REAL ESTATE TRANSACTIONS: THE EXISTENCE OF A FEDERAL SECURITY

ROBERT F. VARGO*

INTRODUCTION

The securities and real estate industries are becoming more closely related than ever before. Whenever a real estate promoter sells an interest in a real estate development or raises equity capital, the promoter should analyze closely both federal and state securities laws, in order to determine whether some government agency will consider the proposed activity to be an offer and/or sale of a security, and as such within the sphere of governmental regulations. If the activity is subject to government regulation, registration with federal or state authorities may be required. Such registration can be costly, time consuming, and sometimes impractical.

The promoter, syndicator, or general partner must initially determine whether the offer and/or sale of a real estate interest involves a "security" that will fall within the purview of the securities laws. The basic definition of a "security" is so comprehensive that it can include any kind of investment interest whether or not it is represented by a formal document. For instance, limited partnership interests are classic examples of investment contracts that are usually securities within the meaning of federal securities laws. It is also possible that certain joint venture and general partnership interests may, under certain circumstances, be considered securities. Certain collateral arrangements may also transform the purchase of a real estate interest in a unit development into a security transaction.

This Article analyzes in detail the elements necessary to bring the offer and/or sale of an interest in a real estate transaction within the perimeters of the federal securities laws.

I. DEFINITIONAL LANGUAGE

In determining whether a particular real estate transaction

* B.A., University of South Flordia; J.D., St. Mary's University of San Antonio. Mr. Vargo is associated with the San Antonio, Texas law firm of Holbrook, Kaufman & Becker.

The author gratefully acknowledges the assistance of Stephen E. Leidheiser and Donald Alan Thomas in preparing this article for publication.

involves the sale of a "security" under federal securities laws and therefore subject to the filing requirements of section 5, Securties Act of 1933, and the anti-fraud provisions of section 10 and rule 10b-5 of the Securities Exchange Act of 1934, resort must first be made to the specific statutes involved. Under the Securities Act of 1933, a "security" is defined as:

> [A]ny note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation of 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.[1]

Section 3(a)(10) of the Securities Exchange Act of 1934 defines a "security" similarly.[2] In fact, both definitions are viewed as being "essentially the same."[3] Because real estate activities generally do not involve conventional securities, a "security" in real estate transactions is not easily recognized.[4] Moreover, since real estate interests are not explicitly included in the definitions of a "security", an analysis of the specific transaction is necessary to determine if an investment contract exists.[5]

The term "investment contract" is not defined by either the federal securities statutes or the applicable legislative reports.[6] Nevertheless, courts, guided by the basic principle that form

---

[1] 15 U.S.C. § 77b*(1)* (1976).

[2] 15 U.S.C. § 78c(a)(10) (1976).

[3] Marine Bank v. Weaver, 455 U.S. 551 (1982); Tcherepnin v. Knight, 389 U.S. 332, 335-36 (1967). The Senate Report on the Securities Exchange Act indicates that the definition of a "security" under the 1934 Act was intended to be "substantially the same as [contained] in the Securities Act of 1933." S. REP. No. 792, 73d Cong., 2d Sess. 14 (1934).

[4] *See, e.g.*, SEC v. W. J. Howey Co., 328 U.S. 293 (1946).

[5] *See, e.g.*, Westchester Corp. v. Peat, Marwick, Mitchell & Co., 626 F.2d 1212 (5th Cir. 1980). That certain real estate interests are now covered by the Interstate Land Sales Full Disclosure Act (ILSFDA), §§ 1402-1422, 15 U.S.C. §§ 1701-1720 (1976), does not automatically exclude them from the purview of the securities laws. Aldrich v. McCulloch Properties, Inc., 627 F.2d 1036 (10th Cir. 1980); "In enacting the ILSFDA, Congress acknowledged that there is a point at which the sale of unimproved, subdivided land becomes a securities transaction." *Id.* at 1039 n.2.

[6] *Howey*, 328 U.S. at 298.

should be disregarded for substance, have developed well established definitional standards. These standards emphasize the "economic realities" of the transaction, requiring consideration of the motivation of the purchaser as well as the promotional emphasis of the developer.[7]

II. THE "ECONOMIC REALITY" ANALYSIS: THE *HOWEY* TEST

In determining whether a particular real estate transaction is an "investment contract" and, therefore, within the "securities" definitions of the 1933 and 1934 Acts, most courts have employed the "economic realities" approach, measuring the transaction against the requirements set forth by the Supreme Court in *SEC v. W.J. Howey Co.*[8] In *Howey*, a company sold small tracts of land in a citrus grove development to individual investors, coupled with a contract for cultivating and marketing the trees and remitting the net proceeds to the investor. The company explained to the investors that it was uneconomical to purchase the land without the service contract. The service contract was for a ten year period and did not contain an option to cancel. The investors possessed right of entry, and most investors were nonresidents and lacked the necessary knowledge, skill, and equipment to care for the trees. In holding that the offering was an "investment contract," the Supreme Court recognized that something more than simply a fee interest in land coupled with management services was needed to convert these sales of land into investment contracts. That "something more" was the company's plan to gather the individual plots and manage them as one. The investors realized that they were part of a larger scheme, the success of which depended on the company's ability to manage a large grove. The plan ran "through the whole transaction as the thread on which everybody's beads were strung."[9] The only way the investors could hope for a return of their investment was by reliance on the effort and abilities of the company.

In deciding *Howey*, the Supreme Court set out its definition

[7] *See* United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 848, 852-54, 856 (1975); SEC v. W. J. Howey Co., 328 U.S. at 293, 298-300 (1946); Aldrich v. McCulloch Properties, Inc., 627 F.2d 1039 (10th Cir. 1980); Woodward v. Terracor, 574 F.2d 1023, 1024-25 (10th Cir. 1978); McCown v. Heidler, 527 F.2d 204, 209-10 (10th Cir. 1975); Fogel v. Sellamerica, Ltd., 445 F. Supp. 1269, 1277-78 (S.D.N.Y. 1973).

[8] *See, e.g.*, SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

[9] *Id. See also* SEC v. C. M. Joiner Leasing Corp., 320 U.S. 344, 348 (1943).

of an investment contract. The Court stated that "[t]he test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others."[10] The test was reaffirmed by the Court in *United Housing Foundation, Inc. v. Forman*,[11] which involved the stock of a corporation owning and operating a housing cooperative. In holding that the transaction did not involve securities, the Supreme Court quoted the *Howey* test, but then went on to state:

> This test, in shorthand form embodies the essential attributes that run through all the Court's decisions defining a security. The touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profit to be derived from the entrepreneurial or managerial efforts of others.[12]

Although the *Howey* test has been generally unaltered since 1946, the meaning and applicability of the test has been extensively litigated. There is considerable case law, however, devoted to analyzing the character of the relationship between the investor and the promoter and examining the extent of investor participation that will prevent an investment contract from qualifying as a security.[13]

The *Howey* test is generally comprised of three distinct elements: (1) There is an investment of money; (2) The investment is made in a common enterprise; and (3) The investor is led to expect profits solely from the efforts of the promoter or a third party.[14] All three *Howey* elements must be present for a

---

[10] *Howey*, 328 U.S. at 300.

[11] *Forman*, 421 U.S. 837 (1975).

[12] *Id.* at 852. This statement by the Supreme Court has led some courts to assume that the *Howey* test defines not only investment contracts but the entire universe of securities. The returns on debt instruments are fixed and independent of the profits from the enterprise, thus causing debt instruments of all kinds to be excluded from the coverage of the securities laws. This result had led some courts to limit the *Howey* test to equity instruments, and to apply a "risk capital" or "commercial-investment" test to debt instruments. *See* Meason v. Bank of Miami, 652 F.2d 542 (5th Cir. 1981), *cert. denied*, 455 U.S. 939 (1982); Wolf v. Banco Nacional De Mexico, 549 F. Supp. 841 (N.D. Cal. 1982).

