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## Securities Law

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# SECURITIES LAW

## PROFITS IN PARADISE: WHEN RESORT CONDOMINIUMS QUALIFY AS INVESTMENT CONTRACTS

### I. INTRODUCTION

In *Hocking v. Dubois*,<sup>1</sup> the Ninth Circuit held that where an arrangement to sell a condominium included an option to participate in a rental pool arrangement (“RPA”), the arrangement constituted an investment contract.<sup>2</sup> Consequently, what appeared to be a simple sale of real estate was subject to the provisions of the federal securities laws<sup>3</sup> including the antifraud provisions of Rule 10b-5.<sup>4</sup> This note will examine the rationale supporting the Ninth Circuit’s application of securities law to condominium sales, examine the application of rules limiting private causes of action, and analyze the issues presented by the facts of *Hocking*.

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1. 839 F.2d 560 (9th Cir.) (per Reinhardt, J.; the other members of the panel were Goodwin and Hug, JJ.), *reh’g granted en banc*, 852 F.2d 503 (1988).

2. *Id.* at 563.

3. The securities laws discussed in this note include the Securities Act of 1933, 15 U.S.C. §§ 77a-77z (1982 & Supp. IV 1986) (“1933 Act”) and the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78kk (1982 & Supp. IV 1986) (“1934 Act”).

4. 17 C.F.R. § 240.10b-5 (1988). *See infra* note 161. Rule 10b-5 was promulgated under § 10b of the 1934 Act, 15 U.S.C. § 78b (1982), *see infra* note 159.

Although not mentioned in the Ninth Circuit’s opinion, *Hocking* also sought to recover damages for violations of § 5 of the 1933 Act, 15 U.S.C. § 77e (1982), *see infra* note 184; § 12 of the 1933 Act, 15 U.S.C. § 77l (1982), *see infra* note 183; and § 17 of the 1933 Act, 15 U.S.C. § 77q (1982), *see infra* note 190. *See* Appellant’s Opening Brief at 2, *Hocking*, 839 F.2d 560 (9th Cir.) (No. 85-1932), *reh’g granted en banc*, 852 F.2d 503 (1988).

## II. FACTS

While visiting Hawaii, Gerald Hocking became interested in buying a Hawaiian condominium as an investment.<sup>5</sup> When he returned to his home in Las Vegas, he met with Maylee Dubois, a real estate agent licensed in Hawaii and employed by a Hawaiian real estate brokerage firm.<sup>6</sup> Dubois agreed to help Hocking find a suitable unit.<sup>7</sup> Dubois found such a unit offered for sale by Tovick and Yaacov Liberman.<sup>8</sup>

The condominium unit was located in a resort complex developed by Aetna Life Insurance Company ("Aetna").<sup>9</sup> As part of the original development, Aetna had offered the Libermans an opportunity to participate in an RPA in which an agent of Aetna<sup>10</sup> was responsible for renting and managing the units.<sup>11</sup> The RPA pooled income earned on the rental of condominium units owned by participants.<sup>12</sup> Each owner received a pro rata share of income and expenses regardless of whether his unit was actually rented.<sup>13</sup> The RPA was optional and the Libermans had elected not to participate.<sup>14</sup> Prior to the sale, Dubois advised Hocking of the existence of the RPA and that it was available to individuals owning condominiums in the resort complex.<sup>15</sup> Hock-

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5. *Hocking*, 839 F.2d at 563.

6. *Id.*

7. *Id.*

8. *Id.* Hocking asserts that he initially believed that he was purchasing the condominium unit as a first purchaser from the developer. Appellant's Brief On Rehearing En Banc at 4, *Hocking*, (9th Cir. Dec. 7, 1988) (No. 85-1932). While Hocking later became aware that he was a second purchaser, he still believed that he was dealing with an RPA company provided by the developer. *Id.*

9. *Hocking*, 839 F.2d at 563.

