the federal redress of fraud and misrepresentation provided under section 10 of the Exchange Act is virtually identical to that provided under section 1709 of the Land Sales Act. See Berman & Stone, supra note 44, at 412 n.6.


The plaintiffs in Forman sought to invoke the protection of the federal securities laws and avail themselves of the antifraud remedies. These remedies, however, are accessible only when the instruments involved meet the statutory definition of a security set forth in the Acts. By deciding whether the Riverbay shares were securities within the meaning of the Acts, the Court necessarily decided whether the protection of the federal securities laws would be extended to cooperative housing.

II. Section 2(1) Securities: An Economic Analysis

One major purpose of federal securities regulation is to protect the investing public against fraud in the purchase or sale of certain investments.\(^5\) The method chosen to provide this protection is disclosure, the theory being that the investor should retain the freedom to make the investment decision whether good or bad, but that all appropriate information to aid in the determination of value should be made available to the investor and the marketplace.\(^5\) Structured information dissemination in the marketplace and the accompanying specter created by the various antifraud provisions of the federal securities laws does not accompany all investment decisions, however, since all investments do not fall within the definitional provisions of section 2(1).\(^5\)

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5. The aim [of the Securities Act] is to prevent . . . exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentation; to place adequate and true information before the investor; to protect honest enterprise, seeking capital by honest presentation, against the competition afforded by dishonest securities offered to the public through crooked promotion. . . .

S. REP. No. 47, 73d Cong., 1st Sess. 1 (1933). In the decade following World War I, $50 billion in new securities were floated in the United States; fully one-half proved worthless when the Depression arrived. H.R. REP. No. 85, 73d Cong., 1st Sess. 2 (1933). It is little wonder that President Roosevelt stated in regard to the need for securities regulation that "[w]hat we seek is a return to a clearer understanding of the ancient truth that those who manage banks, corporations, and other agencies handling or using other people's money are trustees acting for others." Message of President Roosevelt, March 27, 1933, in 1 L. Loss, SECURITY REGULATION 127 (2d ed. 1961).

51. Most states have chosen merit regulation as an alternative approach to protect the investor. Merit regulation entrusts a state agency with the responsibility of analyzing the investment and passing judgment on its quality. The agency is given the power to prevent the sale of any security not determined to be "fair, just, and equitable." See Long, An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation, 24 OKLA. L. REV. 135, 159 (1971).


52. Once an investment comes within the provisions of section 2(1), numerous statutory requirements are triggered. In certain cases, exemptions from various
Section 2(1) defines a security by the technique of enumeration, spawning a method of analysis which tends to create pigeonholes for the various instruments or transactions alleged to fall within the purview of that section. Yet, the Supreme Court continually has stated that economic realities are to govern the consideration of the issue. This invitation by the Court has led numerous commentators to develop other approaches to the problem of defining the scope of section 2(1). At the base of both the Court’s statement and the critical commentary lies an awareness of the pragmatic need to consider the concept of a security in its own setting—the realm of economics. Not only is economic theory enlightening, it is indeed

requirements are provided for in the Acts. For example, the two major exceptions to the registration requirements are the private offering exemption, Securities Act of 1933, § 4(2), 15 U.S.C. § 77d(2) (1970), and the intrastate offering exemption, Securities Act of 1933, § 3(a) (11), 15 U.S.C. § 77c(a)(11) (1970). In private offerings purchasers must have access to the kind of information that a registration statement normally provides. See SEC v. Ralston Purina Co., 346 U.S. 119, 125-26 (1953). Although the intrastate offering exemption may be applicable in real estate transactions, the great majority of cooperative housing corporations would be exempt from registration pursuant to SEC rule 235, 17 C.F.R. § 230.235 (1975) (promulgated pursuant to section 3(b) of the Securities Act, which authorizes the SEC to exempt by regulation defined classes of securities). Under this rule if the corporation engages in no business or activity other than the owning or leasing of residential property (unless such activity is incidental), if the corporation permits transfers of stock only in connection with transfers of leases, and if the total value of the stock issued within any 12-month period is less than $300,000, then the cooperative housing corporation is exempted from registration. There is no exemption, however, from the antifraud provisions of the Acts. Thus, even though the promoters of Co-op City were not required to file a registration statement, defrauded tenant-shareholders alleged that the shares in Co-op City were securities within the meaning of the Acts and that the antifraud provisions of the federal securities laws applied. It has been suggested that the very existence of the various exemptions demonstrates that the considerations bearing on whether an investment is a security in the first instance are not coextensive with those involved in requiring full disclosure or state administrative agency approval. See Coffey, The Economic Realities of a “Security”: Is There a More Meaningful Formula?, 18 W. Res. L. Rev. 367, 371-72 (1967).

53. This is true even though the Act was drafted “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, 73d Cong., 1st Sess. 11 (1933). The concept of a security for federal regulatory purposes, however, was narrowed one year later. While the Securities Act included a “certificate of interest in property, tangible or intangible” in the definitional section, Securities Act of 1933, § 2(1), 48 Stat. 74 (1933), the 1934 amendments deleted this phrase “as possibly involving too broad and uncertain application.” H.R. Rep. No. 1838, 73d Cong., 2d Sess. 39 (1934).


the most relevant nonlegal tool to assist in resolving the question, “What is a security?”

The economist, who uses the terms "security" and "investment" interchangeably, endorses an extremely broad notion of an investment. To lay the foundation for defining an investment, one must start with the concept of wealth. The maximum amount of present money one can obtain (the stock of one's present resources) is economically defined as his wealth. Wealth can either be presently consumed to satisfy taste or devoted to nonconsumptive uses which will produce wealth for consumption in the future. All nonconsumptive uses of wealth are, economically speaking, investments. An investment constitutes a claim on (or the prospect of) future consumptive opportunities or contributions to wealth and can include not only real capital and financial assets, but also durable goods. Each type of investment promises future consumptive opportunity appearing as part of the investor's wealth in a subsequent period—a return. A durable good is thus included in the category of economic investments because, even though it has an immediate consumptive value, it will also make a future contribution to wealth over its useful life.