[13] *See, e.g.*, Villeneuve v. Advanced Business Concepts Corp., 698 F.2d 1121, *reh'g en banc granted*, 698 F.2d 1127 (11th Cir. 1983); Williamson v. Tucker, 645 F.2d 404 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981); SEC v. Koscot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974); SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973); Slevin v. Pedersen Assocs., Inc., 540 F. Supp. 437 (S.D.N.Y. 1982).

[14] *See, e.g.*, Gordon v. Terry, 684 F.2d 736, 740 (11th Cir. 1982); Williamson v. Tucker, 645 F.2d 404, 417 (5th Cir. 1981); Slevin v. Pedersen Assocs., 540 F. Supp. 437,

real estate contract to constitute a security.[15] Each of these elements will now be examined in detail.

A. Investment of Money

The first requirement of the *Howey* test is that there is an "investment of money." In order to satisfy this requirement, the purchaser must be giving up some specific, tangible, and definable consideration in return for a financial interest that has substantially the characteristics of a security.[16] The investment need not take the form of cash, but may be goods and services, so long as the "exchange" of consideration is for an interest with the characteristics of a security.[17] For example, in *Howey* the purchasers paid money for interests in a citrus grove coupled with a management service contract whereby the promoters retained full possession of the property, cultivated and marketed the crops, and allocated net profits to the purchasers.[18] In *International Brotherhood of Teamsters v. Daniel*,[19] the purchasers gave up tangible and definable consideration and received in return a compensation package that was substantially devoid of the aspects of a security.[20] In looking at the economic realities of an "exchange," the Court in *Daniel* found that the employee was "selling his labor primarily to obtain livelihood, not in making an investment."[21]

Some courts have stated that the *Howey* "investment of money" requirement means that the investor must commit his assets to an enterprise or venture in such a manner as to subject himself to financial loss.[22] This definitional language, however, requires an examination of the nature and degree of risk accompanying the transaction for the party providing the funds. This "risk capital" test appears to be at odds with and to depart from the *Howey* test, which focuses prospectively on what the investor stands to gain and the requirement of a "fi-

---

440 (S.D.N.Y. 1982); Stowell v. Ted S. Finkel Inv. Serv., 489 F. Supp. 1209, 1218-19 (S.D. Fla. 1980).

[15] *See, e.g., Westchester Corp.*, 626 F.2d at 1215.

[16] International Bhd. of Teamsters v. Daniel, 439 U.S. 551 (1979).

[17] *Id. Forman*, 421 U.S. at 852 n.16.

[18] *Howey*, 328 U.S. 283 (1946).

[19] 439 U.S. 551 (1979).

[20] *Id.* at 560.

[21] *Id.*

[22] El Khadem v. Equity Sec. Corp., 494 F.2d 1224 (9th Cir.), *cert. denied*, 419 U.S. 900 (1974); SEC v. Intern Mining Exch., Inc., 515 F. Supp. 1062, 1067 (D. Col. 1981); Stowell v. Ted S. Finkel Inv. Serv., 489 F. Supp. 1209, 1220 (S.D. Fla. 1980).

nancial return."[23]

B. Common Enterprise

The second requirement of the *Howey* test is that the parties be engaged in a "common enterprise," focusing on the transactional relationship between the investor and the promoter. The precise meaning of this requirement is, however, far from clear. There is considerable debate on whether a horizontal or vertical relationship between the investor and the promoter satisfies the "common enterprise" language of *Howey*.[24] Some courts have adopted the horizontal approach,[25] while others have opted for the more liberal vertical approach.[26] Still others have not adopted either approach and instead apply both to analyze the particular transactions.[27]

1. Horizontal Commonality Approach

A horizontal relationship occurs between an individual investor and the pool of other investors.[28] This horizontal approach to interpreting "common enterprise" ties the fortunes of each investor in a pool of investors to the success of the overall enterprise.[29] It requires both multiple investors and a pooling or sharing of their funds.[30] The investors are participants in a joint common enterprise, with each investor expecting to ob-

---

[23] Wolf v. Banco Nacional De Mexico, 549 F. Supp. 841 (N.D. Cal. 1982). The "risk capital" analysis is frequently used in the context of debt instruments such as promissory notes and commercial loan participations to distinguish between investment and commercial transactions. *See, e.g.*, Union Planters Nat'l Bank v. Commercial Credit, 651 F.2d 1176 (6th Cir. 1981); Great Western Bank & Trust v. Kotz, 532 F.2d 1252 (9th Cir. 1976); Elson v. Geiger, 506 F. Supp. 238 (E.D. Mich. 1980). The Supreme Court in *Forman* reserved judgment on the appropriateness of this approach, finding it unnecessary to engage in "risk capital" analysis to dispose of the particular case before it because governmental regulations made the subject transaction virtually risk-free to the investor. 421 U.S. at 857 n.24.

[24] State v. Crofters, 525 F. Supp. 1133, 1138 (S.D. Ohio 1981).

[25] *See, e.g.*, Curran v. Merrill Lynch, Pierce, Fenner & Smith, 672 F.2d 216 (6th Cir. 1980); Hirk v. Agri-Research Council, Inc., 561 F.2d 96 (7th Cir. 1977); Milnarik v. M-S Commodities, Inc., 457 F.2d 274 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972); Wasnowic v. Chicago Bd. of Trade, 352 F. Supp. 1066 (M.D. Pa.), *aff'd mem.*, 491 F.2d 752 (3d Cir. 1$, 416 U.S. 994 (1974).

[26] *See, e.g.*, SEC v. Koscot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974); Miller v. Central Chinchilla Group, Inc., 494 F.2d 414 (8th Cir. 1974); SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 473 (5th Cir. 1974); Stowell v. Ted S. Finkel Inv. Serv. Inc., 489 F. Supp. 1208 (S.D. Fla. 1980).

[27] *See, e.g.*, SEC v. Iupp. 1062 (D. Col. 1981).

[28] *Curran*, 672 F.2d at 221.

[29] Hirk v. Agri-Research Council, Inc., 561 F.2d 96 (7th Cir. 1977).

[30] *Id.*

tain profits from the entire enterprise and not from a particular individual investment.[31] This approach was initially adopted in *Milnarik v. M-S Commodities, Inc.*, in which the court's interpretation of *Howey* required the pooling of funds and the pro-rata distribution of profits as investor remuneration.[32] In *Milnarik*, Judge Stevens noted that the Supreme Court had found that the individual investor had no right to specific fruit and that "[t]he Company is accountable only for an allocation of the net profits based upon a check made at the time of picking. All the produce is pooled by the responding companies that do business under their own names."[33] In another passage indicative of the *Howey* Court's estimation of the relative importance of separate as opposed to common elements of the enterprise, the court stated that "the investors provide the capital and share in the earnings and profits; the promoters manage, control and operate the enterprise."[34]

2. Vertical Commonality Approach

Some jurisdictions, however, interpret that the emphasis on "pooling" of funds under the *Milnarik*-horizontal approach as being a strict construction of the definition of an "investment contract" and, therefore, have adopted the vertical approach to interpreting "common enterprise."[35] A vertical relationship is essentially a one-to-one agreement between the investor and the promoter.[36] The vertical commonality approach requires that the investor and the promoter be involved in some common venture without mandating that other investors also be involved in that venture.[37] This approach was championed by the Fifth Circuit's decision in *SEC v. Continental Commodities Corp.*[38] In *Continental Commodities*, the Fifth Circuit refused to adopt the *Milnarik*-horizontal approach and emphasized its view that pooling of investors' funds and a pro-rata sharing of profits is not critical to a finding of commonality.[39] Applying a test formulated by the Ninth Circuit to deal with the various

---

31 *Milnarik*, 457 F.2d at 277.

