

Shares in Private Cooperative Apartment Held Not to Be Securities (Grenader v. Spitz)

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attacked as fraudulent—an examination which includes, but is not necessarily limited to, the question of whether there exists a valid corporate purpose. So interpreted, the *Marshel* decision opens the way to a positive attack on the abuses rule 10b-5 was intended to prevent, without mandating the extreme position adopted by the *Green* court.

Thérèse M. Haberle

SHARES IN PRIVATE COOPERATIVE APARTMENT HELD NOT TO BE SECURITIES

Grenader v. Spitz

The Securities Act of 1933¹ and the Securities Exchange Act of 1934² represent the principal congressional attempts to curb serious abuses in a previously unregulated financial market.³ In defining the term "security" as used within the Acts,⁴ Congress included not only the more commonly known instruments traded for speculation or investment, such as stocks and bonds, but also instruments such as "investment contracts,"⁵ which are capable of lending themselves to a more flexible interpretation.⁶ In light of these rather adaptable

¹ 15 U.S.C. §§ 77a to 77aa (1970 & Supp. V 1975).

² 15 U.S.C. §§ 78a to 78hh (1970 & Supp. V 1975).

³ See S. REP. No. 1455, 73d Cong., 2d Sess. 9-77 (1934). Essentially, the Senate Committee on Banking and Currency listed the extensive use of credit in the markets, the manipulation of prices, short-swing trading by insiders, and inadequate financial disclosure by listed corporations as the major abuses sought to be remedied. *Id.* See Loomis, *The Securities Exchange Act of 1934 and The Investment Advisers Act of 1940*, 28 GEO. WASH. L. REV. 214, 216-17 (1959). See also Gadsby, *Historical Development of the S.E.C.—The Government View*, 28 GEO. WASH. L. REV. 6, 9 (1959).

⁴ The definition of a "security" appears in the Securities Act as follows:

[U]nless 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"

Securities Act § 2(1), 15 U.S.C. § 77b(1) (1970). The definition of a security in the Exchange Act § 3(a)(10), 15 U.S.C. § 78c(a)(10) (1970), is practically identical to that contained in the Securities Act. See *Teherapnin v. Knight*, 389 U.S. 332, 335-36 (1967); S. REP. No. 792, 73d Cong., 2d Sess. 14 (1934).

⁵ See note 4 *supra*.

⁶ In *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), the Supreme Court was faced with the issue of whether offerings of small parcels of orchard land, coupled with service contracts

terms, the status of many transactions has been dependent upon judicial determination. One transaction which has created controversy as to whether it involves an investment contract, and thus a security, is the sale of shares in a cooperative apartment house. Recently, in *Grenader v. Spitz*,⁷ the Second Circuit ruled that the sale of shares in a privately owned and operated cooperative apartment house was not a sale of securities. In so holding, the court expressly overruled its own contrary precedent.

In 1974, the Second Circuit had twice been faced with attempts to apply federal securities law to sales of cooperative apartments. In *1050 Tenants Corp. v. Jakobson*⁸ and *Forman v. Community Services, Inc.*,⁹ the court held respectively that shares in a privately

to cultivate the land and sell the produce for the benefit of the purchasers, were securities. Specifically, the Court posed the issue as being whether the agreements in question constituted investment contracts. *Id.* at 297. The Court noted that although Congress itself had failed to define an investment contract when it had enacted the securities legislation, the term was utilized in various state blue sky laws and had been given broad meaning by many state courts prior to the passage of the Acts. *Id.* at 298. *See, e.g.,* *Freeze v. Smith*, 254 Mich. 386, 236 N.W. 810 (1931); *State v. Gopher Tire & Rubber Co.*, 146 Minn. 52, 177 N.W. 937 (1920). The *Howey* Court determined that Congress had intentionally used a term, the meaning of which had been established by state laws and decisions, and which it summarized 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" 328 U.S. at 298-99. Applying this test to the facts before it, the Court found that the transactions were indeed "investment contracts." *Id.* at 299-300.

For an illuminating discussion of the state and federal case law regarding investment contracts prior to *Howey*, see Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135, 146-59 (1971). Since the *Howey* decision, the test has been used to include a wide variety of investment schemes within the ambit of the securities laws. *See, e.g.,* *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473 (5th Cir. 1974) (pyramid recruitment scheme in the cosmetics business); *Continental Marketing Corp. v. SEC*, 387 F.2d 466, 468 (10th Cir. 1967), *cert. denied*, 391 U.S. 905 (1968) ("sale, care, management, replacement or resale of live beaver for breeding purposes").

⁷ 537 F.2d 612 (2d Cir.), *cert. denied*, 97 S. Ct. 541 (1976), *rev'g* 390 F. Supp. 1112 (S.D.N.Y. 1975).