All investments share one important characteristic: when purchased, the buyer must attach a present value to the future or expected contributions of the good. In other words, the value of what is not immediately consumed must be considered with respect to the investment's expected return. If future contributions are certain (the investment thereby being riskless), the valuation process is less complex, and the present value of future consumptive opportunities is discounted at the appropriate interest rate. The interest rate is merely the rate at which the investor will trade present consumption for future consumption. If, however, future contributions to wealth are uncertain (the investment thereby being risky), the future consumptive opportunities will be capitalized at a rate

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56. Professor Sharpe, for example, has stated: "In general, a security is a decision affecting the future." W. Sharpe, Portfolio Theory and Capital Markets 19 (1970).

57. Id. at 18.

58. In theory one can consume all of his wealth in any one period; in reality one does not.

59. The totality of these decisions regarding future period choices is the individual's portfolio. An economic analysis of the portfolio will generally consider only liquid investments. However, other assets which warrant particular attention are durable consumer goods (homes, automobiles, and appliances) and human capital. See E. Fama & M. Miller, The Theory of Finance 250-53 (1972). For a detailed treatment of portfolio analysis, see W. Sharpe, Portfolio Theory and Capital Markets (1970).
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higher than a simple interest rate. Here the investor values by quantifying the risk associated with the probability of an expected future return.\(^{60}\) This valuation process may well lie at the root of regulatory concern over certain types of securities. All future contributions to wealth must be valued. This means that the investor must have information about the investment to establish the timing and amount of these contributions and to quantify the amount of uncertainty or risk.

The valuation process and the type of information needed varies with the investment valued. For example, valuation of a financial asset can be distinguished from valuation of a durable good. When an investor purchases a durable good, such as a house, he possesses complete dominion and control over the good. The buyer not only intends to engage in immediate consumption, but also to extract a return from the house by capturing its future flow of contributions to his wealth. Assuming no deflation, these contributions, at a minimum, would be equivalent to the projected costs that the buyer would otherwise have to incur for a similar dwelling. These costs can be estimated without specialized disclosure. If the investor is certain that he will have continued possession of the property, he can be assured of a steady flow of contributions to his wealth in the form of the future availability and enjoyment of the dwelling. The risk involved in the flow turns on the investor’s own knowledge about himself. He must consider the degree to which he is likely to conserve or neglect the house. If the house is purchased with an eye toward future personal use, the investor will inspect the good in

\(^{60}\) All investments, whether risky or riskless, are valued in the same manner. When risky securities are valued, however, the process becomes more complex. Valuation of a risky security is accomplished through the use of a statistical analysis which quantifies data under risk and provides a rational procedure for optimization. First, the most likely expected return must be established. This value is represented by the weighted average of the set of all possible returns for a given investment, i.e., the sum of all possible values in the set of possible returns, weighed by their frequency, divided by the number of values in that set. Next, variance from a set of values is determined by taking the arithmetic mean, computing the deviation from the mean to each value in the set, adding the squares of each deviation, and then dividing the sum of those squares by the number of values in the set. The square root of the variance is the standard deviation for the set of values. The higher the value of the standard deviation, the greater the possibility that there will be a deviation from the representative value. The value of future consumptive opportunities offered by a particular investment is quantified by comparing the return (arithmetic mean) with possible levels of risk (standard deviation) associated with that return. C. Hubbard & C. Hawkins, Theory of Valuation 1-57 (1969); W. Sharpe, Portfolio Theory and Capital Markets 21-24 (1970).

As an alternative to statistical analysis, an intuitive approach may be used. The investment is valued by using two summary measures — a predicted rate of return, or best guess, and a measure of uncertainty with respect to that return. Id. at 20-21.
its present state and determine its capacity to continue providing consumptive opportunities, i.e., contributions to wealth in the future. Moreover, if the investor possesses the durable good during its future flow of wealth contributions, he will have the opportunity to watch over it personally and protect its capacity to produce a future return. Under this set of circumstances, the investor is capable of making an informed valuation of future contributions to wealth without structured information dissemination. Perhaps then there is no need for the special regulation provided by the federal securities laws.

To value a financial asset, on the other hand, the investor examines information provided by those seeking his capital and estimates the amount of return. He must rely on balance sheets, income statements, and other financial papers rather than on physical inspection of the asset. Moreover, the riskiness of the return will be dependent upon the success or failure of the management practices of third parties. For example, when an investor purchases a financial asset, such as stock in a corporation, the discretionary management of the underlying asset pool is left to the corporation's directors and officers. Future contributions to the investor's wealth are contingent upon the managerial success of these corporate fiduciaries. A similar situation exists in the purchase of a durable good such as a house or apartment building when the investor subsequently turns over control to third parties with the expectation of receiving future contributions to wealth generated by the asset. The need for structured information dissemination where valuation is dependent on these characteristics is great.

It is postulated that there are two factors determinative to holding that a particular economic investment falls within section 2(1): Whether there is a special need for data to make an informed and sufficiently accurate valuation of future consumptive opportunities,\(^6\) and whether the discretionary control of the underlying assets or durable goods is outside the hands of the investor. The presence of each of these factors tends to point to the existence of a section 2(1) security.

III. COOPERATIVE HOUSING UNDER JOINER AND HOWEY

The hybrid nature of shares in a cooperative housing corporation presents a unique challenge to the viability of this suggested method

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61. This article leaves to other commentators questions about the amount and type of information which should be made available and the effectiveness of the disclosure provisions of the federal securities laws.
of defining a section 2(1) security. On the one hand, cooperative shares are akin to other financial assets because they represent ownership of stock in a corporate enterprise. On the other hand, the right to enter into a lease with the cooperative corporation which accompanies the purchase of its stock is similar to any purchase of housing. It is an economic investment, to be sure, but one traditionally viewed as being outside the confines of section 2(1). Rather than analyzing the investment in Riverbay by a more theoretical and fundamental method such as suggested here, the Court in *Forman* chose the traditional approach suggested by other section 2(1) cases.