32 *Id.*

33 *Id.* at 279 n.7 (quoting *Howey*, 328 U.S. at 296).

34 *Id.* (quoting *Howey*, 328 U.S. at 300).

35 *See*, 7 F.2d at 473, 479 n.8 (5th Cir. 1974).

36 *See supra* note 26. *See also* Union Planter's Nat'l Bank v. Commercial Credit, 651 F.2d 1174 (6th Cir. 1981).

37 *See supra* note 26. *See also* Brodt v. Bache & Co., Inc., 595 F.2d 459 (9th Cir. 1978).

38 497 F.2d 516 (5th Cir. 1978).

39 *Id.* at 522.

pyramid-type investment schemes challenged as securities, the court held that a common enterprise is "one in which the fortunes of the investor are interwoven with and dependent upon the effort and success of those seeking the investment or of third parties."[40] Thus, whether an investment flourishes or perishes is related directly to either the general financial health of the promoter or the ability of the promoter to perform his duty.[41] In criticizing the "pooling" ingredient of the vertical commonality approach, the Fifth Circuit in *Continental Commodities* held that "the critical factor is not the similitude or coincidence of investor input, but rather the uniformity of impact of the promoter's efforts."[42] Under this approach, an investor's return can be independent of that of the other investors in the scheme.[43]

As was the case with the horizontal commonality approach, it can be argued that the vertical approach finds support in *Howey*.[44] The Supreme Court in *Howey* did not emphasize whether profits were pooled. Instead the Court stressed that the feasiblity and success of the enterprise not only in attracting individuals to invest, but also in the cultivating, harvesting, and marketing the citrus products, rested on the availability of the Howey Company's management. In particular, the Court stated:

> Such persons (investors) have no desire to occupy the land or to develop it themselves; they are attracted solely by the prospect of a return on their investment. Indeed, individual 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. A common enterprise managed by respondents or third parties with adequate personnel and equipment is therefore essential if the investors are to achieve their paramount aim of a return on their investment.[45]

This vertical commonality approach finds support not only

---

[40] *Id.*, (quoting SEC v. Glenn W. Turner Enters., 474 F.2d 476, 482 n.7 (9th Cir. 1973)).

[41] *See, e.g.*, Brodt v. Bache & Co., 595 F.2d 459 (9th Cir. 1978).

[42] SEC v. Continental Commodities Corp., 497 F.2d 516, 522 (5th Cir. 1978) (quoting SEC v. Koscot Interplanetary, Inc. 497 F.2d 473, 478 (5th Cir. 1973)).

[43] SEC v. Koscot Interplanetary, Inc., 497 F.2s of America, Inc., 608 F.2d 187 (5th Cir. 1979), *modified on reh'g on other grounds*, 611 F.2d 105 (1980).

[44] *Howey*, 328 U.S. 283 (1946). *See Koscot Interplanetary*, 497 F.2d at 478).

[45] *Howey*, 328 U.S. at 300 (citing Koscot Interplanetary, 497 F.2d at 478).

in the cases, but also in the position taken by one of the leading authorities in the field of securities regulation, Professor Louis Loss. In discussing what he terms "investment contracts and the other catchall varieties" of securities, Professor Loss makes the following observation: "In all these cases proof of some sort of pooling arrangement among investors . . . helps, but it is not essential."[46] In addition, the Securities and Exchange Commission has ruled that various arrangements with no pooling features constitute investment contracts.[47] Such administrative interpretations by the SEC have been given considerable weight by the courts in attempting to resolve this horizontal-vertical commonality debate.[48]

3. The Horizontal-Vertical Commonality Debate as Applied to Offers and Sales of Condominiums or Other Units in a Real Estate Development

The horizontal-vertical commonality debate is more acute when analyzing transactions involving the sale of condominium units or other units in a real estate development for the existence of securities. This is especially true in light of certain SEC interpretations of *Howey*.

In 1973, the Securities and Exchange Commission issued guidelines concerning the applicability of federal securities laws to offers and sales of condominiums or other units in a real estate development.[49] That release, No. 5347, which draws upon the SEC's interpretation of the *Howey* decision, gives examples of collateral arrangements that cause the offering of condominium units to involve an offering of securities in the form of investment contracts. In this release, the SEC stated that an offering of condominium units or other units in a real estate development constitutes an offering of securities if it involves:

(i) Both a rental arrangement and sales emphasis on the eco-

---

46 1 L. LOSS, SECURITIES REGULATION 489 (2d ed. 1961).

47 *See, e.g.*, Priv. Letter Rul., Finanswer America Invs., Inc., [1970-71 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78,111; SEC Securities Act Release No. 5347 (Jan. 4, 1973), FED. SEC. L. REP. (CCH) ¶ 1049 (discussed *infra*); SEC Securities Act Release No. 5018 [1969-70 Transfer Binder], FED. SEC. L. REP. (CCH) ¶ 77,757 [1969-70 (Nov. 13, 1969).

48 Marshall v. Lamson Bros. & Co., 368 F. Supp. 486 (S.D. Iowa 1974).

49 *See* SEC Release No. 33-5347, 38 Fed. Reg. 1735 (Jan. 18, 1973).

nomic benefits to the purchaser from the managerial efforts of the promoter or their parties;

(ii) A rental pool arrangement; or

(iii) Material restrictions on the owner's occupancy or rental of his unit, such as a requirement for making the unit available for rental for part of the year or a requirement for using an exclusive rental agent.

Two of the above arrangements do not have pooling features. Hence, although a particular offering of condominium units or other units in a real estate development may fall squarely within the perimeters of those the SEC has concluded do constitute an investment contract, the offering may still not satisfy the "common enterprise" requirement of the *Howey* test. Therefore, it may not be subject to the federal securities laws.

This scenario may be exemplified by the facts of *Cameron v. Outdoor Resorts of America, Inc.*[50] In *Cameron*, Outdoor Resorts was constructing a condominium campsite near Orlando, Florida. The plaintiffs, Karl and Cameron, invested in multiple-unit blocks for the manifest purpose of realizing rental income. The condominium declaration gave Outdoor Resorts the exclusive right to rent a campsite in the owner's absence with the owner paying the condominium fees, utility expenses, and property taxes and receiving half of the rental income from his lot. Rental income was determined by the particular lot chosen by the campers rather than by Outdoor Resorts' pooling of all rental income or by its random assignment of lots. The court, applying Release 5347, held that the offering of these campsites constituted an offering of a security since the sale involved both a rental arrangement with emphasis on rental benefits from another's management, and material restrictions on the owner's rental through the exclusive agency provision. In addition, the court measured the offering of the multiple unit blocks against the requirements of *Howey* and found that the "common enterprise" requirement was satisfied. The court made this finding despite the fact that rental income varied according to the campsite chosen by tourists and that such income was not evenly divided from a rental pool. By utilizing the vertical commonality approach, the court in *Cameron* found the critical factor to be that the benefits to Karl and

[50] 608 F.2d 187 (5th Cir. 1979).

