

Sell a Condominium, Buy a Securities Lawsuit: Unwarranted Liabilities in the Secondary Market

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I. INTRODUCTION

Securities law litigation regarding condominium units coupled with rental arrangements is poised to enter a new and largely uncharted field: the sale of individual units in the secondary market. Recent case law suggests that customary, routine practices in condominium resales, undertaken without deceit or dishonesty, expose unit owners and their real estate brokers to securities law liabilities that are substantial, wholly unanticipated, and unwarranted. The negative ramifications on condominium unit owners, developers, and real estate brokers may be serious. Potentially even more important may be the effect on the development of securities law, due to a number of analytical defects in the reasoning presented in support of this inappropriate extension of securities liability.

The applicability of securities law to condominiums with rental arrangements (typically though not exclusively in resort locations) is well established¹ and unobjectionable. The judicial and administrative standards leading to that conclusion, however, were developed to address primary sales, from a condominium developer to the first group of unit purchasers.² Only recently has attention been directed to the resale or secondary market, which in fact is far more important, in terms of frequency and aggregate volume of transactions. A particular unit may change hands a dozen or more times over its useful life, yet up to now only the first sale has been considered.

When standards developed in one context are applied in a superficial manner to a different context for which they were not designed, the results can be disturbing. In one particularly unfortunate recent decision, for example, the Ninth Circuit ruled that an ordinary resale of a single condominium unit by its owner became subject to securities law merely because the real estate broker put the buyer in contact with a rental manager having no affiliation or relationship whatsoever with either the seller or the broker.³ Though the plaintiff in that case alleged fraud, the decision is based on an expansive interpretation of the definition of "investment contract" and hence is not limited to fraud actions.

Onerous and expensive registration requirements apply to every offer and sale of a security, and to every broker engaged in securities

¹ The SEC has taken regulatory action against condominium offerings, and obtained registration statements for them, since 1967. Peter M. Gunnar, *Regulation of Resort Time-sharing*, 57 OR. L. REV. 31, 36 n.24 (1977) (citing Hale Kaanapali Apartment Hotel Dev. Co., Registration Statement No. 2-25489 (Apr. 13, 1967)). Commentators have addressed the securities law aspects of condominiums since at least 1969. Patrick J. Rohan, *The Securities Law Implication of Condominium Marketing Programs Which Feature a Rental Agency or Rental Pool*, 2 CONN. L. REV. 1 (1969); see also David Clurman, *Condominiums as Securities: A Current Look*, 19 N.Y.L.F. 457 (1976); Lane L. McVey & David R. Murchinson, Comment, *Federal Securities Regulation of Condominiums: A Purchaser's Perspective*, 62 GEORGETOWN L.J. 1403, 1409-10 (1974) (also discussing early SEC no-action letters on condominiums).

² See generally Robert C. Art, *Securities Law Aspects of Condominium, Cooperative and Timeshare Marketing Programs*, in POWELL ON THE LAW OF REAL PROPERTY, Chap. 54B (1986).

³ *Hocking v. Dubois*, 885 F.2d 1449, 1457-62 (9th Cir. 1989), cert. denied, 110 S.Ct. 1805 (1990). The only subsequent decision to cite the *Hocking* case resolved its issue (relating to marketability of title of leaseholds with rental pooling arrangements) on other grounds, but noted "grave doubts about the correctness of *Hocking*." *Allison v. Tigor Title Ins.*, 907 F.2d 645, 649 (7th Cir. 1990).

transactions, unless a specific exemption applies.⁴ Though logic would dictate that a private sale of a single condominium unit would fall within some exemption, a detailed examination of the statutes and rules proves otherwise.⁵ Moreover, complete honesty and candor in a nonexempt securities transactions is no defense; those who act merely in innocent ignorance of the complex and specialized regime of federal securities regulations are subject to liability.⁶ As a result, purchasers of condominium units who become dissatisfied with their purchases, perhaps due to a general decline in market prices or other reasons wholly unconnected to fraud or nondisclosure, will have available an array of civil liability provisions to rescind or otherwise penalize the unit seller or real estate broker.⁷

Analysis of whether such liability is justified involves a number of issues of more general application and importance to the field of securities regulation. A primary issue is whether the parties supplying the elements of an investment contract must be related to each other. Using the classical phraseology from the Supreme Court's *Howey* test—an "expect[ation of] profits . . . from the efforts of the promoter or third party"⁸—is there an implicit requirement that the promoter or third party be affiliated or otherwise connected to the offeror?

Another issue is whether a form of investment that is once correctly characterized as a security retains that status once it is in the hands of a

⁴ Securities Act of 1933, § 5, 15 U.S.C. § 77e(c) (1988) (registration of securities); Securities Exchange Act of 1934, § 15, 15 U.S.C. § 78o (1988) (registration of securities broker-dealers). Registration of securities and of brokers is addressed in Section VI of this Article, *infra*.

⁵ Many of the exemptions—notably the nonpublic offering, Regulation D, and intrastate exemptions—are available only to "issuers," a term not likely to include an individual condominium owner selling a single unit in the resale market (though one possible interpretation would so classify that person). The formal exemptions such as Rule 144 are useful only if a lengthy holding period is satisfied. Analysis of the applicability and practicality of the various exemptions in the condominium resale context is contained in Section VI.C. of this Article.

⁶ *See, e.g.*, Securities Act of 1933, § 12(1), 15 U.S.C. § 77l(1) (1988) (rescission or damages available for any violation of securities act, without regard to mental state of defendant); *Ballay v. Legg Mason Wood Walker Inc.*, 925 F.2d 682 (3d Cir.), *cert. denied*, 112 S. Ct. 79 (1991) (mere negligence is sufficient to establish liability under § 12(2) for oral misrepresentation).

⁷ Similar consequences have been noted in other industries. *See, e.g.*, Gordon L. Allott, *Unanticipated Liability of the Landman*, 31 ROCKY MT. L. INST. 21-1, 21-23 (1985); John Cooper, *Win, Place or Show Through Multiple Ownership of Thoroughbreds in Alabama*, 15 CUMB. L. REV. 317, 318 n.35 (1985).

⁸ *S.E.C. v. Howey*, 328 U.S. 293, 298, *reh'g denied*, 329 U.S. 819 (1946).

different party. Stated otherwise, does the intuitively attractive formula "once a security, always a security" withstand analysis?

Finally, the position of the Securities and Exchange Commission (SEC) on these issues deserves attention. Through a large number of Releases, "No-Action Letters," and amicus briefs, the SEC has established policies of substantial practical importance to parties involved in condominium sales.

This Article will address each of those issues, after first establishing the basic framework of analysis derived from the leading Supreme Court precedents in the field, and recent circuit court case law directly addressing securities aspects of condominium resales. Case law created the problem, and can cure it, if analytical defects in recent decisions are recognized and rejected. Alternately, legislative and administrative solutions are proposed.

II. CASE LAW ON CONDOMINIUMS AS SECURITIES

Case law explicating the characteristics of an "investment contract," one of the terms within the statutory definition of "security,"⁹ leaves no doubt that real estate offerings meeting those characteristics are included.

⁹ The key definition is:

§ 2. When used in this title, 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.

Securities Act of 1933, § 2(1); 15 U.S.C. § 77b(1) (1976). The definition in the Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C. § 78c(a)(10) (1976), is virtually identical, and the two are interpreted the same. *See* *Marine Bank v. Weaver*, 455 U.S. 551, 556 n.3 (1982); *Tcherepnin v. Knight*, 389 U.S. 332, 336-43 (1967).

Particular attention is warranted to the words "unless the context otherwise requires" in the opening clause, and the terms "stock" and "investment contract." The "context" has been interpreted as referring to the context of an investment transaction, rather than the statute, leading to an analysis of whether an investment instrument that in isolation would not be a security should be considered a security because it is offered in conjunction with other interests. *See e.g.*, *United Housing Foundation v. Forman*, 421 U.S. 837 (1975).

Tangible property of any type,¹⁰ ranging from earthworm farms¹¹ and thoroughbred horses¹² to cosmetics marketing franchises¹³ are investment contracts and hence securities, if coupled with management arrangements. Though not "investment contracts" when considered in isolation,¹⁴ condominium units fall into that classification when offered in conjunction with rental services.¹⁵

A. *The Framework for Analysis: Supreme Court Interpretations of "Investment Contracts"*

A brief review of the very few Supreme Court rulings on the definition of the term investment contract is useful to establish the core principles applicable to the issue of condominium sales and resales. Three decisions directly involved real estate interests alleged to constitute investment contracts. Two others are useful also, though less directly on point.

¹⁰ See, e.g., *Bell v. Health-Mor, Inc.*, 549 F.2d 342 (5th Cir. 1977) (vacuum cleaners); *S.E.C. v. Continental Commodities*, 497 F.2d 516 (5th Cir. 1974) (managed customer accounts at brokerage firms); *Miller v. Central Chinchilla Group, Inc.*, 494 F.2d 414 (8th Cir. 1974) (chinchillas); *Glen-Arden Commodities v. Costantino*, 493 F.2d 1027 (2d Cir. 1974) (scotch whisky); *S.E.C. v. Glenn W. Turner Enterprises*, 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973) (self-improvement courses); *Continental Marketing Corp. v. S.E.C.*, 387 F.2d 466 (10th Cir. 1967) (beavers); *S.E.C. v. Payne*, 35 F. Supp. 873 (S.D.N.Y. 1940) (silver foxes); *Holloway v. Thompson*, 42 N.E.2d 421 (Ind. App. 1942) (cemetery lots). In each of these situations, the tangible property was coupled with some managerial services.

¹¹ *Smith v. Gross*, 604 F.2d 639 (9th Cir. 1979).

¹² See generally *Cooper*, *supra* note 7.

¹³ *S.E.C. v. Koscot Interplanetary, Inc.*, 497 F.2d 473 (5th Cir. 1974).

¹⁴ See, e.g., *De Luz Ranchos Inv. v. Coldwell Banker & Co.*, 608 F.2d 1297, 1301 (9th Cir. 1979) (when seller's only obligation is to transfer title to land, no security is involved); *Woodward v. Terracor*, 574 F.2d 1023, 1025 (10th Cir. 1978) (mere transfer of title to land does not involve a security). The Securities and Exchange Commission agrees. Ray Garrett Jr., former chairman of the SEC, stated that "[I]nterests in property are not ordinarily securities. We have nothing to do with the normal buying and selling of interests in property, and we don't want to have anything to do with it." Address by Ray Garrett, Jr., before the San Diego Mortgage Bankers Ass'n, July 4, 1974, *quoted in* Alan M. Berman & Andrew D. Stone, *Federal Securities Law and the Sale of Condominiums, Homes and Homesites*, 30 BUS. LAW. 411, 425 (1975). The two-judge majority in the *Hocking* case conceded that "real estate, without more" is not a security, but then found that more was involved in the particular transaction. 839 F.2d 560, 564-66 (9th Cir. 1988).

¹⁵ Art, *supra* note 2, at 54B-13; George K. Chamberlin, Annotation, *What Interests in Real Estate Are "Securities" Within Meaning of § 3(a)(10) of Securities Exchange Act of 1934*, 15 U.S.C.S. § 78c(a)(10), 52 A.L.R. FED. 146, 164 (1981).

The earliest decision, in *SEC v. C.M. Joiner Leasing*,¹⁶ (hereinafter *Joiner*) emphasized the marketing approach used by the promoter. The Supreme Court accorded key importance to the contents of the advertising and "sales literature," quoting extensively from letters sent by the promoter to the prospective investors.¹⁷ The decision, however, did not enumerate the component elements of an investment contract.

The framework for most subsequent interpretation of the term "security" was established three years later, in *SEC v. W.J. Howey Co.*¹⁸ (hereinafter *Howey*), a 1946 decision concerning the marketing of what was ostensibly an interest in real estate. The Howey Company had offered investors fee simple in long narrow strips of land in a Florida orange grove—an interest that in isolation would not be a security.¹⁹

Concurrently, however, a closely affiliated company had offered a "service contract," which for practical purposes was necessary to make the real estate interest economically feasible and attractive to investors. The service company would manage the property, pick and market the fruit, and distribute the profits to the owners. Of key importance to later decisions was the fact that the fruit from all of the strips would be commingled or "pooled," so that the economic return to each owner would depend on the profitability of the enterprise as a whole, rather than the production of the specific trees owned by each investor.²⁰

The Supreme Court ruled that the combination in the offer²¹ of the fee simple and the service contract constituted an "investment contract," even though the real estate had intrinsic value apart from the management services.²² The *Howey* decision's formulation, which has come to be

¹⁶ 320 U.S. 344 (1943).

¹⁷ *Id.* at 346 & n.3.

¹⁸ 328 U.S. 293, *reh'g denied*, 329 U.S. 819 (1946).

¹⁹ *Howey*, 328 U.S. at 299.

²⁰ *Id.* at 300. Pooling is important to the issue of whether "vertical commonality" is sufficient to establish the existence of a security, or whether "horizontal commonality" is necessary.

²¹ Even investors who chose to purchase the land without the contract were held to be protected by the securities laws, because the laws prohibit offers as well as sales of unregistered securities. *Id.* at 300-01.

²² The key language, the basis for extensive exegesis in the subsequent lower court decisions, defined an investment contract as:

. . . 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, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise. . . .

known as the "economic realities test," classifies an interest as a security only if the three elements are concurrently present:

- (1) "an investment of money;" in
- (2) "a common enterprise" (with divergence of authority as to the meaning of commonality); and
- (3) "an expectation of profits solely from the efforts of the promoter or a third party" (but note that the term "solely" was subsequently deleted, as explained below).²³

Only one subsequent Supreme Court case has dealt directly with the issue of whether real estate interests are securities. *United Housing Foundation, Inc. v. Forman*²⁴ (hereinafter *Forman*) concerned stock in a state-subsidized housing cooperative, entitling the stockholder to lease an apartment in the building. In a split decision, the Court ruled that no security was present.

First focusing on the term "stock," one of the items listed in the statutory definition of security, the Court determined that the cooperative shares did not qualify because they lacked the conventional characteristics of stock.²⁵ Next, focusing on the "investment contract" term in the statutory list,²⁶ the Court applied the *Howey* test. The third element,

. . . . If that test be satisfied, it is immaterial whether the enterprise is speculative or non-speculative or whether there is a sale of property with or without intrinsic value.

Id. at 298-99, 301.

²³ *Id.* at 299, 301.

²⁴ 421 U.S. 837 (1975).

²⁵ The shares were not transferable except to the cooperative itself, which would merely refund the original purchase price, making appreciation in value to the shareholder impossible. The owners had voting rights, but on the basis of one vote per apartment rather than one vote per share (even though larger apartments required the purchase of more shares). No dividends would be paid. For these reasons, the Court determined that the shares were not "stock" in the statutory sense, even though they had been given that label. "[F]orm should be disregarded for substance and the emphasis should be on economic reality." *See id.* at 850 n.15 (quoting *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967)).

²⁶ This characterization of the *Forman* decision is based on subsequent Supreme Court explanations in *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985). Ambiguities in *Forman* provided considerable support for the view that the *Howey* factors applied to all types of securities, not merely investment contracts, and

“expectation of profits” was absent, the Court determined, because the marketing program had not emphasized the investment benefits of ownership, and the arrangement in fact excluded the possibility of profit.²⁷

Forman is significant also for its modification of the *Howey* formula’s reference to “profits solely from the efforts of the promoter or third parties.”²⁸ Though that phrase was appropriate to the particular facts of the *Howey* case,²⁹ a literal application would allow promoters to escape securities law virtually at will, merely by requiring investors to perform token efforts, perhaps of a ministerial nature.³⁰ The Supreme Court in

underlied the entire “sale of business controversy” finally resolved in *Landreth Timber*.

²⁷ The purchasers were “motivated by a desire to use or consume the item purchased,” not to profit from it. Accordingly, the majority in *Forman* concluded that the offering was not an investment contract and not a security. The majority rejected the argument of the dissenting justices that savings in housing costs due to state subsidies and tax benefits were equivalent to profit. *Forman*, 421 U.S. at 852–55.

²⁸ *Howey*, 328 U.S. at 299. Elsewhere in the same opinion, referring to earlier case law from state courts regarding the phrase “investment contract,” the Court used the terminology “solely through the efforts of the promoter or some one other than themselves.” *Id.* at 298.

²⁹ The *Howey* investors were offered strips of citrus groves plus a service contract. The Supreme Court noted that “[i]ndividual development of the plots of land that are offered and sold would seldom be economically feasible due to their small size. Such tracts gain utility as citrus groves only when cultivated and developed as component parts of a larger area.” *Id.* at 300. The offerees were professional and business people from distant localities, lacking the knowledge, skill, and equipment requisite to cultivation, harvesting, and marketing citrus products. Therefore, they would be unable to derive any benefit from their investment unless they purchased a service contract. *Id.* at 296, 300.

³⁰ For example, in two cases involving the same operator of pyramid schemes, investors were required to expend some efforts, such as bringing new potential investors to sales meetings. All key aspects of the marketing program, sales techniques, and product, however, were controlled by the promoter. Both courts declined to apply the *Howey* “solely” term literally, disregarded the incidental efforts of the investors, and deemed the investments to be securities. The only efforts to be considered were “the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.” *S.E.C. v. Glenn W. Turner Enterprises*, 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973); *accord S.E.C. v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 483 (5th Cir. 1974); *see also Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.*, 840 F.2d 236, 240 n.4 (4th Cir. 1988); *S.E.C. v. Professional Assoc.*, 731 F.2d 349, 357 (6th Cir. 1984); *Goodwin v. Elkins & Co.*, 730 F.2d 99, 103 (3rd Cir.), *cert. denied*, 469 U.S. 831 (1984); *Baurer v. Planning Group, Inc.*, 669 F.2d 770, 779 (D.C. Cir. 1981); *Fargo Partners v. Dain Corp.*, 540 F.2d 912, 914–15 (8th Cir. 1976). One commentator has suggested that the origin of the view eliminating the term “solely” was merely a judicial attempt to apply securities law when it did not directly apply, to penalize a

Forman referred instead to "profits to be derived from the entrepreneurial or managerial efforts of others,"³¹ effectively deleting the word "solely" from the *Howey* formula.³² One of the other component elements of the *Howey* test, "common enterprise," has no authoritative Supreme Court interpretation,³³ and so remains problematic in condominium situations as in many others. The circuit courts are split on the issue of which types of relationships provided the necessary commonality.³⁴ One point of general agreement is that the requirement is satisfied by "horizontal commonality": sharing of risk and profits among two or more investors.³⁵

clear fraud, and thus "demonstrating the truth of the old maxim that hard cases made bad law." James S. Mofsky, *Some Comments on the Expanding Definition of "Security,"* 27 U. MIAMI L. REV. 395, 405 (1973).

³¹ *Forman*, 421 U.S. at 852.

³² *Piambino v. Bailey*, 610 F.2d 1306, 1317 n.18 (5th Cir. 1980) (Supreme Court has "read the word 'solely' out of the *Howey* test. . ."); *Williamson v. Tucker*, 645 F.2d 404, 418 (5th Cir.) (word "solely" omitted from Supreme Court test of investment contract), *cert. denied*, 454 U.S. 897 (1981).

³³ The Court has declined to review the split in the lower courts. *Mordaunt v. Incomco*, 469 U.S. 1115, 1116 (1985) (White, J., dissenting) (certiorari should be granted to resolve split in authority among the circuits). One Supreme Court decision lent some support to the view that the more stringent horizontal commonality is necessary. *Marine Bank v. Weaver*, 455 U.S. 551, 559-60 (1982) (an agreement to provide one party a share of the other party's profits from operation of a business was a "unique agreement negotiated one-on-one," not involving any other investors, and not constituting a security.) As one commentator concluded, after a detailed review of the case law, "[t]he requisite commonality to satisfy *Howey's* common enterprise element appears to remain an open question." Marc I. Steinberg & William E. Kaulbach, *The Supreme Court and the Definition of "Security": The "Context" Clause, "Investment Contract" Analysis, and Their Ramifications*, 40 VAND. L. REV. 489, 520-21 (1987).

³⁴ For analysis of the differing positions, see Susan G. Flanagan, Comment, *The Common Enterprise Element of the Howey Test*, 18 PAC. L.J. 1141, 1150-58 (1987).

³⁵ See, e.g., Steinberg & Kaulbach, *supra* note 33, at 519 ("Generally, all courts hold that horizontal commonality (which looks to the relationship between an individual investor and the pool of other investors) meets this element of the *Howey* test.") The Third, Sixth, and Seventh Circuits require horizontal commonality. *Curran v. Merrill Lynch, Pierce, Fenner & Smith*, 622 F.2d 216, 223-25 (6th Cir. 1980) (commonality requires a relationship among investors exemplified by pooling of funds or pro rata distribution of profits); *Hirk v. Agri-Research Council, Inc.*, 561 F.2d 96, 101 (7th Cir. 1977) (discretionary futures trading account was not a security because only one investor was involved); *Milnarik v. M-S Commodities, Inc.*, 457 F.2d 274, 278 (7th Cir.) (there must be more than one investor, and some kind of joint participation or dependency between investors must be present), *cert. denied*, 409 U.S. 887 (1972); *Wasnowic v. Chicago Bd. of Trade*, 352 F. Supp. 1066, 1069 (M.D. Pa. 1972), *aff'd mem.*, 491 F.2d 752 (3d Cir. 1973), *cert. denied*, 416 U.S. 994 (1974). In the First Circuit, horizontal commonality was accepted by a district court.

The disagreement is whether "common enterprise" is established merely by proof of "vertical commonality," which relates to the relationship between the promoter and the investor. According to many courts, the element is fulfilled if the promoter shares profit and risk with the investor, even though there may be only one investor.³⁶ An alternate, more liberal interpretation of "vertical commonality" is satisfied if the investor's return is dependent on the expertise of the promoter whether or not the promoter's profits are tied to the investor's, and whether or not there is more than one investor.³⁷ The Supreme Court has not directly ruled on the various interpretations of commonality.

Holtzman v. Proctor, Cook & Co., 528 F. Supp. 9, 15 (D. Mass. 1981). Even in these circuits, however, a court might discuss vertical commonality. *See, e.g.*, *Stenger v. R.H. Love Galleries, Inc.*, 741 F.2d 144, 147 (7th Cir. 1984) (arrangement between seller and buyer of paintings involved only one buyer so lacked horizontal commonality, but also resulted in differing financial interests of the two parties so lacked vertical commonality); Flanagan, Comment, *supra* note 34, at 1152-53. One criticism of insistence on horizontal commonality is that "it makes no sense to penalize the single investor simply because he happens to be alone in his misfortune." *Walsh v. International Precious Metals Corp.*, 510 F. Supp. 867, 871 (D. Utah 1981).

³⁶ The Fourth, Eighth, Ninth, and Tenth Circuits accept strict vertical commonality, in which the fortunes of an investor are inextricably tied to the success of the promoter, without necessarily any pooling with other investors. *McGill v. American Land & Exploration Co.*, 776 F.2d 923, 925 (10th Cir. 1985) (joint venture for real estate development is a security, as horizontal commonality is not required); *Mordaunt v. Incomco*, 686 F.2d 815, 817 (9th Cir. 1982), *cert. denied*, 469 U.S. 1115 (1985); *Meyer v. Thomas & McKinnon Auchincloss Kohlmeyer, Inc.*, 686 F.2d 818, 819 (9th Cir. 1982), *cert. denied*, 460 U.S. 1023 (1983); *Brodv. Bache & Co.*, 595 F.2d 459, 461 (9th Cir. 1978) (discretionary commodities trading account did not satisfy the common enterprise element because fortunes of promoter and investor were not mutually dependent); *Miller v. Central Chinchilla Group, Inc.*, 494 F.2d 414, 418 (8th Cir. 1974); *El Khadem v. Equity Sec. Corp.*, 494 F.2d 1224, 1229 (9th Cir.) (either horizontal or vertical commonality satisfies the requirement), *cert. denied*, 419 U.S. 900 (1974); *Commercial Iron & Metal Co. v. Bache & Co.*, 478 F.2d 39, 42 (10th Cir. 1973) (discretionary commodities trading account was a security if promoter promised to make all investment decisions and earn large profits); *SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

³⁷ Two Fifth Circuit decisions are the best examples of the liberal commonality position. *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 485 (5th Cir. 1974) (pyramid marketing scheme was a security even though each investor's success depended in part on that investor's own efforts because the essential managerial efforts were provided by the promoter); *SEC v. Continental Commodities Corp.*, 497 F.2d 516, 522 (5th Cir. 1974) (relationship between broker and a single customer satisfies the commonality requirement; "[t]he critical factor is not the similitude or coincidence of investor input, but rather the uniformity of impact of the promoter's efforts" (quoting *Koscot*, 497 F.2d at 478)). The rationale is that an investor who lacks the

The two most recent Supreme Court decisions on the definition of a security merit brief mention for their possible effect on condominium resales, though they do not directly relate to real estate. In *Marine Bank v. Weaver*,³⁸ the Court reviewed a private business arrangement between a bank and the guarantor of a loan.³⁹ According to the Court, "this unique agreement, negotiated one-on-one by the parties, [was] not a security."⁴⁰ Because sales of condominiums in the secondary market typically involve the owner of a single condominium unit privately negotiating a transaction with a single buyer, *Marine Bank v. Weaver* suggests that the situation does not involve a security.

That interpretation is unreliable, however, in light of the Supreme Court's subsequent decision, in *Landreth Timber Co. v. Landreth*,⁴¹ substantially undercutting or limiting its decision in *Marine Bank*. The *Landreth Timber* case stands for the proposition that stock is always a security (if it has the traditional attributes of stock) regardless of the transactional context. Thus even privately negotiated one-on-one sales might be securities. The Court emphatically and specifically limited its opinion to stock, however, disclaiming any ruling relating to investment contracts.⁴²

These precedents, particularly *Howey* and *Forman*, provide the most authoritative criteria for analysis of whether real estate interests constitute a "security." Lower-court decisions and SEC positions are valid to the extent that they are reconcilable with the Supreme Court authority and the statute.

B. *Application to Condominiums: The Central Importance of Rental Arrangements and "Pooling"*

In a usual condominium transaction, the first element of the *Howey* test—investment of money—is plainly satisfied by the payment of the purchase price. The more difficult issues are whether the purchaser is led

knowledge and skill to protect himself or herself deserves the protection of the securities laws. A persuasive opposing viewpoint is that even knowledgeable investors deserve protection from fraud. Flanagan, Comment, *supra* note 34, at 1157.