⁸ 503 F.2d 1375 (2d Cir. 1974), *aff'g* 365 F. Supp. 1171 (S.D.N.Y. 1973). In *Jakobson*, the plaintiffs were purchasers of shares in a private cooperative apartment building. The corporation assumed the management contracts, service contracts, and mortgages on the building, all of which were entered into on its behalf by the promoters. Monthly charges were assessed by the corporation to cover the mortgage and maintenance of the building. Tenant-shareholders elected directors on the basis of one vote per share and were entitled to financial statements each year. Subject to certain restrictions requiring the consent of the directors, the shareholders were allowed to sublet their apartments or transfer their apartments along with their shares. Based on both a literal approach, *see* text accompanying note 11 *infra*, and the *Howey* test, *see* note 6 *supra*, the court held that the federal securities acts were controlling. *See* notes 10-14 and accompanying text *infra*.

⁹ 500 F.2d 1246 (2d Cir. 1974), *rev'd sub nom.* *United Hous. Foundation, Inc. v. Forman*, 421 U.S. 837 (1975). In *Forman*, the plaintiffs were residents of Co-op City, a massive cooperative housing project which was organized, financed, and constructed under the Mitchell-

owned and a publicly owned cooperative were securities under the federal acts. To reach these results, the Second Circuit utilized two alternative tests for determining whether a particular transaction involves a security, and found that under both tests the shares in a cooperative apartment building are within the purview of the securities laws.¹⁰ Applying a "literal" test the Second Circuit in both *Jakobson* and *Forman* held that shares of cooperative stock are securities simply because the term "stock" is commonly understood to refer to a security.¹¹ Both the *Jakobson* and the *Forman* panels also employed the three-prong test developed by the Supreme Court in *SEC v. W.J. Howey Co.*¹² for determining whether the transaction in question is an investment contract. An investment contract, as defined by the Supreme Court, is "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."¹³ Utilizing this test, the Second Circuit found in both cases that the economic realities underlying the transactions indicated that an investment contract, and therefore a security, was involved.¹⁴

Lama Act, N.Y. PRIV. HOUS. FIN. LAW §§ 10-37 (McKinney 1976). The shares could not be transferred to a nontenant, nor could they be pledged, encumbered, or bequeathed, except to a surviving spouse. Upon subsequent disposition, the shares could only be sold at their purchase price. Votes were not allocated per share; instead, the residents were given one vote per apartment. The suit was instituted by purchasers alleging misrepresentation and omissions in an information bulletin. The major impetus for suit was that the monthly carrying charges were considerably larger than those stated in the bulletin. The *Forman* court, applying both the literal test and the *Howey* test, found the transaction to be covered by the federal securities laws. See notes 10-14 and accompanying text *infra*.

¹⁰ For discussion of *Forman* and *Jakobson* and the application of the literal test and the *Howey* test to their respective fact patterns, see 49 ST. JOHN'S L. REV. 395 (1975).

¹¹ See 1050 *Tenants Corp. v. Jakobson*, 503 F.2d at 1378; *Forman v. Community Servs., Inc.*, 500 F.2d at 1252-53.

¹² 328 U.S. 293 (1946).

¹³ *Id.* at 298-99; see note 6 *supra*.

¹⁴ In *Jakobson*, the court stated that the "common enterprise" and the "solely from the efforts of the promoter" elements were too obvious to warrant discussion. The "profits" element was found to be satisfied by: (1) a reduction in the monthly carrying charges arising from substantial nonresidential income; (2) personal income tax savings for the tenant's share of the cooperative corporation's deductible expenses; (3) maximum services at a minimum cost; and (4) capital appreciation on a resale of stock. 503 F.2d at 1378.

The *Forman* court similarly addressed only the "profits" element since it felt that the other ingredients of the *Howey* test undoubtedly were present. See 500 F.2d at 1253-54. Conceding that there was no possible profit on resale, the court nevertheless found that income from three sources could have been expected by the shareholders: (1) rentals from office space, parking facilities, and commercial enterprises, which was applied to reduce carrying charges; (2) tax deductions for interest paid on the building mortgage; and (3) savings in the form of lower rent than that charged in nonsubsidized housing. *Id.* at 1254.

The Supreme Court, however, reversed the *Forman* decision, holding that shares in a publicly owned cooperative apartment complex are not securities.¹⁵ In so holding, the Court first expressly disapproved the literal approach, and then found that the transaction did not satisfy the *Howey* test.¹⁶ Since the Court's opinion was restricted to publicly owned cooperatives, *Jakobson* remained the precedent in the Second Circuit with respect to private cooperatives. Hence, prior to *Grenader*, a dichotomy existed in the Second Circuit—publicly owned cooperatives were not securities, whereas privately owned cooperatives apparently were.