Cameron from their multiple unit blocks were "inextricably wedded to the success of Outdoor Resorts' rental business including its advertising and management."[51]

It is clear that if the court in *Cameron* had applied the horizontal commonality approach in measuring the transaction against the "common enterprise" requirement of *Howey*, the sale of the condominium campsite blocks would not be held to involve an investment in a "common enterprise." There was no pooling or sharing of the invested funds; the fortunes of Karl or Cameron were not tied to the success of the overall enterprise, but instead to each investor's individual campsite lots. Hence, notwithstanding the fact that a transaction may appear to involve the offering of securities when measured against Release No. 5347, it may ultimately be held not subject to the federal securities laws for failure to satisfy the "common enterprise" requirement of *Howey*.

C. *Profits Derived Solely from the Efforts of Others*

The final element of the *Howey* test is that the investor's expected return of profit must be derived solely from the efforts of others. This element of the *Howey* test focuses prospectively on what the investor expects to gain from the investment and recognizes that an essential attribute of an investment contract is the possibility that there will be some financial or economic benefit in return for the investment.[52]

A real estate transaction is not a "security" under the *Howey* test if the investor is to receive something for the intrinsic value of the transaction that he intends to use, consume, develop or occupy.[53] As the Court in *United Housing Foundation, Inc. v. Forman* stated:

> . . . when a purchaser is motivated by a desire to use or consume

---

[51] *Id.* at 193.

[52] United Housing Found., Inc. v. Forman, 421 U.S. at 837; Tcherepnin v. Knight, 389 U.S. at 332. By contrast, the "risk capital" test used to analyze debt instruments for the existence of a security focuses retrospectively on what the investor stands to lose. *See* Wolf v. Banco Nacional De Mexico, 549 F. Supp. 841 (N.D. Cal. 1982).

[53] *See, e.g., Forman*, 421 U.S. at 852-53; *Howey*, 328 U.S. at 300. *See also, e.g.*, Joyce v. Ritchie Tower Properties, 417 F. Supp. 53 (N.D. Ill. 1976) (condominiums); B. Rosenberg & Sons v. St. James Sugar Coop., 447 F. Supp. 1, 4 (E.D. La. 1976) ("when a purchaser is motivated by a desire to use what he has purchased, the securities laws do not apply"); SEC v. Bailey, 41 F. Supp. 647, 650 (S.D. Fla. 1941) (investment in tung groves was a security because purchasers bought land not "for its intrinsic value" but "as a source of income").

> the item purchased — 'to occupy the land or to develop it themselves,' as the *Howey* court put it, . . . — the securities laws do not apply . . . . What distinguishes a security transaction — and what is absent here — is an investment where one parts with his money in the hope of receiving profits from the efforts of others, and not where he purchases a commodity for personal consumption or living quarters for personal use.[54]

In *Forman*, the Supreme Court based its decision that shares in a cooperative housing corporation were not securities, in part, in the absence of any expectation by the shareholders of a "financial" benefit. In the Court's wording, "[T]here can be no doubt that investors were attracted solely by the prospect of acquiring a place to live, and not by financial returns on their investments."[55] The Court defined "financial returns" or profits as "capital appreciation resulting from the . . . participation in earnings resulting from the use of investors' funds . . . ."[56]

Such a test, however, poses obvious difficulties when applied in the context of real estate transactions. Almost any real estate investor in today's inflationary market expects "capital appreciation" of his interest.[57] A purchaser may thus be attracted by the dual motives of obtaining housing and realizing a profit and thus will be seeking real estate for both personal use and appreciation.[58]

The requisite "profits," however, may be derived not only from capital appreciation, but also from investment income.[59] This expected yield may be in such familiar form as dividends

---

[54] 421 U.S. at 852-53, 858.

[55] *Id.* at 853.

[56] *Id.* at 852.

[57] In *Forman*, a key characteristic lacking in most real estate transactions was the possibility of appreciation. The shares could not appreciate in value since they were subject to a buy back agreement whereby the housing cooperative could repurchase the shares at the tenants' original cost.

[58] *See* Grenader v. Spitz, 537 F.2d 612 (2d Cir.), *cert. denied*, 429 U.S. 1009 (1976); Joyce v. Ritchie Tower Properties, 417 F. Supp. 53 (N.D. Ill. 1976). The duality of motive problem does not arise when one's own home is involved because an expectation of "profit" is not the motive for the purchase. The owner himself is primarily responsible for maintaining its value, and, of course, such factors as inflation and general improvement of the surrounding areas are not due solely to the efforts of the seller.

The motive problem usually arises in the marketing of condominiums and other unit developments. For example, in McCown v. Heidler, 527 F.2d 204 (10th Cir. 1975), the court was confronted with a situation in which the promoter was offering lots in a recreational subdivision in an "investment/ownership package." *See also* SEC Release No. 33-5347, 38 Fed. Reg. 1735 (Jan. 19, 1973), which sets forth certain guidelines to alleviate this problem.

[59] *See, e.g., Howey*, 328 U.S. 293 (1946).

or rent, so long as it is a function of the profits that are in turn tied to the managerial skills of the business.[60] In *Forman*, the expectation of income was precluded because the shares sold did not include the right to any financial return (dividends) contingent upon an apportionment of profits.

To determine whether there exists the requisite "profit" expectation by the investor, consideration must be given to the motivation of the purchaser as well as the promotional emphasis of the developer. This requires a thorough examination of the representations made by the promoter as the basis of the sale.[61] For example, in *Forman* the Court found no "reasonable expectation of profit", at least in part because the brochures advertising the Co-op living arrangement did not feature the income-producing aspects of a Co-op living arrangement (as a means of off-setting costs) which the plaintiffs claimed as profits, and thus did not "seek to attract investors by the prospect of profits resulting from the efforts of the promoters or third parties."[62] In *Davis v. Rio Rancho Estates*, the court found that "defendants' promotional materials, fairly read, place more emphasis on development of a residential community than on purchase as an investment."[63] In contrast, the advertisement brochures which were published by the promoters in *Goodman v. Epstein* featured detailed financial projections for the project showing large figures for "net income" and "profit" which could be reasonably expected by a purchaser.[64] The court found that these projections strongly support the conclusion that the ventures were entered into with an expectation of eventual profitability as contemplated by the *Howey* definition.[65] Similarly, in *SEC v. C.M. Joiner Leasing Corp.*, the Supreme Court noted that "the advertising literature emphasized the character of the purchase as an investment and

---

[60] *See, e.g.*, United Housing Found., Inc. v. Forman, 421 U.S. 837 (1975); Cameron v. Outdoor Resorts of America, Inc., 608 F.2d 187 (5th Cir. 1978)(rent from condominium campsites).

[61] *See, e.g., Forman,* 421 U.S. at 853-54; *Howey*, 328 U.S. at 300 (1946); *Joiner*, 320 U.S. at 346-47 (1943); Aldrich v. McCulloch Properties, Inc., 627 F,2d 1036, 1039-40 (10th Cir. 1980); Woodward v. Terracor 574 F.2d 1023, 1024-5 (10th Cir. 1978); McCown v. Heidler, 527 F.2d 204, 209-10 (10th Cir. 1975); Davis v. Rio Rancho Estates, Inc., 401 F. Supp. 1045, 1049-1050 (S.D.N.Y. 1975); Fogel v. Sellamerica, Ltd., 445 F.Supp. 1269, 1278 (S.D.N.Y. 1973).

[62] *Forman*, 421 U.S. at 853-54.

[63] *Davis*, 401 F. Supp. at 1049.

[64] Goodman v. Epstein, 582 F.2d 388 (7th Cir. 1978), *cert. denied*, 440 U.S. 939 (1979).