³⁸ 455 U.S. 551 (1982).

³⁹ A couple who had purchased a \$50,000 certificate of deposit from a bank pledged it to the bank to guarantee a bank loan to third parties. The third parties agree to pay the guarantors 50% of its profits and \$100 per month for the duration of the guarantee, and to allow the guarantors to use the third party's horses, barn and pasture. *Id.* at 552-53.

⁴⁰ *Id.* at 560.

⁴¹ 471 U.S. 681 (1985); *accord*, *Gould v. Ruefenacht*, 471 U.S. 701 (1985) (decided the same day; involved sale of 50% of a corporation's stock).

⁴² *Landreth Timber*, 471 U.S. at 690.

to expect profits from the managerial efforts of others and whether the purchaser is involved in a common enterprise. A closely related issue is whether, under the *Joiner* approach, the promoter's publicity and promotional efforts emphasize the economic benefits rather than the suitability of the condominium unit as a personal residence for the buyer.⁴³ In practical application, the analysis typically centers on arrangements for unit owners to rent their units.

Expectation of profits from certain sources can be disregarded when determining whether a transaction in real estate involves a security. Most importantly, appreciation in the value of the real estate (depending on the vagaries of the real estate market) does not satisfy the test.⁴⁴ Also, courts

⁴³ See, e.g., *United Housing Found., Inc. v. Forman*, 421 U.S. 837, 854 (1975) (developer's "information statement" emphasized residential benefits and provided no basis for expectation of profits); *Aldrich v. McCulloch Properties, Inc.*, 627 F.2d 1036, 1039 (10th Cir. 1980) (promises that developer's activities would result in increase in values of lots); *De Luz Ranchos Inv., Ltd. v. Caldwell Banker & Co.*, 608 F.2d 1297, 1301 (9th Cir. 1979) (promoter's references to future construction of nearby facilities and amenities were too generalized to create any specific expectations by investors); *Woodward v. Terracor*, 574 F.2d 1023, 1025 (10th Cir. 1978) (developer stated plans for future development but contracted only for sale of land, not creating a security); *McCown v. Heidler*, 527 F.2d 204, 210 (10th Cir. 1975); *Happy Inv. Group v. Lakeworld Properties, Inc.*, 396 F. Supp. 175, 180-81 (N.D. Cal. 1975) (developer's literature and sales talks gave an impression that developer would exert substantial efforts to build a subdivision, but was devoid of any concrete promises or plans, and so did not lead to classification as a security).

⁴⁴ *Grenader v. Spitz*, 537 F.2d 612, 618 (2d Cir.) (stating that every purchaser of real estate, including a single-family residence, is aware that "he may eventually sell his property at a profit or loss depending on the vagaries of the real estate market, . . ." but that fact does not by itself make real estate a security), *cert. denied*, 429 U.S. 1009 (1976); *Bender v. Continental Towers Ltd. Partnership*, 632 F. Supp. 497, 501 (S.D.N.Y. 1986) (expectation of appreciation in value not sufficient to cause condominiums to be securities even though developer's marketing strategies would marginally affect those values); *Mosher v. Southridge Assocs., Inc.*, 552 F. Supp. 1226, 1230 (W.D. Penn. 1982) ("profit by appreciation earned through the retention of real estate" does not make a condominium a security); *Johnson v. Nationwide Indus., Inc.*, 450 F. Supp. 948, 953 (N.D. Ill. 1978) ("expectation of appreciation in value" does not make a condominium a security when developer did not agree to rent the units or provide any services other than management of such facilities as the garage). In other contexts as well, case law has made clear that expectation of market price increases does not satisfy the *Howey* test element of "expectation of profit from the efforts of others." See, e.g., *SEC v. Belmont Reid & Co.*, 794 F.2d 1388, 1391 (9th Cir. 1986) (gold coins); *Noa v. Key Futures, Inc.*, 638 F.2d 77, 79-80 (9th Cir. 1980) (silver bars); *Sinva, Inc. v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 253 F. Supp. 359, 366-67 (S.D.N.Y. 1966) (sugar futures). Nevertheless, to avoid even any unfavorable inference, some commentators have suggested that developers of

have tended to assign little or no importance to incidental sources of income, such as receipts from laundry machines or small stores maintained primarily for the convenience of residents.⁴⁵ Similarly, income tax benefits that are available to all owners of real estate are disregarded, even though they are obtained only because the development was properly planned and structured by the developer's tax experts.⁴⁶

The only profits likely to cause a residential condominium to be a security derive from rentals during periods in which the owners do not occupy them. Arrangements to facilitate and manage rentals can make the investment considerably more attractive to potential purchasers, particularly in the context of condominiums in resort areas, which the owners expect to use as vacation accommodations rather than permanent residences.⁴⁷

Almost any type of rental arrangement offered by the developer or an affiliate of the developer satisfies the "efforts of others" element of the *Howey* test. When the unit owner depends on the rental manager's efforts to advertise and otherwise promotes the property for rental, clean and maintain the premises, and collect and disburse the rental revenue, there seems little doubt that the investor is relying on the managerial efforts of others for profit.

timeshare condominiums restrict the ability of unit purchasers to resell at a profit. David M. Fields, *Real Estate Interests as Investment Contracts: An Update and a New Application—The Shared-Equity Program*, 12 REAL EST. L.J. 307, 313 (1984); Joseph Wm. Byrne, *Securities Regulation of Time-Sharing Resort Condominiums*, 7 REAL EST. L.J. 3, 8-9 (1978).

⁴⁵ *Forman*, 421 U.S. at 855-57 (income from professional offices, parking facilities, and washing machines was used to reduce rental costs, and did not raise the "expectation of profits" necessary to a security), *but see* 421 U.S. at 860-62 (Brennan, J., dissenting); *Grenader*, 537 F.2d at 617 (receipts from coin-operated laundry and cable television, used to reduce maintenance charges of residents, could not have created an expectation of profits or dividends); *Joyce v. Ritchie Tower Properties*, 417 F. Supp. 53, 55 (N.D. Ill. 1976) (allegation of expectation of "'income' from the various concessions which were to be located in the building" insufficient to establish that condominium was a security); *see also* Securities Act Release No. 5347, [1972-73 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,163. Use of incidental income (such as from laundry machines) to reduce maintenance assessments, rather than to distribute in a form comparable to dividends reinforces the conclusion that the purchaser has no expectation of profits. *Id.*; *see also* Robert F. Vargo, *Real Estate Transactions: The Existence of a Federal Security*, 14 CUMB. L. REV. 301, 315-16 (1984).

⁴⁶ *Forman*, 421 U.S. at 855. *But see id.* at 862-63 (Brennan, J., dissenting).

⁴⁷ Robert D. Rosenbaum, *The Resort Condominium and the Federal Securities Laws—A Case Study in Governmental Inflexibility*, 60 VA. L. REV. 785, 785-87 (1974) (also noting certain tax benefits if a condominium unit is owned as an activity engaged in for profit); Gunnar, *supra* note 1; Rohan, *supra* note 1, at 1-3.

When applying the "common enterprise" element, however, considerably more attention to the specific structure of the arrangement is necessary. The issue of whether expenses and income are "pooled" is particularly important, even critical. In the non-pooled arrangement, the rental manager maintains separate accounts for each condominium unit, managing it as agent for its owner and charging a fee for the service. The unit owner's return depends directly on the number of days that the particular unit was rented.

Although this approach can be successful, problems can arise because the agent typically has the same agreement with the owners of many of the units within a single development. Indeed, advertising, office overhead, and other management expenses typically make the rental service economically unfeasible unless a large number of units are under common management. Those expenses must be allocated to all participating owners in a fair manner. Also, when the rental demand is not sufficient to keep all units occupied, the available guests must be assigned to units in such a way as to keep both the guests and all unit owners satisfied.⁴⁸

To minimize these difficulties, rental arrangements are commonly structured through "rental pool agreements,"⁴⁹ commonly referred to as "RPAs." The manager maintains the units belonging to all participating owners and rents them out with the goal of maximizing total income of the pool. After all administrative expenses are paid, each individual unit owner receives a percentage of the profits from the entire pool, rather than proceeds from the rental of his or her particular unit.⁵⁰ In some condominium developments, participation in the RPA is mandatory.⁵¹

The pooling feature provides "horizontal commonality," in that the risks and returns of the venture are shared by many investors. A condominium with an RPA bears a strong parallel to the facts in the *Howey* case, in which the fruit from all of the small strips of land was pooled, and the net income received by each owner depended on the success of the overall venture rather than the production from the particular trees owned by each owner.

Non-pooled rental arrangements, in contrast, do not provide horizontal commonality because each unit owner receives income based only on rental of that owner's own unit. This type of arrangement can satisfy the *Howey* "common enterprise" element only in jurisdictions that accept the "vertical

⁴⁸ See generally Rosenbaum, *supra* note 47, at 786.

⁴⁹ *Id.* at 786, (citing Recreation Ventures, Registration Statement No. 2-45795; The Ranch at Roaring Fork, Inc., Registration Statement No. 2-46633; Sundial Associates, Registration Statement No. 2-45433; Carlton House Resort Inns, Inc., Registration Statement No. 2-46257.)

⁵⁰ *Id.*

⁵¹ *Id.*

commonality" interpretation, which focuses not on relationships among investors but rather on the relationship of a particular investor with the promoter.

A Fifth Circuit decision⁵² illustrates the importance of the distinction. The case involved a condominium campground in which management arranged to rent camping sites to tourists, accounting separately for the rents earned on each owner's camping site. The circuit courts requiring horizontal commonality would have found no security.⁵³ The Fifth Circuit came to the opposite conclusion, however, ruling that a security was present because each owner's success depended on the manager's success.⁵⁴

Another factual circumstance identified as important is the extent of participation by the developer. If the developer merely offered rental brokerage services on an optional and nonexclusive basis in conjunction with other real estate brokers, the arrangement would not constitute a security.⁵⁵

If rental services are provided through a condominium owners association, the provision for shifting control of the association from the developer to owners after a sufficient number of units are sold is important. If the unit purchasers are granted ultimate control over the investment, or can meaningfully participate in essential managerial decisions, then the requisite reliance on the efforts of the promoter is lacking, and the real estate interest is not a security.⁵⁶ The unit purchasers may choose to delegate their responsibility to a managing agent, perhaps even the original promoter, without losing their power of control.⁵⁷

Though the content of an offer must be judged as of the time of the offer, analysis of the extent of decision-making power to be retained by a condominium owner must focus on the time period after the unit owner

⁵² *Cameron v. Outdoor Resorts of Am., Inc.*, 608 F.2d 187 (5th Cir. 1979).

⁵³ *Vargo*, *supra* note 45, at 310-11.

⁵⁴ *Cameron*, 608 F.2d at 193 (profits were "inextricably wedded" to the success of outdoor resorts, rental business, including its advertising and management.)

⁵⁵ *Byrne*, *supra* note 44, at 8. In its last "no-action letter" on timeshares before the Commission discontinued the issuance of letters on timeshare questions, the SEC staff opined that no security was present in an arrangement to rent timeshare units when the managing agent was selected by the unit owners directly, not the promoter, and arrangement was optional. The *Innisfree Corp.* SEC No-Action Letter, [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,398 (May 7, 1973).

⁵⁶ *Gordon v. Terry*, 684 F.2d 736, 741 (11th Cir. 1982) *cert. denied*, 459 U.S. 1203 (1983); *Fargo Partners v. Dain Corp.* 540 F.2d 912, 915 (8th Cir. 1976) (investor who had right to fire the managers had ultimate control).

⁵⁷ *Vargo*, *supra* note 45, at 319 (citing *Gordon v. Terry*, 684 F.2d 736 (11th Cir. 1982)).

chooses to participate in a rental arrangement. The *Howey* decision made clear that an offer of a real estate interest and a managerial services contract involved a security, even though the contract was optional. The critical factor was that the contract, if accepted, would deprive the real estate owner of control.⁵⁸ The opposite conclusion is justified if the contract, if accepted, would *not* deprive the real estate owner of control. For example, a provision in a condominium rental arrangement allowing the participating unit owner to cancel the contract at any time, or to fire the rental manager, tends to support the conclusion that no security is involved.⁵⁹

C. Secondary Transactions in Condominiums: The Limited Case Law

The issue of whether securities law applies to the resale of a single condominium unit by its owner in the secondary market had never, until recently, received specific attention in either case law or SEC rules. The one case to squarely address that issue, therefore, merits close attention. The case of *Hocking v. Dubois*,⁶⁰ decided by the Ninth Circuit *en banc* in 1989, represents the best available guidance for a market that, up to now, had proceeded without concern for securities regulation.

The *Hocking* case concerned a condominium unit in a relatively new Honolulu resort complex. When the developer of the complex sold the units, all of the elements of an investment contract were present. The developer promoted the real estate together with optional participation in a rental pool agreement with a different company with which the developer had made an arrangement. Rental income from all participating units would be combined into a single "pool," and then divided proportionately among all participants, regardless of differences in the income generated by each

⁵⁸ Robert B. Brannen, Jr., Comment, *The Economic Realities of Condominium Registration Under the Securities Act of 1933*, 19 GA. L. REV. 747, 769 n.96 (1985).

⁵⁹ The use of managers in property investments does not render them investment contracts if the investors maintain sufficient control over selection and termination of the manager. *Deutsch Energy Co. v. Mazur*, 813 F.2d 1567, 1570 (9th Cir. 1987); *Gordon v. Terry*, 684 F.2d 736, 741-42 (11th Cir. 1982), *cert. denied*, 459 U.S. 1203 (1983); *De Luz Ranchos Inv., Ltd. v. Coldwell Banker & Co.*, 608 F.2d 1297, 1301 (9th Cir. 1979); *Fargo Partners*, 540 F.2d at 915; *Perry v. Gammon*, 583 F. Supp. 1230, 1232-33 (N.D. Ga. 1984). In the *Hocking* situation, each condominium unit holder retained complete control over selection of a rental agent (though realistically, agents other than the one arranged by the developer might not be interested). Unlike the *Howey* situation, there were no facts suggesting that the plaintiff in *Hocking* would be deprived of the value of their real estate if they declined to enter into a service contract with a particular company.

⁶⁰ 885 F.2d 1449 (9th Cir. 1989), *cert. denied*, 494 U.S. 1078 (1990).

specific condominium unit. As a result, the arrangement provided horizontal commonality, and expectation of profits from the efforts of others arranged for by the promoter, satisfying the *Howey* test.⁶¹

The developer sold one of the units to an Arizona couple named Liberman, who did not elect to enter into the RPA and had no connection with the rental manager. Approximately one year later, the Libermans resold the unit to Hocking, the plaintiff. The Libermans' contract of sale did not purport to transfer any rights in the RPA, was not conditioned on the purchaser participating in the RPA, and indeed was completely silent regarding the RPA. Hence, what the Libermans sold was exclusively real estate, devoid of any management services. Perhaps for that reason, the plaintiff purchaser did not assert any securities law claims against the Libermans.

Hocking, the purchaser, later became dissatisfied with the appreciation in value of the condominium, and brought a securities fraud action under Rule 10b-5. Hocking named as defendants the real estate broker that had arranged the sale, and the brokerage company for which she worked. Conspicuously absent from the list of defendants were the sellers of the unit (the Libermans), the condominium developer, and the RPA manager.

Hocking alleged that the real estate brokers had promoted the availability of the RPA as an inducement to purchase the condominium unit and in the process misrepresented certain key facts (such as the amount of rental income that could be expected).⁶² Hocking further alleged that he would not have purchased the condominium if the RPA had not been available, and that in fact he did enter into the rental pool approximately two weeks after his purchase.

The federal district court dismissed the case on the ground that no security was involved. A three-judge panel of the Ninth Circuit, in a split decision, reversed and remanded, finding that a security was present.⁶³

⁶¹ All judges on the Ninth Circuit correctly noted that the developer offered and sold a security, though that transaction was not at issue in the case. *Id.* at 1456 (majority); *id.* at 1462 (Norris, J., dissenting).

⁶² Other alleged misrepresentations, mentioned in the decision of the three-judge panel but not in the *en banc* decision, concerned the prior ownership of the condominium unit, and the efforts that the brokers were making to again resell the condo on behalf of the plaintiffs. 839 F.2d 560, 563 (9th Cir. 1988) (petition for rehearing withdrawn December 7, 1988).

⁶³ *Id.* The two-judge majority held "that the offer of a condominium with an option to participate in a rental pool arrangement constitutes the offer of an investment contract under the securities laws." *Id.* at 563. The fact that the rental arrangement was offered by the developer's rental manager, not by the Libermans, was held to be insignificant. According to the court, the key is "what tangible bundle of rights was actually offered to or purchased by the buyer, not *who* offered or sold those rights to

(The flawed reasoning of the majority, essentially holding that once an investment vehicle satisfies the requirements to be a security it retains that status even when conditions change, is discussed in the following section of this article.) Subsequently, however, that opinion was withdrawn and the Ninth Circuit granted the defendants' petition for rehearing *en banc*,⁶⁴ a rare occurrence.

The Ninth Circuit *en banc* decision was deeply divided, reflecting the difficulty of the issue and the lack of directly applicable precedent. Six of the eleven judges—a slim majority—ruled that a security was present. Their rationale was completely different, and more defensible, than the one asserted by the majority of the three-judge panel below, but still flawed. In

him." *Id.* at 569. The court's reference to an "option" to participate in an RPA certainly was not intended in the common-law sense of an offer that was irrevocable by contract for a period of time. The broker had no capacity, and did not purport, to bind the RPA manager. Apparently the court was using the term "option" to mean a mere possibility that the plaintiff could approach a rental manager, who was not in any sense a party to the contract between the seller and the plaintiff, to ask whether the rental manager would be interested in entering into a separate contract.

That extreme position is avoided, however, because the Ninth Circuit hedged on the critical fact. The majority stated at the outset of its opinion that there was a genuine issue of material fact regarding the existence of an "option," and that, for purposes of the motion for summary judgment, it would assume that an option was offered. *Id.* at 562 n.1. The allegations cited by the two judges, however, support only the position that the purchaser desired rental services, not, as the judges stated, that he received an option for them. In footnote 1 of their opinion, the majority points to the allegation that the purchaser "[w]as informed of the availability of the rental pool arrangement by Dubois, and that he would not have purchased the condominium without the option. Further, within two weeks of purchasing the condominium, Hocking entered into the rental pool arrangement." *Id.* None of these allegations support the conclusion for which they are cited. *Id.* at 572 (Hug, J., dissenting) (noting also that the record contained no evidence suggesting that either the Libermans ever had a transferable option or that the real estate agent Dubois ever offered one to Hocking). Being "informed of the availability" of the RPA seems quite different from receiving an option, especially when the RPA was operated by a person not a party to, and not mentioned in, the condominium sale contract. Even the SEC takes the position that "mere notice of the existence of rental services . . . does not make the condominium offering one of securities." North Shore Project, SEC No-Action Letter, summarized in Sec. Reg. & L. Rep. (BNA) No. 194 at C-2 (March 21, 1973), cited in Rosenbaum, *supra* note 47, at 794 n.35. The SEC staff continues to take the position that developers can inform potential purchasers of the existence of rental services, provided that they are not emphasized in the marketing program. See also *infra* note 135 and accompanying text. Moreover, the plaintiff's subjective state of mind (wanting to participate in the RPA) and subsequent conduct (entering into the RPA) do not relate to receipt of an option or an offer of an option, at least in the strict sense.

⁶⁴ 852 F.2d 503 (9th Cir. 1988) (*en banc*).

a cogent dissent, five judges opposed the application of securities law to the situation, and two of those five supplemented the arguments for that position in a second dissent.⁶⁵ Certiorari to the Supreme Court was sought but denied.⁶⁶ No reported decision after *Hocking* has squarely addressed the same issue, though one case from the Seventh Circuit, in *dicta*, expressed "grave doubts about the correctness of *Hocking*."⁶⁷ Thus the *en banc* decision stands as the leading authority on securities law issues in the secondary condominium market.

1. The "Presented as Part of the Same Transaction" Standard

The Ninth Circuit majority constructed a new standard to guide application of the *Howey* test in situations in which management services and the tangible assets are provided by different parties: the two will be considered a single "package" if they are presented "as part of the same transaction or scheme."⁶⁸ The fact that the person offering the benefits was not legally authorized or capable of delivering them was deemed irrelevant to characterizing the offer.

Applying that approach to the *Hocking* facts, the majority ruled that Dubois, the real estate agent, had offered both the rental pool (available from the rental manager) and the condominium unit (available from the individual unit owner) as one "package" that satisfied all of the elements of the *Howey* test.⁶⁹ The conclusion was reached even though the agent, Dubois, and her principal (the unit owner), had no contract, relationship to or affiliation with the rental manager.

That holding should give pause to all real estate brokers dealing in condominiums with associated rental services (commonly in resort areas), and also to unit owners seeking to resell their units. Though *Hocking* asserted liability against only the real estate agent, the precedent will in

⁶⁵ *Hocking*, 885 F.2d at 1463-64 (Norris, J., dissenting); *id.* at 1468 (Wiggins, J., dissenting).

⁶⁶ 494 U.S. 1078 (1990).

⁶⁷ *Allison v. Ticor Title Ins.*, 907 F.2d 645 (7th Cir. 1990). The court described *Hocking* as "a 6-5 decision that did not satisfactorily address the question of how a unit owner who conveys only an interest in real property vends a 'security' just because the proprietor of the condominium development offers a rental pool in which unit owners may participate if they choose." *Id.* at 649. Resolution of that issue, however, was not necessary to decide the issue before the Seventh Circuit involving whether a title company had breached a contractual obligation to defend against claims of unmarketability of certain leases. Said the court, "even if we were to follow *Hocking*, the leases would not be 'unmarketable.'" *Id.*

⁶⁸ *Hocking*, 885 F.2d at 1458.

⁶⁹ *Id.*

other cases apply equally to unit owners marketing their units, whether or not they use real estate agents. More broadly, the holding has the potential of diminishing the attraction of resort condominiums by complicating their resale, thereby causing an unfavorable impact on the sale of resort condominiums in the first instance.

2. Wrapping the "Package": The Specific Conduct Creating Potential Liability

The findings of an investment contract is properly based on what is included in the "offer," a term that in securities law encompasses far more than what is covered by that term in the common law of contracts. The remedial purposes of the securities acts, and the ease by which any narrow definition could be evaded by promoters of securities schemes and, most importantly, the breadth of statutory definitions of the term, justify a broad interpretation. Hence the fact that a real estate agent, such as Dubois in the *Hocking* case, does not purport to bind the RPA manager, and does not have the authority or capacity to do so, does not resolve the issue of whether the RPA is "offered."

In Dubois' case, the determination that the RPA was part of the "package" offered to the buyer was based on four specific factual allegations. Close inspection of those acts is warranted to determine what precisely triggers the application of securities law. *Hocking*, the plaintiff buyer, alleged that the real estate agent:

- (1) "assured him rental of his investment would be taken care of for him," and "handled by the 'company'";
- (2) "informed him of the average daily rental";
- (3) "presented the rental agreements to him for his signature"; and
- (4) placed "emphasis on the economic benefits to *Hocking* to be derived from the managerial efforts of third parties designated or arranged for by Dubois. . . ." ⁷⁰

According to the six judges that formed the majority, the four facts alleged satisfy the "presented as parts of one transaction" standard. The six judges further assert, without explanation, that those allegations "distinguish this case from the everyday situation in which a real estate agent or broker merely provides information to the purchaser regarding the availability of a

⁷⁰ *Id.* The plaintiff also alleged that he would not have purchased the condominium except for the availability of the RPA, and that he in fact entered into the pooling agreement after the purchase. Those allegations, however, do not relate to the issue of whether the broker "presented" the RPA "as part of the same transaction."

rental pool or shared amenities such as a swimming pool or tennis courts.”⁷¹

The real estate brokerage industry and condominium unit owners are thus relegated to pondering the demarcation between “presenting” an RPA “as part of a single transaction” and “merely providing information” regarding availability of an RPA. On that gossamer distinction⁷² hinges substantial liability.

The four specific types of conduct alleged involve varying degrees of risk. Assuring the purchaser that rental will be taken care of for him (the first allegation) is not by itself likely to lead to characterization of the transaction as a security, though some uncertainty exists. Because the core function of any rental management arrangement is to take care of rentals for the owner, stating that fact ought to fall within the allowable “merely providing information” domain.

Informing the purchaser of the average daily rental (the second allegation) entails greater peril because it bears on the “expectation of profits” element of the *Howey* test. A broker might argue that the prevailing rental rates are basic, vital information, when discussing a property that is routinely rented, and should be permitted under the “merely providing information” standard, but may not succeed. Disclosing the daily rental may encourage the prospective purchaser to consider the rental agreement and the real estate as a single transaction. (The Ninth Circuit majority apparently accepted this proposition even though the broker made no representation regarding the number of days per month that rental could be expected, thus leaving to the prospective purchaser any projection of total monthly income.)

Presenting the rental pooling agreement for signature (the third allegation) appears to be the strongest support for the majority’s conclusion, although they accorded it no special attention. Although obtaining the forms may have been simple, supplying them as part of the sales pitch for the condominium unit indicates that the RPA was “presented as part of the same transaction.” (The dissenting justices assert that this conduct was “unexceptional and surely too inconsequential,” but fail to explain or support their view.)⁷³

Finally, placing emphasis on economic benefits from third parties (the last allegation) almost certainly also exceeds the bounds. That emphasis in the context of marketing the real estate suggests that the RPA is part of the overall condominium transaction, thereby triggering the application of securities law.

⁷¹ *Id.*

⁷² *Id.* at 1466 (Norris, J., dissenting).

⁷³ *Id.*

In sum, the message that *Hocking v. Dubois* provides for condominium unit owners and their real estate brokers is this: mentioning that a rental pool is available from a third party is probably permissible, but describing any aspect of it is dangerous, and drawing attention to its benefits or obtaining the RPA forms for a prospective purchaser invites federal securities law litigation.