In *Grenader*, members of a partnership that owned a 60-dwelling-unit residential apartment building agreed among themselves to sponsor and promote a plan converting the building into a cooperative. The conversion plan involved the formation of a corporation which would issue shares to the tenants and then use the capital derived from the sales to purchase the building from the partnership. Each purchaser would be required to subscribe to the number of shares allocated to his apartment unit and would thereby be entitled to a proprietary lease covering the premises. If a tenant decided to move out of the building, he would then have the right to sell his shares and the accompanying lease, subject to approval of the purchaser by the corporation, at whatever price the real estate market would permit. Contending that there were several misleading omissions in the offering statement,¹⁷ the tenants of 17 apart-

¹⁵ *United Hous. Foundation, Inc. v. Forman*, 421 U.S. 837 (1975), *rev'g sub nom.* *Forman v. Community Servs., Inc.*, 500 F.2d 1246 (2d Cir. 1974).

¹⁶ The Court rejected the Second Circuit's suggestion that the federal securities acts apply to a transaction evidenced by a sale of "stock," "simply because the statutory definition of a security includes the words 'any . . . stock.'" 421 U.S. at 848. Rather, the Court adhered to a principle which it maintained had guided all previous Supreme Court decisions in the securities area: "[I]n searching for the meaning and scope of the word 'security' in the Act[s], form should be disregarded for substance and the emphasis should be on economic reality." *Id.*, quoting *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967). Applying the *Howey* test, the Court found that the transaction did not involve a security. It concluded that purchasers were motivated solely by the prospect of acquiring a home, since the information bulletin distributed to prospective purchasers described the aesthetic advantages of cooperative apartment life and emphasized the nonprofit nature of the transaction. See 421 U.S. at 853-54. Furthermore, the three elements of income pronounced by the Second Circuit, see note 14 *supra*, were found not to be profits within the contemplation of *Howey*. Tax deductions for interest on a mortgage could have been taken by any homeowner; the low cost of the housing could not have been converted into cash; and rentals from facilities were too speculative and insubstantial. See 421 U.S. at 854-57. The Court noted that the profits element of the *Howey* test includes only capital appreciation or a participation in earnings. *Id.* at 852.

¹⁷ Plaintiffs alleged that the sponsors omitted to state or include in the offering statement: (1) that Jerome Spitz was a resident of California, thus failing to apprise prospective

ments, some of whom had actually purchased their apartments pursuant to the plan, commenced the instant action in federal district court. Their complaint alleged, *inter alia*, various violations of the registration and fraud provisions of the federal securities laws.¹⁸ Arguing that no security was involved in the transaction, the defendants¹⁹ moved for dismissal on the ground of lack of subject matter jurisdiction.²⁰

Based upon the Second Circuit's prior holding in *Jakobson*, the district court found that there was a sale of securities and thus it

purchasers that the intrastate exemption was inapplicable, and therefore, that the federal securities laws covered the offering; (2) the profits of each of the partners; (3) the amount of depreciation of the apartment building; and (4) a letter of adequacy with respect to the projected schedule of expenses for the first year of operation. 390 F. Supp. at 1119.

¹⁸ The plaintiffs contended that § 5 of the Securities Act, 15 U.S.C. § 77e (1970), requiring registration of any issuance of securities not specifically exempted, was violated since no registration statement for the shares had ever been filed with the SEC. Violations of the fraud provisions of the Acts, specifically § 17 of the Securities Act, 15 U.S.C. § 77q (1970), § 10(b) of the Exchange Act, 15 U.S.C. § 78j(b) (1970), and rule 10b-5, 17 C.F.R. § 240.10b-5 (1976), were also alleged. See 537 F.2d at 613-14. The basis for these violations were certain alleged omissions in the prospectus and offering plan. See note 17 *supra*. Additionally, the plaintiffs alleged common law fraud and violations of the filing requirements set forth in N.Y. GEN. BUS. LAW § 352-e(1)(a), (b) (McKinney 1968) (amended 1976). See 537 F.2d at 614.

¹⁹ Named as defendants were the former owners of the building (as sponsors of the conversion plan), the corporation organized to consummate the conversion, and the tenants who supported the plan.

²⁰ 537 F.2d at 614. Alternatively, the defendants contended that even were the federal securities laws applicable, the § 3(a)(11) intrastate exemption provided an affirmative defense to their failure to register the issue with the SEC. *Id.* Section 3(a)(11) of the Securities Act, 15 U.S.C. § 77c(a)(11) (1970), exempts from registration:

Any security . . . sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such State or Territory.

After declaring that the cooperative shares were securities, 390 F. Supp. at 1115-16, the district court found that the intrastate exemption was applicable, reasoning that: (1) the residence of the general partnership was in New York; (2) the partnership was doing business in New York since the financing was provided locally, the offering was made only to residents of the apartment, and its sole purpose was to create the cooperative housing corporation in New York; and (3) the plaintiffs failed to show that any offerees were nonresidents. *Id.* at 1116-18.