Plaintiffs in *Forman* alleged that the shares in Riverbay were investment contracts for the purpose of section 2(1). The term "investment contract" is not defined in the Acts and has been held to cover a wide range of investment situations. In *SEC v. C. M. Joiner Leasing Corp.*, the first Supreme Court case to consider this question, the Court held the sale of assignments in oil leases were investment contracts. Justice Jackson, speaking for the Court, followed previous federal and state court decisions by not attempting to define the term comprehensively. Rather, he examined only the particular investment before the Court. Since "[t]he trading in these documents had all the evils inherent in the securities transactions which it was the aim of the Securities Acts to end," the Court concluded that the instruments fell within the investment contract language of the Acts. The test proposed was merely the "character" the instrument was given in commerce. The Court thus committed itself to a liberal construction, one which it found necessary in order to carry out the legislative purpose and intent of the Acts.

This same liberal philosophy was reflected subsequently in *SEC v. W. J. Howey Co.* The investments at issue were units in a

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62. The investment contract language of the statute has been held to include such things as whiskey warehouse receipts, Glen-Arden Commodities, Inc. v. Costantino, 493 F.2d 1027 (2d Cir. 1974); franchise and pyramid sales licenses, SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476 (9th Cir.), cert. denied, 414 U.S. 821 (1973); discretionary commodity trading accounts, SEC v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974), contra, Milnarik v. M-S Commodities, Inc., 457 F.2d 274 (7th Cir.), cert. denied, 409 U.S. 887 (1972); and charter country club memberships, Silver Hills Country Club v. Sobieski, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961) (applying California law, but reasoning pari materia with the federal securities laws).

63. 320 U.S. 344 (1943).

64. *Id.* at 349.

65. *Id.* at 352-53.

Florida citrus grove development offered to the public. The units were coupled with contracts for cultivation and marketing, the net proceeds from operations to be remitted to the investor in proportion to his investment. Justice Murphy, holding that the units were section 2(1) securities, stated: "The statutory purpose of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae." Moreover, he added that emphasis must be placed on the underlying economic realities of the transaction.

In contrast to Joiner, however, the Court established a four-part test, holding that when "a person [1] invests his money [2] in a common enterprise and [3] is led to expect profits [4] solely from the efforts of the promoter or a third party," the investment is a section 2(1) security. Although the Howey Court cautioned that excessive reliance should not be placed on the test it established, the Court's language has become the magic formula in state and federal courts. No recent Supreme Court decision has clarified the test or reconsidered its underlying policies.

The Howey test can lead to various complications when slight modifications are made in the investment scheme, placing it outside the reach of the Court's language. However, a strict reading of the Court's language fails to recognize that the test was merely a statement flowing from the specific facts of the case. While

67. Id. at 301.
68. Id. at 298.
69. Id. at 298-99. Some commentators consider the test to be a three-part test, combining the third and fourth elements.

Justice Murphy indicated that this test was the foundation of the Joiner decision and was consistent with other earlier federal and state decisions. This view, however, has been challenged as not being adequately supported. In a detailed examination of the state cases preceding Howey, Professor Long finds little support for Justice Murphy's assertions. Long, supra note 51, at 148-55.

72. For example, pyramid sales schemes, founder-member contracts, and franchise arrangements have been held not to be investment contracts, since in each of these the investor performs some duties. In SEC v. Koscot Interplanetary Inc., 365 F. Supp. 588 (N.D. Ga. 1973), the court explained such a result by stating: [T]he Court of Appeals for this Circuit, as well as the Supreme Court, has repeatedly stated the "solely" test as the standard for an investment contract. This district court sees no freedom to coin a new, different and more expansive standard in light of these binding higher court decisions. Id. at 592. See, e.g., Beefy Trail, Inc. v. Beefy King Int'l, Inc., 348 F. Supp. 799, 805 (M.D. Fla. 1972); Gallion v. Alabama Mkt. Centers, Inc., 282 Ala. 679, 213 So.2d 841 (1968); Georgia Mkt. Centers, Inc. v. Fortson, 225 Ga. 854, 171 S.E.2d 620 (1969) (de minimis efforts ignored); Bruner v. State, 463 S.W.2d 205 (Tex. Crim. App. 1970); Koscot Interplanetary, Inc. v. King, 452 S.W.2d 531 (Tex. Civ. App. 1970).
73. See Hannan & Thomas, supra note 55, at 236.
those factual circumstances might have been typical, they certainly were not unique. A mechanical application can be counterproductive to the acknowledged statutory policy of providing broad investor protection,\(^74\) and fails to focus on the essential economic considerations relevant to the identification of a section 2(1) security. Indeed, it has been contended that no mechanical test should be utilized in defining a security, because any test applied strictly provides ingenious promoters with the opportunity to circumvent the rule.\(^75\) This should not, however, prevent a rational and analytical approach from being formulated.\(^76\) Certainly, the synthesis of a hard and fast test from the flexible principles stated in both \textit{Joiner} and \textit{Howey} not only has permitted the ingenious promoter to discover methods of circumvention, but also has forced the courts to be nearly as clever in foiling obvious attempts to avoid regulation.

When the considerations posed by the Court in \textit{Howey} are applied to shares in a cooperative housing project, the first two prongs of the Court's test are met easily: it is clear that purchasers of Riverbay shares invested money in a common enterprise.\(^77\) The

\footnote{76. \textit{Coffey}, supra note 55, at 384 n.82. Professor Coffey defines a section 2(1) security as:

(1) a transaction in which (2) a person ("buyer") furnishes value ("initial value") to another ("seller"); and (3) a portion of initial value is subjected to the risks of an enterprise, it being sufficient if — (a) part of initial value is furnished for a proprietary interest in, or debt-holder claim against, the enterprise, or (b) any property received by the buyer is committed to use by the enterprise, even though the buyer retains specific ownership of such property whose present value is determined by taking into account the anticipated but unrealized success of the enterprise; and (4) at the time of the transaction, the buyer is not familiar with the operations of the enterprise or does not receive the right to participate in the management of the enterprise; and (2) the furnishing of initial value is induced by the seller's promises or representations which give rise to a reasonable understanding that a valuable benefit of some kind, over and above initial value, will accrue to the buyer as a result of the operation of the enterprise.

\textit{Id.} at 377.