3. *Practical Implications: Hocking vs. Economic Realities*

The restrictions and limitations that condominium unit owners and their brokers would have to follow to satisfy the *Hocking v. Dubois* standards are drastically divergent from conventional marketing practices. Real estate owners and brokers consistently and routinely draw attention to every attractive feature of the property they are marketing, provide all information and documents that are likely to facilitate a sale, and emphasize economic benefits. If the services of an unrelated third party are available and would enhance the attractiveness or value of the real estate, the owner or broker would of course include that fact in the marketing effort. Prior to *Hocking v. Dubois*, there was no basis for concern that referring to the availability of services from an outside party would convert a real estate transaction into a securities transaction, triggering a plethora of restrictions and liabilities.

The *Hocking* decision, stated in its extreme, is that a condominium unit—which in isolation is merely real estate—becomes a security merely because the seller or seller's broker describes to a prospective buyer rental services available from an unrelated third party, with whom the unit owner and the owner's broker have no connection and over whom they have no control. If that position were taken to its logical extension, any sale of real estate would become subject to the securities law if the seller draws attention to a third party who is willing to manage it—surely a surprising and extreme position.

III. ONCE A SECURITY, ALWAYS A SECURITY?

Can a condominium unit be correctly characterized as a security when initially offered and sold by the developer, and yet not be a security when resold by its first purchaser on the secondary market? The most apparent answer is that once an investment becomes a security it retains that character in all subsequent transactions. This position, which has been termed "once a security, always a security,"⁷⁴ has an initial visceral

⁷⁴ One commentator accurately described the position of the three-judge panel, *Hocking v. Dubois*, 839 F.2d 560, 568-70 (9th Cir. 1988), as "once a security always

appeal, and includes some elements which individually are correct, but does not withstand analysis. The more defensible view is that each transaction must be examined individually, creating the possibility that a single condominium unit may be a security in some circumstances but not in others.

A. *The Error of Focusing on Preceding Transactions*

In approaching the issue of whether a condominium transaction is a security, one understandable tendency is to begin by examining the marketing efforts of the developer. That approach conforms well to the precedent on the issue, which has involved developers in almost all instances. When the transaction at issue is a resale in the secondary market, however, focusing on the developer is inappropriate and potentially seriously misleading.

The *Hocking* facts are useful to illustrate the issue, though the same issue could arise in many other contexts. Originally, the condominium developer offered the units with an optional RPA, unquestionably satisfying all elements of the *Howey* test. The developer would have been subject to securities law liability even in favor of purchasers who elected to buy a unit but not to participate in the RPA.⁷⁵ The following year, one of the nonparticipating unit owners proceeded to offer and sell the unit on the secondary market. One of the arguments of the purchaser was that because the developer's transaction involved a security, the resale necessarily also involved a security.⁷⁶

The three-judge panel of the Ninth Circuit, whose opinion was subsequently withdrawn by the Circuit *en banc*, found the argument to be persuasive. The court found "absurd" the possibility that a "unit could alternate between being a security and not being one as each successive purchaser made his individual decision whether to participate in the RPA."⁷⁷

That statement reveals basic errors in analysis, deriving from its misdirected focus on whether a "unit" in a condominium is a security. A

a security," though that particular phrase is not found in the Ninth Circuit opinion. *Hawaii Real Estate Reacts to Hocking vs. Dubois*, 7 CONDOMINIUM HOTEL REP.No. 3, 2 (Peter M. Gunnar, ed., Fall 1988).

⁷⁵ In *S.E.C. v. Howey Co.*, 328 U.S. 293, 299-301 (1946), citrus land was offered together with a managerial services contract. The Supreme Court ruled that the combination of elements in the offer created an investment contract, causing securities law to be applicable to all offerees, even those who purchased only the land and not the services.

⁷⁶ *Id.*

⁷⁷ *Hocking*, 839 F.2d at 570.

condominium unit, or any other tangible property (such as a horse, beaver, or earthworm), is never a security when considered in isolation. The property may become an investment contract, and a security, when offered in conjunction with a service contract or other arrangement for producing "profits from the efforts of others."

Once it is recognized that the investment contract is not the tangible item but rather the combination of the item with a service contract, the purported absurdity evaporates. Whenever the combination is absent from an offer, there is no investment contract and thus no basis for applying securities law.⁷⁸ If the law were that every tangible item which once was coupled with a profit-making arrangement is immutably a security even when it is not coupled with a profit-making arrangement, then securities regulation would be implausibly boundless in its reach. As an analogy, similar reasoning would lead to application of motor vehicle registration laws to a dismantled and scrapped fender merely because it once was part of a vehicle.

The statement "once a security, always a security" could be correct in situations in which a security is an indivisible item such as a bank certificate of deposit,⁷⁹ but is not correct when a security is defined as

⁷⁸ See, e.g., Rosenbaum, *supra* note 47, at 801-02. Rosenbaum criticized the position that an initial offering that was deemed a security only because it was offered with "emphasis" on economic benefits from the rental program would necessarily remain a security on resale. He said: "[I]t seems that no security would be involved if the owner were to employ a real estate broker to resell the unit without such emphasis." *Id.*

⁷⁹ The holding by the Supreme Court that a bank certificate of deposit ("C.D.") was not a security when sold by the bank, *Marine Bank v. Weaver*, 455 U.S. 551 (1982), was followed by a district court case on whether a C.D. was a security in relation to an auditor who prepared incorrect disclosures of the finances of the bank, which later failed. *Brockton Saving Bank v. Peat, Marwick, Mitchell & Co.*, 577 F. Supp. 1281, 1286 (D. Mass. 1983). The district court concluded that the C.D. "must be found to be a security before recovery under the securities laws can be sought for the alleged fraud of accountants, bankers or anyone else involved with the instrument[.]" and that the Supreme Court precedent established that a C.D. was never a security. Using memorable imagery, the court stated that the plaintiff "may be able to allege that it purchased a car with no motor and that the seller was a crook, but it cannot show that the car it purchased was "in effect" a bicycle." *Id.* at 1286-87, quoted and discussed in M. Thomas Arnold, "When is a Car a Bicycle?" *And Other Riddles: The Definition of a Security Under the Federal Securities Laws*, 33 CLEV. ST. L. REV. 449, 474-77 (1984-85). (I.e., the plaintiff may allege that the bank C.D. was inordinantly risky but not that it was a security.) That language is colorful and appealing, but inapposite to the *Hocking* situation. The defendant in *Hocking* would not argue that property it offered (a condominium unit in isolation) had changed its basic identity, but rather than it was no longer complete enough to constitute the

being a combination of items. In that instance an investment becomes a security as soon as the combination is offered, and loses that status whenever the combination is absent.

B. *The "Janus-Faced" Transaction: Illustrations from the Partnership Context*

Comparable principles are evident in judicial treatment of partnerships which, like condominiums, are not specifically listed in the statutory definition of security, and thus are securities only if they meet the *Howey* test.⁸⁰ General partnerships usually are not securities because each partner has the right to manage, and so does not expect profits from the managerial efforts of others.⁸¹ Conversely, limited partnership interests typically are securities because limited partners normally cannot exercise managerial powers.⁸²

Significantly, however, these characterizations are not immutable. General partnership interests can become securities if the partnership agreement denies key managerial powers to partners⁸³ or the interests are sold to persons who lack the business experience or expertise to exercise management rights.⁸⁴ Limited partnership interests can lose their status as securities if the limited partners in fact exercise managerial powers.⁸⁵

combination of items required by the definition. Applying the *Brockton* court's imagery, the condominium unit had once been a bicycle (an investment contract security, when it was offered with a profit-making arrangement), but now was merely a bicycle *part*, being offered with no representation that it was anything more than that. Even that analogy is unsatisfying, however, because a condominium unit is useful and valuable whether or not it is connected to rental services, while a bicycle part is useful only when connected to other parts.

⁸⁰ Arnold, *supra* note 79, at 481.

⁸¹ See, e.g., a list of three criteria, any of which will cause general partnership interests to be classified as securities in *Williamson v. Tucker*, 645 F.2d 404, 424 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981).

⁸² *Goodman v. Epstein*, 582 F.2d 388, 406-07 (7th Cir. 1978), *cert. denied*, 440 U.S. 939 (1979) (limited partnership interest was a security because of restrictions on limited partners' powers); *Hirsch v. duPont*, 396 F. Supp. 1214, 1227 (S.D.N.Y. 1975), *aff'd*, 553 F.2d 750 (2d Cir. 1977); Arnold, *supra* note 79, at 482.

⁸³ A respected authority on securities stated that "[i]ndeed, even interests in something called a *general* partnership may be securities when the venture, though a general partnership *de jure*, functions *de facto* like a limited partnership." LOUIS LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 191 (1983).

⁸⁴ A leading case in this area explained the rule as follows:

If, for example, the partner has irrevocably delegated his powers, or is incapable of exercising them, or is so dependent on the particular expertise of the promoter

One decision involving partnership interests is particularly apposite, demonstrating how a particular investment interest can change from a security to a non-security. In *Siebel v. Scott*,⁸⁶ the general partner in a cable television limited partnership allegedly persuaded all of the limited partners to sell back their interests at a low price, and then resold the interests to new limited partners at over five times the price, keeping the profit himself. The original limited partner sued, asserting securities fraud. The general partner argued that in his hands the limited partnership interests were not securities, because he was not dependent on the managerial efforts of any other party.⁸⁷

The Ninth Circuit, however, found that the *Howey* test had been satisfied. The court focused on the fact that the original limited partners, up until the moment they sold, were dependent on the managerial efforts of the general partner for profits. The court stated that "it is not necessary that an interest be deemed a security in the hands of both the seller and the purchaser," and continued:

The characterization of an interest as a security or not can vary with the relationship of its holder to the venture Otherwise stated, transactions involving the sale of an interest which is a security because it is an investment contract can be Janus-faced—simultaneously looking forward and away from status as a security.⁸⁸

or manager that he has no reasonable alternative to reliance on that person, then his partnership powers may be inadequate to protect him from the dependence on others which is implicit in an investment contract.

Williamson, 645 F.2d at 422-23; accord, *Koch v. Hankins*, 928 F.2d 1471 (9th Cir. 1991) (reaffirming that all *Williamson v. Tucker* factors continue to apply in the Ninth Circuit after the *Hocking v. Dubois* decision); *Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.*, 840 F.2d 236, 241 (4th Cir. 1988) (accepting the *Williamson v. Tucker* position but with the proviso that each partner's business expertise need not be evaluated separately); *Deutsch Energy Co. v. Mazur*, 813 F.2d 1567, 1570 (9th Cir. 1987) (quoting *Williamson* with approval); *Less v. Lurie*, 789 F.2d 624, 627 (8th Cir. 1986); *Odom v. Slavik*, 703 F.2d 212, 215 (6th Cir. 1983); *Gordon v. Terry*, 684 F.2d 736, 741 (11th Cir. 1982), cert. denied, 459 U.S. 1203 (1983). *Koppel v. Wien*, 575 F. Supp. 960, 966 (S.D.N.Y. 1983). In comparison, limited partnership interests typically are securities, because all managerial efforts are provided by the general partner. See, e.g., *Pawgan v. Silverstein*, 265 F. Supp. 898, 900 (S.D.N.Y. 1967).

⁸⁵ *Rodeo v. Gillman*, 787 F.2d 1175, 1178-79 (7th Cir. 1986).

⁸⁶ 725 F.2d 995 (9th Cir. 1984).

⁸⁷ *Id.* at 999.

⁸⁸ *Id.*

Comparable analysis applies to the condominium context. A person who receives an offer of a unit with an RPA is entitled to the protection of securities law. If that same individual buys the unit and later offers and sells it without the RPA, however, securities law will not apply. The determining factor in each instance is the content of the offer.

The question of whether the unit purchaser chose to participate in the RPA is not determinative, or even particularly relevant—a point misunderstood by the three-judge panel in the *Hocking* case. In the *Hocking* situation, the Libermans (who bought from the developer) did not participate in the RPA, but the plaintiff (who bought from the Libermans) did participate. The opposite scenario, in which the first buyer participates but the subsequent buyer does not participate, is equally likely to occur.

In both of those situations, and all variations of them, the appropriate analysis is the same: determine whether the offer contains the essential combination of condominium unit and rental pooling. The question of whether the offeror or the offeree elected to participate in the pool does not properly enter the analysis unless that evidence, in the factual context presented, is probative of what the offer contained.

C. Identity and Characteristics of the Parties

Significant differences between developers of condominium complexes and secondary sellers of condominium units provide yet another reason to carefully separate analysis of whether the initial sale was a security from the different issue of whether the resale was a security. The identity and characteristics of both the seller and the buyer deserve consideration in determining whether a particular transaction should be subject to securities law.

Case law applying the *Howey* test has always considered the type of offeree to which the offer was directed. In the *Howey* case itself, the fact that the strips of citrus grove were sold to persons who lived far away and had no interest or experience in cultivating the trees was important to finding a security. If the purchasers had been fruit processing companies, the result would very likely be different. Similarly, if an oil and gas interest is sold to a dentist, it is far more likely to be classified as a security than if it sold to Exxon.⁸⁹ In the *Hocking* case, the facts that the

⁸⁹ Allott, *supra* note 7, at 21–29, 21–30. Similarly, an interest in a thoroughbred horse syndicate is far more likely to be deemed a security if sold to persons having little or no experience in the horse industry than if sold to experienced horsemen. Cooper, *supra* note 7, at 326. Similarly, an interest in general partnerships producing jojoba beans is likely to be a security when sold to doctors and dentists. *Koch*, 928 F.2d 1471. Likewise, a fractionalized undivided interest in oil, gas, or other mineral rights is a security when sold by the promoter, but not a security when sold by the

purchaser of the Hawaii real estate resided in Arizona, and was pragmatically unable to derive the full economic benefits of ownership unless he participated in the rental pool, were correctly considered and provided support for the finding of a security.

The seller's characteristics are equally important. Courts have held, for example, that a person who separates oil and gas or other mineral rights into fractional undivided interests, and then sells them to individual investors, is selling securities.⁹⁰ Yet when one of those investors resells a single one of those interests—all that the investor owns—it is no longer a security.⁹¹

In the condominium context, this line of precedent normally will tend towards a finding that a secondary sale does not involve a security. A developer who converts a building into the condominium form of ownership, and sells individual units, is highly likely to be subjected to securities laws, assuming that the developer simultaneously offers or arranges for an RPA. An individual who buys a single unit, however, is in a different situation. When that individual sells the single unit—all that the investor owns—a court should be less prone to impose securities law liability (although of course other factors may override this one).

D. Distinguishing Investment Contracts from Other Forms of Security

Important precedent supports the “once a security, always a security” position. That precedent, however, is explicitly limited to stock and forms of security that have a similarly well-defined meaning, and do not extend to investment contracts, which must be analyzed separately. Those decisions,

owner of a single such interest. Allott, *supra* note 7, at 21–30 (citing SEC Releases and case law); *see also* Continental Mktg. Corp. v. S.E.C., 387 F.2d 466, 468–69 (10th Cir. 1967) (beavers were investment contracts when coupled with specialized breeding, boarding, and related services and sold to investors unable to care for the animals themselves); *Roe v. United States*, 287 F.2d 435, 438–39 n.4 (5th Cir. 1961) (oil leases were investment contracts when coupled with promise to drill test wells nearby and sold to small investors incapable of drilling themselves).

⁹⁰ One of the list of items in the statutory definition of the term “security” is “fractional undivided interest in oil, gas, or other mineral rights. . . .” Securities Act of 1933, § 2(1); 15 U.S.C. § 77b(1); *see also* Oil & Gas Royalty Interests, Release No. 33-185, Fed. Sec. L. Rep. (CCH) ¶ 1031 (June 20, 1934); Harold S. Bloomenthal, *SEC Aspects of Oil and Gas Financing*, 7 WYO. L.J. 49, 53 (1953).

⁹¹ *Woodward v. Wright*, 266 F.2d 108, 112 (10th Cir. 1959). The rationale has been explained as follows: “It is the fractionalization for sale that creates the security. Therefore, the courts have held that the transfer of all the seller owns, even though the seller owns only an undivided fractional interest[,] is not the sale of an undivided fractional interest” (for purposes of the statutory definition of security). Allott, *supra* note 7, at 21–30.

therefore, do not apply to condominium resales. Condominium transactions involve securities, if at all, because the combination of elements in the offer constitutes an investment contract.

The greatest body of case law on whether an investment interest could be a security in one party's hands but not in another party's hands involved the sale of a business through transfer of its stock. A widely-accepted position—subsequently overruled by the Supreme Court—held that stock was a security in ordinary transactions in small blocks, but not when used merely as a device to convey an entire business to a new owner.⁹² The reasoning, known as the “sale of business doctrine,” was that a purchaser of an entire business was realistically buying assets, not an interest in a “common enterprise,” and was expecting profits from the purchaser's own efforts, not the efforts of others.⁹³

⁹² See, e.g., *Sutter v. Groen*, 687 F.2d 197, 200 (7th Cir. 1982); *King v. Winkler*, 673 F.2d 342, 346 (11th Cir. 1982); *Canfield v. Rapp & Son, Inc.*, 654 F.2d 459, 464 (7th Cir. 1981); *Chandler v. Kew, Inc.*, 691 F.2d 443, 444 (10th Cir. 1977). Other circuits rejected the sale of business doctrine. *Daily v. Morgan*, 701 F.2d 496, 499 (5th Cir. 1983); *Seagrave Corp. v. Vista Resources, Inc.*, 696 F.2d 227, 230 (2d Cir. 1982); *Coffin v. Polishing Machines, Inc.*, 596 F.2d 1202, 1204 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979). One of the primary objections to the doctrine was its potential for creating different results relating to the same investment document. One critic, for example, stated that “[i]nstruments purchased by multiple investors might be securities as to some purchasers and non-securities as to others, or securities as to sellers but not as to purchasers. Instruments might be securities if traded in a series of small transactions but non-securities if the same transaction is effectuated in a single sale.” *Ruefenacht v. O'Halloran*, 737 F.2d 320, 325–26 (3d Cir. 1984), *upheld sub. nom.*, *Gould v. Reufenacht*, 471 U.S. 701 (1985). Another commentator said that “[s]hares of stock, unlike lizards, are not chameleons. Just as a leopard cannot change its spots, an instrument cannot change its status as a security depending on who holds it.” Keith B. Darrell, *Redefining a “Security”: Is the Sale of a Business Through a Stock Transfer Subject to the Federal Securities Laws?*, 12 SEC. REG. L.J. 22, 52 (1984).

⁹³ According to one judicial survey, the sale of business doctrine had been accepted by the Seventh, Tenth and Eleventh Circuits, and rejected by the Second, Third, Fourth, Fifth and Eighth. *Landreth Timber Co. v. Landreth*, 731 F.2d 1348, 1351–52 (9th Cir. 1984), *rev'd*, 471 U.S. 681, 685 (1985) (adding the Ninth Circuit to those adopting the doctrine). Among the commentators explaining and defending the doctrine were Irving P. Seldin, *When Stock Is Not a Security: The “Sale of Business” Doctrine Under the Federal Securities Laws*, 37 BUS. LAW. 637 (1982); Larry E. Ribstein, *Securities Regulation*, 34 MERCER L. REV. 1461, 1484 (1983) (stating that it is “difficult to understand” why securities laws should apply “whether a transfer of all of the assets of a business is structured as a sale of ‘assets’ or of ‘stock’”); Robert B. Thompson, *The Shrinking Definition of a Security: Why Purchasing All of a Company's Stock Is Not a Federal Security Transaction*, 57 N.Y.U. L. REV. 225 (1982). Among the representatives of the opposing view were Dennis S. Karjala,

In 1985 the Supreme Court, in *Landreth Timber Co. v. Landreth*,⁹⁴ decisively rejected the “sale of business” doctrine, but did so in a manner explicitly and strictly limited to interpretation of the term “stock.” Clarifying an ambiguity from its earlier decisions,⁹⁵ the Court stated that if an interest labelled stock—one of the terms listed in the statutory definition of security—had the usual characteristics of stock, it was a security regardless of the transactional context.⁹⁶ On the surface, this conclusion may appear to support the “once a security, always a security” view.⁹⁷

Realigning Federal and State Roles in Securities Regulation Through the Definition of a Security, 1982 U. ILL. L. REV. 413, 429 (stating that “courts upholding the sale of business doctrine have introduced a disconcerting asymmetry into securities transactions in that one party to a transaction may be dealing in a security while the other is not”); Thomas Lee Hazen, *Taking Stock of Stock and the Sale of Closely Held Corporations: When Is Stock Not a Security?*, 61 N.C. L. REV. 393 (1983); Barbara Black, *Is Stock a Security? A Criticism of the Sale of Business Doctrine in Securities Fraud Litigation*, 16 U.C. DAVIS L. REV. 325 (1983).

⁹⁴ 471 U.S. 681 (1985).

⁹⁵ Particularly ambiguous was *United Housing Found. v. Forman*, 421 U.S. 837 (1975), in which the majority opinion (supported by five Justices) was followed by dissenting opinions of three Justices. One highly plausible interpretation was that the housing cooperative stock at issue was not a security because it did not satisfy the *Howey* test and hence was neither stock nor an investment contract as the statute used those terms. In this interpretation, the *Howey* test was applied in relation to all terms listed in the statutory definition of security. The Respondents in *Landreth Timber* took this position. *Landreth Timber*, 471 U.S. at 684. An equally likely interpretation was that the Court used a two-step analysis, in which the *Howey* test was applicable only in the second step. First, the interest was not stock as the statute used that term because it lacked the usual characteristics of stock (proportional voting rights, dividends, possibility of appreciation in value, etc.). In addition, the interest was not an investment contract because it lacked some of the elements required by *Howey* (such as expectation of profits). The Court in *Landreth Timber* conceded, in a rather marked understatement, that its previous cases had not been “entirely clear” on the issue. *Id.* at 688. For a statement of the opposing interpretations, prior to the *Landreth Timber* decision, see Arnold, *supra* note 79, at 455 (“vigorous debate” existed over whether the *Howey* test applies only to investment contracts or also to “less elusive types of securities, such as corporate stock . . .”).

⁹⁶ *Landreth Timber*, 471 U.S. at 693–94 (involving sale of 100% of the stock of a corporation). See also the companion case, decided the same day, which rejected the sale of business doctrine in the context of a sale of 50% of the stock of a corporation. *Gould v. Ruefenacht*, 471 U.S. 701, 706 (1985).

⁹⁷ One commentator interprets the *Landreth Timber* decision as suggesting that a thing “must be a security as to all or as to none . . .,” and casting doubt on earlier lower court cases finding that a partnership may be a security or non-security depending on the sellers and purchasers involved. M. Thomas Arnold, *The Definition of a Security Under the Federal Securities Law Revisited*, 34 CLEV. ST. L. REV. 249, 264–65 (1986). Professor Arnold’s interpretation, however, ignores the Court’s

The Court, however, drew a distinction between the terms in the statutory list that had a well-settled meaning, such as "stock" or a bank "certificate of deposit," and terms that had a more variable character that were used as catch-alls, such as "investment contract" or "instruments commonly known as a 'security.'"⁹⁸ The *Howey* test applied only to "unusual instruments not easily characterized as 'securities.'"⁹⁹ The decision explicitly disclaimed any holding regarding interests other than stock, which was treated as having a special status as the "paradigm" of a security,¹⁰⁰ and so the decision has no direct application to condominium securities.

Indeed, in an indirect manner, the mode of analysis in the *Landreth Timber* case tends to support the position that a condominium that is a security in one transaction does not necessarily retain that status perpetually. The Supreme Court focused, quite logically and correctly, on the characteristics of the interest at the time of the transaction that was at issue. In the condominium resale context, the appropriate time to apply the *Howey* test is the time of the resale, not the time of the initial sale.

E. Foregoing a Bright-line Test

A practical objection to the argument for transaction-by-transaction analysis of condominium sales is the uncertainty that results. If the rule were that condominiums originally offered by developers with RPA's were at that point immutably stamped as a security, for all subsequent transactions, that rule at least is simple to understand and apply. Such

explicit limitation of its decision to stock, disclaiming any holding regarding other types of securities.

⁹⁸ *Landreth Timber*, 471 U.S. at 689. The reference to a bank certificate of deposit was directed at the Court's prior decision in *Marine Bank v. Weaver*, 455 U.S. 551 (1982). The result, as one commentator phrased it is that "we now know that the Court will apply the *Howey* test to investment contracts and a literal or plain meaning approach to corporate stock . . .," though we still do not know which approach applies to other types of instruments which are listed in the statutory definition of security. Arnold, *Revisited*, *supra* note 97, at 266.

⁹⁹ The *Howey* test, the Court stated, "was designed to determine whether a particular instrument is an 'investment contract,' not whether it fits within *any* of the examples listed in the statutory definition of 'security'." *Landreth Timber*, 471 U.S. at 691. In an early landmark case on the subject, the Court interpreted the purpose of the terms "investment contract" and "any interest or instrument commonly known as a 'security'," located in the statutory definition of security, as referring to "[n]ovel, uncommon, or irregular devices" which are effectively securities even though they do not fit the more standardized forms listed in other parts of the definition. *S.E.C. v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943).

¹⁰⁰ *Landreth Timber*, 471 U.S. at 693.

"bright line" tests have definite appeal in terms of administrative and judicial efficiency, and the certainty that they provide to economic actors.¹⁰¹

The goal of judicial economy, however, is not promoted by making ordinary condominium resales actionable under securities law.¹⁰² And the goal of certainty does not justify judicial interpretations that exceed the scope intended by Congress.¹⁰³ As the Supreme Court has made clear (both before and after *Landreth Timber*), Congress did not intend the securities acts to provide a federal remedy for all types of fraud, and transaction-by-transaction analysis is vital when interpreting the term "investment contract."¹⁰⁴

¹⁰¹ One of the circuit courts opposed to the "sale of business doctrine," for example, voiced the common concern that "[t]he dangers in creating uncertainty as to the scope of the Acts and in generating slippery legal and factual issues . . . are substantial." *Golden v. Garafalo*, 678 F.2d 1139, 1146 (2d Cir. 1982). The court conceded that treating stock as a security regardless of the transactional context could result in "a certain overbreadth in application," *id.*, but considered that result to be acceptable. The Supreme Court in *Landreth Timber* similarly stated its concern that, without a bright-line rule regarding stock, "coverage by the Acts would in most cases be unknown and unknowable to the parties at the time the stock was sold," and the federal courts' caseloads would be high. *Landreth Timber*, 471 U.S. at 696; *see also* Arnold, *Revisited*, *supra* note 97, at 258-60 (discussing "How Important is a Clear and Predictable Definition?" in relation to the *Landreth Timber* decision).