[65] *Id.* at 408 n.57.

as a participation in an enterprise," the subject land being purely an incidental consideration of the transaction.[66] Hence, in each case the inducement held out to the prospective buyer is characterized by liberally examining the promotional materials, merchandising approaches, oral assurances, and contractual agreements to determine the existence of the requisite investment intent.[67]

1. Potential Tax Benefits as Profits

In general, potential tax benefits from an investment are not "profits" for the purposes of the *Howey* test.[68] In *Forman*, the Supreme Court held the following: "We know of no basis in law for the view that the payment of interest, with its consequent deductibility for tax purposes, constitutes income or profits. These tax benefits are nothing more than that which is available to any homeowner who pays interest on his mortgage."[69]

The general rule that potential tax benefits from an investment are not considered "profits" for the purposes of the securities laws may be subject to qualification, as seen in *Forman*, which involved shares in a non-profit cooperative housing development. The tax benefits were derived from a special tax provision which intended to place tenant shareholders in the same position as homeowners as far as deductions for interest and taxes were concerned. In a footnote to the majority opinion, the court appeared to be drawing a distinction upon the finding that the subject tax benefits did not result from the managerial efforts of others, adding: "Even if these tax deductions were considered profits, they would not be the type associated with a security investment since they do not result from the managerial efforts of others."[70] The fact that this distinction may be critical when considering tax benefits as "profits" was accentuated by the fact that the dissenting opinion in *Forman* was based upon a finding that the tax benefits involved could only have been realized through the efforts of others.[71] Hence, potential tax benefits that result from the managerial efforts of others may be considered "profits" for purposes of

66 *Joiner*, 320 U.S. at 346-47.
67 *See supra* note 61.
68 *Forman*, 421 U.S. at 855.
69 *Id.*
70 *Id.* at n.20.
71 *Id.* at 860-865.

the *Howey* test.[72]

The mere fact, however, that potential tax benefits are the primary or even sole inducement for an investment does not defeat a finding of the "profit" element so long as there exists an expectation of profit.[73] In *Stowell v. Ted S. Finkel Investment Service, Inc.*, the tax shelter benefits of the investment in a limited partnership interest in a coal mining venture were found to be "substantial consideration" in the plaintiffs' decision to invest in the venture.[74] This held true even though plaintiffs expected to receive profit from the mining of the coal. In finding that the profit element of the *Howey* test was satisfied, the court held that the fact that tax benefits to be derived from the investment were an important consideration to the investor was not compelling, and "[s]o long as there exists an expectation of profit, the tax consequences can properly be the inducement for, as well as an incidental benefit of, an investment."[75] Moreover, the court stated that tax benefits could be the sole reason why an investor decides to make an investment.[76] *Stowell* is consistent with other cases in which the overall scheme involved the essential elements of an investment contract, and the profits were to take the form of a direct return on the investment coupled with a favorable tax shelter.[77]

2. Benefits from Common Elements

Income derived from commercial facilities which are part of the common elements of a project may constitute "profits" in the sense intended by *Howey*.[78] SEC Release No. 5347 set cer-

---

[72] *Cf.* SEC v. Intern Mining Exch., Inc., 515 F. Supp. 1062 (D. Col. 1981). In *Intern Mining*, in addition to finding an expectation of profits from the gold being mined, the court emphasized that the tax benefits (writeoffs) resulted solely from the managerial efforts of others. *Id.*

[73] *See, e.g.*, Stowell v. Ted S. Finkel Inv. Serv., Inc., 489 F. Supp. 1209 (S.D. Fla. 1980).

[74] *Id.* at 1221.

[75] *Id.*

[76] *Id.* Although not emphasized by the court, the tax benefits were to be derived solely from the managerial efforts of the promoters. This factor was discussed, however, in SEC v. Intern Mining Exch., Inc., 515 F. Supp. 1062, 1069 (D. Col. 1981). In any event, the tax benefits of a transaction are relevant because they are used as an economic inducement and thus provide a basis for predicting the reasonable expectation and behavior of prospective investors. SEC v. Aqua Sonic Products, 687 F.2d 577 (1982).

[77] *See Intern Mining Exch.*, 515 F. Supp. at 1062. *See also* Goodman v. Epstein, 582 F.2d 388 (7th Cir. 1978); Sharp v. Coopers & Lybrand, 457 F. Supp. 879 (D. Pa. 1978); Bayoud v. Ballard, 404 F. Supp. 417 (D. Tex. 1975).

[78] *Forman*, 421 U.S. at 855-56.

tain perimeters within which income derived from commercial facilities may be found to constitute an investment contract.[79] This Release states:

> In situations where commercial facilities are a part of the common elements of a residential project, no registration would be required under the investment contract theory where (a) the income from such facilities is used only to offset common area expenses and (b) the operation of such facilities is incidental to the project as a whole and are not established as a primary income source for the individual owners of a condominium or cooperative unit.

In *Forman*, the income derived from the leasing by the Co-op of parking space and the operation of washing machines was not "profit". The Court based this determination on the fact that any net income collected was used to reduce tenant rental costs and the facilities were provided for the purpose of making essential services available for the residents.[80]

Although the 1973 release was issued primarily in connection with the growing number of resort development rental pools, the above quoted language would appear to have considerable significance for commercial condominiums as well. It should therefore be reviewed in that connection. Many specialized commercial condominiums such as those developed for medical practices or as research centers have commercial facilities as common elements from which considerable net income is derived. These developments may provide such shared facilities as clinical laboratories, pharmacies, or computer equipment managed by the developer or other third party. Income derived from such facilities will likely fall within the perimeters of the SEC release and be held to constitute "profits" under the investment contract concept of *Howey*.[81]

3. Solely from the Efforts of Others: Managerial and Entrepreneurial Efforts

All investments made with the expectation of profits are not securities.[82] The key element in determining whether an in-

---

[79] SEC Release No. 33-5347, 17 C.F.R. 231, 38 Fed. Reg. 1735 (Jan. 19, 1973).

[80] In *Forman*, the SEC filed an amicus curiae brief which took a position that contradicted the guidelines set forth in SEC Release No. 33-5347. 421 U.S. at 855-56.

[81] *See generally* D. CLURMAN, THE BUSINESS CONDOMINIUM 140-46 (1973).

[82] *See, e.g.*, DeLuz Ranchos Investment, Ltd. v. Coldwell Banker & Co., 608 F.2d

vestment is a security under the *Howey* test is whether entrepreneurial or managerial efforts of others are the source of the return on the investment. As the Court stated "[T]he touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial efforts of others."[83]

If no managerial efforts of others are involved there is no security, notwithstanding an expectation of profit from the investment.[84] According to Professor Loss:

> The line is drawn, however, where neither the element of a common enterprise nor the element of reliance on the efforts of another is present. For example, no 'investment contract' is involved when a person invests in real estate, with the hope perhaps of earning a profit as the result of a general increase in values concurrent with the development of the neighborhood, as long as he does not do so as part of an enterprise whereby it is expressly or impliedly understood that the property will be developed or operated by others.[85]

For example, the purchase of land with the thought of reselling it in the future when property values increase is an investment, but will not be a security if there is no management of the investment by others.[86] A purchaser of lots in a recreational subdivision may have relied upon the representations of the promoter or developer that the development of residential services and recreational facilities will enhance the value of the lots in the development. But in the absence of any obligation by contract or promise by the developer to provide significant development or management services for the benefit of the purchasers, the expectation of profit on resale is insufficient to transform what is essentially a sale of real estate into the sale of an investment contract.[87] Likewise, some condominiums are

---

1297 (9th Cir. 1979); Woodward v. Terracor, 574 F.2d 1023, 1026 (10th Cir. 1978); Joyce v. Ritchie Tower Properties, 417 F.Supp. 53 (N.D. Ill. 1976); Davis v. Rio Rancho Estates, Inc., 401 F.Supp. 1045, 1050 (S.D.N.Y. 1975).