Professor Long, in a similar vein, defines a security as "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." \textit{Long, Introduction to Symposium — Interpreting the Statutory Definition of a Security: Some Pragmatic Considerations}, 6 ST. MARY'S L.J. 96, 128 (1974).
\footnote{77. Under one view, a common enterprise exists when the economic welfare of both purchasers and promoters is "inextricably woven" together. \textit{Los Angeles Trust Deed & Mortgage Exch. v. SEC}, 285 F.2d 162, 172 (9th Cir. 1960). An alter-}
real problem lies in the application of the last two aspects of the test—the expectation of profits solely from the efforts of promoters or third parties.

While some courts have construed this aspect of the Howey test strictly, others have expressed concern over viewing the Court's language too narrowly. Traditionally, profit has been defined as the realization of gains. But, as one state court pointed out, "[p]rofit 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 benefitted." Indeed, the Court itself has indicated that return promised for the use of an investor's capital is not limited to a share of profits in the narrow accounting sense. Appreciation in value, which is not a commercially recognized profit, has been held to be the significant factor in finding a security. The important consideration should be framed in terms of an expectation by the investor of some benefit over and above his initial investment.
In *Davenport v. United States*,

promoters offered potential investors continuous employment in a proposed plywood cooperative in return for their initial $1,000 investment. Affirming the conviction of the defendants under section 17(a) of the Securities Act for conspiracy to use the mails to defraud, the Court of Appeals for the Ninth Circuit impliedly held that the investment scheme fell within the scope of section 2(1) in the first instance. Job security, such as that offered in *Davenport*, is more akin to an economist’s view of profit than the traditional view that the benefit must be received in cash or a cash equivalent.

Indirect economic benefit may arise in a cooperative housing corporation when monetary surplus is accumulated. Rather than distribute to the individual tenant-shareholders, the directors might choose to use the surplus for the benefit of the entire housing community.

Indeed, there is no question that the tenant-shareholder receives economic benefits.

It may, however, be contended that economic benefit in the form of expense savings and special tax treatment should not by itself make an investment a section 2(1) security;

is not the type of inducement central to the existence of a commercial profit;

is de minimis;

is beyond a fair reading of the statutes and their legislative history; and

is the benefit inherent in any form of home ownership.

Noneetheless, economic benefits exist in the cooperative housing situation.

While the majority in *Forman* reiterated the importance of economic reality, it refused to recognize any expense savings or tax benefits as profits under the *Howey* test. The dissenters took issue with this conclusion. Discussing the benefits of subsidized housing, Justice Brennan stated “[i]nvestors on Wall Street who . . . everyday [utilize the efforts of others to obtain government subsidies] will be surprised to learn that the benefits so obtained are not considered profits.”

84. 260 F.2d 591 (9th Cir. 1958).
87. In addition to those federal tax benefits discussed at note 28, supra, similar deductions are often allowed under state statutes. *See, e.g.*, N.Y. TAX LAW § 615 (McKinney Supp. 1975-76).
88. *See 53 Texas L. Rev. 623, 631 n.45 (1975).*
91. *See 53 Texas L. Rev. 623, 630-31 (1975).*
93. 421 U.S. at 862 (Brennan, J., dissenting).
that the economic benefits were profits,\textsuperscript{94} he asserted: "[T]he [majority] must surprise knowledgeable economists with its proposition . . . that profits cannot assume forms other than appreciation of capital and participation in earnings."\textsuperscript{95}

The treatment given to profits by the Court in \textit{Forman} seems to fly in the face of the Court's language that economic realities are to govern. Economists from Adam Smith to John Stuart Mill have viewed profits as residual income—the amount remaining in the hands of the entrepreneur at the end of the period once all expenses are paid.\textsuperscript{96} Profit is only one of four categories of income recognized by economists. The other categories are wages, the return to labor; interest, the return to capital; and rent, the return to land.\textsuperscript{97} Although profit occupies the final category of income, it is not as easily defined as the others.\textsuperscript{98} Opinions vary greatly. For example, the late economist Joseph Schumpeter believed that profit was the reward for innovation and enterprise.\textsuperscript{99} Others see profit as a monopoly return, whether contrived or the result of a natural scarcity.\textsuperscript{100} According to Marx, profit is simply all that does not go to the worker. The prevailing view, however, is that profits are surplus income, so that in order to find pure profit all

\textsuperscript{94} See note 23 \textit{supra} and accompanying text.

In Pine Grove Manor, Inc. v. Director of Taxation, 68 N.J. Super. 135, 171 A.2d 676 (App. Div. 1961), involving four nonstock cooperative apartment corporations, the court defined profit in terms of "profitable advantages that inure to [the co-op owner's] benefit." \textit{Id.} at 151, 171 A.2d at 685. Such advantages were held to include low cost housing at lower-than-market prices made possible by government financing aid, tax deductions for real estate taxes and mortgage interest, and reduced monthly charges from income accrued from vending machines, laundry machines, and other nondwelling, on-premises facilities. \textit{Id.} Similarly, in Commonwealth v. 2101 Cooperative, Inc., 27 Pa. D. & C.2d 405 (C.P. 1961), \textit{aff'd per curiam}, 408 Pa. 24, 183 A.2d 325 (1962), "profits" were held to be more than the actual receipt of dividends. Also included were "pecuniary benefits in the form of reduced rentals, patronage refunds . . . and other material benefits accru[ing] to defendant and its shareholders." \textit{Id.} at 409. Both of these cases dealt with tax issues and not securities law. Nonetheless, the reasoning of the cases is analogous on a theoretical level.

\textsuperscript{95} 421 U.S. at 863 (Brennan, J., dissenting).

\textsuperscript{96} See \textsc{E. Whittaker}, \textsc{A History of Economic Ideas} 609-15 (1940).

\textsuperscript{97} These are incomes of a contractual nature. The entrepreneur's failure to pay will result in a cause of action. Failure to "make" profits, however, will not result in any such contractual action. See \textsc{W. Kiekhoefer}, \textsc{Economic Principles, Problems, and Policies} 581 (4th ed. 1951).

\textsuperscript{98} For a synopsis of the generally accepted views, see \textsc{P. Samuelson}, \textsc{Economics} 618-26 (9th ed. 1973).