¹⁰² An argument made by the Seventh Circuit in support of the sale of business doctrine remains persuasive in relation to investment contracts, despite the Supreme Court's decision in *Landreth Timber* regarding stock. The circuit court stated that:

We agree that the costs of administering legal rules are a proper concern in designing those rules. But rarely will a net savings in those costs be produced by expanding liability, since even if the legal standard will be simpler and therefore cheaper to apply in each case the number of potential cases in which it will be applied will be greater.

Sutter v. Groen, 687 F.2d 197, 202 (7th Cir. 1982).

¹⁰³ *Landreth Timber*, 471 U.S. at 699-700 (1985) (Stevens, J., dissenting). In a "sale of business doctrine" case prior to *Landreth Timber*, the Seventh Circuit conceded that ignoring the transactional context might simplify judicial decision-making, but even "if there were some net cost savings we doubt they could justify expanding liability to reach substantive evils far outside the scope of the legislature's concern." *Groen*, 687 F.2d at 202.

¹⁰⁴ *United Housing Found. v. Forman*, 421 U.S. 837, 849 (1975) (stating that the test of an investment contract is flexible, based primarily upon the substance of the transaction). *Marine Bank v. Weaver*, 455 U.S. 557 (1982), decided after the *Landreth Timber* case, is particularly significant. The Court ruled that a bank certificate of deposit was not a security, but noted that "[i]t does not follow that a

IV. "EFFORTS OF OTHERS"—THE IMPLICIT NECESSITY FOR A NEXUS BETWEEN THE OFFEROR AND THIRD PARTIES

When the profit-generating managerial efforts that might transform a tangible item into an investment contract are provided not by the offeror but by some third party, a key issue is whether those efforts satisfy the *Howey* test's "efforts of others" element.¹⁰⁵ Case law has rarely examined the type of relationship, if any, necessary between the offeror and the party providing the services. The courts have generally assumed, rather than decided, that the conduct of different parties can be attributed to one another only if the parties have some arrangement, relationship or affiliation. On examination, that assumption is sound and logically based, even though one court has ruled to the contrary.

A. *The Nexus Issue in the Condominium Context*

The key importance of the nexus issue to sales of condominium units in the secondary market can be illustrated by the facts in the *Hocking* case. The defendant real estate broker marketed a condominium unit, described an RPA that operated in the complex, obtained the necessary forms from the RPA manager, and submitted them to the prospect, who purchased the unit and later enrolled in the RPA. It was undisputed that the broker had no authority or power to bind the RPA manager, and there was no allegation that the broker received compensation from the RPA manager.

The Ninth Circuit ruled that the unit and the RPA were "presented . . . as part of the same transaction,"¹⁰⁶ and constituted the offer of an investment contract. The six judge majority deemed the lack of affiliation between the broker and the RPA manager to be unimportant, asserting in fact that the issue was "nearly irrelevant."¹⁰⁷ For purposes of

certificate of deposit or business agreement between transacting parties invariably falls outside the definition of a 'security' Each transaction must be analyzed and evaluated on the basis of the content of the instruments in question, the purposes intended to be served, and the factual setting as a whole." *Id.* at 560 n.11.

¹⁰⁵ See *supra* notes 21–30 and accompanying text.

¹⁰⁶ *Hocking v. Dubois*, 885 F.2d 1449, 1458 n.7 (9th Cir. 1989).

¹⁰⁷ *Id.* An indication of the majority's lack of regard for the issue is that they relegated it to a footnote. The note further states that "any hypothetical arrangement" such as [the broker] receiving a commission from the RPA manager might tend to support the plaintiff's arguments that the broker "presented" the RPA to him, but "would have no bearing on whether or not she presented the condominium and RPA as part of the same transaction." *Id.* The majority's point was that if the broker

securities law, the majority noted, the term "offer" can include elements which the offeror is not capable of delivering.

Many of the principles relied upon by the majority are firmly based in precedent, correct in the abstract, but misapplied. More importantly, however, the majority ignored (or relegated to a footnote) critical facts that should have reversed the outcome of the case. Further, the majority sought to bolster its position with language from a precedent that did apply but was misconstrued and presented out of context.

B. *Precedent on Integrating Conduct of Different Parties To Form an Investment Contract*

Though many judicial decisions have integrated the offerings or efforts of more than one party, to determine that the overall offer constituted the offer of an investment contract, those cases almost invariably involved parties that were related or affiliated to one another in some meaningful manner. The very few judicial intimations that no nexus is necessary are dicta or poorly reasoned, and should not be followed.

The two Supreme Court decisions providing the foundation for most subsequent interpretation of the definition of a security, *Joiner* and *Howey*, provide excellent illustrations. In *Joiner*, oil leases were found to be investment contracts because they were marketed with oil drilling by a party closely related to the promoter. The Court pointedly noting that "drilling of this well was not an unconnected or uncontrolled phenomenon."¹⁰⁸ Similarly, in *Howey*, the citrus grove land offered by the W.J. Howey Company was marketed with agricultural management services to be provided by Howey-in-the-Hills Service, Inc. Significantly, the Court pointed out that the two corporations were "under direct common control and management."¹⁰⁹

Numerous subsequent decisions have combined, for purposes of applying the *Howey* test, the efforts of more than one company or person. The common element in these decisions, however, is that the different parties in each situation have a relationship or affiliation with one another.¹¹⁰ The efforts of an individual clearly should be combined with

presented the RPA several months after the condominium purchase was complete, the majority's "package" standard would not be satisfied.

¹⁰⁸ SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 348 (1943).

¹⁰⁹ SEC v. Howey Co., 328 U.S. 293, 295 (1945).

¹¹⁰ Cameron v. Outdoor Resorts of Am., 608 F.2d 187 (5th Cir. 1979) (developer offered both a condominium campground and mandatory rental pool); Hodges v. H&R Inv., 668 F. Supp. 545 (N.D. Miss. 1987) (promoter offered both condominium units and a collateral rental agreement guaranteeing minimum rental income); Wooldridge Homes v. Bronze Tree, 558 F. Supp. 1085 (D. Colo. 1983)

the efforts of a corporation owned or controlled by that individual. The efforts of a corporation should be combined with the efforts of a second corporation when the two have a contractual relationship or are so intertwined at the shareholder or management levels as to support a conclusion that they are acting for their joint interests.¹¹¹

The entirely legitimate, and necessary, purpose of integrating for analysis the activities of related or affiliated parties is to prevent promoters from escaping securities laws by adopting forms of organization for evasive purposes. In many securities law contexts, persons acting "in concert" are treated as a single person for the purpose of applying regulations and standards. The concept is well established and is supported by the Supreme Court's repeated admonitions, in *Howey* and in previous and subsequent decisions, to focus on the substance rather than the form of transactions when applying securities laws.

Yet none of this precedent or reasoning supports integration of efforts of parties who have no relationship or affiliation with one another whatsoever. No decision before *Hocking* concluded that a person marketing a tangible item of property is subject to securities law merely because she also assisted the offeree in obtaining managerial services from an unrelated third party.

The *Hocking* court's sole citation in support of its position on this point was *Blackwell v. Bentson*¹¹², a case (like *Howey*) involving an offer of citrus groves and harvesting services, found to constitute an investment contract. The *Hocking* majority chose to select one phrase from that decision, a reference to the real estate and the services forming "constituent parts of what is essentially one transaction,"¹¹³ and offer that phrase as precedent for its own "presented as part of one transaction" formula.¹¹⁴

The majority's use of that prior decision is mistaken and misleading, because it entirely omits a vital factual predicate of the decision: the company offering the services was owned and operated by the same people that owned the company that offered the real estate. Thus *Blackwell v. Bentson* in fact supports the view that services and property can be

(promoter offered unimproved resort property, promised to build condominiums, and made arrangements with another company to provide management services).

¹¹¹ *Blackwell v. Bentsen*, 203 F.2d 690 (5th Cir.), *cert. dismissed*, 347 U.S. 925 (1953) (offers by two companies owned and operated by the same parties treated as one offer).

¹¹² *Id.* (cited by the *Hocking* majority, 885 F.2d at 1458 n.7, and by the *Hocking* dissent, 885 F.2d at 1466).

¹¹³ *Id.*

¹¹⁴ *Hocking v. Dubois*, 885 F.2d 1449, 1458 n.7 (9th Cir. 1989).

integrated as “essentially one transaction” only when there is common ownership or other relationship or affiliation.

Apparently only two other judicial opinions assert that nexus is unnecessary:¹¹⁵ *Continental Marketing Corp. v. SEC*,¹¹⁶ and *Roe v. United States*.¹¹⁷ Those decisions deserve attention, but are flawed. The *Continental Marketing* case involved the sale of live beavers by one company, which marketed them as a “royal road to riches” with “fabulous possibilities,”¹¹⁸ but only if the purchaser also purchased extensive breeding, boarding and management services from one of several other companies operating beaver “ranches.”¹¹⁹ The Tenth Circuit ruled that the arrangement constituted an investment contract.

Some of the “ranches” named as defendants in that case were in competition with the beaver seller, whose own involvement was limited to the sale of the animal. That fact might be seized upon as support for the proposition that activities of unrelated businesses can be merged to find an investment contract.¹²⁰ That approach, however, ignores critical additional facts. The Tenth Circuit described in some detail the overall program of a single promoter to establish a market for domestic beaver fur at prices many hundreds of times higher than the previous market, through various business entities.¹²¹ The selling and servicing components of the scheme were divided among different companies only in response to investigatory and enforcement action by blue-sky administrators, and even then the new companies “involve principally the same people who were involved in the earlier organization.”¹²² The ranch services were provided by someone whom the promoter “had induced to take up ranching” and operated under his “expert supervision.”¹²³ Though the Tenth Circuit stated that “[w]e do not think the element of ownership or control is essential,”¹²⁴ the factual circumstances plainly entailed extensive long-term relationships among the

¹¹⁵ Peter A. MacLaren, Note, *Profits in Paradise: When Resort Condominiums Qualify as Investment Contracts*, 19 GOLDEN GATE U. L. REV. 177, 200-01 (1989). Further research by the author of this Article did not disclose any additional examples.

¹¹⁶ 387 F.2d 466 (10th Cir. 1967).

¹¹⁷ 287 F.2d 435 (5th Cir. 1961).

¹¹⁸ *Continental Marketing Corp.*, 387 F.2d at 470, 468.

¹¹⁹ *Id.* at 468-69. Though a beaver purchaser theoretically could take possession of the animals directly, doing so was impractical, heavily discouraged by the seller, and in fact never occurred.

¹²⁰ MacLaren, *supra* note 115, at 200.

¹²¹ *Continental Marketing Corp.*, 387 F.2d at 470 n. 1 (sales at between \$2,000 and \$6,000 per beaver, when in actuality prices as low as \$20 were available).

¹²² *Id.* at 469.

¹²³ *Id.*

¹²⁴ *Id.* at 470.

provider of the animals and the provider of the services. The case cannot reasonably be accepted as supporting the proposition that services offered by one party can be attributed to another party having no connection, relationship, or affiliation whatsoever.

The other case superficially appearing to deny the need for nexus, *Roe v. United States*, involved the sale of oil leases on small tracts of land, using methods the Fifth Circuit described as “a high-pitched, hard-sell extravagant solicitation campaign.”¹²⁵ The promoter told prospective investors that they could get rich quick not by operating the leases—which was plainly impractical for them—but by dramatic increases in value once successful test wells were drilled.¹²⁶ The Fifth Circuit correctly found that the “efforts of others” element was satisfied, but further stated that “it mattered not whether the test wells were to be drilled by the sellers, or by third persons either under, or independent of their control.”¹²⁷ That sentence appears to deny the need for nexus.

The very next paragraph, however, seriously undercuts the authority of that assertion. The court notes that the sellers (both the corporation and its president) fixed the location of the test wells, substantially contributed to the drilling (directly and through another wholly-owned corporation), and continually supervised the wells.¹²⁸ Hence any intimation that an offeror is responsible for conduct of unrelated parties is, at best, *dicta* and at worst misleading. This case fits squarely within the principle that the efforts to be analyzed are those, in Supreme Court’s phraseology, of “the promoters or third parties.”¹²⁹

C. Practical Implications

If the views of the *Hocking* majority are accepted and given broad application, the implications are extensive. A broad range of offers of tangible property could result in application of securities law if the offeror includes in the marketing effort any injudicious references to an unaffiliated, unrelated third party who would be willing if asked to provide some managerial service in relation to the item.

To illustrate, suppose that an enterprising real estate management company in a resort community approached the individual owners of cottages and other single-family residences, offering a rental service. In exchange for a percentage of the rents generated, the management company

¹²⁵ *Roe v. United States*, 287 F.2d 435, 436 (5th Cir. 1961).

¹²⁶ *Id.* at 438, 439 n.4.

¹²⁷ *Id.* at 439 n.5 (citations omitted).

¹²⁸ *Id.* at 439–40.

¹²⁹ *United Housing Found., Inc. v. Forman*, 421 U.S. 837, 854 (1975).

would advertise all the facilities to tourists from metropolitan areas, and handle reservations, on behalf of any property owner whose residence was vacant at the time and who chose to participate. One of the cottage owners, who did not participate, later advertises her cottage for sale, listing as one of its attractions the fact that a purchaser might earn rental income by contracting with the management company. The purchaser later alleges some misstatement or omission—perhaps nondisclosure of a leak in the roof.

Are those facts, without more, enough to state a securities fraud action? The Ninth Circuit standard would hold that it was, at least to the extent of surviving a motion to dismiss. Because both the real estate and the services were presented as a “package,” the seller and any real estate broker that was involved could be found to have offered an investment contract. The facts that the seller and broker had no relationship, connection or affiliation with the management company, and never used the management company’s services, would be deemed irrelevant.

In the condominium context, any owner of an individual unit who contemplates sale must be extremely circumspect if any third party stands ready to provide rental services for such units. Mere mention of that third party to a prospective purchaser might be permissible, but any further discussion raises the danger that the seller and any broker involved will be subjected to a quagmire of federal securities law litigation and liability.

Moreover, nothing in the standards enunciated in *Hocking* limit their application to real estate. Anyone marketing any type of real or personal property (as principal or agent) might be blindsided by a securities law complaint if the sales pitch included discussion of managerial services available from an unaffiliated third party.

The logical means to avoid this unwarranted and unprecedented extension of securities law is to recognize the necessity for a nexus between the offeror and the provider of any services sought to be integrated into the offer. Just as in the *Howey* case and every previous decision on investment contracts, tangible property and services should be deemed part of a single offer only if the parties offering are connected through common ownership, contractual relationship, or agreement. When that nexus is missing, the only defensible application of securities law might be to the RPA, considered separately from the condominium unit.

D. Preventing Use of an Intermediary as a Subterfuge

One valid, but surmountable, objection to excluding downstream or secondary sales of condominiums from the registration requirements is the potential for opening an avenue for evasion of registration by developers. Developers who directly offer to the public condominium units with

associated rental services are unquestionably subject to registration requirements. If resales are not subject to registration, some developers might be tempted to structure a sale ultimately to the public through an intermediary.

A two-step scheme is possible. First, the developer would sell to a person or entity who is not formally connected to either the developer or the rental manager, but is nevertheless cooperative—perhaps a friend or business associate. A number of exemptions available to issuers (such as those for private placements, accredited investors, or intrastate offerings) might be asserted to avoid registering that transaction. Then, the intermediary would resell to the ultimate owners—members of the public intending to use the condominium as a residence and a long-term investment. The exemption for “transactions [not involving] an issuer, underwriter, or dealer”¹³⁰ might be asserted. The overall result would be sale by the developer ultimately to the public without registration, circumventing the Securities Act’s requirements and goals.

That concern is valid and reasonable, but adequately addressed by existing securities law principles developed for just such situations. The SEC’s Rule 144 deals specifically with resales, for the purpose of preventing use of intermediaries to evade registration.¹³¹ The rule defines the statutory “underwriter” and an additional term “control person” (a “person[] controlling, controlled by, or under common control with the issuer”), and imposes restrictions on resale with registration. Application of those existing standards would separate the ordinary condominium unit resale, which should not be subject to registration requirements, from the contrived resale by a developer through an intermediary.

V. COURTS VS. THE SECURITIES AND EXCHANGE COMMISSION

Normally, the position of a federal regulatory agency on a controversial issue is a prime concern of a party engaged in a transaction within the agency’s area of authority, and also is accorded substantial deference by courts. Thus it would be natural to expect that the Securities and Exchange Commission would play an important role in the application of securities law to condominiums units sold in the secondary market with rental arrangements. In fact, those assumptions are not correct; the SEC is not oriented toward stringent regulation in this field, and the Commission’s views are as likely to receive derision as deference in the courts.

¹³⁰ Securities Act § 4(1), 15 U.S.C. § 77d(1) (1988).

¹³¹ Rule 144, 17 C.F.R. § 230.144 (1989).

A. SEC's Guidelines on Condominiums as Securities

The most comprehensive single statement of the Security and Exchange Commission's policy regarding condominiums as securities is its Release No. 33-5347¹³² (hereinafter "Release"), issued in 1973. The Release noted that securities law may apply to certain types of real estate development, and set out a list of key criteria.

The SEC correctly focused on the content of the offer, rather than the purchase, stating that a condominium unit can be treated as a security if it is "offered in conjunction with" any of three specified factors. (That phrase is not inconsistent with the "presented as part of the same transaction" standard recently adopted by the Ninth Circuit in the *Hocking* case.) The three factors are as follows:

- (1) Emphasis on economic benefits to the purchaser to be derived from the managerial efforts of the promoter, or a third party designated or arranged for by the promoter, from rental of the units.
- (2) The offering of participation in a rental pooling arrangement.
- (3) The offering of a mandatory "rental or similar arrangement" by which the owner is "materially restricted in his occupancy or rental of his unit."¹³³

Those guidelines are subject to some criticism for vagueness and overbreadth in some respects, but generally are consistent with principles drawn from judicial precedent.¹³⁴ Developers in the initial offerings market

¹³² Guidelines as to the Applicability of the Federal Securities Laws to Offers and Sales of Condominiums or Units in a Real Estate Development, S.E.C. Securities Act Release No. 33-5347 (Jan. 4, 1973), 38 Fed. Reg. 9587, 1 Fed. Sec. L. Rep. (CCH) ¶ 1049, [hereinafter Securities Act Release No. 33-5347]. The Release is discussed in Brannen, *supra* note 58.

¹³³ Securities Act Release No. 33-5347, *supra* note 132.

¹³⁴ The first factor, marketing emphasis, was explicitly based on the *Joiner* decision, in which the Supreme Court stated that "it is not inappropriate that promoters' offerings be judged as being what they were represented to be." SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 353 (1943). Though the *Joiner* decision antedated *Howey*, it was not overruled and is not inconsistent. Indeed the phrase in the *Howey* formula that an investor is "*led to expect profits . . .*" appears to suggest that a focus on the sales effort is valid. The *Howey* decision itself analyzed the promoter's marketing techniques, and subsequent judicial decisions have followed suit. See, e.g., *Aldrich v. McCulloch Properties*, 627 F.2d 1036, 1039 (10th Cir. 1980) ("Central to the test is the promotional emphasis of the developer."). The second factor on the SEC Release's list, an RPA, is consistent with the *Howey* "economic realities" test, in that an RPA raises an expectation of profits from the efforts of others, plus horizontal commonality because rental income is shared among all participating unit owners. The

have found ways to structure economically viable condominium complexes and marketing programs to avoid the application of securities law under the Release's standards.¹³⁵

final factor, mandatory rental or material restrictions on use, is more questionable. Though restrictions are relevant, tending to show that investors are led to expect profits from the efforts of others, it is not clear that the "commonality" element of the *Howey* test is satisfied. The factor would be satisfied even by non-pooled rental arrangements lacking horizontal and even strict vertical commonality, resulting in merely a fee-for-services arrangement with no emphasis in the marketing on profit-making potential. Under established case law, courts would not normally find a security under those circumstances. The imprecision of the SEC in this respect is perhaps not surprising, because the Release was issued in 1973 before extensive case law development of the commonality principle. This is one area that deserves renewed attention from the SEC.

¹³⁵ One safe, and apparently typical, course is to carefully avoid any pooling aspect in rental arrangements that developers offer or promote. *See, e.g.*, Marco Polo Hotel, Inc., SEC No-Action Letter, 1987 WL 108553 (Sept. 30, 1987) (rental services offered by the developer will not involve pooling); Choice Hotel Group of N.Y., Inc., SEC No-Action Letter, 1987 WL 108438 (Sept. 2, 1987) (rental program without pooling offered by the developer); QMR Coop, SEC No-Action Letter, 1987 WL 107880 (March 25, 1987) (rental program without pooling offered by a cooperative organized after sale of all units); Pacific Lighting Properties, Inc., SEC No-Action Letter, 1985 WL 54519 (Oct. 16, 1985) (leaseback arrangement without pooling offered by the developer). Many developers go to the extent of expressly prohibiting pooling even if offered by third parties such as the condominium owners association and independent real estate management firms. *See, e.g.*, Congdon's Resort Corp., SEC No-Action Letter, 1986 WL 67156 (June 30, 1986) (no pooling allowed while developer is in control of the condominium owners association); Point East Associates, Inc., SEC No-Action Letter, 1986 WL 669041 (May 15, 1986) (no pooling allowed); Sunrise Terrace Trust, SEC No-Action Letter, 1986 WL 65174 (Jan. 8, 1986) (no pooling contemplated; if pooling is ever adopted, it can only be by owners association after sale of entire project, subject to possible retention of certain of the units by the developer or its affiliates); Rank Dev., Inc., SEC No-Action Letter, 1985 WL 54133 (April 5, 1985) (no pooling allowed).

Some other developers, however, have taken a more aggressive stance, using "rotation," or "ladder rotation," in which the rental manager assigns each new prospective paying guest to the condominium unit which has been rented for fewer days than the other available units. *See, e.g.*, Resort Holdings I, Ltd. and Resort Holdings II, Ltd., SEC No-Action Letter, 1986 WL 67101 (June 19, 1986) (unless guests specify a particular unit, they "will be assigned to the Unit of the desired size or type which has been rented and occupied by its owner the least number of days"). The result is to allocate overall rental income from the rental operation equally, or nearly equally, among all participating unit owners—a consequence very similar to the result of a rental pool. A description of the process is contained in Peter M. Gunnar, SEC No-Action Letter, 1987 WL 108044 (May 7, 1987). Rotation may be permitted, while pooling is not, because the income allocated to each owner participating in a

In relation to the secondary market, however, little or no guidance can be found in the Release. The Release's purpose, stated in its introduction, was to "alert persons engaged in the business of building and selling condominiums" to their responsibilities under securities law.¹³⁶ The purchaser of an individual condominium unit who later seeks to sell that one unit is not normally "in the business of building and selling condominiums." All of the standards explicated in the Release apply

rotation rental arrangement derives only from that owner's unit, so that horizontal commonality is lacking. *Recreational Indus., Inc.*, SEC No-Action Letter, 1987 WL 107952 (March 13, 1987). Whether rotation successfully avoids the SEC's strong position on pooling, however, remains uncertain. *See, e.g.*, Peter M. Gunnar, SEC No-Action Letter, *supra* (noting that when five lawfirms were consulted, two agreed and three disagreed that rotation violated the standards in Securities Act Release No. 33-5347, and asking for a definitive statement; the staff declined to provide such a statement).

Another approach used by developers is to lease units from the owners for a flat daily rate, and then rent them to tourists. Because lease payments are due whether or not paying guests are found, the unit owners are not in a "common enterprise" with the developer. *See, e.g.*, *Marco Polo Hotel, Inc.*, SEC No-Action Letter, *supra* (permitting a developer to offer both a non-pooled rental services program and a leaseback program to prospective purchasers of condominium units, without securities registration). The inquiry letter cited no-action positions taken in similar arrangements in *Indian River Plantation*, 1977 WL 14542 (May 4, 1977) (leases for annual, winter, or summer terms), and *Real Property Ventures*, 1983 WL 28538 (Aug. 11, 1983).

Expressly leaving investors with power to make important decisions may avoid a finding of "expectation of profits" from managerial "efforts of others." *See, e.g.*, *Fargo Partners v. Dain Corp.*, 540 F.2d 912, 915 (8th Cir. 1976) (stating that an investor who retains partial control over management, even if she does not exercise that control, does not need the protection of securities laws); *Perry v. Gammon*, 583 F. Supp. 1230, 1233 (N.D. Ga. 1984) (stating that merely hiring a property manager does not satisfy the *Howey* test, and "[t]o hold otherwise would convert into a securities transaction almost any sort of real estate investment where the investors delegate management of the properties"); *see also Williamson v. Tucker*, 645 F.2d 404, 421 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981), *citing Schultz v. Dain Corp.*, 568 F.2d 612 (8th Cir. 1978). Accordingly, rental program contracts often allow condominium unit owner participants to opt out at will, suggesting that the unit owner retains managerial rights at all times, even when delegating those rights to the developer. *See, e.g.*, *Recreational Indus., Inc.*, SEC No-Action Letter, *supra*; *Planners Dev. Corp. of Am.*, SEC No-Action Letter, 1985 WL 55678 (Nov. 8, 1985); *Investment Properties Int'l, Ltd.*, SEC No-Action Letter, 1985 WL 55492 (June 10, 1985). Rental programs also sometimes provide that the participating unit owner retains the right to determine the rental rate, a primary managerial decision. *See, e.g.*, *Silverado Banking*, SEC No-Action Letter, 1985 WL 54134 (April 3, 1985); *Richfield Properties*, SEC No-Action Letter, 1985 WL 51990 (Dec. 18, 1984).

¹³⁶ Securities Act Release No. 33-5347, *supra* note 132, at 82,536.

logically to developers or promoters of condominium complexes, but not to individual unit owners or their real estate agents.

For example, part one of the Release focuses on marketing emphasis on benefits from the "managerial efforts of the promoter, or a third party designated or arranged for by the promoter, from rental of the units." It is entirely logical that rental services that the promoter mentions in the course of marketing a condominium unit should be deemed part of the offer if the promoter will provide both the real estate and the services. Extending that rule to include services from a third party "designated or arranged for by the promoter" is logical and necessary to foreclose a simple subterfuge for avoiding the application of securities law.