Nevertheless, the transactions were held to be subject to the antifraud provisions of the securities acts. *Id.* at 1118. Although Congress has exempted certain transactions in securities from registration, such transactions are still subject to the antifraud provisions of the Securities Act:

The legislative program against fraud and deception . . . is broader. Secs. 17 and 12(2) of the Act, respectively, render unlawful and authorize civil recovery for fraud and misrepresentation in the sale of securities even with respect to securities and security transactions which are exempted from the registration requirements.

Wilko v. Swan, 127 F. Supp. 55, 58 (S.D.N.Y. 1955). Similarly, the antifraud provisions of the Exchange Act apply to security transactions which are exempt from registration. See *Pawgan v. Silverstein*, 265 F. Supp. 898, 900-01 (S.D.N.Y. 1967).

had jurisdiction over the subject matter of the action.²¹ The plaintiffs moved for renewal and reargument.²² Before there was any disposition of this motion, the Supreme Court reversed the Second Circuit's decision in *Forman*.²³ Thereupon, the district court requested both parties to file briefs regarding the effect of *Forman* on the earlier *Grenader* decision. Nonetheless, Judge Stewart, who had authored the initial *Grenader* decision, affirmed his prior holding and distinguished the factual situation in *Grenader* from that considered by the *Forman* Court.²⁴ Determining that an immediate appeal would accelerate termination of the litigation, he then certified the following question for appellate review: Whether the shares of the defendant corporation were securities.²⁵

Initially, the Second Circuit, in an opinion written by Judge Mulligan for a unanimous bench, stated that the *Grenader* shares would unquestionably be securities under the holding of *Jakobson*.²⁶ The *Grenader* court, however, did not feel that *Jakobson* could be dispositive of this issue. Construing *Jakobson* as being based strictly on a literal approach, Judge Mulligan concluded that it was no

²¹ 390 F.Supp. at 1115-16. Once it found that a "security" existed, the district court in *Grenader* cited § 22 of the Securities Act, 15 U.S.C. § 77v (1970), and § 27 of the Exchange Act, 15 U.S.C. § 78aa (1970), both of which confer jurisdiction upon the federal courts for violations of the Acts.

²² *Grenader v. Spitz*, No. 72-3784 (S.D.N.Y. Sept. 29, 1975).

²³ For a discussion of the Supreme Court's holding in *Forman*, see notes 15-16 and accompanying text *supra*.

²⁴ Judge Stewart concluded that the shares in question were distinguishable from those in *Forman* in many respects. Noting that the Supreme Court found a number of the traditional characteristics of "stock" lacking in the Co-op City shares, he felt that the *Grenader* shares possessed factors common to most stocks:

Apartment owners here have voting rights in proportion to the number of shares they own, and the number of shares owned is different for each apartment. . . . [T]he shares here may be and have been sold at a profit. . . . [T]hey are more freely transferable than the Co-op City Shares. . . . Here, by contrast, tenants purchased shares with the dual motives of obtaining housing and realizing a profit on their investments.

No. 72-3784, slip op. at 6 (S.D.N.Y. Sept. 29, 1975).

Judge Stewart also believed that, unlike the *Forman* shares, the *Grenader* shares were investment contracts.

Here the situation is different. Tenants . . . sought both housing and profits, the profits to be derived from the managerial efforts of the sponsor and the apartment corporation. To the extent that they utilized their resources and skills in efficiently managing the building, maintaining it in good condition, and attracting desirable tenants, they enabled the tenants to obtain profits as a result of the appreciation in their property.

Id. at 7.

²⁵ *Id.* at 8.

²⁶ 537 F.2d at 616.

longer viable in view of the antiliteralist language of *Forman*.²⁷ Therefore, pursuant to the Supreme Court's mandate in *Forman*, the court examined the economic realities of the transaction, applying the *Howey* test to determine whether the offering of the *Grenader* shares involved a security. Emphasizing that the purchasers of the cooperative apartments were primarily interested in obtaining a residence and any profit motives were merely incidental, the Second Circuit found that the "led to expect profits" element of the *Howey* test was not satisfied.²⁸ Additionally, the court found that any appreciation in value would arise from the "general housing market, the status of the neighborhood and the availability of credit."²⁹ Thus, Judge Mulligan found that the transaction did not meet the "solely from the efforts of others" prong. Accordingly, the court held that the shares in the cooperative apartment were not securities within the definition provided by the federal securities laws.

It is evident that the *Grenader* court, in reasoning that *Jakobson* was based solely on a literal approach, misinterpreted the rationale of that decision. Even a cursory reading of *Jakobson* reveals that the Second Circuit held that the sale of shares in a privately owned and operated cooperative constitutes an investment contract under the *Howey* test,³⁰ as well as under the literal approach. It is submitted, moreover, that the *Grenader* court applied the *Howey* test superficially and, in effect, simply extended the *Forman* result to the private cooperative before it. While it may be true that not all private cooperatives are securities, when the sale of shares in a private cooperative apartment satisfies the *Howey*

²⁷ *Id.* at 616-17.