[83] *Forman*, 421 U.S. at 852.

[84] *See supra* note 81. *See also* Aldrich v. McCulloch Properties, Inc., 627 F.2d 1036 (10th Cir. 1980); Happy Inv. Group v. Lakeworld Properties, Inc., 396 F. Supp. 175 (N.D. Cal. 1975); Fogel v. Sellamerica, Ltd., 445 F. Supp. 1269 (S.D.N.Y. 1973).

[85] 1 L. Loss, *supra* note 46, at 491-92.

[86] McGreghar Land Co. v. Meguiar, 521 F.2d 833 (9th Cir. 1975); Murphey v. Hillwood Villa Assoc., 411 F. Supp. 287 (S.D.N.Y. 1976).

[87] DeLuz Ranchos Investment, Inc. v. Coldwell Banker & Co., 608 F.2d 1297 (9th Cir. 1979); Woodward v. Terracor, 574 F.2d 1023 (10th Cir. 1978); Davis v. Rio Rancho Estates, Inc., 401 F.Supp. 1045 (S.D.N.Y. 1975); Happy Inv. Group v. Lakeworld Proper-

purchased for investments for a profit motive, but if it is occupied by the owner exclusively as a residence and not rented out in accordance with a rental arrangement or rental pool arrangement, it is not covered by the securities acts.[88]

When determining whether the efforts of others are to be characterized as "managerial" or "entrepreneurial" as contemplated by *Howey* and *Forman*, a distinction must be made between the developer's efforts which produce purely incidental benefit to an individual purchaser/investor, against those efforts that are directly related to the investor and upon which a reasonable investor would expect a financial return.[89] For example, the building of roads and other improvements was held in *Davis v. Rio Rancho Estates*[90] not to be the type of managerial services contemplated in *Howey*.[91] The court noted, however, that had the developer promised to run the development and distribute profits to the investors, as did the operators of the orange groves in *Howey*, there would exist the kind of third-party effort envisioned by the *Howey* Court.[92] Similarly, while efficient management of a housing cooperative will enhance its desirability as a place of residence, it is not considered a factor that will result in the appreciation in value of the shares of a corporation operating a building.[93] This would depend upon the general housing market, the status of the neighborhood, the availability of credit, and such third-party efforts not of the character contemplated by *Howey*.[94]

---

ties, Inc., 396 F. Supp. 175 (N.D. Cal. 1975); Fogel v. Sellamerica, Ltd., 445 F. Supp. 1269 (S.D.N.Y. 1973).

88 Joyce v. Ritchie Tower Properties, 417 F. Supp. 53 (N.D. Ill. 1976).

89 Aldrich v. McCulloch Properties, Inc., 627 F.2d 1039, 1040 (10th Cir. 1980); Grenader v. Spitz, 537 F.2d 612 (2d Cir. 1976); Davis v. Rio Rancho Estates, 401 F.Supp. 1045 (S.D.N.Y 1975).

90 *Davis*, 401 F. Supp. 1045 (1975).

91 But compare *Davis* with McCown v. Heidler, 527 F.2d 204 (10th Cir. 1975), in which the court recognized that the development of certain residential services and recreational facilities could constitute the requisite managerial efforts upon which the investor relies for the appreciation in his investment.

92 *Davis*, 401 F. Supp. at 1050.

93 Grenader v. Spitz, 537 F.2d 612 (2d Cir. 1976).

94 *Id. See also* Johnson v. Nationwide Indus., Inc., 405 F. Supp. 948 (N.D. Ill. 1978) in which the court rejected the investors' argument that their investment depended on the efforts of the developers in the sense that, to the extent the developers managed the commercial facilities owned by them in the building successfully, the reputation of the building would be enhanced and the value of the residential units would appreciate. The SEC in its Release No. 33-5347, 17 C.F.R. 231, 38 Fed. Reg. 1735 (Jan. 19, 1973), has outlined the types of collateral management arrangements that may transform the purchase of certain real estate interests into a security transaction.

4. Investor Reliance.

Howey provides that the third element for finding the existence of an "investment contract" is satisfied if the profits are "solely from the efforts of the promoter or a third party." The focus of this element is on the economic realities of the transaction and whether there is in fact investor dependence on the entrepreneurial and managerial skills of the promoter or other party for the success of the enterprise.[95]

If the investor retains ultimate control over the investment or has the ability to participate, either by his own efforts or by majority vote in a group venture, the requisite investor dependence on others is lacking and there is no security.[96] Thus, if the investor landowner does not wish to manage the property and delegates the responsibility to an agent, the investor does not hold a security since ultimate control over the investment has been retained under the concept of agency.[97] Likewise, general partnerships and other arrangements that grant the investor control over the significant decisions of the enterprise are generally not securities.[98] "The general partners of a partnership are not passive investors who place money in an enterprise with the expectation of deriving profits solely from the efforts of others. Rather, they expect to reap profits through

[95] *See, e.g.*, United Housing Found., Inc. v. Forman, 421 U.S. 837, 852 (1975); Gordon v. Terry, 684 F.2d 736 (11th Cir. 1982); SEC v. Aqua-Sonic Products Corp., 687 F.2d 577, 582 (2d Cir. 1982); Williamson v. Tucker, 645 F.2d 404, 418 (5th Cir. 1981); Fund of Funds, Ltd. v. Arthur Andersen & Co., 545 F. Supp. 1314, 1348 (S.D.N.Y. 1982).

[96] Gordon v. Terry, 684 F.2d 736, 741 (11th Cir. 1982); Schultz v. Dain Corp., 540 F.2d 912 (8th Cir. 1976) (investor retained ultimate control over an apartment complex by reserving right to fire the management). The fact, however, that investors can elect a new general partner to carry on the business of a partnership is not sufficient investor control to defeat the finding of a security. Stowell v. Ted S. Finkel Inv. Serv., Inc., 489 F. Supp. 1209 (S.D. Fla. 1980).

Some courts have stated that the reason *Howey* excluded the investor who participates in the enterprise from the protection of the disclosure and fraud provision of the securities laws is that an investor does not need such protection when the investor obtains a degree of managerial control that affords access to information about the issuer. The fact that the investor performs nominal services or physical labor provides no access whatever to information about the issuer and affords no reason for depriving him of the protection of the securities laws. By virtue of managerial powers, the investors have rights of inspection and thus the ability to inform themselves as to the condition of the business and to promote its success. *See* Hirsch v. DuPont, 396 F. Supp. 1214 (S.D.N.Y. 1975), *aff'd*, 553 F.2d 750 (2d Cir. 1977); Oxford Finance Co's, Inc. v. Harvey, 385 F. Supp. 431 (E.D. Pa. 1974).

[97] *Gordon*, 684 F.2d at 740.

[98] *Id.* at 741. *See also* Ballard & Cordell Corp. v. Yoller & Oanneberg Exploration, Ltd., 544 F.2d 1059 (10th Cir. 1976).

their own active participation in the control and management of the business."[99] By contrast, in the limited partnership the limited partners do not participate in management, but are passive investors in order to obtain limited liability.[100] As a result, the element of reliance upon the management of others is present and the limited partnership interest is, therefore, generally considered a security.[101]

The degree of reliance of the investor on the promoter, however, has been the subject of much controversy, and considerable case law has been devoted to interpreting the word "solely" and to unraveling the extent of investor participation that will prevent an investment contract from qualifying as a security.[102] The "sticking point" is whether the term "solely" should be read as a strict and literal limitation on the definition of an investment contract (that the investor cannot contribute in any manner to the project) or be given a broader interpretation (that the investor can provide ministerial, nonmanagerial help).[103]

The broader interpretaion of the *Howey* test was originally developed by the Ninth Circuit in *SEC v. Glenn W. Turner Enterprises, Inc.*[104] In *Glenn Turner* the court was faced with a pyramid franchise scheme that depended for its success on the efforts of the promoters to sell the products, but nevertheless required an effort on the part of the investor to bring new prospects to the promoters. Although profits were not strictly to

---

[99] R. JENNINGS & H. MARSH, SECURITIES REGULATION 252 (4th ed. 1977).