Further extension of this approach to an offeror in the secondary market, however, is not rational when the third party is not owned, controlled, affiliated with, or arranged by the offeror. The Release's reference to integration of the unit with third party services is justified in its context discussing promoters' offers, but should not be indiscriminately applied to inappropriate contexts.¹³⁷ When an individual purchases a single unit (with or without the rental services) and subsequently offers to sell the unit on the secondary market, nothing in the Release supports the position that rental services should be deemed part of the seller's offer merely because the seller honestly discloses their availability from a third party having no nexus to the unit owner.

Removing any possible uncertainty, the Commission has specified unequivocally, in a litigation context,¹³⁸ that the Release "does not apply to persons who resell their own individual units . . . and have no affiliation or selling arrangement with the pool operator."¹³⁹ Though the Release itself did not expressly exclude secondary sales from its coverage, it was by its own terms directed only to developers and promoters. The SEC's

¹³⁷ Rosenbaum, *supra* note 47, at 793 n.32 ("The limitation to benefits to be derived from the efforts of either the developer or someone designated or arranged for by the developer is significant and is required by the case law."); *see* SEC v. W.J. Howey, 328 U.S. 293 (1946). An offering of condominiums would presumably not involve securities merely because promotional literature emphasized the rental income purchasers might realize through the use of unaffiliated real estate agents.

¹³⁸ According to a former Chairman of the SEC, "positions taken in all amicus briefs are reviewed, before they are filed, by the entire Commission, and are approved by the Commission. The positions . . . are not simply the work of the Commission's counsel—they are the Commission's views." David S. Ruder, *The Development of Legal Doctrine Through Amicus Participation: The SEC Experience*, 1989 Wis. L. Rev. 1167, 1180.

¹³⁹ Brief of the Securities and Exchange Commission, Amicus Curiae at 13-14 (quoting *Hocking v. Dubois*, 885 F.2d 1449, 1464 (9th Cir. 1989) (Norris, dissenting)).

interpretation of its own Release, therefore, is logical and consistent, and deserves acceptance by the courts and commentators.

B. "No-Action" Interpretations from the SEC Staff

Moreover, advice issued by the SEC's staff in a number of instances (but with one notable exception) supports the view that attribution of the rental efforts of one party to an unaffiliated offeror is not warranted.

The advice has come in the form of "no-action letters," responses by the staff of the SEC in response to written inquiries, stating that if particular transactions occur as described in the inquiry the staff will not recommend that the Commission take enforcement action against the individuals involved.¹⁴⁰ Though no-action letters are not binding on the five-member governing Commission,¹⁴¹ or on private litigants,¹⁴² and certainly not on the courts,¹⁴³ they are useful as examples of what the SEC staff finds acceptable, form patterns that provide guidance, and, at the very minimum, tend to protect those who rely on them from charges of wilful misconduct.¹⁴⁴

¹⁴⁰ Procedure Applicable to Requests for No Action or Interpretive Letters, Securities Act Release No. 5127 (Jan. 25, 1971), 6 Fed. Sec. L. Rep. (CCH) ¶ 66,481.10. No-action letters have been publicly available since 1970. 17 C.F.R. § 200.81 (1988); Exchange Act Release No. 9006, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,921 at 80,051 (Oct. 29, 1970).

¹⁴¹ The letters reflect the views of the S.E.C. staff that prepares them, and "do not constitute an official expression of the Commission's views . . ." 17 C.F.R. §202.1(d) (1987). They "are subject to reconsideration and should not be regarded as precedents binding on the Commission." Exchange Act Release No. 9006, *supra* note 140, at 80,052.

¹⁴² Nonpublic Offering Exemption, Securities Act Release No. 4552 (Nov. 6, 1962) ¶¶ 2770-2783, 27 Fed. Reg. 11316 (a private litigant may argue in court that certain facts constitute a violation of securities laws despite a no-action opinion that those facts do not constitute a violation).

¹⁴³ Courts are not bound by views expressed by employees of an administrative agency. Nevertheless, no-action letters "clearly influence judicial decisions," at least at the District Court level. David A. Lipton, *A Primer on Broker-Dealer Registration*, 36 CATH. U.L. REV., 899, 941 (1987) (citing *ADM Corp. v. Thomson*, No. 82-1618, slip op. (1st Cir. May 24, 1983)); *Bauman v. Bish*, 571 F. Supp. 1054 (N.D. W.Va. 1983). According to Kenneth Bialkin, former chair of the A.B.A. section on Corporation, Business and Banking Law, "most courts, when presented with a no-action letter, will agree with the letter's position." Lipton, *supra* at 940 n.213 (citing K. Eppler, *Rule 145 in Practice*, 5 PLI Inst. Sec. Reg. 337 (1974)).

¹⁴⁴ *See, e.g., H. Kook & Co. v. Scheinman, Hochstin & Trotta, Inc.*, 414 F.2d 93, 98 (2d Cir. 1969) (broker's reliance on no-action letters was reasonable, protecting broker from charges of violating an S.E.C. order); *Colema Realty v.*

The single no-action letter that addressed the application of securities law to secondary sales of condominiums responded to an inquiry in 1976 regarding a condominium named Embarcadero.¹⁴⁵ The associated rental pool agreement automatically terminated according to its own provisions upon sale of unit, and the new owner could then apply for entrance into the pool. When asked whether a local real estate agent could sell a unit on behalf of an individual owner without being licensed as a securities broker-dealer, the SEC staff (without explanation) declined to provide assurance that it would not recommend enforcement action.¹⁴⁶ This 1976 staff letter is inconsistent with more recent no-action letters, and has been specifically rejected by the SEC,¹⁴⁷ yet continues to constitute a source of embarrassment for the Commission.¹⁴⁸ Interestingly, the Embarcadero inquiry was submitted not by the real estate agent but by the developer, suggesting the possibility of a relationship between them.¹⁴⁹

More recent no-action letters have not involved resales by individual owners,¹⁵⁰ but a number of them deal with situations presenting allied issues. The SEC staff has indicated, for example, that a developer's offer of condominium units will not be integrated with rental services available from an entity other than the developer and not controlled by the

Bibow, 555 F. Supp. 1030, 1037 (D. Conn. 1983) (position stated in a prior no-action letter was more persuasive to the court than position taken by the Commission itself).

¹⁴⁵ Embarcadero, SEC No-Action Letter [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,956, at 87,512 (Dec. 3, 1976).

¹⁴⁶ *Id.* The entire "SEC staff reply" consists of only four short paragraphs stating the issue and the conclusion, with no discussion whatsoever.

¹⁴⁷ The SEC stated that the Embarcadero letter was not binding on the present staff or the Commission. MacLaren, *supra* note 115, at 221 n.235 (citing Brief of the Securities and Exchange Commission, Amicus Curiae at 14 n. 5, Hocking v. Dubois, 885 F.2d 1449 (9th Cir. 1989)).

¹⁴⁸ Hocking v. Dubois, 885 F.2d 1449, 1456-57 (9th Cir. 1989) (rejecting SEC's *amicus* position in part because it was "perhaps inconsistent" with the Embarcadero letter).

¹⁴⁹ Embarcadero, SEC No-Action letter, *supra* note 145 (Letter of Inquiry from Yaquina Dev. Corp., which originally offered the condominium units and subsequently operated the rental pool).

¹⁵⁰ Only one No-Action Letter was located that even mentioned resale of condominium units. Planners Dev. Corp. of Am., SEC No-Action Letter, *supra* note 135. Planners Development planned to purchase and then sell units that it had just previously converted to condominiums itself, or which an independent third party had converted. No particular attention was directed to the fact that sale of units converted by some third party would constitute resales, and the situation seems distinct from the more routine type of condominium unit resale, exemplified by the *Hocking v. Dubois* case, in which the purchaser of a single unit sells that unit.

developer.¹⁵¹ In one case, the rental pool was organized by the condominium unit owner's association after the developer had released control over it.¹⁵²

In two similar situations, the staff granted no-action even though establishment of a rental pool in one phase of a large condominium project may have raised a presumption in the minds of potential purchasers of units in subsequent phases that a rental pool would be eventually offered to them.¹⁵³ No-action was also granted in yet another case in which the developer advised potential purchasers that the independent condominium owners' association might effect a future rental pool arrangement after the developer sold all except certain of the units.¹⁵⁴

Two no-action letters that are particularly useful involved companies named Rockresorts, Inc.¹⁵⁵ and Planners Development Corporation.¹⁵⁶ In the Planners Development situation, in 1985, the developer proposed to offer condominium units through conventional real estate processes, using advertising, projections of income, and other means of solicitation that would not be permissible if its offering involved a security, unless it were registered. At the same time, the developer would arrange for the condominium owners association to offer optional leasing services to unit

¹⁵¹ One developer, for example, noted that the homeowners association might select a rental agent, and unit owners might decide to use that agent's services, but that the developer will not make any such arrangements or designations and has no affiliation with any management company. Richfield Properties, SEC No-Action Letter, *supra* note 135. Another no-action request, going further, stated that "It is probable that at some time during which the Developer is still in control of the Development, a rental office will be established on the site of the Development to provide rental services, on a non-pooled basis . . ." and that the rental agent might be the same broker who sold the units under an agreement with the developer. This no-action request emphasized that pooling would be avoided and participation was optional. Rank Dev., Inc., SEC No-Action Letter, *supra* note 135.

¹⁵² Recreational Indus., Inc., SEC No-Action Letter, *supra* note 135.

¹⁵³ *Id.* (rental pool operated by condominium association in a previous phase of the project may have raised an expectation in minds of purchasers of a subsequent phase that a rental pool would also be made available to them); Terrace Hills Condominium, SEC No-Action Letter, 1983 WL 28696 (July 27, 1983), cited and discussed in ROBERT J. HAFT, ANALYSIS OF KEY SEC NO-ACTION LETTERS, 1-10 and 1-11 (1985-86 ed.) (a completed project with a rental pool operated by condominium association would be followed by "identical" project by the same developer).

¹⁵⁴ Sunrise Terrace Trust, SEC No-Action Letter, *supra* note 135, cited and described in Recreational Indus., Inc., SEC No-Action Letter, *supra* note 135.

¹⁵⁵ Rockresorts, Inc., SEC No-Action Letter, 1986 WL 55887 (Nov. 12, 1986).

¹⁵⁶ Planners Dev. Corp. of Am., SEC No-Action Letter, *supra* note 135.

purchasers. The SEC staff granted a No-Action Letter, apparently because the developer and the association were separate entities.¹⁵⁷

In the other case, in 1986, Rockresorts, Inc. proposed offering rental services to owners of condominium units who had previously purchased them from a developer, and to do so without filing a registration statement. Rockresorts would contract with the developer, to control such matters as advertising (to assure that availability of rental services was not mentioned as an inducement to buy the condominiums), but the two companies were otherwise unaffiliated. The staff granted no-action (though admittedly its failure to explain its position allows for alternate interpretations).¹⁵⁸

The *Hocking* facts present an even stronger basis for concluding that the condominium seller and the rental services manager were distinct parties whose activities should not be integrated. Unlike Planners Development, the private individuals in *Hocking* who sold the one condominium unit that they owned did not have the capacity to influence

¹⁵⁷ The completely conclusory nature of the letter concededly does allow for alternate explanations. For example, the developer also argued that the right of each unit owner to select the association, some other agent, or no agent for rental services established that unit owners would not be depending for profits on the managerial efforts of others. Planners Dev. Corp. of Am., SEC No-Action Letter, *supra* note 135. Possibly that argument was persuasive to the SEC staff. There may possibly be significance also in the fact that the no-action letter gave no response whatsoever to the developer's request for advice that offer of the condominiums would not involve the sale of securities. The SEC staff stated only that it would not recommend enforcement action to the Commission—its standard formula in all no-action letters on condominiums in recent years. One possible inference is that the staff feels that the offering did involve a security, but that other types of transactions deserve priority for the staff's limited enforcement resources.

¹⁵⁸ Rockresorts' counsel, Peter M. Gunnar, requested no-action advice by a letter dated August 23, 1985, and supplemented that request by a letter dated September 12, 1985 that began "You have asked us to comment . . . on the 'vertical commonality' concept . . ." Rockresorts argued, first, that vertical commonality is not accepted by most circuits or by the Supreme Court and, secondly, that even if the "common enterprise" element was present, the "investment of money" element was absent, because the unit owners would be merely contracting for services on property they already owned. Although the unit owners had paid the developer money for their units, no part of that investment was received by Rockresorts, and the two companies operated independently. The SEC staff then issued a No-Action Letter which, regrettably but characteristically, provided no clue as to which of the two arguments (or both) it found persuasive. Rockresorts, Inc., SEC No-Action Letter, *supra* note 155. (If the no-action decision was based on the "investment of money" argument, it supports the position that the offer of condominium units by one party and the offer of rental services by another party do not combine to form an investment contract when the two parties are not affiliated.)

the operations of the rental services corporation.¹⁵⁹ Unlike Rockresorts, the seller had no affiliation, relationship, or contractual arrangement with the rental manager.¹⁶⁰ Accordingly, having adopted no-action positions in the Planners Development and Rockresorts situations, the SEC staff could not logically have denied similar treatment to the *Hocking* sellers, if they had asked.

These administrative interpretations reinforce the logical inferences suggested by the SEC's Release and the explicit interpretations publicly expressed by the SEC. All of these sources (after the 1976 Embarcadero staff letter) suggest that private parties have little cause for concern that the SEC will rigidly enforce regulations in cases involving condominiums coupled with rental arrangements. Even more clearly, the SEC is not oriented to pursue individual condominium unit owners who market units on the secondary market when the rental arrangements are offered by unaffiliated third parties.

C. No Respect for the SEC in the Courts

The SEC's release and administrative interpretations govern its own enforcement policies, but do not necessarily influence the courts. The Commission's record of success in the courts, as direct party plaintiff in its enforcement role, and as *amicus curiae* in actions brought by private plaintiffs, has been decidedly mixed. During the 1970's, the Supreme Court repeatedly rejected the SEC's positions, sometimes with harsh criticism.¹⁶¹ More recently, the SEC's success rate has improved

¹⁵⁹ Planners Development proposed "to purchase all or a significant portion of a residential condominium project and to resell one or more Units to individual purchasers for a profit." Planners Dev. Corp. of Am., SEC No-Action Letter, *supra* note 135 (1985). The developer would write the project's condominium declaration, presumably during the period in which the developer maintained ownership, to require the association of unit owners to provide certain rental services in addition to the usual functions of such an association, such as maintenance of the common elements. In contrast, the defendant real estate agent in *Hocking* never owned any condominium units and never had the economic power to control or influence the operations of the rental services manager.

¹⁶⁰ Rockresorts had a contract with the developer that allowed Rockresorts to limit the types of solicitations used by the personnel selling the condo units, including reviewing the advertising to ensure that it did not promote any expectation of profits from the managerial efforts of Rockresorts. Rockresorts, Inc., SEC No-Action Letter, *supra* note 155. The condominium seller in *Hocking*, in contrast, did not enroll in the rental manager's program and had no contractual relationship at all with the rental manager.

¹⁶¹ See, e.g., *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 566 (1979) (SEC's argument, that employee's interest in a pension plan was a security,

dramatically,¹⁶² though the Supreme Court continues to criticize the agency on occasion.¹⁶³

The small number of judicial decisions that refer directly to the Release display a similar pattern of deference mixed with derision. The Supreme Court in *Forman* noted that the SEC's amicus brief flatly contradicted its position in the Release, and concluded that "we accord no special weight to its views."¹⁶⁴ The Ninth Circuit majority in *Hocking* cited that Supreme Court precedent, and an alleged inconsistency between the SEC's amicus brief and a twenty-year-old advisory letter written by the SEC staff, as justification for completely rejecting the SEC's position in the *Hocking* case.¹⁶⁵

was not "even arguably within its outer limits of authority" and not entitled to deference); *SEC v. Sloan*, 436 U.S. 103, 117-19 (1978); *Piper v. Chris Craft Indus.*, 430 U.S. 1, 41 n.27 (1977); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 212-14 (1976); *United Housing Found. v. Forman*, 421 U.S. 837, 858 n.25 (1975); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 746-47 n.10 (1975); *Reliance Elec. v. Emerson Elec.*, 404 U.S. 418, 426 (1972). A former SEC Chairman acknowledges the 1970's as a "low period" for the Commission in its litigation record. Ruder, *supra* note 138, at 1182.

¹⁶² The Supreme Court adopted the SEC's views in eight of the nine Supreme Court cases in which the SEC filed amicus briefs between 1980 and 1989. *Pinter v. Dahl*, 486 U.S. 622, at 651 n.27 (1988) ("seller" liability under the 1933 Act); *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988) ("fraud on the market" theory); *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987) (arbitration clauses); *Randall v. Loftsgaarden*, 478 U.S. 647 (1986) (damages); *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299 (1985) (*in pari delicto* defense); *Gould v. Rueferacht*, 471 U.S. 701 (1985) ("sale of business" doctrine); *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985) ("sale of business" doctrine); *Herman & MacLean v. Huddleston*, 459 U.S. 375 (1973) (implied causes of action). The SEC position lost in *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69 (1987) (constitutionality of state takeover law). A former SEC Chairman pronounces the agency's amicus program "a very successful policy making tool" and indeed "brilliant." Ruder, *supra* note 138, at 1168, 1180.

¹⁶³ See, e.g., *Dirks v. S.E.C.*, 463 U.S. 646 (1983) (both the majority and the dissenting Justices criticized the SEC for arguing that a defendant was liable derivatively as a "tippee," based on the primary breach of duty by a "tipper," yet did not prosecute the tipper).

¹⁶⁴ *Forman*, 421 U.S. at 859 n.25 (particularly interesting because the Release had been issued by the SEC only two years previously, in 1973).

¹⁶⁵ *Hocking v. Dubois*, 885 F.2d. 1449, 1456-57. According to the Ninth Circuit majority, the SEC's position that the Release applied only to developers having affiliation with a rental pool operator was "not readily apparent from the language of the release" and "perhaps inconsistent with the SEC Division of Corporate Finance's refusal to take a no-action position in *Embarcadero*." *Id.* Accordingly, the court declined to rely on the Release as a basis for its decision, and implicitly rejected the rationale of the SEC's amicus brief. The dissenting judges argued that the SEC's

In a few other instances, however, the lower federal courts have accorded deference to the SEC's position regarding treatment of condominium transactions under the securities laws.¹⁶⁶ Nevertheless, conformity with the SEC position provides only limited comfort that a court will agree.

VI. CONSEQUENCES ON THE CONDOMINIUM INDUSTRY: THE IMPRACTICALITY OF COMPLIANCE

A determination that a condominium unit coupled with rental management services as an investment contract triggers extensive legal and pragmatic repercussions. The federal securities registration, exemption, and liability provisions that apply entail such great complexity, expense, and delay as to be daunting even to large and sophisticated condominium developers. Extending the applicability of those provisions to individual unit owners in the secondary sales market risks serious negative consequences on the resort condominium industry.

A. Registration Requirements Applicable to Condominium Resales

Categorizing a condominium as an investment contract makes it subject to the Securities Act of 1933 (hereinafter 1933 Act). The act applies to "any person"—whether or not an issuer—and "any offer or sale," whether in the primary or secondary markets.¹⁶⁷ Every security must be registered, unless the transferor can sustain the burden of proof that a specific exemption applies.¹⁶⁸

position in *Hocking* (even if not in *Forman*) was consistent with the Release, and logical, justifying deference. *Id.* at 1463, 1465 n.11.

¹⁶⁶ Private plaintiffs have successfully relied on the Release in, for example, *Hodges v. H & R Inv.*, 668 F.2d 545, 550 (N.D. Miss. 1987) (applying the Release in securities fraud case); *Cameron v. Outdoor Reports of Am.*, 608 F.2d 187, 192 (5th Cir. 1979), *aff'd in part, vacated and remanded on other grounds*, 611 F.2d 105 (1980); *Dumbarton Condominium Assoc. v. 3120 R Street Assoc.*, 657 F. Supp. 226, 230-31 (D.D.C. 1987) (applying the Release to determine definition of security in a RICO case); *Bender v. Continental Towers*, 632 F. Supp. 497, 501 (S.D.N.Y. 1986) (applying the Release to determine whether securities registration was necessary); *Mosher v. Southridge Assocs.*, 552 F. Supp. 1231, 1233 (W.D. Pa. 1982) (securities registration case); *Johnson v. Nationwide Indus.*, 450 F. Supp. 948, 953 (N.D. Ill. 1978).

¹⁶⁷ Securities Act of 1933, § 5, 15 U.S.C. § 77e (1988).

¹⁶⁸ Securities Act of 1933, § 5(c), 15 U.S.C. § 77e(c) (1988) (unlawful to sell, buy, or offer to sell a security in interstate commerce unless a registration statement has been filed).

For an individual unit owner contemplating resale, a key preliminary issue is whether the initial offering by the developer was itself registered. If the developer properly registered prior to selling to the initial group of purchasers (and a forty- or ninety-day period has elapsed thereafter),¹⁶⁹ then the purchasers are free to resell without concern for the registration provisions of the 1933 Act.¹⁷⁰ On the other hand, if the developer did not register, then the purchaser must either register or find an exemption.

In actual practice, very few developers offering condominiums coupled with rental agreements have filed registration statements.¹⁷¹ In some cases, ignorance of the law may be the explanation. In other cases, the expense, delay, and complexity of registration may have led to a conscious economic decision to forego registration and accept the risks that accrue to noncompliance.¹⁷² Still others may have chosen to rely on an exemption from registration.

In any of those cases, the owner of a condominium unit that was not previously registered has only two options if she wants to sell on the secondary market without violating the law: file her own registration statement, or find an exemption. Each of those options deserves consideration.

B. *The Registration and Sales Process*

A brief summary of the processes mandated by the 1933 Act for registered offerings plainly demonstrates that compliance by an individual unit owner is implausible. The requirements divide into a pre-filing period,

¹⁶⁹ Securities Act of 1933, § 4(3), 15 U.S. C. § 77d(3) (1988); Rule 176, 17 C.F.R. § 230.176 (1982).

¹⁷⁰ To prevent sales activity after the registration statement becomes effective, the SEC must commence stop order or refusal order proceedings, or an examination. Securities Act of 1933, § 5(c), 15 U.S.C. § 77e(c) (1988).

¹⁷¹ During the 15 years between 1967, when the SEC made known its position that certain condominium offers should be registered, and 1973, when the SEC reemphasized the point by issuing the Release, the number of condominium offerings which the SEC would consider subject to the Act was estimated at several hundred, yet the number of registration statements for such offerings was only 42. Rosenbaum, *supra* note 47, at 786 (citing "SEC Issues Guidelines on Advertising, Sales of Condominium Units," Wall St. J., Apr. 10, 1973, at 14). An expert in condominium securities noted that, as of 1972, of over 500 resort rental condominium offerings only 21 had registered with the SEC. Gunnar, *supra* note 1, at 36 n. 26.

¹⁷² One expert in condominium securities discussing whether lawyers for developers of condominiums should advise registration, noted that the SEC's "lack of enforcement leaves conscientious counsel in a dilemma. The majority have advised their clients to follow form rather than substance and hold their breath." Gunnar, *supra* note 1, at 39 n.45.

a waiting period after filing but before the "effective date," and the post-effective period.

In the pre-filing period, before a registration statement is submitted to the SEC, the seller must avoid all offers and sales. The term "offer," for this purpose includes even "conditioning the market" by publicity that tends to arouse interest in buying the security. These rules, clearly, run directly counter to the economic incentives of any seller of real estate, to encourage as much public interest as soon as possible. During the pre-filing period, the seller is precluded from advertising, listing the unit as being for sale, or otherwise generating interest among potential purchasers.

Preparing the registration statement is an imposing challenge, since it must disclose at length and in detail all material facts regarding the security. In the case of condominium unit, material facts would logically include a massive degree of detail regarding the entire condominium complex and the rental manager, because the value and the benefits and risks of ownership of each unit is connected to a significant degree to the rest of the complex and the condominium association.¹⁷³

After a registration statement is filed with the SEC, but before it is "effective," a waiting period is imposed. During this period, the seller may accept indications of interest but must carefully avoid any statement or conduct that could result in a sale or contract to sell.¹⁷⁴ The seller may provide offerees a "preliminary prospectus" consisting of most of the contents of the registration statement. The duration of this waiting period is weeks, perhaps months, and in practice is difficult to predict. The delay could impose unacceptable costs to condominium sellers.

¹⁷³ A partial list of the aspects of disclosure necessary in the registration of a condominium security includes the following: the type, number, and descriptions of units; the topography, climate, population, recreational facilities, public safety services, and commercial facilities in the area; all details of costs, financing, taxes, and monthly expenses and assessments; full information on any rental arrangement; the condominium association rules and processes; identity and experience of the issuer, affiliates, and managers; use of the proceeds; and conflicts of interest. Robert Klein, *Preparation of an SEC Registration Statement for an Offering of Condominium Units*, 2 REAL ESTATE L.J. 461, 462-71 (1973) (containing a detailed treatment of each of the listed factors). Financial statements and copies of significant documents must be attached. Moreover, any further information that an investor would consider important in deciding whether or not to purchase must be disclosed, even if it is not specifically listed on the SEC's registration form. Rule 408, 17 C.F.R. § 230.408.

¹⁷⁴ Only when the registration statement becomes effective can contracts be signed. Securities Act of 1933, § 5(b), 15 U.S.C. § 77e(b) (1988) (permissible to sell or buy securities after the effective dates). For an explanation of restrictions applicable in the "waiting period" between filing a registration statement and its effective date, see THOMAS L. HAZEN, *THE LAW OF SECURITIES REGULATION* § 2.4 (2d ed. 1990).

When the registration statement becomes effective, the seller is finally permitted to make offers and complete sales. No written materials relating to the condo may be used in connection with an offer or sale unless, however, the purchaser is furnished a formal prospectus—a lengthy, detailed document consisting of most of the contents of the registration statement.¹⁷⁵

The process is extremely complex and costly, requiring massive documentation and advice from lawyers, accountants, and other experts. Costs from fifty thousand to hundreds of thousands of dollars are routine.¹⁷⁶ The lengthy delays, of at least a few weeks, add further costs and are especially objectionable in the real estate industry,¹⁷⁷ which is so markedly cyclical and requires expeditious responses to changing market conditions.