\textsuperscript{99} See \textsc{G. Bach}, \textsc{Economics} 435 (8th ed. 1974).

\textsuperscript{100} Successful innovation results in a temporary monopoly. \textit{Id.} See also \textsc{M. Bowman & G. Bach}, \textsc{Economic Analysis and Public Policy} 545 (2d ed. 1949); \textsc{F. Knight}, \textsc{The Economic Organization} 118-21 (1951), \textit{quoted in C. Harriss}, \textsc{Selected Readings in Economics} 188-89 (2d ed. 1962).
expenses, including implied ones, must be netted out. Items such as interest, wages, and rents which are otherwise earnable but not specifically charged as an expense by the enterprise must be recognized as costs of production.101 Once this adjustment is made, the remaining surplus income is correctly defined as pure profit. For this reason, it is impossible to "earn" profits in the accepted sense.

While the economist can attempt to define profit in this manner, however, he has yet to explain its nature precisely. Hoping to simplify the problem, economist Frank Knight proposed the now generally accepted view that profit is the reward for risk.102 Not all risks necessarily give rise to profits or, for that matter, losses. A risk which can be insured against does not generate a profit, since the factor of uncertainty can be eliminated by transforming it into a constant element of expense.103 From an economic perspective, then, profits constitute surplus income arising from the investor's assumption of a noninsurable risk.

The Joiner Court recognized this fundamental characteristic of profit by isolating the element of "risk to initial value" when it attempted to define a section 2(1) security.104 While Howey may be viewed as an expansion of Joiner, the Court instead may have shifted the focus from risk to initial value to profit without fully recognizing the implications of its holding.

In Silver Hills Country Club v. Sobieski,105 the Supreme Court of California, construing an analogous provision of California law, rejected a strict reading of the Howey profit language and gave judicial recognition to the economic notion of profit as it relates to risk to initial value. At issue in the case was a transaction in which investors had supplied capital in exchange for charter memberships in a country club yet to be built. Justice Traynor stated that the purpose of the California securities law was "to afford those who risk their capital at least a fair chance of realizing their

101. For example, a fair return to capital must be provided; otherwise, capital will be withdrawn from the enterprise. The same result will occur regarding non-waged workers and land used in the enterprise. See W. Kiehoffer, Economic Principles, Problems, and Policies 582-85 (4th ed. 1951).
objectives in legitimate ventures whether or not they expect a return on their capital in one form or another.\footnote{106} Rejecting the notion that an interest in the assets or profits of a venture was crucial to the existence of a security, he stated:

We have nothing here like the ordinary sale of a right to use existing facilities. Petitioners are soliciting the risk capital with which to develop a business for profit. The purchaser's risk is not lessened merely because the interest he purchases is labelled a membership. Only because he risks his capital along with other purchasers can there be any chance that the benefits of club membership will materialize.\footnote{107}

In essence, \textit{Silver Hills} held that risk capital could not be raised without the issuance of securities.

The risk capital test has met with some small degree of success as an alternative to the \textit{Howey} requirement of profit expectation.\footnote{108} It requires only that the investor contribute capital to finance or operate an enterprise over which he exercises no managerial control. There is no requirement that a right to some present benefit be created.\footnote{109} The risk the investor takes is that his consideration may dissipate to creditors prior to producing any benefit. His capital must be employed successfully for any benefit to arise. Often the benefit promised to the investor as an inducement is merely the return of all or a specified portion of his investment at a specific time—perhaps at the termination of the venture or enterprise.\footnote{110}

One advantage of risk capital analysis is that it allows the court to focus on the degree of risk taken by the investor when ordinary profits are not offered.\footnote{111} When profit is expected from an invest-

\footnote{106}{\textit{Id.} at 815, 361 P.2d at 908-09, 13 Cal. Rptr. at 188-89.}
\footnote{107}{\textit{Id.} at 815, 361 P.2d at 908, 13 Cal. Rptr. at 188.}
\footnote{110}{The benefit need not be material or tangible. For example, the right to use facilities to be constructed in the future is intangible. Certainly, the benefit does not have to be paid in money alone. \textit{See Long, supra} note 51, at 167-69.}
\footnote{111}{Risk capital analysis is not without its problems, however. Questions arise whether the analysis should extend or be limited to capital necessary to finance totally new ventures, risky, unproven ventures, or ventures offering less than a fair chance of return. \textit{Mofsky, Some Comments on the Expanding Definition of "Security."} 27 \textit{U. MIAMI L. REV.} 395, 401-02 (1973). In addition, the use of a}
ment, both risk capital analysis and the Howey test with its profit requirement will reach the same result. But, when venture capital is solicited in a manner that shifts the risk of loss to the investor, risk capital analysis will support the finding of a section 2(1) security, while Howey might not. Schemes with none of the general characteristics of an investment, such as retail trading stamps, street car tokens, or gift certificates, will not be characterized as securities by either theory. All schemes with investment characteristics, however, should receive uniform treatment. To accomplish this, a more flexible approach to the Howey profit expectation requirement would seem to be mandated.

Nonetheless, the Supreme Court in Forman rejected risk capital analysis. Confining consideration of this important issue to a footnote, Justice Powell stated:

Even if we were inclined to adopt such a "risk capital" approach we would not apply it in the present case. Purchasers of apartments in Co-op City take no risk in any significant sense. If dissatisfied with their apartments, they may recover their initial value in full.

Respondents assert that if Co-op City becomes bankrupt they stand to lose their whole investment. But in view of the fact that the State has financed over 92% of the cost of construction and carefully regulates the development and operation of the project, bankruptcy in the normal sense is an unrealistic possibility.

While the Court was not inclined to adopt a risk capital approach, some question still remains whether the Court carefully considered this analytical tool. Justice Powell's statement evi-
dences the belief that a risk capital analysis is appropriate only where there is some requisite level of risk—a threshold greater than that attributable to the Riverbay shares. This view would foreclose instruments such as federal government obligations from the status of securities because, economically speaking, they are examples of classic riskless investments. While risk to initial value "is the single most important economic characteristic which distinguishes a security from the universe of other transactions," it is not determinative. In the process of valuation, the investor compares various returns with their correlative risks. The fact that a particular investment has a low risk or is riskless does not mean that structured information dissemination may not be necessary to the valuation process.