[100] *See, e.g.*, SEC v. Murphy, 626 F.2d 633 (9th Cir. 1980); Goodman v. Epstein, 582 F.2d 388 (7th Cir. 1978); Stowell v. Ted S. Finkel Inv. Serv., Inc., 489 F.Supp. 1208 (S.D. Fla. 1980). *See also* SEC Release No 33-4877, August 8, 1967, which states, in pertinent part:

> Under the Federal Securities Law, an offering of limited partnership interest and interest in joint or profit sharing agreement' or an 'investment contract' which is a 'security' within the meaning of Section 2(1) of the Securities Act of 1933. . . . [I]f the promoters of a real estate syndication offer investors the opportuniiy to share in the profits of real estate syndications or similar ventures, particularly when there is no active participation in the management and operation of the scheme on the part of the investors, the promoters are, in effect, offering a 'security.'

1 FED. SEC. L. REP. (CCH) ¶ 1046 at 2062-63.

[101] *Id.*

[102] *See, e.g.*, Villenueve v. Advanced Business Concepts Corp., 698 F.2d 1121, *reh'g en banc granted*, 698 F.2d 1127 (11th Cir. 1983); SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 476 (9th Cir. 1973).

[103] SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 476, 481 (9th Cir. 1973); Slevin v. Pedersen Associates, Inc., 540 F. Supp. 440 (S.D.N.Y. 1982).

[104] *Turner*, 474 F.2d at 481.

come "solely" from the efforts of the promoters, who gave the sales pitch and ran the program, the court stated that the portion of the *Howey* test which requires that the expected profits accrue "solely" from the efforts of others "should not be read as a strict or literal limitation on the definition of an investment contract" and held the scheme was an investment contract.[105] The court in *Glenn Turner* held that the issue posed by this element of the *Howey* test is "whether the efforts by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."[106] The focus of this "essential managerial efforts" test is on the quality of the efforts of others and requires an assessment of the significant managerial or entrepreneurial contribution of the promoter or a third party to the success of the venture; the reliance of the investor on the promoter need not be total.[107] This broader test explicated by the Ninth Circuit in *Glenn Turner* has been generally accepted by the other circuits and is the subject of long standing precedent.[108]

The recent Eleventh Circuit opinion in *Villeneuve v. Advanced Business Concepts Corp.* evidences the continued controversy over the meaning of "solely."[109] In *Villeneuve*, the court denied the appellants'/investors' claims that certain area purchaser agreements/distributorships for the sale of self-watering planters were investment contracts. The court held that the agreement failed to satisfy the *Howey* definition because of the control exercised by the purchasers over the profit potential.[110] In the opinion, Judge Hatchett reaffirmed the *Howey* "solely" test and not the broader "essential managerial efforts" test of *Glenn Turner*.[111] As support for the "solely" test, the

---

105 *Id.* at 482.

106 *Id.*

107 *See* Gordon v. Terry, 684 F.2d 736 (11th Cir. 1982); Williamson v. Tucker, 645 F.2d 404 (5th Cir. 1981); SEC v. Intern Mining Exch., Inc., 515 F.Supp. 1062 (D.Col. 1981).

108 *See, e.g.*, Gordon v. Terry, 684 F.2d 736, 741-2 (11th Cir. 1982); SEC v. Aqua-Sonic Products Corp., 687 F.2d 577, 582 (2d Cir. 1982),; Williamson v. Tucker, 645 F.2d 404, 418 (5th Cir. 1981); Union Planters Nat'l Bank v. Commercial Credit, 651 F.2d 1174, 1185 (6th Cir. 1981); Crowley v. Montgomery Ward & Co., 570 F.2d 877 (10th Cir. 1978); Goodman v. Epstein, 582 F.2d 388, 408 n.59 (7th Cir. 1978); Fargo Partners v. Dain Corp., 540 F.2d 912 (8th Cir. 1976); Hector v. Weins, 533 F.2d 429, 433 (9th Cir. 1976).

109 698 F.2d 1121, *reh'g en banc granted*, 698 F.2d 1127 (11th Cir. 1983).

110 *Id.* at 1125.

111 *Id.* at 1124-25.

court relied on the decisions of *Forman*[112] and *Piambino v. Bailey*,[113] because both cases had restated and reaffirmed the original standard articulated in *Howey*.[114]

Neither of the cases relied upon by Judge Hatchett, however, require the use of the literal "solely" test, nor do they overrule *Glenn Turner*.[115] In *Forman*, the court acknowledged the existence of the broader "essential managerial efforts" test developed by Judge Duniway in *Glenn Turner*, but declined to express an opinion on the holding, evidently because the "solely" issue was not involved.[116] The Court held against the members primarily on the ground that there was no expectation of profit in a co-op share.[117] In *Piambino*, the court reversed a grant of summary judgment and remanded the cause for a factual determination of whether "reasonable investors did or did not believe they were buying into an enterprise whose profits would be determined by Bestline's managerial and entrepreneurial methods with no substantial effort by the investor."[118] A determination of the substantiality of the investors' efforts, however, would not be necessary under the literal "solely" test because "solely" allows no help from the investor.[119]

A close examination of the *Villeneuve* opinion reveals that the court did not apply the "solely" test. Instead, the court proceeded to assess the efforts and activities of the investor to the success of the venture, finding that the investors were making substantial efforts toward profits.[120] But again, this substantiality of efforts determination would not be necessary under the "solely" test in which the investor cannot contribute in any manner to the project.[121] Hence, the focus of the courts' analysis in *Villeneuve* and in *Piambino* was the same as it was in *Glenn Turner*, that is, whether the investor believed that the profits of the venture would be determined by the promoters' or others' managerial and entrepreneurial efforts with no sub-

112 *Id.*
113 610 F.2d 1306 (5th Cir. 1980).
114 *Villeneuve*, 698 F.2d at 1124-25.
115 *Id.* at 1125-28.
116 *Forman*, 421 U.S. at 852, n.16.
117 *Id.*
118 *Piambino*, 610 F.2d 1319-20.
119 *See supra* note 102.
120 *Villeneuve*, 689 F.2d at 1125.
121 *See supra* note 102.

stantial effort by the investor.[122] This conforms to the Supreme Court's mandate in securities cases to disregard form and focus on economic realities.[123]

5. Determining the Existence of the Requisite Investor Dependence

Central to determining the existence of the requisite investor dependence is an examination of the representations and promises made by the promoters or others to induce reliance upon their entrepreneurial abilities.[124] As in the case of determining whether there exists the requisite "expectation of profits," consideration must be given to the promotional materials, merchandising approaches, oral assurances, and contractual agreements.[125] When representations or promises have not been made, or if made, they do not involve concrete plans or do not involve claims of unique entrepreneurial or managerial abilities, the dependency required cannot exist.[126] For example, in *Happy Investment Group v. Lakeworld Properties, Inc.*,[127] the court examined the sale representations, literature and handouts to determine whether the developers offered the essential managerial efforts that would affect the success of the project and from which the plaintiff investor could expect a profit. The court found that although the developer, through the literature and sales talks, gave the impression that it would contribute substantial efforts to create a thriving subdivision, it in fact offered no concrete programs and presented no substantive plans to further this goal; the developers were "masters of generalizations." Moreover, the developer was not under any obligation by contract or promise to provide significant development services for the benefit of the purchasers and, therefore, the transaction was held not subject to the securities laws. Similarly, in *Forman* the court found that the "Information Bulletin" distributed by the promoters to the prospective residents did not "seek to attract investors by the prospect of prof-

---

122 *Piambino*, 610 F.2d at 1319-1320.