Presented with the prospect of those heavy burdens, why register? Pragmatic sellers of condominiums will consider the extent of civil and criminal sanctions for noncompliance (described below), and the likelihood of enforcement action, and will weigh the costs. From the point of view of a developer of a large condominium development, a cost-benefit analysis could produce either result: registration, or a conscious decision not to register, whether or not an exemption is available.

From the point of view of the owner of a single condominium unit that had not been previously registered by the developer, the decision seems far more certain: registration is simply not plausible. One reason is the probable inability to provide adequate disclosure even if cost were not an object. Since the “security” consists of the unit plus the rental pool, the registration statement would have to include all material facts regarding the pool.

The *Hocking* facts serve to emphasize the impracticality. The seller of the single condominium unit involved in that case was not a participant in the rental pool, and had no right to access to information regarding it. Although a unit seller might request the massive and detailed data that would be necessary, there is no assurance that the pool operator would comply. Indeed the danger of securities law liability is a strong disincentive

¹⁷⁵ For description of the rules applicable in the “post-effective period” (after the SEC allows the registration statement to become effective), see generally LOUIS LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 131–39 (2d ed. 1988).

¹⁷⁶ Registration of a condominium project in 1973, for example, costed between \$50,000 and \$100,000. Brannen, *supra* note 58, at 749 n.18.

¹⁷⁷ See, e.g., Linda A. Wertheimer & Stephen S. Mark, *Special Problems of Unregistered Real Estate Securities*, 22 *UCLA L. REV.* 1219, 1221 (1975) (real estate syndicators are “unable or unwilling to bear the expense of registering . . . or are unable to delay their contractual commitments and business decisions during registrations”).

for the pool operator to cooperate, especially since the transaction provides no direct economic benefit to the pool operator.

Even if the individual unit owner were capable of accumulating the necessary information, the costs, delays, and burdens of registration would be grossly excessive in relation to the value of the transaction. In practical effect, an individual unit owner will not register. The only realistic issues, then, are whether exemptions from registration are available, and the sanctions that result from failure to register.

C. Exemptions from Registration

Exemptions provide significant benefits to sellers of securities, even though they do not protect against antifraud liability. If the transaction is exempt, the seller need not register and is not exposed to the automatic rescission remedy. The burden of proving that a transaction is exempt, however, is always on the party asserting the exemption.¹⁷⁸

In determining which exemption provisions apply to the sale of a single condominium unit, a key preliminary question is whether the "issuer"¹⁷⁹ of the security, for purposes of the 1933 Act, is the developer or the unit owner. Many of the exemption provisions are available only to issuers, while others apply only to non-issuers.

1. Exemptions Available to Non-Issuers

Courts that accept the "once a security, always a security" rationale should determine that the condominium unit (by itself merely a real estate interest) became a security when the developer combined it with the RPA. The characterization as a security then continued into the hands of the purchaser of the condo unit (whether or not the purchaser also entered into the rental pool), on the premise that conversion from security to non-security, and perhaps back again, would produce unacceptable confusion and difficulties.

Implicit in that line of reasoning is a determination that the "issuer," or creator, of the security was the original developer, not the buyer of an individual unit. The individual unit owner who proceeds to sell the unit on

¹⁷⁸ See, e.g., *Kane v. SEC*, 842 F.2d 194, 198 (8th Cir. 1988) (broker must determine whether securities being distributed are exempt); *Mary S. Krech Trust v. Lakes Apts.*, 642 F.2d 98 (5th Cir. 1981) (plaintiff carries burden on every one of the exemption's elements).

¹⁷⁹ The term "issuer" is defined as "every person who issues or proposes to issue any security." Securities Act of 1933, § 2(4), 15 U.S.C. § 77b(4) (1988).

the secondary market, therefore, would be precluded from using certain exemptions which are available only to issuers.¹⁸⁰

The only exemptions available to non-issuers are under section 4(1)¹⁸¹ and Rule 144,¹⁸² the so-called "4(1 1/2) phenomenon,"¹⁸³ the short-form filing exemption under Regulation A,¹⁸⁴ and the statutory intrastate exemption.¹⁸⁵ Each of them entails difficulties or uncertainties.

Section 4(1) exempts "transactions by any person other than an issuer, underwriter, or dealer."¹⁸⁶ Though an initial reading would suggest that the exemption is available to a seller of a single condominium unit on the secondary market, hidden complexities make that conclusion uncertain. The owner of a single unit is not an issuer, under the rationale discussed above, and normally is not a dealer,¹⁸⁷ but might be classified as an underwriter—a term with a technical meaning¹⁸⁸ and interpretation far broader than its everyday usage would suggest.¹⁸⁹

¹⁸⁰ Included are exemptions for nonpublic offerings (or "private placements"), Securities Act of 1933, § 4(2), 15 U.S.C. § 77a(2) (1988); accredited investors, Securities Act of 1933, § 4(6), 15 U.S.C. § 77d(6) (1988), Rule 215, 17 C.F.R. § 230.215; intrastate offerings under the SEC's Rule 147, 17 C.F.R. § 230.147; or any of the exemptions under the SEC's Regulation D, Rules 504, 505, 506, 17 C.F.R. § 230.504-.506.

¹⁸¹ Securities Act of 1933, § 4(1), 15 U.S.C. § 77d(1) (1988).

¹⁸² 17 C.F.R. § 230.144.

¹⁸³ ABA Committee on Federal Regulation of Securities, *The Section "4(1 1/2)" Phenomenon: Private Resale of "Restricted Securities,"* 34 BUS. LAW 1961 (1979) [hereinafter ABA Report].

¹⁸⁴ Regulation A, 17 C.F.R. §§ 230.251-.262 (1981).

¹⁸⁵ Securities Act of 1933, § 3(a)(11).

¹⁸⁶ Securities Act of 1933, § 4(1), 15 U.S.C. § 77d(1) (1988).

¹⁸⁷ The term "dealer" means as any person who engages, full or part-time, directly or indirectly, as broker, agent, or principal, in the business of trading in securities issued by another person. Securities Act of 1933, § 2(12), 15 U.S.C. § 77b(12) (1988).

¹⁸⁸ The term underwriter includes "any person who purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security . . ." Securities Act of 1933, § 2(11), 15 U.S.C. § 77b(11).

¹⁸⁹ In common parlance in the securities industry, an underwriter is a professional who, as a regular business, arranges with issuers to market their securities to investors, receiving either commissions or profit on the transactions. That usage, however, is far narrower than the meaning used in applying the 4(1) exemption. The need for a more inclusive construction arises from the danger that a promoter might seek to avoid registration by selling first to an intermediate party, such as a director or officer of the issuer, who proceeds to sell to members of the public. If the meaning of the term underwriter was construed narrowly to exclude the director or officer, then 4(1) could be used to justify part of a scheme to evade registration of securities sales by an issuer indirectly to the public.

Under highly technical and abstruse interpretations by the courts and the SEC, including a line of reasoning known as the "4(1 1/2) phenomenon,"¹⁹⁰ a purchaser of securities may be categorized as an underwriter even without any affiliation or relationship to the issuer. Factors supporting such a conclusion include a purchaser's intent at the time of purchase to resell rather than to hold the security as an investment or merely the fact of a short holding period before a resale. In the *Hocking* situation, as one illustration, both the defendant and the plaintiff purchaser could be found to be underwriters because their holding periods were short, and their intent from the outset was to resell quickly.

The lack of precise or reliable standards in the case law addressing the definition of an underwriter is perhaps the most serious problem for a condominium seller. The 4(1) exemption is often useful to avoid liability after an unregistered security transaction is completed, but is far from satisfactory as a planning device because of uncertainties in its application.¹⁹¹

¹⁹⁰ Part of the difficulty derives from the Act's omission to define the term "distribution," which appears in the definition of "underwriter." Many commentators have reasoned that the term distribution is equivalent to the concept of nonpublic offering, which appears in a different exemption provision, section 4(2), and has generated a substantial body of judicial interpretation, but again no precise or reliable criteria. This approach is commonly termed the "section 4(1 1/2) phenomenon" (because it blends terminology from 4(1) with case law interpreting 4(2)). *See, e.g.*, ABA Report, *supra* note 183. The approach has some support in case law and SEC No-Action letters, but provides no solace to a condominium seller seeking certainty about the 4(1) exemption. For example, the ABA Committee reviewed six cases and a number of SEC No-Action letters regarding private resales of securities, and found numerous inconsistencies and uncertainties, even as to the particular statutory exemption that was applicable. *Id.* None of the six cases was explicit in recognizing the "4(1 1/2)" phenomenon. Dean Olander & Margret Stevens Jacks, *The Section "4(1 1/2)" Exemption-Reading Between the Lines of the Securities Act of 1933*, 15 SEC. REG. L.J. 339, 351 n. 50 (1988). Commentators have described the "4(1 1/2)" exemption as being "lore, rather than law," and "of dubious origin and uncertain application." *Id.* at 341. The SEC has not specified the circumstances under which the exemption applies, and the A.B.A. Committee addressing the subject merely recommended general guidelines. *Id.* at 341-42.

¹⁹¹ No precise or reliable standards crystallized in the case law, and the determination remains largely subjective and difficult to predict. *See, e.g.*, ABA Report, *supra* note 183; Olander & Jacks, *supra* note 190, at 344; Preliminary Note to Rule 144, 17 C.F.R. § 230.144 (1990). The SEC takes the position that anyone relying on section 4(1) rather than on SEC rule has a "substantial burden" of proof that the statute is satisfied. Adoption of Rule 144, SEC Securities Act Release No. 5223 [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78487 (Jan. 11, 1972). One commentator refers to the case law and the SEC position on § 4(1) as "a trap for the careless and unwary." HAZEN, *supra* note 174, at 212.

Rule 144,¹⁹² issued by the SEC in response to the high degree of uncertainty in the case law,¹⁹³ helps, somewhat, to set objective standards. Nevertheless, Rule 144 provides only limited benefit to sellers of condominiums and other types of securities. From a pragmatic point of view, the most important criterion in the Rule is the "holding period"—the length of time that has elapsed after the investor became the beneficial owner of the security.¹⁹⁴ If the investor pays with a promissory note or other installment obligation in favor of the seller (not uncommon in real estate transactions), the holding period begins only when payment has been completed.

If the investor's holding period is less than two years, Rule 144 is not available at all.¹⁹⁵ If the holding period is more than two years but less than three years, Rule 144 is available but the requirements are so extensive and complicated as to be plainly prohibitive for the owner of a single condominium unit seeking to sell on the secondary market.

To qualify for Rule 144, a unit owner would need to convince the rental pool operator to supply extensive information on its business and finances for exposure to public scrutiny.¹⁹⁶ The owner would have to ascertain how many other units were sold by other parties recently.¹⁹⁷ They would have had to find a registered securities broker¹⁹⁸ who was willing to accept the transaction, even though secondary sales of condominium units normally are handled by real estate brokers. The securities broker would have to agree not to solicit offers to buy but rather to merely passively await offers¹⁹⁹—a blatantly unrealistic scenario for selling real estate. All except the most sophisticated condominium unit

¹⁹² 17 C.F.R. § 230.144 (1990).

¹⁹³ Preliminary Note to Rule 144, 17 C.F.R. § 230.144 (1990).

¹⁹⁴ Rule 144(d), 17 C.F.R. § 230.144(d) (1990).

¹⁹⁵ *Id.*

¹⁹⁶ Information regarding the securities, similar to what is provided under 1934 Act periodic disclosure, must be available to the public. Rule 144(c), 17 C.F.R. § 230.144(c) (1990); *see also* Olander & Jacks, *supra* note 190, at 346 (making a similar point in the more general context of sales of securities of any company that is not a reporting company under the 1934 Act).

¹⁹⁷ The amount of securities that can be sold is strictly limited, in any three-month period, to 1% of the issues' outstanding securities, or the average weekly trading volume in the preceding four weeks, whichever is smaller. Rule 144(e) 17 C.F.R. § 230.144(e) (1990).

¹⁹⁸ The seller must use a registered securities broker to arrange the sale, and the broker cannot solicit for offers to buy. Rule 144(f), 17 U.S.C. § 230.144(f) (1990).

¹⁹⁹ The sales process envisioned by Rule 144 is not workable in any situation in which there is not an active trading market. Olander & Jacks, *supra* note 190, at 346.

owners, of course, would not even reach these issues, because they would fail to submit the required notice to the SEC in a timely manner.²⁰⁰

If the investor completes a holding period of a full three years, then the usefulness of Rule 144 dramatically increases. The requirements for public information and for use of a securities broker are removed, as are limits on the amount of securities that can be sold.²⁰¹ Perhaps most importantly, the requirement for filing a notice of sale with the SEC is removed, making it possible for a condominium unit owner who lacks securities law legal advice to inadvertently qualify for the exemption, without even being aware of its existence. The three-year requirement, however, excludes a large portion of unit owners (including for example the owners in the *Hocking* case, who resold within one year after their purchase).

Regulation A is another possibility. It provides an exemption to issuers and non-issuers, permits advertising, and has no limitation on the number and residence of offerees.²⁰² The maximum value of securities that a non-issuer can sell under the regulation is \$100,000—a limitation which will exclude some owners of condominium units.

The primary difficulty of Regulation A are its disclosure requirements, which parallel in many respects the full statutory registration process.²⁰³ Though somewhat less burdensome than a full registration, the disclosure requirements still present a nearly insuperable pragmatic barrier to the owner of a single condominium unit seeking to resell.²⁰⁴ The costs and delays involved in Regulation A remove any doubt that the exemption is not practical for a condominium unit resale.²⁰⁵

The statutory intrastate exemption²⁰⁶ is the final exemption for non-issuers to consider. An SEC rule²⁰⁷ on intrastate transactions limits its

²⁰⁰ A notice of a proposed sale must be filed with the SEC prior to or concurrently with the order to sell. Rule 144(h), 17 C.F.R. § 230.144(h) (1990)

²⁰¹ Rule 144(k), 17 C.F.R. § 230.144(k).

²⁰² Rules 251–264, 17 C.F.R. § 230.251–.264 (1981).

²⁰³ A person seeking to comply with Regulation A must submit to the SEC a Notification (similar to a Registration Statement but somewhat less detailed) and provide investors with an Offering Statement (generally comparable to a prospectus). These documents include substantial information about the security.

²⁰⁴ Because the “security” entails the condominium unit plus the rental pool, the unit owner would be required to provide full disclosure regarding the RPA. Even if the rental pool operator chose to cooperate, the expense of producing the documentation would likely exceed the value of the transaction in a single unit.

²⁰⁵ Regulation A has been evaluated as hardly preferable to full registration, for small transactions. Olander & Jacks, *supra* note 190, at 347 n.35.

²⁰⁶ Securities Act of 1933, § 3(a)(ii), 15 U.S.C. § 77c(a)(ii) (1988).

²⁰⁷ Rule 147, 17 C.F.R. § 230.147 (1989).

exemption to issuers, but the statute does not contain that limitation.²⁰⁸ The exemption is attractive because it allows advertising (if limited to residents of the same state),²⁰⁹ does not mandate specific disclosures to offerees (though the antifraud provisions always apply), and has no maximum dollar limitation. Nevertheless, only in a rare case would the statutory exemption be useful to a seller of a single condominium unit.

The exemption would apply only if all offers and sales were made to individuals who resided in the same state as the developer of the condominium. The requirements apply not merely to the particular unit but to the entire "issue," presumably the entire condominium development. Even one offer to an out-of-state resident disqualifies the entire issue, whether or not that offeree decides to buy.²¹⁰ Clearly most owners of individual units of a resort condominium could not rely on this exemption, and those who do rely are subject to substantial uncertainties due to varying judicial interpretations.²¹¹

Summarizing, the only exemption likely to be useful to resellers of single condominium units, and to provide a comfortable degree of certainty, is Rule 144, and even that is practical only after three years have elapsed since the owner paid for the unit. Alternatively, a unit owner might hope to qualify as a non-underwriter under diffuse case law interpretation, recognizing that the burden of proof is on the person seeking the exemption.

2. Exemptions Available to Issuers

If the condominium unit seller is deemed to be the "issuer"²¹² of the security, other exemptions are available, though they are also not likely to be workable. The principal exemptions potentially useful in that instance would be the nonpublic, intrastate, accredited investor statutes and rules and, of particular value, the small-offerings exemption under Regulation D.

²⁰⁸ The statutory provision applies to any "security which is part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident . . . within such State or Territory." Securities Act of 1933, § 3(a)(11), 15 U.S.C. § 77c(a)(11) (1988). The provision does not limit the exemption to issuers, though the residency of the issuer is vital.

²⁰⁹ Letter of General Counsel discussing nature of the exemption from registration provided by § 3(a)(11). Exchange Act Release No. 33-1459 (May 29, 1937) (Westlaw, FSEC-IR Database) [hereinafter Exemptions].

²¹⁰ The statutory response is to "offers," not "purchases."

²¹¹ See HAZEN, *supra* note 174, at 143-49.

²¹² A unit owner would be the "issuer" if the court focuses on the offer, and identifies the party who combines the various elements of the *Howey* test to form an investment contract.

A recurring problem with those exemptions are limitations or prohibitions on advertising, which is standard and commonly vital in marketing real estate.

The 1933 Act exempts from registration "transactions not involving any public offering,"²¹³ but does not define the term "public offering." Generally, case law has limited the exemption to situations in which every offeree (not merely the purchaser) is sufficiently sophisticated to evaluate the opportunity and financially able to bear the investment risk, so as not to need the protections of the registration provisions.²¹⁴ The offeree must receive or have access to information comparable to what would be disclosed in a registration statement.²¹⁵ Moreover, the number of offerees must be limited, and the SEC has taken the position that "public advertising is inconsistent with a claim of private offering."²¹⁶ Marketing a condominium unit under these constraints would require drastic departures from conventional practice, and nevertheless expose the offeror to significant risk.

The intrastate offerings exemptions is another possibility. Issuers may use the statutory intrastate exemption (discussed above) or, for far greater certainty, an SEC "safe harbor" rule.²¹⁷ The rule requires that the issuer, all offerees, and the business be all in a single state, and 80% of the proceeds of the offering be used in the state.²¹⁸ Plainly, such restrictions make the rule useless for resort condominiums since potential purchasers may be from a different state. Moreover, downstream sales to nonresidents

²¹³ Securities Act of 1933, § 4(2), 15 U.S.C. § 77 d(2) (1988).

²¹⁴ SEC v. Ralston Purina Co., 346 U.S. 119, 124-25 (1953).

²¹⁵ Van Dyke v. Coburn Enters., Inc., 873 F.2d 1094, 1098 (8th Cir. 1989); Doran v. Petroleum Management Corp., 545 F.2d 893, 903 (5th Cir. 1977), *appeal after remand*, 576 F.2d 91 (5th Cir. 1978); Woolf v. S.D. Cohn & Co., 515 F.2d 591, 613 (5th Cir. 1975), *cert. denied*, 434 U.S. 831 (1977); SEC v. Continental Tobacco Co. of S.C., Inc., 463 F.2d 137, 159-60 (5th Cir. 1972); Gilligan, Will & Co. v. SEC, 267 F.2d 461, 466 (2d Cir.), *cert. denied*, 361 U.S. 896 (1959).

²¹⁶ Nonpublic Exemption Offering, Securities Act Release No. 33-4552 (Nov. 6, 1962) (Westlaw, FSEC-IR Database); *see generally* Stuart R. Cohn, *Securities Markets for Small Issuers: The Barrier of Federal Solicitation and Advertising Prohibitions*, 38 U. FLA. L. REV. 1 (1986); Patrick Daugherty, *Rethinking the Ban on General Solicitation*, 38 EMORY L.J. 67 (1989). Brokers can contact their customers, however, if they meet the suitability standard, though burden of proof is on the issuer. Mary S. Krech Trust v. Lakes Apartments, 642 F.2d 98, 101-03, *reh'g denied*, 645 F.2d 72 (5th Cir. 1981).

²¹⁷ Rule 147, 17 C.F.R. § 230.147 (1989). The rule is available to issuers only, though the statutory provision may apply to others. *Id.*, Preliminary Note 4.

²¹⁸ *Id.*, subsections (c), (d); *see also* SEC v. McDonald Inv. Co., 343 F. Supp. 343, 346 (D. Minn. 1972) (statutory intrastate exemption not available when proceeds of sales were used largely in another state).

within nine months, even if inadvertent, can invalidate the exemption,²¹⁹ giving all purchasers a right to rescission.²²⁰

The exemptions for "accredited investors"²²¹ may be useful in some instances to sellers of condominiums. Accredited investors include natural persons with incomes over \$200,000 or net worth over \$1 million, so some potential purchasers of high-end condominium units are covered. No specific information need be provided, only a simple notice is required, and "insignificant and inadvertent deviations" from the Rule's requirements will be tolerated.²²² A prohibition on general solicitation or advertising,²²³ however, constitutes an insuperable barrier for most real estate transactions.²²⁴

The exemption most likely to be useful to the owner of a single condominium unit selling in the secondary market is Rule 504,²²⁵ a small-offerings exemption within Regulation D. It allows sales not exceeding \$1 million, to any type of investor, without providing any information, and countenances "insignificant deviations" from the requirement.²²⁶ General solicitation and advertising is prohibited, however, unless the offeror is in a state having certain types of state blue-sky disclosure requirements and the seller complies.²²⁷ A form must be filed with the SEC in a timely manner²²⁸—a requirement that is not difficult to satisfy but operates to

²¹⁹ See *Hillsborough Inv. Corp. v. SEC*, 276 F.2d 665, 668 (1st Cir. 1960); HAZEN, *supra* note 174 § 4.12, at 147. Resales do not destroy prior exemptions, however, if the securities "[came] to rest." Section 3(a)(11) Exemptions from Local Offerings, Exchange Act Release No. 33-4434 (Dec. 6, 1961) (Westlaw, FSEC-IR Database); *Busch v. Carpenter*, 827 F.2d 653, 657 (10th Cir. 1987), *aff'g in part*, 598 F. Supp. 519 (D. Utah 1984).

²²⁰ Exemptions, *supra* note 209. The right to rescission is under Securities Act section 12(1), 15 U.S.C. § 77l(1).

²²¹ Securities Act of 1933, § 4(6), 15 U.S.C. § 77d(6) (1988); Rule 506, 17 C.F.R. § 230.506.

²²² Rules 502(b)(1) (information), 503 (notice of sales), 508 (devictions), 17 C.F.R. §§ 230.502(b)(1), .503, .508 (1989). The general antifraud provisions, of course, continue to apply.

²²³ Rule 502(c), 17 C.F.R. § 230.502(c) (1989).

²²⁴ Additional disincentives.

²²⁵ Rule 504, 17 C.F.R. § 230.504 (1989).

²²⁶ Rules 504(a)(2)(1) (dollar limitation), 502(b)(1) (omitting any information requirements for Rule 504 offerings), 508 (deviations), 17 C.F.R. §§ 230.504(a)(2)(1), .502(b)(1), .508 (1989).

²²⁷ Rule 504(b)(1), 17 C.F.R. § 230.504(b)(1) (1989).

²²⁸ Rule 503, 17 C.F.R. § 230.503 (1989) (requiring filing of 5 copies of Form D within 15 days of the first sale).

prevent inadvertent compliance by sellers who are not aware of the specific rules.²²⁹

3. *Summation: Exemptions Are Not Pragmatically Available*

Pragmatically, the various exemptions are useful only to a small portion of the sellers in the secondary market for condominium units. Numerous and complex requirements and prohibitions, particularly those preventing advertising, are unworkable in the real estate market. Moreover, the heavy burden of proof imposed on sellers makes assertion of an exemption uncertain and risky.

As a result, even the select few owners of individual condominium units that are cognizant and sophisticated regarding securities law will face the prospect of selling securities that are neither registered nor exempt. Added to this number is the far larger number of owners who have no knowledge of securities law and are unlikely to invest the sums needed to purchase expert legal, accounting, and other advice, and so do not even attempt to comply with the securities law. Together, these groups probably include the overwhelming preponderance of owners of condominium units.

D. *Consequences of Non-Compliance by a Condominium Unit Seller*

Noncompliance with the federal securities registration and disclosure requirements exposes a seller to both criminal and civil liability. The government may prosecute for any violation of the 1933 Act or the SEC's rules, including failure to register.²³⁰ One provision penalizes misstatements or omissions in connection with offers or sales (whether in a registration statement or any other context), imposing liability even when the defendant acted without scienter or intent to defraud.²³¹ Penalties can be as high as \$10,000 in fines, or five years in prison, or both, for willful violations.²³² The SEC also can seek to enjoin marketing efforts for unregistered offerings, through stop order proceedings.

²²⁹ An argument may be made that failure to file the report is excusable as an "insignificant deviation" under Rule 508, but is unlikely to succeed. The party seeking the exemption must prove a "good faith and reasonable attempt to comply with all . . . requirements of Rule 504.505, or .506." Rule 508(a)(3), 17 C.F.R. § 230.508(a)(3) (1989).

²³⁰ Securities Act of 1933, § 20(b), 15 U.S.C. § 77t(b) (1988).

²³¹ Securities Act of 1933, § 17(a)(2), 15 U.S.C. § 77q(a)(2) (1988).

²³² Securities Act of 1933, § 24. Criminal prosecutions are handled by the Attorney General rather than the SEC. Securities Act of 1933, § 20(b), 15 U.S.C. § 77t(b) (1988).

As a pragmatic matter, however, the likelihood of prosecution by the SEC is remote.²³³ The SEC has priorities, such as insider trading by market professionals and protecting the integrity of the national stock markets, which so vastly outweigh the significance of an isolated condominium unit sale that the agency would not expend its resources to be involved. Even if the SEC chose to emphasize condominium sales, it lacks the resources to police individual unit sales.

Far more realistic is the possibility of civil actions initiated by a purchaser of a condominium unit who subsequently becomes dissatisfied with it. The reason for dissatisfaction might be a false or misleading statement or omission made during the course of negotiations. (In the *Hocking* situation, for example, the plaintiff alleged certain misrepresentations.) Equally likely is that dissatisfaction arises from a decline in value due to external market forces, or merely from the purchaser's belated belief that the price paid was too high. Realistically, the buyer might be motivated to sue merely because market prices declined—a reason completely unrelated to any conduct or statement of the seller.²³⁴

The 1933 Act provides ample opportunity for civil litigation. Section 12²³⁵ imposes strict liability for offering or selling a security without complying with the requirements to register. No defenses are available; even a condominium unit owner who is able to prove complete honesty, good faith, and candor will be held civilly liable.²³⁶ Another subsection of section 12²³⁷ imposes liability for any misstatement or omission of material fact in any written or oral communication involved in the offer or sale of a security, whether or not a registration statement has been filed. A plaintiff is not required to prove intent to defraud, but a defendant is allowed a defense that "he did not know and, in the exercise of reasonable care could

²³³ One expert in condominium securities noted "a reluctance on the part of SEC staff to pursue regulation of resort housing securities," due to their many other more pressing responsibilities, and stated that the "Commission refuses to allow enforcement actions in these cases" Gunnar, *supra* note 1, at 39 n.45.