²⁸ *Id.* at 616-19.

²⁹ *Id.* at 619, citing Berman & Stone, *Federal Securities Law and the Sale of Condominiums, Homes and Homesites*, 30 Bus. Law. 411, 422-24 (1975).

³⁰ Judge Mulligan, in *Grenader*, stated:

There is no doubt that the shares of stock involved here would be deemed securities within the federal securities acts under the holding of this court in *1050 Tenants Corp. v. Jakobson* However, Judge Timber's opinion there was premised upon the so-called "literal" approach

537 F.2d at 616 (citation and footnote omitted). In so stating, however, Judge Mulligan clearly missed the full import of the *Jakobson* rationale. Judge Timbers, in *Jakobson*, stated:

First, we ground our decision on what has been characterized as the "literal approach". . . . The structure of 1050 Corp. is more closely analogous to that of corporations whose stock unquestionably is a "security". . . .

Secondly, we hold, as we did in *Forman*, that the sale of a cooperative share constitutes the sale of an "investment contract" under the three pronged test formulated by the Supreme Court in *SEC v. W. J. Howey Co.*

503 F.2d at 1378 (citations and footnote omitted).

test, such a transaction should be held to involve a security.

The first element of the *Howey* test, a common enterprise, was not discussed by the *Grenader* court. It appears, however, that the commonality element in cooperative housing³¹ has been generally conceded to exist.³² Discussing the second element of the *Howey* test, Judge Mulligan declared that the "solely from the efforts of others" prong had not been satisfied because the appreciation of the cooperative depended primarily on conditions beyond the control of management.³³ It is submitted, however, that external factors are always present and bear upon any type of security transaction.³⁴ Had the *Grenader* court properly applied the solely element of the *Howey* test, it would have ignored external variables and determined whether it was the activities of the promoters as opposed to those of the investors which were to lead to the realization of profits. Viewed thusly, the promoters of the cooperative, through management and maintenance of the building, normally have a direct and substantial impact on the cooperative's appreciation in value,³⁵

³¹ A common enterprise has been defined as "one in which the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties." SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476, 482 n.7 (9th Cir.), cert. denied, 414 U.S. 821 (1973); accord, SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 478-79 (5th Cir. 1974). Once it is established that the proceeds from the sale of shares in a private cooperative apartment are to be used by the promoters to effect a return on the purchaser's investment, a common enterprise necessarily exists. For a discussion of the effect of the promoters' efforts on the appreciation in value of the cooperative, see note 35 and accompanying text *infra*.

³² See, e.g., 1050 Tenants Corp. v. Jakobson, 503 F.2d 1375 (2d Cir. 1974). The *Jakobson* court was of the opinion that "[t]he 'common enterprise' element is too plain to warrant discussion." *Id.* at 1378. One commentator maintains that a common scheme or plan is one of the "essential features" of a cooperative. Note, *Cooperative Housing Corporations and the Federal Securities Laws*, 71 COLUM. L. REV. 118, 128 (1971) [hereinafter cited as *Cooperative Housing*]. See also Miller, *Cooperative Apartments: Real Estate or Securities?*, 45 B.U.L. REV. 465, 467 (1965) ("It is easy to prove a common enterprise . . .") [hereinafter cited as Miller].

³³ 537 F.2d at 619; see text accompanying note 29 *supra*.

³⁴ The value of a share of stock traded on a national exchange will depend to some extent upon the general confidence of the investor in the stock market, an external factor clearly not within the control of the seller. Even more relevant to cooperative apartments is the situation presented in *Howey*, discussed in note 6 *supra*. The value of the citrus groves offered in that case certainly was affected by both Florida real estate values and the national citrus market.

³⁵ It is clear that promoters perform vital functions in the preliminary stage of the cooperative. In *Jakobson*, the lower court found the requisite reliance of the tenants on the promoter's expertise since the promoters had made all the initial financing arrangements, drafted the guidelines for corporate operations, and entered into various long term contracts on behalf of the cooperative. 365 F. Supp. at 1176-77. One commentator maintains, however, that the *Jakobson* district court misapplied the *Howey* test by focusing on the conversion rather than the management stage. 62 GEO. L.J. 1515, 1524-26 (1974). Nevertheless, he con-

whereas the tenant-shareholders, each owning only a small proportion of the aggregate number of shares, in actuality make little, if any, contribution to profit realization.³⁶ Therefore, it is submitted

cedes that if the developers exercise "substantial control over the operational as well as the developmental stages of a cooperative," a sale of securities may be found. *Id.* at 1526. That the requisite managerial involvement frequently exists in the cooperative setting is illustrated by another author's comments:

[M]ost of the important decisions have been conclusively made by the sponsor before the board of directors begins to function and are not subject to change. Such decisions include the allocation of shares, the financing arrangements, long-term commercial leases, and long-term service contracts. Indeed, the actual management is often provided for by a long-term management contract, again arranged by the sponsor. Finally, the shareholder's control of the board of directors is often tenuous at best, since it is common for the sponsor to retain significant control over the Board by allocating board seats to unsold shares that, if not remaining under his direct control, are sold to purchasers produced by the sponsor-purchasers, one might assume, who are likely also to be controlled by the sponsor When one considers all the decisions actually made by the sponsor for the corporation, the board of directors is left only with a small amount of residual power. The necessary conclusion, on the basis of control, is that most cooperative shares are securities.