The *Forman* majority's characterization of the riskiness of the Riverbay shares is also questionable. While all former tenant-shareholders of Co-op City were fully reimbursed by Riverbay for their initial investment, the corporation was under no legal obligation to repurchase any shares. In fact, the Mitchell-Lama Act prohibits tenant-shareholders of a corporation organized under its provisions from making any profit whatsoever on the sale of that corporation's shares. Thus, the investor faces a very real risk of loss to initial value. If the corporation refuses to repurchase, not only is the investor unable to realize any capital appreciation on his investment, but he may be forced to sell his shares elsewhere at a loss.

The Court also added the troubling statement that "the risk of insolvency of an ongoing housing cooperative 'differ[s] vastly' from the kind of risk of 'fluctuating' value associated with securities investments." While fluctuation in value is a characteristic of most shares of stock, it is of little consequence with respect to other investments. Certainly, the quantification of riskiness in the process of valuing a security cannot be limited to a consideration of the risk of fluctuation in value. Risk of loss from insolvency must also be considered. The presence of fluctuation in value is not a characteristic sufficient to distinguish section 2(1) securities from all other investments. Instruments held to be section 2(1) securities

116. *See* note 60 *supra* and accompanying text.
117. 421 U.S. at 842 n.6.
in both *Joiner* and *Howey* could not be characterized as tied to a risk of fluctuating value; however, they did fall within section 2(1).

Profits may be difficult to isolate in many investment situations, and basing the finding of a section 2(1) security on a search for profits or profit expectations can only confuse the issue in some cases. Instead, it is easier to start with an examination of the value paid by the buyer. If the consideration given represents more than the present consumptive value received, then it can be presumed that the transaction has investment qualities. Once this has been established, a court might examine the character of the investment to determine whether there is a specialized need for structured information dissemination in the valuation process. This approach would eliminate many of the problems raised by the application of the profit expectation language of the *Howey* test. Indeed, the *Howey* Court itself stated that "the statutory policy of affording broad protection for investors is not to be thwarted by unrealistic and irrelevant formulae."\(^{120}\)

The second part of the *Howey* test which has caused difficulties with its application is the "solely from the efforts of [others]" language.\(^{121}\) A strict reading of the language would create absurd results. In the *Howey* case itself, for example, if investors had been required to pick one orange, the instruments would no longer meet the Court's test. The Supreme Court of Hawaii has stated an alternative standard in *State v. Hawaii Market Centers, Inc.*\(^{122}\) Holding that founder-member arrangements fell within the Hawaii Blue Sky Law, the court focused on the quality of participation by the investors. This reading of the *Howey* test tempered the otherwise harsh consequences that would have resulted from a strict interpretation.

The most recent interpretation of this prong of the *Howey* test was expressed subsequently in *SEC v. Glenn W. Turner Enterprises, Inc.*,\(^{123}\) a case involving a pyramid sales scheme. The Court of Appeals for the Ninth Circuit held that self-improvement contracts offered in exchange for the opportunity to earn commissions on the

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120. 328 U.S. at 301.
121. There are two possible explanations for the *Howey* Court's inclusion of the word "solely." It may have been included deliberately as a specific element of the test. Alternatively it may have been a manifestation of the specific factual circumstances in the case and added without intending to restrict consideration of the economic realities. Regardless of the proper explanation, "solely" has been read as a specific requirement. No case since 1970, however, has followed a strictly literal application. Long, *Partnership, Limited Partnership, and Joint Venture Interests as Securities*, 37 Mo. L. Rev. 581, 602 (1972).
123. 474 F.2d 476 (9th Cir.), cert. denied, 414 U.S. 821 (1973).
sale of similar contracts to others were investment contracts. Believing that adherence to a strict interpretation would result in "a mechanical, unduly restrictive view of what is and what is not an investment contract," the Ninth Circuit found that a strict application of Howey was contrary to the broad purposes of the Act, and that it carried the potential for creating loopholes:

[W]e adopt a more realistic test, whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.

Our holding in this case represents no major attempt to redefine the essential nature of a security. Nor does our holding represent any real departure from the Supreme Court's definition of an investment contract as set out in Howey. We hold only that the requirement that profits come "solely" from the efforts of others would, in circumstances such as these, lead to unrealistic results if applied dogmatically, and that a more flexible approach is appropriate.

The underlying assumption in Turner is that the presence of efforts other than essential managerial efforts is insignificant. This consideration is important in the context of the cooperative housing corporation. The corporate form provides the shareholder with the right to control those who contribute essential managerial efforts. A shareholder participates in the election of directors. But the right to control others should be distinguished from the actual contribution of essential managerial efforts by the investor. In most cooperative corporations, the individual investor in fact does not personally contribute essential managerial efforts. Certainly this is true in developments such as Co-op City, and would be true to an even greater extent in developer-initiated cooperatives where the promoter maintains control of the management function. Yet, where the number of investors is small, control could be equated with contribution of essential managerial efforts. Nevertheless, the

124. Id. at 482.
125. Id.
mern right to control should not be determinative. While neither Turner nor Forman consider this problem, it should be noted.127

IV. COOPERATIVE HOUSING SHARES AS FINANCIAL ASSETS

Because the Riverbay shares are shares of stock in a corporation, they take on many of the attributes of other financial investments. Plaintiffs in Forman sought to call upon the financial asset characteristics of the cooperative shares by alleging that they fell within the "any stock" language of section 2(1). The plain-meaning concept of statutory construction would seem to mandate treatment of Co-op City shares as section 2(1) securities, since the word "stock" is specifically included in the definition and since the shares were called stock by the issuer.128 In Joiner, the Court said: "Instruments may be included within [section 2(1)], as a matter of law, if on their face they answer to the name or description."129 This language implies that the federal securities law literally apply to schemes where a stock corporation is used, regardless of the presence of a profit motivation.130 All shares of corporate stock represent a proprietary ownership interest in the asset pool of the corporation, and for regulatory purposes, the fact that the issuer is a cooperative housing corporation should not be altogether determinative.131

Here, too, the Forman Court rejected a literal reading of the

127. Professor Long proposes that the Howey "solely through the efforts of others" test should be changed to read "where the investor has no direct control over the investment or policy decisions of the venture." Long, Introduction to Symposium — Interpreting the Statutory Definition of a Security: Some Pragmatic Considerations, 6 ST. MARY'S L.J. 96, 122 (1974).