²³⁴ An article oriented to the mineral industry offered an example of an interest in an oil and gas venture that was sold in violation of § 12. If the hole subsequently turned out to be dry, the investor could sue and get his money back, regardless of the equities or contracts of the parties. Allott, *supra* note 7, 21-1, 21-23. An article oriented to equine syndicates raised the same point in connection with thoroughbred horse transactions that do not live up to expectations. Cooper, *supra* note 7, at 318 n.351.

²³⁵ Securities Act of 1933, § 12(1), 15 U.S.C. § 771(1) (1988).

²³⁶ See, e.g., Allott, *supra* note 7, at 21-24.

²³⁷ Securities Act of 1933, § 12(2), 15 U.S.C. § 771(2) (1988).

not have known" of the misstatement or omission.²³⁸ Notably, a plaintiff need not prove any causal connection between the violation and the plaintiff's harm.²³⁹

The remedy for violation of either part of section 12 is essentially rescission²⁴⁰ or, if the defendant no longer owns the security, damages. The statute of limitations is only one year.²⁴¹ In effect, the seller of a condominium unit who fails to register is saddled with the full economic risk of declines in market value for at least one year after the sale. The result can be disastrous.²⁴²

The 1933 Act's antifraud provision²⁴³ may also be available to private plaintiffs, allowing recovery for any false or misleading statement or omission by a condominium unit seller, even if merely negligent.²⁴⁴ Several federal circuits have held that this action is available to private plaintiffs,²⁴⁵ although others disagree,²⁴⁶ and the Supreme Court has not yet resolved the conflict.

²³⁸ The "reasonable care" standard of § 12(2) is similar to negligence but includes a duty to investigate. *See, e.g.,* Davis v. Avco Fin. Servs., Inc., 739 F.2d 1057, 1068 (6th Cir. 1984); Junker v. Croy, 650 F.2d 1349, 1361 (5th Cir. 1981); Sanders v. John Nuveen & Co., 619 F.2d 1222, 1228 (7th Cir. 1980), *cert. denied*, 450 U.S. 1005 (1981); Wigand v. Flo-Tek, Inc., 609 F.2d 1028, 1034 (2d Cir. 1979).

²³⁹ *See, e.g.,* Diskin v. Lomasney & Co., 452 F.2d 871, 876 (2d Cir. 1971); HAZEN, *supra* note 174, § 7.2 at 279.

²⁴⁰ The purchaser of a condominium that is ruled to be a security would be entitled to refund of the price paid, plus interest, less any income (presumably rent) received by the defendant during the period of his ownership, in exchange for a reconveyance of title.

²⁴¹ Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 111 S. Ct. 2773 (1991) (limitations period applicable to Rule 10b-5 actions is one year from date of discovery of the facts constituting the violation but not to exceed three years after such violation).

²⁴² As an example, when one condominium developer was compelled to offer rescission, 48 out of 152 purchasers cancelled their contracts and refunds of over \$200,000 were required. The developer, Hale Kaanapoli Hotel Development Co., was also required to halt marketing and file a registration statement. Rohan, *supra* note 1, at 7-8.

²⁴³ Securities Act of 1933, § 17(a), 15 U.S.C. § 77q(2) (1988).

²⁴⁴ Scienter is necessary under some subsections of § 17(a), but not subsection (3), due to differences in language. Aaron v. SEC, 446 U.S. 680, 697 (1980). Subsection (3) prohibits conduct that would operate as a fraud or deceit. *Id.*

²⁴⁵ *See, e.g.,* Kirshner v. United States, 603 F.2d 234, 241 (2d Cir. 1978), *cert. denied*, 442 U.S. 909, *cert. denied*, 444 U.S. 995 (1979); Daniel v. International Bhd. of Teamsters, 561 F.2d 1223, 1244-45 (7th Cir. 1977), *rev'd on other grounds*, 439 U.S. 551 (1979); Hanraty v. Ostertag, 470 F.2d 1096, 1098 (10th Cir. 1972); Simmons v. Wolfson, 428 F.2d 455, 456 (6th Cir. 1970), *cert. denied*, 400 U.S. 999 (1971).

The most commonly used liability provision, however, is Rule 10b-5²⁴⁷—the general antifraud rule that is based on the Securities and Exchange Act of 1934 (hereinafter 1934 Act) (unlike all of the provisions discussed above, which are in the 1933 Act). Both the government and private plaintiffs can bring actions for false or misleading statements in connection with the purchase or sale of a security. If a condominium unit is offered with a rental arrangement, forming an investment contract, the seller is subject to Rule 10b-5, probably even if the purchaser buys the condominium but not the rental services.²⁴⁸

Scienter is always a necessary element of the case.²⁴⁹ Causation of a loss is another necessary element, but is presumed if the plaintiff demonstrates nondisclosure of any material fact.²⁵⁰ Other principal attractions of Rule 10b-5, as compared to both the 1933 Act provisions and state law remedies, include wider choice of venue, nationwide service of process, and perceived sophistication of federal judges. Yet another advantage was a longer statute of limitations, but one court recently eliminated that advantage.²⁵¹ In the *Hocking* situation, one factor causing

²⁴⁶ See, e.g., *In re* Washington Pub. Power Supply Sys. Sec. Litig., 823 F.2d 1349, 1351 (9th Cir. 1987) (no implied private cause of action under section 17(a)); *Landry v. All Am. Assurance*, 688 F.2d 381, 391 (5th Cir. 1982); *Shull v. Dain, Kalman & Quail, Inc.* 561 F.2d 152, 159 (8th Cir. 1977), *cert. denied*, 434 U.S. 1086 (1978).

²⁴⁷ 17 C.F.R. § 240.106-5 (1988).

²⁴⁸ One possible defense would be the Supreme Court's decision that Rule 10b-5 is not available when the defendant offered a security but the plaintiff did not buy one. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1974); see also *Koppel v. Wien*, 575 F. Supp. 960, 971 (S.D.N.Y. 1983) (real estate joint venture participating interest was an investment contract but non-purchaser could not bring Rule 10b-5 action). A commentator has noted that apparently only one reported case has applied this rule when different elements were combined in an offer to constitute an investment contract but only one of those elements was actually purchased. *MacLaren*, *supra* note 115, at 217, 224-27, (citing *Jones v. International Investors Inc. East*, 429 F. Supp. 119, 124 (N.D. Ga. 1976) (offer of separate contracts to evaluate and to market an invention constituted an offer of an investment contract and was actionable under Rule 10b-5 even though plaintiff never signed the marketing contract, because the evaluation contract was nearly worthless without the additional services)).

²⁴⁹ *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976) (in private action for damages plaintiff must prove that defendant intended to deceive, manipulate or defraud).

²⁵⁰ *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 153, *reh'g denied*, 407 U.S. 916 (1972).

²⁵¹ Because a private cause of action under Rule 10b-5 was implied, rather than express in the Act or rules, no precise limitation period was established. Following the *Erie* doctrine, federal courts selected a period on the basis of state law in the jurisdiction in which the court was located, sometimes using state securities ("blue

the plaintiff to assert Rule 10b-5 was the possibility of bringing the action in federal district court in Arizona, where the plaintiff resided, rather than Hawaii, where the condominium was located. After establishing a federal claim, the plaintiff appended Hawaii state law causes of action.

In summation, classifying the resale of single condominium units as a securities transaction security exposes the seller to numerous securities law liabilities. For a period of one year after the sale, the buyer of a unit has a right to rescind whether or not fraud has occurred, and so the seller assumes the economic risk of the buyer becoming dissatisfied during that period. Moreover, in most jurisdictions, the seller will be liable for any misstatement or omission in the offer or sale, if the buyer can prove an intent to defraud.

E. Assessing the Consequences

If routine resales of condominium units are deemed to involve securities merely because the seller draws attention to rental services available from an unrelated third party, the consequences may be extensive and extremely negative to the condominium industry.

The relatively few unit owners who are sufficiently well informed to understand their obligations and risks under securities law will find compliance far too expensive to even consider. The only practical and prudent solution is to assiduously avoid discussion of rental arrangements in the marketing of the unit, but it is highly improbable that many unit owners would do so. The vast preponderance of unit owners will proceed in blissful ignorance of even the possibility of securities law applicability and will draw attention to every attractive feature of the property, including available rental arrangements, in accordance with conventional practices and the financial incentives of the situation.

Conventional practices, however, will inadvertently but consistently violate securities law, even if undertaken in complete good faith and

sky") laws, other times using the periods applicable to fraud or other causes of action. The results varied among jurisdictions but generally extended to several years after the sale, or discovery of the violation. *See HAZEN, supra* note 174 § 13.8. The Third Circuit in 1988 determined that the variation from one federal court to the next was inappropriate and that a limitation period should be based on federal rather than state law. The most comparable statute, the court ruled, was the 1933 Act, with its one-year period of limitation. If this analysis is adopted by other circuit courts, or by the Supreme Court, it could dramatically reduce the reach of Rule 10b-5, for owners of condominium units and all other potential defendants. At this point, however, the Third Circuit decision stands alone from the rest of the case law. The SEC has argued for a uniform 5-year period. Ruder, *supra* note 138, at 1167 (citing various amicus briefs).

subjective honesty. Unit owners, therefore, will be exposed to occasional litigation based on a completely unexpected theory. They will be subject to liability for securities fraud and, even more distressing, rescission on a strict liability basis merely for selling securities without registration or on an exemption.

Developers may also be affected. If prospective purchasers of units from developers become aware of the difficulties of resale, they may be dissuaded from buying or may demand compensatory price reductions. To counter this sales resistance and maintain demand, developers may need to provide resale services.

One indication of the seriousness ascribed to these potential repercussions was the reaction in Hawaii, a state with a large resort condominium industry.²⁵² Almost immediately after the first appellate decision in *Hocking* was published, resolutions were introduced in both houses of the Hawaii legislature urging both Congress and the SEC to exclude condominium resales from the securities laws. The resolutions stated that the "severe 'roadblock'" to condominium resales threatened by the *Hocking* decision was unnecessary and damaging to the industry.²⁵³

F. Brokers

The real estate brokerage industry has a critical stake in the issue of whether isolated resales of resort condominium units involve securities. If discussion of an RPA, available from an unrelated third party, converts a condominium unit into a security, then real estate agents are exposed to liabilities of a nature and extent that few of them currently understand.

²⁵² *Hawaii Real Estate Reacts to Hocking v. Dubois*, 7 CONDOMINIUM HOTEL REP. No. 3 at 2-3 (Peter M. Gunnar ed., Fall 1988). According to testimony in support of the resolution from Calvin Kimura, Executive Secretary of the Hawaii Real Estate Commission, Hawaii has more than 1,900 condominium projects, representing about 100,000 apartment units of which more than 21,000 are operated as hotel accommodations. *Id.*

²⁵³ *Id.* The representative of the real estate industry stated that "present laws governing the resale of condominium apartments, including those laws that regulate real estate brokers and salesmen, provide ample regulatory protection." An opposing view is held by Peter M. Gunnar, the editor of the Condominium Hotel Reporter and a lawyer with great depth of experience and expertise in condominium securities law, who had chaired an industry task force and was closely involved in the Dickey Report that led to Release 5347. Mr. Gunnar takes the position that adequacy of one state's regulations should not affect federal securities laws, and that the *Hocking* decision was merely an application of law that has been settled for fifteen years. *Id.*; *Ninth Circuit Affirms Offering of Rental Pool Creates Security*, 7 CONDOMINIUM HOTEL REP. No. 2, pp. 1-2 (Peter M. Gunnar ed., Summer 1988).

Real estate agents are faced with a few alternatives. The most prudent approach would be to steadfastly refuse to discuss an available RPA with prospective purchasers, at the risk of foregoing a sale. Another approach would be to register as a securities broker, and to comply with a host of complex and burdensome requirements. The most probable alternative—due either to inadvertence or to conscious cost-benefit analysis—is to proceed to handle condominium transactions in the traditional manner and hope for the best.

1. The "Silence Is Golden" Option

In theory, assiduous avoidance of information regarding rental is the best and safest course of action for real estate agents marketing condominiums. If real estate is offered without any reference that might be deemed an offer of managerial services, there is no danger that securities law will apply. Whether this method is likely to be followed in practice deserves some examination.

In some contexts, withholding information on rental possibilities is both practical and common. In the initial-offerings market, condominium developers striving to satisfy the standards in the Release go to substantial lengths to avoid any suggestion of "emphasis on economic benefits from the efforts of others" in their marketing. Developers instruct their sales staff not to discuss rental services unless a prospective purchaser specifically inquires,²⁵⁴ and not to discuss rental income at all.²⁵⁵ Sales

²⁵⁴ See, e.g., Condominium Associates, Inc., SEC No-Action Letter, 1987 WL 108269 (May 14, 1987) (investor would be informed of rental services from a property manager having a contractual relationship but no ownership by the developer, but only if the investor inquired); Choice Hotel Group, SEC No-Action Letter, *supra* note 135; Recreational Indus., SEC No-Action Letter, *supra* note 155 (investor who inquires will be given package of information on rental services); Rockresorts, SEC No-Action Letter, *supra* note 135 (investor would be informed of rental services from a company having a contract but no affiliation with the developer, plus two other unaffiliated rental agents, only if the investor inquired). This approach has been used for many years. See, e.g., North Shore Project, SEC No-Action Letter, 1972 WL 12276 (Feb. 12, 1973), summarized in BNA Sec. Reg. & L. Rep. No. 194 at C-2 (March 21, 1973), and cited in Rosenbaum, *supra* note 47, at 794 n.35 (1979).

²⁵⁵ One expert on securities aspects of condominiums asserts that any forecast of cash flow will violate the SEC's standards. Peter M. Gunnar, SEC No-Action Letter, *supra* note 135. The staff declined to either confirm or deny this statement of their position, however, on the grounds that it was presented in the abstract rather than in the context of specific facts and transactions. *Id.* Requests for no-action positions, however, routinely promise not to provide any projection of potential investment performance to prospective purchasers. See, e.g., Condominium Associates, SEC No-Action Letter, *supra* note 254; Rockresorts, SEC No-Action Letter, *supra* note 155

personnel are restricted to advising prospective purchasers that they may rent their unit if they choose to do so, and may use any agent that they choose.²⁵⁶ Sanctions against sales staff are specified in advance, in case of deviation from the restrictions.²⁵⁷

In the secondary market, similar policies are possible but not likely to be widely followed. The obvious first hurdle is that the preponderance of real estate agents are not attuned to or knowledgeable about securities law, and so will not even consider the issue. Those who are aware of the securities law pitfalls will then have to weigh the real but uncommon occurrence of securities liability against the immediate negative impact on marketing should the agent consciously omit to describe and promote an attractive feature of the property. Most agents probably will not forego the

(requested by Peter M. Gunnar, author of the 1987 letter, on behalf of a client); Rank Dev., Inc., SEC No-Action Letter, *supra* note 135. Projections that rental income will cover mortgage, maintenance and other carrying costs are specifically excluded. *See, e.g.*, Marco Polo Hotel, Inc., SEC No-Action Letter, *supra* note 135.

²⁵⁶ *See, e.g.*, Marco Polo, SEC No-Action Letter, *supra* note 135; Choice Hotel Group, SEC No-Action Letter, *supra* note 135; Rockresorts, SEC No-Action Letter, *supra* note 155. This approach has been used for many years. *See, e.g.*, Big Sky of Montana, Inc., SEC No-Action Letter, 1973 WL 9644 (March 14, 1973), summarized in BNA SEC. REG. & L. REP. No. 199 at C-1 (April 25, 1973), and cited in Rosenbaum, *supra* note 47, at 794 n.36.

²⁵⁷ To support their requests for no-action positions, developers routinely describe at considerable length the measures they will take in case any sales personnel violate the restrictions on marketing emphasis; dismissing the employee, denying the employee any commission income on a sale, and offering rescission to the purchaser are typical. *See, e.g.*, Marco Polo, SEC No-Action Letter, *supra* note 135; Condominium Associates, SEC No-Action Letter, *supra* note 254; Point East Associates, SEC No-Action Letter, *supra* note 135; Rockresorts, SEC No-Action Letter, *supra* note 135; Rank Dev., Inc., SEC No-Action Letter, *supra* note 135. Even after receiving those representations, however, standard practice of the SEC staff is to caution the developer that any oral representations that deviate from the developer's description of sales practices will invalidate the no-action position. *See, e.g.*, Choice Hotel Group, SEC No-Action Letter, *supra* note 135; Condominium Associates, SEC No-Action Letter, *supra* note 254; Recreational Indus., SEC No-Action Letter, *supra* note 135; Resort Holdings I, Ltd. and Resort Holdings II, Ltd., SEC No-Action Letter, *supra* note 135; Sunrise Terrace Trust, SEC No-Action Letter, *supra* note 135; Planners Dev. Corp., SEC No-Action Letter, *supra* note 135; Pacific Lighting Properties, SEC No-Action Letter, *supra* note 135; Investment Properties Int'l, Ltd., SEC No-Action Letter, 1351985 WL 55492 (June 10, 1985) (Westlaw, FSEC-NAL Database); Rank Dev., Inc., SEC No-Action Letter, *supra* note 135. The pattern has been followed since at least 1974. *Brannen, supra* note 58, at 762 (citing Virginia Beach Resort Conference Hotel, SEC No-Action Letter, 1984 WL 45576 (July 27, 1984)).

additional commission income that could result from normal unrestrained marketing.

Advising studied silence regarding rental services makes eminently good sense from a lawyer's perspective, but will be perceived by a real estate agent as comparable to advice not to mention the magnificent view, the proximity to the beach or shopping, or other features contributing to the attractiveness and marketability of the property. The advice runs counter to standard practice and economic incentives inherent in the industry and is unlikely to be widely followed.

2. *Registration as a Securities Broker*

If real estate agents effect transactions in property classified as "investment contracts," they may well be required to register as securities brokers or dealers. Registration entails filing an application²⁵⁸ and a statement of financial condition that includes extensive information and undertakings regarding facilities, capital, financing, and record keeping.²⁵⁹ Applicants must demonstrate competency and training in securities processes and regulations by passing an examination.²⁶⁰

The 1934 Act defines a securities "broker" as "any person engaged in the business of effecting transactions in securities for the account of others,"²⁶¹ and a "dealer" as "any person engaged in the business of buying or selling securities for his own account" as a part of a regular business.²⁶² (Because the same individuals typically perform both functions, the term "broker-dealer" is commonly used.) Real estate agents who advertise or sell condominium units with associated rental services on more than an isolated occasion are in serious jeopardy of inclusion within those definitions.²⁶³

²⁵⁸ Rule 15b1-1, 17 C.F.R. §240.15b1-1 (1987). The application, on Form B-D, requires basic business information and data on any previous securities law violations by the registrant or the registrant's associates.

²⁵⁹ Rule 15b1-2, 17 C.F.R. § 240.15b1-2 (1987).

²⁶⁰ Securities Exchange Act of 1934, § 15(b)(7), 15 U.S.C. § 78o (1988).

²⁶¹ Securities Exchange Act of 1934, § 3(4), 15 U.S.C. § 78c(4) (1988).

²⁶² Securities Exchange Act of 1934, § 3(5), 15 U.S.C. § 78c(5) (1988).

²⁶³ Advertising "on a single, isolated" transaction does not indicate that a person is "engaged in the business," but more frequent advertising, "holding oneself out as willing to engage in securities transactions" is sufficient, and earning a commission based on the volume of securities transactions is additional evidence. HAZEN, *supra* note 174, § 10.2.2 at 512. Real estate agents, of course, routinely advertise their services and their listings.

One significant exclusion is available to "associated persons of an issuer," under SEC staff interpretations and an SEC safe-harbor rule.²⁶⁴ The class of "associated person of an issuer" includes an issuer's partners, officers, director and, notably, employees. To qualify, a person cannot receive commissions based on sales or be associated with a broker-dealer, and must meet several other conditions.²⁶⁵ A condominium developer's sales staff could very well qualify as "associated persons" and, therefore, be deemed not to be securities "brokers,"²⁶⁶ but an independent real estate agent in the resale market would not qualify.²⁶⁷

In fact, no-action letters tend to classify persons who perform certain functions ordinarily performed by real estate agents, such as holding the earnest money, as securities brokers.²⁶⁸ Moreover, the rule is not even

²⁶⁴ Rule 3a4-1, 17 C.F.R. § 240.3a4-1 (1989) (adopted in 1985). Because the rules safe-harbor provisions of Rule 3a4-1 are not exclusive, the no-action letters that preceded it may still be useful in situations not specifically covered by the Rule. Both the Rule and the no-action letters are analyzed in Gregory S. Crespi, *The Reach of the Federal Registration Requirements for Broker-Dealers and Investment Advisors*, 17 SEC. REG. L.J. 339, 343-44 (1990).

²⁶⁵ Rule 3a4-1, 17 C.F.R. § 240.3a4-1 (1989). The additional conditions are stated in three alternatives, each one suited to a different type of business.

²⁶⁶ The developer who sells condominium units plus rental services would be the "issuer" of a security. By carefully structuring and supervising the sales staff, the developer could avoid using registered securities brokers. Among numerous requirements, the staff members must avoid solicitation, merely responding to inquiries of potential purchasers. Rule 3a4-1(4)(iii)(B), 17 C.F.R. § 240.3a4-1(4)(iii)(B) (1989).

²⁶⁷ An initial step is to identify the "issuer" in a secondary transaction. If the issuer is the original condominium developer, under the "once a security, always a security" rationale, then further inquiry is not necessary. If, however, the "issuer" of an investment contract is whichever party combines into a single offer a condominium unit and rental services (even if provided by a third party), the issuer of a condominium security would be the individual unit owner or the owner's real estate agent. An agent therefore conceivably could qualify as an "associated person of the issuer," but only in the implausible circumstance that the agent was not paid a commission. See Rule 3a4-1(a)(2), 17 C.F.R. § 240.3a4-1(a)(2) (1989).

²⁶⁸ Crespi, *supra* note 264, at 348 (stating that "[t]he SEC staff has consistently taken the position that registration is required for a person that takes custody of a client's funds or securities in connection with a transaction) (citing several no-action letters including one issued for The Stallion Fund, Inc., 1972 WL 7623 (Sept. 13, 1971) ("If a company . . . maintains custody or possession of client funds or securities at any stage of a securities transaction," it must register as a securities broker)).

available to a condominium developer's employees assisting in resales of the units originally sold by the developer.²⁶⁹

Once persons are properly classified as securities brokers or dealers (or their employers²⁷⁰), a requirement to register applies unless any one of three exceptions applies:

- (1) their business is entirely intrastate;
- (2) they deal only in securities that are exempt under the 1934 Act (whether or not exempt under the 1933 Act); or
- (3) a statutory or administrative rule applies exempting the brokers or dealers from registration.

The first exception, for exclusively intrastate business, is interpreted so stringently as to virtually eliminate its usefulness.²⁷¹ Even if an agent were to market only real estate located in her own state, dealing only with sellers and buyers resident in the same state, it is difficult to imagine a business so completely unconnected to the mail, telephone, banking system, and other instrumentalities of interstate commerce as to qualify as purely intrastate.²⁷²

²⁶⁹ See HAZEN, *supra* note 174, at 404 (stating that Rule 3a4-1 "does not extend safe harbor to an issuer's employees who assist buyers and sellers of the issuers securities with secondary market transactions.").

²⁷⁰ The registration requirement applies to any "person," a term defined to include companies, but not to persons who are associated with persons who are brokers or dealers. Securities Exchange Act § 15(a)(1). The effect is that registration is required of brokerage firms or individual brokers who are not associated with a brokerage firm. Lipton, *supra* note 143, at 905.

²⁷¹ As one commentator stated, "the administrative interpretations of this exemption have effectively eliminated the exemption in most instances." Haft, *supra* note 153, at 10-21; *accord*, Crespi, *supra* note 264, at 356 ("The 'exclusively intrastate' exemption has been very narrowly construed by the Commission and as a practical matter is generally unavailable to a broker or dealer"). A broker who relies on the purely intrastate nature of his or her business to avoid registration is choosing a highly hazardous course. See Lipton, *supra* note 143, at 943-47; Wertheimer & Mark, *supra* note 177.

²⁷² Use of instrumentalities of interstate commerce, such as telephones, can defeat the exemption. Securities Exchange Act § 3(a)(17); Securities Exchange Act Release No. 7105 (July 30, 1963); Hoare & Govett, Ltd., SEC No-Action Letter, 1973 WL 9080 (Sept. 28, 1973) ("use of the mails at any stage of a securities transaction" defeats the exemption), *cited in* Crespi, *supra* note 264, at 352 n.28. All aspects of the negotiation, agreement, and payment must occur within a single state. Peoples Sec. Co., 39 SEC 641, 653, *aff'd*, 289 F.2d 268 (5th Cir. 1961); Guon v. United States, 285 F.2d 140, 144 (8th Cir. 1960). A single interstate transaction can defeat the exemption for the broker permanently. EZRA WEISS, REGISTRATION AND REGULATION OF BROKERS AND DEALERS 15, (1965), *cited in* Wertheimer & Mark,

The second exception, for brokers dealing only in exempt securities is more realistic, but still of no avail to real estate agents in the secondary condominium market. Exemptions of securities for this purpose (under the 1934 Act) are entirely separate from a seller's exemptions of security transactions (under the 1933 Act). Thus, even if every condominium transaction the agent handles has an exemption (under the 1933 Act), the agent would still have to register.²⁷³

The SEC has statutory authority to classify certain interests as "exempted securities,"²⁷⁴ and has exercised that authority to exempt securities of cooperative apartment buildings.²⁷⁵ Recommendations to

supra note 177, at 1227 n.51; Securities Exchange Act Release No. 6859 (July 24, 1962). Interstate business affiliations might defeat the exemption even if a broker's activities are limited to a single state. In re Capital Funds, Inc., Exchange Act Release No. 7398 [1964-66 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶77,131 (Aug. 20, 1964), *aff'd sub nom.* Capital Funds, Inc. v. SEC, 348 F.2d 582 (8th Cir. 1965); Winchester Sec. Corp., SEC No-Action Letter, [1970-71 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,119 (April 1, 1971).