Cooperative Housing, *supra* note 32, at 128-29 (footnotes omitted). *Cf.* *Sire Plan Portfolios, Inc. v. Carpentier*, 8 Ill. App. 2d 354, 359, 132 N.E.2d 78, 80 (1956) (solely element met where sellers managed building and leased apartments on behalf of nonresident owners).

Many of these continuing managerial factors were alleged by the plaintiffs in *Grenader*. By the terms of the offering plan, the apartment corporation was required to take the building subject to a mortgage maturing five years after the initial closing date. Additionally, the corporation was obligated to take title subject to a 20-year purchase money mortgage. *See* Offering Plan, Plaintiff's Exhibit A, *Grenader v. Spitz*, 390 F. Supp. 1112, (S.D.N.Y. 1975), at 19-21. The closing date also marked the commencement of a two-year management agreement, which the corporation was bound to enter into with the selling agent. Services under the management contract were to include: billing and collecting rent; hiring and firing employees; supervising maintenance and repairs; purchasing supplies; paying mortgage charges; maintaining records; and furnishing financial reports to the tenants. *Id.* at 26. Other agreements "made or to be made by the Sponsor that will be binding on the Apartment Corporation," *id.* at 26, included a union contract expiring two years after the initial closing date, a laundry concession terminating four years after the initial closing date, and short term exterminating, elevator, and water service contracts. *Id.* at 26-28.

Moreover, there existed a definite possibility of continuing control over the corporation by the sponsor, who was to present a buyer for any unsold shares. Any such buyer was to have the right to dispose of these shares subject only to the consent of the sponsor. *See id.* at 22-23. Finally, neither any of the officers of the corporation, except the president, nor any of the board of directors were required to be shareholders. Therefore, it seems that the promoters in *Grenader* had a potentially tremendous degree of control over the cooperative, at least during its operational stages.

³⁶ The interpretation of the solely requirement has divided the courts. Some have read the word solely in its literal sense. Consequently, where the purchaser was required to make some efforts, even though minimal, these courts have not found an investment contract to be present. *See, e.g.,* *Gallion v. Alabama Mkt. Centers, Inc.*, 282 Ala. 679, 213 So. 2d 841 (1968) ("founders contracts" under pyramid sales scheme not a security); *Georgia Mkt. Centers, Inc. v. Fortson*, 225 Ga. 854, 171 S.E.2d 620 (1969) (investors who distributed purchase authority cards to potential customers did not own a security).

Other courts have refused to construe the solely test literally. These courts have found

that this element of the *Howey* test was satisfied.

Finally, finding nothing in the record demonstrating that the tenants were "led to expect profits," the *Grenader* court found the "profits" element of the *Howey* test to be lacking.³⁷ The court analyzed the offering plan and found that it was "barren of any . . . intimation of anticipated profits."³⁸ It is submitted, however, that the offering plan did lead purchasers to expect profits. The plan not only described the physical features of the building and apartments, but also provided a recitation of the financial facts pertaining to the transaction.³⁹ While this differs from the traditional offering plan which outlines the issuer's potential for profits, it nevertheless attempted to convey the soundness of the business, or, in this case, the subject property. It certainly is distinguishable from the offering plan in *Forman*, which emphasized "a favorable environment for family and community living."⁴⁰

the central issue to be "whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise." *SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973). Most courts have since used the flexible approach of *Turner*. See, e.g., *McCown v. Heidler*, 527 F.2d 204, 211 (10th Cir. 1975) ("reliance of the investor on the promoter need not be total"); *Bitter v. Hoby's Int'l, Inc.*, 498 F.2d 183, 184 (9th Cir. 1974) ("the focus [is] on the extent of participation"); *Lino v. City Investing Co.*, 487 F.2d 689, 692 (3d Cir. 1973) ("an investment contract can exist where the investor is required to perform [nominal] duties"); *Nash & Assocs., Inc. v. Lum's, Inc.*, 484 F.2d 392, 396 (6th Cir. 1973) ("We find . . . less restrictive approach attractive in view of the broad remedial purposes of the federal legislation . . ."); *SEC v. Brigadoon Scotch Distribs., Ltd.*, 388 F. Supp. 1288, 1292 (S.D.N.Y. 1975) ("'Solely' is not to be read literally.").