129. 320 U.S. at 351. In Movielab, Inc. v. Berkey Photo, Inc., 321 F. Supp. 806, 808-09 (S.D.N.Y. 1970), aff'd per curiam, 452 F.2d 662 (2d Cir. 1971), the court held that courts do not have the discretion to exclude instruments from the Securities Acts. The Second Circuit, however, chose to affirm on a narrower ground — that the particular notes in question were themselves securities. See generally cases cited at note 133 infra.


131. 1 L. LOSS, SECURITIES REGULATION 492-93 (2d ed. 1961). Commentators have indicated that "[p]roprietary leases in stock cooperative apartment projects which are sold coupled with shares of stock in the property owning corporation have long been treated as securities." Wenig & Schulz, Government Regulation of Condominium in California, 14 HASTINGS L.J. 222, 233 (1963). This statement, however, was made with respect to section 25008 of the California Corporation Code, which holds that securities include "stock," and certainly is not controlling with respect to federal securities regulation.
Noting that the primary focus of the Acts is "the capital market of the enterprise system," the Court held that the economic realities of the transaction, not merely the name given to the instruments, should govern.\(^{133}\) The Court distinguished \textit{Joiner}\(^{134}\) by noting that the language of that opinion precluded any indication that the Court intended to establish a mechanical rule.\(^{135}\) Shares in a cooperative housing corporation are merely mechanical incidents to the sale of an interest in real estate.\(^{136}\) \textit{Forman} distinguished cooperative housing corporations from general business corporations, where individuals invest with the sole purpose of making a profit and where consumptive characteristics are not dominant.\(^{137}\)

Drawing a distinction between shares in a cooperative housing corporation and the shares in a general business corporation presents some conceptual problems. Both situations encompass the corporate form whether or not tangible income is generated. The cooperative housing corporation is conceptually no different from any other corporation. It has many of the characteristics commonly attributable to the corporate entity, even though there generally will be one class of stock and limits will be placed on the transferability of those shares.\(^{138}\) For example, each shareholder "owns"

\(^{132}\) 421 U.S. at 848.


An "economic realities" approach would seem to be required by the introductory phrase "unless the context otherwise requires" in section 2(1). The phrase might be interpreted to mean that "securities" include all the listed investments, \textit{e.g.}, stock and investment contracts, unless some other specific portion of the Acts provided a different definition for a special purpose. The better reading is that the phrase represents a recognition of the principle that the context surrounding the investment, and not the name given to the investment, is crucial. This latter view has been adopted by the courts. Thus, although promissory notes are enumerated in section 2(1), certain notes have been held to be outside the statute where there has been no public offering or procurement for speculation or investment. \textit{See, e.g.}, \textit{Lino v. City Investing Co.}, 487 F.2d 689 (3d. Cir. 1973); \textit{McClure v. First Nat'l Bank}, 352 F. Supp. 454 (N.D. Tex. 1973); \textit{Joseph v. Norman's Health Club, Inc.}, 336 F. Supp. 307 (E.D. Mo. 1971).

\(^{134}\) See text accompanying note 129 \textit{supra}.

\(^{135}\) "By using the conditional words 'may' and 'might' in these dicta the [joiner] Court made clear that it was not establishing an inflexible rule barring inquiry into the economic realities underlying a transaction." \textit{United Housing Foundation, Inc. v. Forman}, 421 U.S. at 850.

\(^{136}\) "[J]ust as some things which look like real estate are securities, some things which look like securities are real estate." \textit{I L. Loss, SECURITIES REGULATION} 493 (2d ed. 1961).

\(^{137}\) \textit{See} text accompanying notes 50-51 \textit{supra}.

\(^{138}\) Stock transfer restrictions are valid so long as they are adopted for a lawful purpose and do not act as an unreasonable restraint on the alienability of the shares.
the cooperative corporation and holds a proportionate interest in its earnings and net assets upon liquidation. The number of shares held not only entitles the shareholder to a proprietary lease executed in his favor, but also determines the owner's share of expenses, rights upon dissolution or liquidation, and in some cases the weight of his vote at corporation meetings. Each shareholder also possesses three primary rights: (1) the right to expel management in conjunction with other shareholders; (2) the right to sue management for misuse of power, gross mismanagement, fraud, or dishonesty; and (3) the right to sell his shares. In addition, each shareholder elects with others a board of directors who manage the cooperative property.

These similarities were recognized in 1050 Tenants Corp. v. Jakobson. In that case, plaintiffs brought a class action on behalf of all past and present shareholders of 1050 Tenants Corp., a cooperative, alleging that the defendant promoters violated various antifraud provisions of the federal securities laws. The Court of Appeals for the Second Circuit affirmed the district court's denial of defendants' motion to dismiss for lack of subject matter jurisdiction. The Second Circuit found that shares in 1050 Corp. were both "stock" and "investment contracts" under the definitional language of the Acts. The corporation in Jakobson was organized under New York's Business Corporation Law, whereas Riverbay was organized under the New York Private Housing Finance Law. Although it could be said that Jakobson is now of questionable authority, having been decided prior to Forman, a similar result was reached subsequently by the court in Grenader v. Spitz. After reciting the holding in Forman, the district court distinguished the shares in the cooperative corporation and found that these shares were more akin to traditional shares of stock than the Riverbay shares. Specifically, the court stated that the shares were sold at

Thus, consent restrictions in the cooperative corporation have been upheld by analogy to lease provisions prohibiting assignment of the leasehold interest without consent. H. HENN, THE LAW OF CORPORATIONS 552-54 (2d ed. 1970).

One further variation is that funds are paid over to the cooperative corporation for the comparatively immediate return of recognized property rights and benefits. These rights otherwise would be purchased. Hoisington, Condominiums and the Corporate Securities Law, 14 HASTINGS L.J. 241, 253 (1963).