²⁷³ Wertheim, SEC No-Action Letter, [1972-73 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,286 (Dec. 7, 1972), *cited in* Wertheimer & Marks, *supra* note 177, at 1225 (describing a persistent but mistaken notion that brokers are exempt from registration under the 1934 Act if they sell only securities that are exempt from registration under the 1933 Act); Lipton, *supra* note 143, at 965. The 1934 Act defines certain interests, such as some government, bank trust fund, and insurance securities, as being "exempted securities," and authorizes the SEC to exempt others, Securities Exchange Act § 3(a)(12), but this category of "exempted securities" is not equivalent to the exempt securities or exempt securities transactions under sections 3 and 4 of the 1933 Act.

²⁷⁴ Securities Exchange Act of 1934, § 3(a)(12)(A)(v), 15 U.S.C. § 78c(a)(12)(A)(v) (1988) (SEC is authorized to promulgate rules consistent with the public interest and the protection of investors to exempt securities from the requirements of the Exchange Act). For example, one rule exempts an "investment contract security involving the direct ownership of specified residential real property," but only "with respect to any transaction by a broker or dealer who, directly or indirectly, arranges for the extension or maintenance of credit on the security. . . ." Rule 3a12-5. Because section 15(a) does not require the registration of broker-dealers who deal exclusively in exempted securities, classifying a security as exempt has the effect of exempting from registration the broker-dealers who handle transactions in them. Lipton, *supra* note 143, at 948.

²⁷⁵ Rule 15a-2, 17 C.F.R. § 240.15a-2 (1989). To be exempt, cooperative apartment shares must be sold by a real estate broker licensed not by the SEC but by the state or other local jurisdiction. Thus a real estate agent who arranges the sale of cooperative building stock which is a security under the standards of United Housing Found. v. Forman, 421 U.S. 837 (1975), would not have to register if the agent were properly licensed by the political subdivision where the building was located. Lipton, *supra* note 143, at 971 (citing New York State Urban Dev. Corp., SEC No-Action Letter, 1975 WL 11107 (Oct. 2, 1975)).

similarly exempt condominium securities,²⁷⁶ however, have not yielded any success.²⁷⁷

The only remaining possibility to relieve the burden on real estate agents is an exemption from broker-dealer registration. Once again, however, the SEC has chosen to ignore recommendations to exercise its power²⁷⁸ to exempt real estate agents selling condominium units from the broker-dealer registration requirement²⁷⁹ (which would have an effect very similar to exempting the securities²⁸⁰).

Moreover, the SEC staff has resisted a number of proposals to make compliance more feasible and has imposed restrictions or conditions which are impractical.²⁸¹ For example, a real estate agent is allowed to operate in conjunction with a registered securities broker, but only if the real estate agent never communicates to a potential investor without the supervision of the securities broker.²⁸² An alternate approach might be for a real estate agent to refer potential purchasers of a condominium unit to a registered securities broker, and then share in the commission, but the SEC prohibits that arrangement also.²⁸³

The result of this analysis is that none of the exceptions are likely to be helpful to real estate agents handling resales of individual condominium units. Though some agents in the initial-offerings market are relieved of

²⁷⁶ Rosenbaum, *supra* note 47, at 812-15 (recommending an alternative to the exemption proposed by the Dickey Committee).

²⁷⁷ *Id.* at 812.

²⁷⁸ Securities Exchange Act § 15(a)(2).

²⁷⁹ Rosenbaum, *supra* note 47, at 812-15. Rosenbaum's proposal would specifically exempt agents for individual owners of condominium units trying to resell them.

²⁸⁰ A broker who deals in exempted securities is exempt from broker-dealer registration, but only if the broker does not deal in any nonexempt securities. Securities Exchange Act § 15(a)(2). According to one analyst, "[t]he distinction between the two rulemaking activities is not necessarily significant." Lipton, *supra* note 143, at 970.

²⁸¹ One commentator described the situation as follows: "Despite the recommendation of the Dickey Committee and the arguments of industry representatives, the SEC has refused to follow the lead of more realistic state administrators and exempt licensed real estate sales personnel from broker/dealer qualification, bonding, reporting, net capital, and Securities Investor Protection Corporation (SIPC) requirements." Gunnar, *supra* note 1, at 46; *accord*, Rosenbaum, *supra* note 47, at 798-800.

²⁸² Rosenbaum, *supra* note 47, at 798 n.51 (citing The Woodmoor Corp., SEC No-Action Letter [1971-72 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,653 (Feb. 3, 1972)).

²⁸³ *Id.* at 798 n.52 (citing SEC No-Action Letter, Shareholders Recreation Programs, Inc., 1972 WL 11030 (June 7, 1972)).

the obligation to register as securities broker-dealers if they are "associated persons" of the developer, other real estate agents have no viable argument to escape the registration requirement, if what they sell is classified as a security. The SEC's policy requiring real estate agents who sell condominiums with rental pools to register as securities brokers has been in effect for at least fifteen years,²⁸⁴ and covers sales on behalf of developers and also resales by individual unit owners.²⁸⁵

3. *Continuing Regulatory Restrictions and Burdens*

Registration is just one aspect of a formidable set of requirements applicable to brokers trading in securities.²⁸⁶ Broker-dealers must file periodic reports on financial condition with the SEC, must limit their liabilities to a prescribed multiple of their assets,²⁸⁷ and must obtain insurance to protect customers against loss in the event of brokerage house failure.²⁸⁸ Several requirements apply directly to dealings with the investor, intended to prevent overreaching. Broker-dealers must evaluate each prospective investor's financial situation and expertise, offering only investments that are "suitable."²⁸⁹ They are responsible for providing prospective purchasers with copies of prospectuses in a timely manner,²⁹⁰ must disclose relationships with the issuer,²⁹¹ and must promptly transmit funds from sales to the sellers or others entitled to the money. Certain antifraud provisions apply specifically to brokers, in addition to the more general provisions.

Additional rules, many of which have no practical application to condominium resales, relate to excessive trading in discretionary

²⁸⁴ See, e.g., *The Woodmoor Corporation*, SEC No-Action Letter, [1971-72 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,653 (Feb. 3, 1972) (requiring registration of a real estate agent involved in the sale of a condominium with rental arrangement).

²⁸⁵ Rosenbaum, *supra* note 47, at 801 (citing Don Augustine & Peter M. Fass, *Broker-Dealer Licensing in the Field of Real Estate Syndication*, 29 BUS. LAW 369, 375 (1974)).

²⁸⁶ For a summary of the requirements see Wertheimer & Mark, *supra* note 177, at 1237-45.

²⁸⁷ Rule 10b-10a.

²⁸⁸ The Securities Investor Protection Act, 15 U.S.C. §§ 78aaa-78iii (1988).

²⁸⁹ The "know your customers" and "suitability" rules vary according to the self-regulatory organization governing a particular broker. See generally HAZEN, *supra* note 174, § 10.7; Janet E. Kerr, *Suitability Standards: A New Look of Economic Theory and Current SEC Disclosure Policy*, 16 PAC. L.J. 805 (1985).

²⁹⁰ Rule 15c2-8, 17 C.F.R. § 240.15c2-8 (1989).

²⁹¹ Rule 15c2-4, 17 C.F.R. § 240.15c2-4 (1989).

accounts,²⁹² providing confirmations of transactions,²⁹³ and extending credit to purchasers.²⁹⁴ Beyond the specific rules, the SEC generally subjects broker-dealers to standards of conduct substantially more exacting than those imposed by common law, approaching the status of fiduciaries for their clients.²⁹⁵

Perhaps most clearly illustrating the impracticality of complying with securities regulations are the restrictions on marketing techniques, derived from the 1933 Act and the rules promulgated under its authority. Because individual condominium unit resales will virtually never be registered under the 1933 Act (whether or not the broker is registered), an exemption will be necessary. Most exemptions preclude or severely restrict advertising or other solicitation, permitting the broker merely to accept orders from investors. Securities have long been marketed in that fashion, but to extend that approach to individual condominium units would be a major and unpleasant jolt to unit owners, real estate owners, and the entire resort condominium industry.

Even in the uncommon situation in which a broker or dealer in securities is exempt from registration, some of those restrictions and requirements continue to apply. Exempt brokers and dealers are subject, for example, to the net worth and capital requirements and the special antifraud rules.²⁹⁶ Also, the restrictions on advertising and solicitation, deriving from 1933 Act securities exemptions, apply whether or not the broker is properly registered under the 1934 Act.

²⁹² Rule 15c1-7, 17 C.F.R. § 240.15c1-7 (1989).

²⁹³ Rule 15c1-4, 17 C.F.R. § 240.15c1-7 (1989).

²⁹⁴ Rule 10b-16, 17 C.F.R. § 240.106-16 (1989); *see also* Mark Browning & William A. Jackson, *Brokers Beware! Private Cause of Action May Exist Under Margin Account Disclosure Rules*, 13 SEC. REG. L.J. 3 (1985).

²⁹⁵ Randall W. Quinn, *Deja Vu All Over Again: The SEC's Return to Agency Theory in Regulating Broker-Dealers*, 1990 COLUM. BUS. L. REV. 61, 80 (describing the "shingle" theory, "agency" theory, and other approaches used by the SEC in regulating broker-dealers); F. Harris Nichols, *The Broker's Duty to His Customers Under Evolving Federal Fiduciary and Suitability Standards*, 26 BUFFALO L. REV. 435, 455 (1977) ("Inexorably and perhaps to his own horror, the broker is being elevated to the status and, consequentially, the responsibility of a fiduciary."); HAZEN, *supra* note 174 § 10.6. (describing the "shingle" theory); *see also* United States v. Naftalin, 441 U.S. 768, 775 (1979) (securities brokers are highly regulated and held to high standards of business ethics).

²⁹⁶ Crespi, *supra* note 264, at 344 n.4.

4. *Practical Implications*

The extent and complexity of registering and operating as a securities broker-dealer make it doubtful that many real estate agents can or will comply.²⁹⁷ Relatively few agents, those who are heavily involved in sales of condominium units, perhaps in close affiliation with developers, may find the economic incentives sufficient to justify compliance. The far greater number, including virtually all agents in the secondary market, will be dissuaded. Finally, the typical local real estate agent who is presented only occasionally with the opportunity to market an individual condominium unit would not even seriously consider compliance.

As a result, the few brokers who do comply with the extensive panoply of securities regulations, and also with the applicable state and local real estate licensing requirements,²⁹⁸ will be the only ones legally permitted to market condominiums with rental services (if they are deemed "securities").²⁹⁹ The supply of such specialists is likely to be limited, and, accordingly, their fees are likely to be high.

As condominium unit purchasers come to realize that finding a broker to handle a resale is more difficult and expensive than in the past, they may hesitate to purchase units initially. Developers then may need to reassure potential purchasers by undertaking to either provide or arrange for resale services through a qualified securities broker-dealer.

That scenario, however, presumes that real estate agents will be aware of the applicability of securities law, and also that they will choose to either comply or abstain from a portion of their accustomed business. What is far more likely is that real estate agents will continue listing and showing condominium units, promoting all of their attractive features, including

²⁹⁷ Rosenbaum, *supra* note 47, at 798; *see also* Lipton *supra* note 143, at 984-85 (stating that "it is difficult not to be overwhelmed by the volume and complexity of questions that must be explored in order to determine when broker-dealer registration is necessary" and urging the SEC to make the process more comprehensible).

²⁹⁸ A commentator addressing primarily the initial-offerings market in 1974 noted that real estate brokers are loath to undertake compliance with securities regulations, and securities brokerage firms have hesitated to obtain real estate brokers licenses in each state where a condominium is marketed. As a result, he concluded, there are apparently only a few organizations in the country which are qualified under all applicable laws to sell major resort condominium projects. Rosenbaum, *supra* note 47, at 798.

²⁹⁹ An underlying premise is that the transactions will continue to be handled by real estate agents rather than securities broker-dealers. As one commentator has noted in relation to timeshare interests, potential buyers conceptualize the property as real estate, not securities, and would not go to a securities broker/dealer. Gunnar, *supra* note 1, at 48. The same point is even more plainly applicable to condominium units.

rental services, and earning commissions. Most will proceed in either ignorance or disbelief that the complex machinery of securities regulation could apply to them. Some of the most sophisticated may understand the legal risks of proceeding without registration as a securities broker-dealer, but calculate that the risks are worth taking in comparison to the heavy burdens of attempting to comply.

5. *The Occasional Calamity: Securities Law Liability for Real Estate Agents*

For most real estate agents, the first inkling that securities law might even apply to their marketing of condominium units will be when, in an occasional instance, they are sued. Their primary concern at that point will be the extent and standards of liability.

The primary danger is civil actions brought by disgruntled unit purchasers. One theory available to plaintiffs (illustrated by the *Hocking* case) is that the broker misstated or omitted material facts. That type of action, under Rule 10b-5, the antifraud provision, requires proof of scienter (intent to deceive or recklessness) and a completed purchase or sale. A broker might also be liable for aiding and abetting a Rule 10b-5 violation by the unit owner, if the broker knew of the primary violation and substantially assisted in achieving it.³⁰⁰ A real estate agent who markets a condominium security using false or misleading information, without adequately investigating its accuracy, and actively participates in negotiation, may perhaps be liable for rescission under section 12(2) of the 1933 Act.³⁰¹

³⁰⁰ *DCD Programs, Ltd. v. Leighton*, 833 F.2d 183, 188-89 (9th Cir. 1987); *Zoelsch v. Arthur Andersen & Co.*, 824 F.2d 27, 35-36 (D.C. Cir. 1987); *Moore v. Fenex, Inc.*, 809 F.2d 297, 304 (6th Cir.), *cert. denied*, 483 U.S. 1006 (1987); *Metge v. Baehler*, 762 F.2d 621, 625 (8th Cir. 1985), *cert. denied*, 474 U.S. 1057 (1986). Aiding and abetting liability, however, does not extend to 1933 Act violations. *See Hagert v. Glickman, Lurie, Eiger & Co.*, 520 F. Supp. 1028, 1034 (D. Minn. 1981) (referring to §§ 11 & 12(2) of the 1933 Act).

³⁰¹ 15 U.S.C. § 771(2) (1988). Liability would depend on classifying the agent as a "seller," a term that the Supreme Court recently limited to active, direct, and immediate participants in the sale. *Pinter v. Dahl*, 486 U.S. 622, *on remand*, 857 F.2d 262 (5th Cir. 1988). Earlier lower court decisions, of uncertain validity after the *Pinter* decision, held that a broker who actively touted a security were section 12 "sellers." *Hill York Corp. v. American Int'l Franchises*, 448 F.2d 680, 694 (5th Cir. 1971), *Quincy Co-operative Bank v. A.G. Edwards & Sons*, 655 F. Supp. 78, 83 (D. Mass. 1986). A further issue is whether § 12(2) applies to secondary transactions. A few courts have ruled that section 12 applies only to distributions and not to subsequent trading. *Ralph v. Prudential-Bache Sec.*, 692 F. Supp. 1322, 1325 (S.D. Fla. 1988); *SSH Co. v. Shearson Lehman Bros.*, 678 F. Supp. 1055, 1059 (S.D.N.Y.

Similar actions may also be available under the 1934 Act's section 15(c), an antifraud provision applicable specifically to broker-dealers,³⁰² though courts are divided on whether a private plaintiff has standing.³⁰³ A section 15(c) action probably also requires proof of scienter, but not necessarily completion of a purchase or sale.³⁰⁴

Moreover, a plaintiff may assert the "shingle theory," that a person undertakes heightened obligations of fairness and disclosure to customers merely by holding himself out as a securities broker-dealer.³⁰⁵ Though developed by the SEC in its administrative enforcement of standards in the industry, the theory has also been invoked by private litigants asserting a violation of antifraud provisions.³⁰⁶

Even more troubling, however, is the possibility of liability on theories that do not require proof of either scienter or causation of harm. Purchasers can obtain remedies merely because the security transaction was not registered or exempt under the 1933 Act³⁰⁷ or because the real estate agent was not registered or exempt under the broker-dealer provisions of the 1934 Act.³⁰⁸ Failure to send a proper prospectus or confirmation of

1987); *McCowan v. Dean Witter Reynolds*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,423 (S.D.N.Y. 1989) (unpublished case). The opposing view, that § 12 applies to all transactions seems more in accord with statutory language. *Scotch v. Moseley, Hallgarten, Estabrook & Weeden*, 709 F. Supp. 95, 98 (M.D. Pa. 1988); *HAZEN*, *supra* note 174, § 7.5 at 318.

³⁰² 15 U.S.C. § 78o (1988 Supp. 1989).

³⁰³ *See HAZEN*, *supra* note 174, § 10.14 at 587-88 (citing numerous decisions and commentators at each side of the dispute over whether private plaintiffs have standing to assert § 15(c)).

³⁰⁴ *Id.* at 457.

³⁰⁵ *See, e.g., United Sec. Corp.*, 15 S.E.C. 719, 727 (1944) (basic principle of shingle theory is that all customers, regardless of sophistication and knowledge, are protected by implied representation of fair treatment by securities broker-dealers); *see also Hanly v. SEC*, 415 F.2d 589, 596 (2d Cir. 1969). The shingle theory is described in *Quinn*, *supra* note 295, at 72-75. Though the author (an SEC staff attorney) notes that it has been criticized as excessively broad, and has not been cited specifically by the SEC in recent years, the shingle theory is justified and "maintains current vitality." *Id.* at 80.

³⁰⁶ *Quinn*, *supra* note 295, at 81 n.126 (citing *Ettinger v. Merrill Lynch Pierce Fenner & Smith*, 835 F.2d 1031, 1033 (3d Cir. 1987)); *University Hill Found. v. Goldman, Sachs & Co.*, 422 F. Supp. 879, 898 (S.D.N.Y. 1976)).

³⁰⁷ Securities Act of 1933, § 12(1), 15 U.S.C. § 771(1) (1988). Liability depends on whether a broker is a "seller" and whether § 12 applies to the secondary market, issues discussed *supra* note 290.

³⁰⁸ Securities Exchange Act of 1934, § 29, 15 U.S.C. § 78cc (1988); *Eastside Church of Christ v. National Plan, Inc.* 391 F.2d 357, 362 (5th Cir. 1968), *cert. denied*, 393 U.S. 913 (1968)(customer may void transaction with unregistered broker-dealer without proof that failure to register caused harm to customer, and without

transaction is also actionable.³⁰⁹ Thus, a condominium purchaser might bring an action against a real estate agent motivated solely by a downturn in the value of the condominium purchased, relying entirely on one of these technical violations, without the need to allege any misstatement or other morally culpable conduct by the broker.³¹⁰

Sanctions from the SEC are also possible, but unlikely. Failure to register as a securities broker is a violation even though committed without scienter.³¹¹ The SEC has authority to seek criminal penalties³¹² and injunctions,³¹³ and can deny registration if it is subsequently sought.³¹⁴ As noted elsewhere in this Article, however, the SEC is not likely to pursue such remedies against real estate agents in the secondary market. The SEC considers agents selling condominiums with rental arrangements to be engaged in securities transactions only if the agent is affiliated with the rental manager, and generally has not taken an active stance on regulation in this area in recent years.

6. *Assessing the Ramifications*

As the analysis above demonstrates, extension of securities law to condominium resales, through a misguided interpretation of the term "investment contract," will have undesirable, unwarranted, and probably unintended ramifications on the real estate brokerage and condominium industries. Theoretically and legally, an extensive array of highly complex securities law requirements will be imposed on real estate agents, even though largely irrelevant to their functions.

Adherence to the law would require changes that are not pragmatically likely. Real estate agents handling an individual condominium unit resale could assiduously avoid drawing attention to rental services available from

proof of scienter); *SEC v. National Executive Planners*, 503 F. Supp. 1066, 1973 (M.D.N.C. 1980) (scienter not required in action for failure to register as broker-dealer).

³⁰⁹ HAZEN, *supra* note 174, at 591. The confirmation requirement is in Rule 10b-10. 17 C.F.R. § 240.10b-10 (1989).

³¹⁰ Securities Act of 1933, § 12(1), 15 U.S.C. § 771(1) (1988); *Diskin v. Lomasney & Co.*, 452 F.2d 871, 876 (2d Cir. 1961) (rescission available to purchaser who did not receive timely prospectus even though prospectus was received prior to completion of the transaction); HAZEN, *supra* note 174, § 7.2 at 279 (referring to section 12(1) liability).

³¹¹ *SEC v. National Executive Planners*, 503 F. Supp. 1066, 1073 (M.D.N.C. 1980).

³¹² 15 U.S.C. § 78ff (1988); *see also* *Guon v. United States*, 285 F.2d 140 (8th Cir. 1960).

³¹³ 15 U.S.C. § 78v (1988).

³¹⁴ 15 U.S.C. § 78o (5)(b) (1988).

a third party, but are unlikely to do so. Alternatively, they could decline the business, referring it instead to a small elite of specialists licensed in both the securities and the real estate fields, but that course is also improbable.

The most likely development is that real estate agents will continue to operate as they have in the past, but will occasionally be "blind-sided" by a securities law action, even though the agents never had an inkling that their transactions implicated securities law. Liability may ensue despite their complete lack of scienter, dishonesty, or other culpable motivation. This exposure to liability will likely be perceived as arbitrary, unpredictable, surprising, and unjustified.

VII. CONCLUSION AND RECOMMENDATIONS FOR REFORM

The position that condominium units marketed with rental services are a security even when the services are provided by an unaffiliated third party is unwarranted and unreasonable, but nevertheless a real threat to the condominium industry, unit sellers, and real estate brokers. The problem was created by courts and can best be solved by courts, or by Congress. At a minimum, however, rule-making by the Securities and Exchange Commission would substantially alleviate the problems, though it does not offer a fully satisfactory alternative.

The best, most complete, and most effective solution would be amendment of the securities acts to clarify that the terms "investment contract" and "security" do not include condominium units marketed individually in the secondary market by a person who is not an "underwriter" (in the well-established technical meaning of that term). Such a provision would obviate any danger of securities law actions by either the SEC or private plaintiffs and would extend to actions based on registration of securities transactions, registration of broker-dealers, and securities fraud.

Judicial solutions are also possible, though not as effective. The position of the Ninth Circuit majority in *Hocking* has fortunately not been followed by other circuits, and has been received skeptically by one.³¹⁵

³¹⁵ *Allison v. Ticor Title Ins.*, 907 F.2d 645 (7th Cir. 1990) (expressing "grave doubts about the correctness of *Hocking*" but resolving the issue before the court on other grounds). The *Hocking* decision has been cited in three other decisions, but only for fairly noncontroversial positions. *Long v. Schultz Cattle*, 896 F.2d 85 (5th Cir. 1990), cited *Hocking* for the position that vertical commonality is sufficient. *Koch v. Hawkins*, 928 F.2d 1471 (9th Cir. 1991), used *Hocking* to support the position that, in evaluating general partnerships as securities, investor expectations and circumstances should be considered, in addition to the formal rights accorded to general partners. *SEC v. Thomas D. Kienlen Corp.*, 755 F. Supp. 936 (D. Or. 1991) cited *Hocking* for

The *Hocking* holding should be decisively rejected. Courts should explicitly disavow the attractive but specious “once a security, always a security” approach that initially misled the three-judge panel of the Ninth Circuit. More basically, the need for a nexus between the offeror and any third party whose activities are sought to be attributed to the offeror should be expressly established. The nexus requirement is implicit in virtually all the precedent defining an investment contract and is amply supported by logical and pragmatic considerations, but has yet to be rigorously analyzed and explained in case law. The very few cases to even mention the issue have been inadequately reasoned and unpersuasive.

The prospects for early judicial resolution of these issues, however, are not encouraging. The Supreme Court denied certiorari in *Hocking* and the issue may not reach the Supreme Court in the foreseeable future. The best result likely to occur is a split of authority among the circuits. The resulting uncertainty and uneven application of the law would not solve the problem facing unit sellers, real estate agents, and the condominium industry.

Rulemaking by the Securities and Exchange Commission offers the most realistic and effective solution. The position that the SEC presently takes in litigation is correct and logically based, but not sufficient to correct the problem until formalized into rules of general application. Because the primary threat is from private plaintiffs rather than administrative enforcement, the rules should be modified in such a manner as to preclude civil actions.

The necessary authority is already provided in section 3(b) of the 1933 Act. The SEC is empowered to create exemptions for classes of securities, prescribing the terms and conditions, when application of the Act “is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering.” The limitation to issues of \$5,000,000 or less is sufficient to cover virtually any resale of a single condominium unit by an owner who is not a developer or a rental services manager and not an “underwriter” (under existing standards for usage of that term).

To address the problems of real estate agents, a companion exemption under the 1934 Act should be promulgated, again under existing authority. The exemption could cover the securities or could cover the brokers dealing in that type of security, producing virtually the same result.

The effect of such exemptions would be substantial, though not as complete as a legislative amendment. Individual units could be offered and sold without registration, without meeting the rigorous and burdensome requirements of existing exemptions, and without triggering the automatic

the principle that the term “offer” is used in a more encompassing sense in securities law than in the common law of contracts.

option of purchasers to rescind within one year whenever a nonexempt unregistered security is sold. Real estate brokers would be protected against liability for selling securities without registration as broker-dealers and without compliance with the myriad and complex requirements imposed on the securities industry.

The inherent limitation of any exemption, of course, is that it concedes that the underlying transaction involves a security. Hence, civil actions against unit sellers and real estate agents asserting securities fraud would still be possible.³¹⁶ Despite this limitation, SEC action is desirable. It would solve a large portion of the problem, limit liability to cases involving scienter, and be uniformly applied nationwide.

Until one of the recommended solutions is adopted the resort condominium industry will remain exposed to unwarranted and unreasonable liabilities. Individual unit owners and their real estate brokers risk occasional civil lawsuits for rescission or damages, with or without allegation of culpable mental state, if they draw attention to service's available from unaffiliated third parties.

³¹⁶ *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 692 (1985) (exemptions from registration do not include exemptions from antifraud provisions).