Tenant-shareholders in a cooperative do not necessarily exert sufficient control over the ongoing management of the cooperative to negate the solely element. *Cf. Sire Plan Portfolios, Inc. v. Carpentier*, 8 Ill. App. 2d 354, 132 N.E.2d 78 (1956). As described by one commentator:

Most important of all, in the ideal cooperative the tenant-owners share control. Reality, however, again contradicts the ideal. For instance: the FHA has provisions for ousting boards of directors who fail to operate the cooperative at FHA standards; promoters make binding agreements with management companies to carry on the business of the cooperative for periods up to five years, which agreements are made binding on the shareholder-buyers through clauses inserted in purchase contracts; promoters also assure themselves places on boards of directors for stated periods of time or for so long as a specific percentage of the stock in the cooperative apartment corporation remains unsold.

Miller, supra note 32, at 473 (footnote omitted). *But see* 62 GEO. L.J. 1515, 1525 (1974).

It appears, therefore, that the tenant-shareholders in *Grenader*, who collectively possessed 7000 shares and occupied a 60-unit apartment building and were limited in the control they could exert over the cooperative, see note 35 *supra*, were not in a position to exercise "those essential managerial efforts which affect the failure or success of the [cooperative]." *SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

³⁷ 537 F.2d at 618-19.

³⁸ *Id.*

³⁹ See Brief for Plaintiffs-Appellees at 18-24.

⁴⁰ 421 U.S. at 854.

Judge Mulligan also reasoned that the purchasers merely sought to retain their residence and avoid eviction, since the building, once it became a cooperative, would no longer be protected by rent control and rent stabilization laws.⁴¹ It is arguable, however, that the rationale of the court overemphasizes the actual plight of tenants when presented with a conversion plan. Since New York State law mandates that a certain percentage of tenants must approve the plan before it becomes effective,⁴² the danger of eviction does not arise until tenant approval approaches the required percentage. Not until this point do tenants act in fear of losing their residences.⁴³ Common sense dictates that the initial tenants who purchased into the cooperative did not act out of a desire to obtain a residence; they already occupied the very apartment which they later owned. Rather, it is submitted that the initial purchasers in *Grenader* were motivated to a great extent by economic considerations. The plaintiffs alleged that tenant-purchasers of over 15 percent of the total shares resold their shares for a substantial profit.⁴⁴ It was also alleged that other tenant-purchasers rarely occupied their apartments and were in the process of reselling their shares.⁴⁵ The *Grenader* court itself stated, although in a different context, that "the proprietary lessee of a privately owned cooperative cannot be unconscious of the fact that upon its disposal he will gain or lose"⁴⁶

Assuming, *arguendo*, that some purchasers were motivated by

⁴¹ 537 F.2d at 617.

⁴² The attorney general is prohibited from accepting the filing of a formal prospectus where the plan of conversion does not require 35% tenant approval and include a one-year limitation on obtaining such approval. N.Y. GEN. BUS. LAW § 352-e(2-a)(1)(i)-(ii) (McKinney Supp. 1976).

⁴³ In *Gilligan v. Tischman Realty & Constr. Co.*, 283 App. Div. 157, 126 N.Y.S.2d 813 (1st Dep't 1953), *aff'd mem.*, 306 N.Y. 974, 120 N.E.2d 230 (1954), the court spoke of the tenants' fear in another context:

Obviously, the most obsessing fear of a tenant confronted with a co-operative proposal, and the most paralyzing weapon in the arsenal of the promoter, is the possibility that the necessary percentage of the tenants will purchase stock and that immediate application will be made for the eviction of the nonpurchasing tenants. . . . [I]f they feel that substantial progress is being made toward procuring the dreaded [percentage], many will perforce capitulate.

283 App. Div. at 162, 126 N.Y.S.2d at 818; *accord*, *Richards v. Kaskel*, 32 N.Y.2d 524, 537, 300 N.E.2d 388, 394, 347 N.Y.S.2d 1, 9-10 (1973).

⁴⁴ See Brief for Plaintiffs-Appellees at 29-32.

⁴⁵ *Id.* at 32. It was further alleged that one purchaser, acting on behalf of the sponsor, bought the shares allocated to the apartments of the nonpurchasing tenants (approximately 30% of the aggregate shares) and soon thereafter reoffered them at a 170% profit. *Id.* at 25-29.