123 United Housing Found., Inc. v. Forman, 421 U.S. 837, 851-52 (1975); King v. Winkler, 673 F.2d 342, 344-45 (11th Cir. 1982).

124 United Housing Found., Inc. v. Forman, 421 U.S. 837, 852-54, 856 (1975); SEC v. W. J. Howey Co., 328 U.S. 293, 300 (1946).

125 *See supra* note 61.

126 Happy Inv. Group v. Lakeworld Properties, Inc., 396 F. Supp. 175 (N.D. Cal. 1975).

127 *Id.*

its resulting from the efforts of the promoters or third parties."[128]

The inducement held out to the purchasers was also examined in *Woodward v. Terracor*, in which the court explored the promotional materials and contractual agreement determining that there was no factual basis for reasonable investors to believe that they were buying into an enterprise whose profits would be determined by the managerial or entrepreneurial activities and methods of the developer.[129] The developer detailed plans for a self-sufficient community, but was under no contractual obligation to the investors other than to deliver title to the property once the purchase terms were met.[130] Hence, the promotional emphasis of the developer is an important consideration in examining a transaction to determine whether there exists the requisite investor dependency upon the efforts of others for the expected financial return.

In addition to an examination of the promotional materials, consideration must also be given to the nature of the property interest purchased and to the character of the subject instrument. As discussed above,[131] general partnerships and joint ventures are unlikely to come within federal securities jurisdiction because the investors as general partners have legal rights and responsibilities for the conduct of the partnership's business.[132] On the other hand, under the Uniform Limited Partnership Act, limited partners are effectively precluded from participation in the control of the business by the threat of losing their limited liability, and, therefore, a limited partnership interest usually falls squarely within the definition of "security."[133]

III. ADDED CAVEAT: ECONOMIC REALITY CONTROLS

Although the nature of the property interest and the charac-

---

128 *Forman*, 421 U.S. at 854.

129 *Terracor*, 574 F.2d 1023, 1025-26 (10th Cir. 1981).

130 *Id.* Compare *Woodward* with McCown v. Heidler, 527 F.2d 204 (10th Cir. 1975), in which the sellers were under "contractual promise" to do certain enumerated things that would enhance the value of the individual building sites in the project. By contrast, the developer's representations in Woodward to induce the purchasers to build or their efforts to enhance living conditions in the development were unrelated to the purchasers. *See also* Davis v. Rio Rancho Estate, Inc., 401 F. Supp. 1045 (S.D.N.Y. 1975).

131 *See supra* notes 35-36.

132 *See supra* notes 97-98.

133 *See supra* notes 99-100.

ter of the instrument should be considered, there is an important added caveat. In any analysis of a transaction for the existence of a "security," form should be disregarded for substance and the emphasis should be on economic reality.[134] Thus, if the facts and circumstances indicate that the substance of the investment belies its form, even general partnerships or joint ventures may be subject to securities laws.[135] For example, a "general partnership agreement" may place the controlling power in the hands of certain managing partners, and thus be deemed an "investment contract" with respect to the other partners.[136]

Similarly, partners are generally granted a great deal of latitude in drafting their limited partnership agreements, and thus the nature of the interest held by the limited partners may vary according to the partnership agreement executed by the parties.[137] For example, careful examination of an agreement termed "limited partnership agreement" may reveal that the agreement lacks the attributes of a limited partnership because it permits the partners to control, by majority vote, the general partners' decisions regarding partnership property.[138] In each case the issue is whether, under the partnership agreement entered into by the parties, the partnership's interests meet the criteria of an investment contract.[139] This determination can only be made on a case-by-case basis.[140]

In addition, even though an agreement may provide the investor with substantial control, there may be the existence of factors that "give rise to such dependency on the promoter or on a third party that he is in fact unable to exercise the power given."[141] There is thus created a situation of "forced reliance."[142] The Fifth Circuit in *Williamson v. Tucker* noted three

134 SEC v. W. J. Howey Co., 328 U.S. 293, 298 (1946); Woodward v. Terracor, 574 F.2d 1023, 1024 (10th Cir. 1981).

135 Funds of Funds, Ltd. v. Arthur Andersen Co., 545 F. Supp. 1314, 1348 (S.D.N.Y. 1982).

136 Williamson v. Tucker, 645 F.2d 404, 423 (5th Cir. 1981); Pawgun v. Silverstein, 265 F. Supp. 898 (S.D.N.Y. 1967). In such a case, the agreement allocates partnership power as in a limited partnership. *Id.*

137 *Stowell*, 489 F. Supp. at 1220.

138 *See* Gordon v. Terry, 684 F.2d 736, 741 n.5 (11th Cir. 1982).

139 *Stowell*, 489 F. Supp. at 1220.

140 *Id.* In *Stowell*, the court rejected the plaintiff's assertion that interests in a limited partnership are securities as a matter of law. *Id.* at 1219-20.

141 *Williamson*, 645 F.2d at 424.

142 *Gordon*, 684 F.2d at 742.

examples of when such "forced reliance" may arise:

> A general partnership or joint venture interest can be designated a security if the investor can establish, for example, that (1) an agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership; or (2) the partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or (3) the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers.[143]

An investor with substantial control, but claiming forced reliance, has a difficult burden of proof.[144] For example, if the basis of the forced reliance is the dependency on another's specialized expertise, the fact that the investor has delegated management duties or has chosen to rely on some other party does not establish dependency.[145] The investor must have "no reasonable alternative to reliance on that person."[146] That is, the investor must be "forced to rely on some particular non-replaceable expertise."[147] As an example, the *Williamson* court stated that "investors may be induced to enter a real estate partnership on the promise that the partnership's manager has some unique understanding of the real estate market in the area in which the partnership is to invest."[148] Hence, the investor must demonstrate that, in spite of the powers vested in him by the agreement, he was so dependent on the promoter or on a third party that he was in fact unable to exercise the powers.[149] The presence of some reasonable expectation that the investor might exercise his retained rights in a significant manner precludes a finding of an investment contract, requiring the examination from an objective perspective.[150]

---

143 *Williamson*, 645 F.2d at 424.

144 *Id.*

145 *Gordon*, 684 F.2d at 741-42.

146 *Id.*; *Williamson*, 645 F.2d at 423.

147 *Id.*

148 *Williamson*, 645 F.2d at 424.

149 *Id.*; *Gordon*, 684 F.2d at 742.

150 *Forman*, 421 U.S. at 852.

CONCLUSION

The determination as to whether an offer and/or sale of an interest in a real estate transaction involves a "security" within the purview of the federal securities laws is not easily made under the multi-factor analytical approach developed by the courts. Many real estate transactions exhibit, to some degree, the elements most commonly associated with securities — one person ("the investor") provides funds to another with the expectation of a financial or economic benefit. The purchaser, however, is often times attracted by the dual motives of obtaining housing and realizing a profit from the investment. Complicating the analysis further is the fact that the expected gain may be due to multiple factors, many of which will be beyond the efforts of any of the parties. As a result, a more direct and reliable approach may be to include a particular real estate transaction within the meaning of a security unless it falls into certain well-defined categories, such as those in which the investor is participating in the management of the investment or no managerial efforts are involved.

One thing, however, is clear from the foregoing. A real estate promoter client must be cautioned concerning the possible securities aspects of his proposed activities.