139. H. HENN, supra note 138, at 289; see id. at 252-53.

140. 2 P. ROHAN & M. RESKIN, COOPERATIVE HOUSING LAW AND PRACTICE § 2.02[5][f], at 2-21 (1975).


143. 503 F.2d at 1378.

a profit, that voting rights were determined in proportion to the number of shares owned, and that the shares could be transferred more easily than the Riverbay shares.\footnote{Id. at 98,528.} Thus, even after \textit{Forman}, the issue of whether shares of stock in a cooperative housing corporation are securities for purposes of the federal securities laws is still not completely settled.

\section*{V. Conclusion}

\textit{Forman} decided whether shares in a cooperative corporation fell within either the "stock" or "investment contract" language of section 2(1) of the Securities Act, but the Court's treatment of the issue was less than satisfactory. Approaching the initial question, whether the Riverbay shares were stock for the purpose of section 2(1), the majority stated that economic realities were of major concern, yet they chose to ignore the fact that the issuer of the shares was a corporate entity. Likewise, the Court rejected a more economically sound investment contract analysis in favor of a rigid application of a test originally formulated to overcome "irrelevant formulae." Nevertheless, the \textit{Forman} Court's failure to conclude that section 2(1) securities were issued by Riverbay may be attributable to its conclusion that the "inducement to purchase was solely to acquire subsidized low-cost housing space . . . not to invest for profit."\footnote{421 U.S. at 851.} At least one court has characterized this type of reasoning as an engagement "in the type of mind-probing speculation . . . [which is] unhelpful and unnecessary."\footnote{1050 Tenants Corp. v. Jakobson, 365 F. Supp. 1171, 1176 (S.D.N.Y. 1973), aff'd, 503 F.2d 1375 (2d Cir. 1974).} It indicates a failure to appreciate the underlying economic considerations of the transaction as well as a failure to recognize the hybrid nature of the cooperative housing corporation. Purchase of cooperative housing is both an investment in the first instance and, more important, an investment laden with many of the qualities of other section 2(1) securities.

When one purchases housing, whether it is a house or shares in a cooperative housing corporation, he considers the present period consumptive opportunities as well as the number of consumptive periods the housing will provide in the future. The \textit{Forman} decision impliedly held that purchasers of housing are either consumers or investors. This dichotomy does not always exist. A more satisfying approach to the problem, one which does not attempt to mold
cooperative shares into any restrictive category, may be found in the careful examination of the economic realities of each transaction that the court has invited.\textsuperscript{148}

The investment quality associated with the purchase of housing may be stated in two extreme cases. The normal purchase of a home is clearly not a section 2(1) investment. Since the only hope of profits from such a purchase is tied to a general increase in values which may occur over time, there can be no investment contract unless the purchase is made with the understanding that a third party planned to develop or operate the real estate for profit.\textsuperscript{149}

At the opposite end of the spectrum is the offer and sale of condominiums coupled with a rental pool agreement, in which a developer or his nominee is responsible for management of the property and distribution of profits derived from rentals.\textsuperscript{150} This arrangement clearly constitutes a section 2(1) security. These two forms of housing purchases may be distinguished by looking to the elements of valuation and control as they relate to each investment. The purchaser of a house can determine value by assessing the rate of return and risk without special information. Variations in expected return do not depend upon the performance of third party fiduciaries. The investment is solely within the control of the investor. In the case of a condominium subject to a rental pool agreement, the investor must have information about the capital structure of the venture as well as the performance record of its promoters to analyze its risk and rate of return characteristics. This information is crucial because the investment is controlled by third parties.

\textsuperscript{148} See notes 54 & 55 supra and accompanying text.

\textsuperscript{149} See 1 L. Loss, \textit{Securities Regulation} 491-92 (2d ed. 1961). A systematic plan of development by a subdivision owner would result in investment contract treatment when subdivision parcels are sold for investment purposes. See Long, \textit{supra} note 69, at 162-63.


On the other hand, mere delegation of management for the sake of convenience, coupled with the practical ability to intervene in management, certainly cuts against a finding that there is an investment contract. Long, \textit{Introduction to Symposium — Interpreting the Statutory Definition of a Security: Some Pragmatic Considerations}, 6 \textit{St. Mary's L.J.} 96, 116 (1974).
whose management skills will be the practical determinant of the venture's success.

When juxtaposed with the issues of valuation and control, the hybrid nature of cooperative housing becomes apparent. The investor who initially selects a particular cooperative makes value judgments not unlike those accompanying the purchase of a private home. Yet, he is investing in a corporate entity with a complex capital structure. Whether return flows from a durable good or a financial asset, specialized information is required in the valuation process. While tenant-shareholders do exercise supervisory control over the enterprise, the value of their investment is subject to the discretionary control of management and the continued solvency of the other tenant-shareholders. If enough shareholders fail to pay their monthly assessments or if the property is managed poorly, the investor stands to lose the value of his investment regardless of his solvency.

Recognition of this attribute of the cooperative housing corporation provides a better analytical approach because it highlights the unstated policy factors which lie at the base of the Court's decision. Perhaps Forman may be explained as a recognition on the part of the Court that federal securities regulation of state-financed cooperative housing corporations is not warranted. The Court may have felt that federal regulation of entities organized and established solely for the purpose of providing primary dwellings for low-to middle-class families should be left to state regulation. The Court perhaps recognized the traditionally local concerns involved in providing housing for the state's less fortunate citizens. Under this view, Jakobson and Grenader may be reconciled with Forman because those cases were not limited to purely local concerns.151

A more precise understanding of the economic concepts involved in this type of transaction will allow for symmetry in the law and will not leave a more confused state after the courts have spoken than existed before.

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151. The Court of Appeals for the Second Circuit, by reversing the district court's holding in Grenader and overruling its own decision in Jakobson, has chosen not to follow such an approach. Grenader v. Spitz, CCH Fed. Sec. L. Rep. ¶ 95,523 (2d Cir. Apr. 28, 1976). The court viewed Forman as controlling the question of whether shares in cooperative housing corporations were entitled to the protection of the federal securities laws.