⁴⁶ 537 F.2d at 618.

the economic benefits accompanying conversion to a private cooperative,⁴⁷ the question becomes whether these benefits were of the type contemplated by the term "profits" in the *Howey* formula. The plaintiffs in *Grenader* asserted that the right to sell their shares and apartments at whatever price the market would permit satisfied the profit element. In reply to this contention, the *Grenader* court simply stated "that the opinion of Mr. Justice Powell in *Forman* is definitive."⁴⁸ It is extremely difficult, however, to reconcile this reply of the *Grenader* court with the plain words of the *Forman* opinion. The *Forman* Court explicitly stated that the presence of capital appreciation satisfied the profit component of the *Howey* analysis.⁴⁹ Unlike the situation in *Forman*, where the corporation had the right of first refusal at the original purchase price and there was no possibility of a tenant receiving any profit from capital appreciation,⁵⁰ in *Grenader* there was a very real possibility that the

⁴⁷ It is important to note that the *Howey* test applies even though not all purchasers were motivated by investment considerations. In *Howey*, some purchasers never entered into the service contracts offered by the promoters. The *Howey* majority stated, however, that its conclusion that an investment contract was present

is unaffected by the fact that some purchasers choose not to accept the full offer of an investment contract The Securities Act prohibits the offer as well as the sale of unregistered, non-exempt securities. Hence it is enough that the respondents merely offer the essential ingredients of an investment contract.

328 U.S. at 300-01 (footnote omitted). Similarly, in *McCown v. Heidler*, 527 F.2d 204 (10th Cir. 1975), some purchasers of land intended to build a home thereon, while others intended to hold the property solely as an investment. The court felt that this "merely indicates the duality of this 'investment/ownership package.'" *Id.* at 211.

⁴⁸ 537 F.2d at 618. Judge Mulligan, in further support of his conclusion, equated the tenant's expectation of profit to that of any homeowner. Unquestionably, the sale of a home does not involve an investment contract regulated by the federal securities laws. The reason it is not a security, however, is not necessarily because the element of profit is missing, but rather because any potential appreciation in the value of the home comes from the efforts of the homeowner himself and the general condition of the neighborhood. Thus, the "solely from the efforts of others" requirement is unfulfilled. It is submitted that in a cooperative apartment this element of the *Howey* test is satisfied. See notes 34-36 and accompanying text *supra*.

An analogous argument was presented by the dissenters in *Forman* to rebut the majority's conclusion that tax benefits accruing to a tenant in a cooperative are equivalent to those taken advantage of by a homeowner. Justice Brennan contended that "[t]he difference is that the profit of the individual homeowner does not 'come solely from the efforts of others,' whereas the profit from this source realized by a resident of Co-op City does." 421 U.S. at 862 (Brennan, J., dissenting). The dissent, however, could not convince the *Forman* majority that tax advantages should be deemed "profits" under the *Howey* test. Justice Powell, the author of the majority opinion, stated: "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." *Id.* at 855 (footnote omitted).

⁴⁹ 421 U.S. at 852.

⁵⁰ *Id.* at 842.

tenants would receive profit from capital appreciation.⁵¹

In *Grenader v. Spitz*, the Second Circuit achieved a uniformity in its decisions regarding the applicability of the federal securities laws to cooperative apartment shares. It is highly questionable, however, whether an all-inclusive exclusion of such shares is warranted. Neither the congressional intent behind the Acts nor the Supreme Court decision in *Forman* mandated such a result. Indeed, the Supreme Court in *Howey* stated that the legislative history of the Acts indicates that the definition of an investment contract must be interpreted to adapt "to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."⁵² Additionally, the Court's emphasis on substance over form suggests that in some cooperative housing situations the economic realities underlying the transaction will require the protection of the federal securities laws. It is submitted that in *Grenader* the transaction fell within the definition of an investment contract, and thus the investors should have been afforded the protection of the federal securities laws.⁵³

Douglas Morea

BANK LOANS AS SECURITIES

Exchange National Bank v. Touche Ross & Co.

Plaintiffs who have incurred financial losses in business transactions often attempt to gain redress in the federal courts through the antifraud provisions of the Securities Act of 1933¹ and the Securities Exchange Act of 1934.² Where the allegedly fraudulent transac-

⁵¹ See notes 44-45 and accompanying text *supra*.

⁵² 328 U.S. at 299, citing H.R. REP. NO. 85, 73d Cong., 1st Sess. 11 (1933).

⁵³ Without the protection of the federal securities laws, cooperative apartment shareholders are shielded from abuse only by state laws which many commentators consider inadequate. A majority of the states have either refused to pass laws designed to curb abuses of cooperative apartment housing or have simply extended their securities laws, many of which have been interpreted restrictively. See *Cooperative Housing*, *supra* note 32, at 122. One authority, commenting upon the inadequacy of state securities laws, has stated, "[t]hese statutes, however, seem to have failed in curbing most abuses, primarily because of inadequate regulations and incomplete statutory summaries in their required prospectuses." *Id.* (footnote omitted); cf. Miller, *supra* note 32, at 486-89 (New York regulatory scheme inadequate).

¹ Securities Act of 1933, § 17(a), 15 U.S.C. § 77q(a) (1970).

² Securities Exchange Act of 1934, § 10, 15 U.S.C. § 78j(b) (1970); 17 C.F.R. § 240.10b-5 (1976).