10. *Id.* The court noted that the record was not clear as to the exact relationship between Hotel Corporation of the Pacific and the developer, Aetna. *Id.*

11. *Id.*

12. *Id.* at 563 n.2.

13. *Id.*

14. *Id.* at 563.

15. *Id.* Dubois denied that the offer included an option to participate in an RPA. *Id.* at 562 n.1. The district court did not make a finding with regard to the offer but ordered summary judgment for defendant on the ground that a condominium did not constitute a security if the RPA was optional. *Id.* The Ninth Circuit reversed, holding that for purposes of summary judgment, an issue of material fact was raised as to whether the offer to Hocking included an option to participate in an RPA because Hocking's affidavits indicated that he had been informed of the availability of the RPA by Dubois and that he would not have purchased the condominium without an option to participate in an RPA. *Id.* The Ninth Circuit then remanded the case to the district court to determine

ing purchased the Libermans' condominium unit and subsequently entered into a rental management agreement and RPA<sup>16</sup> with Hotel Corporation of the Pacific.<sup>17</sup>

Hocking filed suit in federal court against Dubois and her employer, Vitousek & Dick Realtors, Inc., alleging various acts of fraud<sup>18</sup> by Dubois in inducing Hocking to purchase the condominium unit and in services she performed or failed to perform thereafter.<sup>19</sup> Hocking alleged violations of the antifraud provisions of Rule 10b-5<sup>20</sup> of the Securities Exchange Act of 1934 ("1934 Act")<sup>21</sup> as well as violations of section 5,<sup>22</sup> section 12,<sup>23</sup> and section 17<sup>24</sup> of the Securities Act of 1933 ("1933 Act").<sup>25</sup> He also alleged state law claims of fraud, negligence and breach of fiduciary duty.<sup>26</sup> The district court held that it lacked subject matter jurisdiction because no security was involved, granted summary judgment for defendants and dismissed the pendent state claims.<sup>27</sup> Hocking appealed.<sup>28</sup>

The Ninth Circuit reversed, holding that the condominium and RPA qualified as an investment contract.<sup>29</sup> The Ninth Cir-

whether the offer had in fact included an option to participate in an RPA. *Id.*

16. *Id.* at 563. The sale was completed June 23, 1979 and the agreements with Hotel Corporation of the Pacific were executed on July 5, 1979. *Id.* The agreements included a rental management agreement, apparently effective immediately and an RPA effective six months later. *Id.*

17. *Id.*

18. Hocking alleged five different misrepresentations by Dubois. Joint Brief of Appellees Maylee Dubois and Vitousek & Dick Realtors, Inc. On Rehearing *En Banc* at 22-23, *Hocking*, (9th Cir. Dec. 7, 1988) (No. 85-1932). Hocking alleged that Dubois misrepresented that Hocking would be the first purchaser from the developer of the Condominium. *Id.* at 23. Hocking alleged that Dubois misrepresented the value of the condominium, stating that it had a value of \$135,000 when the value was much less. *Id.* The three other misrepresentations were made two years later and involved the listing of Hocking's condominium for resale. *Id.*

19. *Hocking*, 839 F.2d at 563.

20. 17 C.F.R. § 240.10b-5 (1988). *See infra* note 161.

21. Rule 10b-5 is promulgated under § 10b of the 1934 Act, 15 U.S.C. § 78j (1982). *See infra* note 159.

22. 15 U.S.C. § 77e (1982). *See infra* note 184.

23. 15 U.S.C. § 77l (1982). *See infra* note 183.

24. 15 U.S.C. § 77q (1982). *See infra* note 190.

25. *See* Appellant's Opening Brief at 2, *Hocking*, 839 F.2d 563 (9th Cir. 1988) (No. 85-1932).

26. *Hocking*, 839 F.2d at 563.

27. *Id.* at 562-63.

28. *Id.*

29. *Id.* at 563.

cuit has ordered that the case be reheard en banc.<sup>30</sup>

### III. BACKGROUND

#### A. DEFINITION OF INVESTMENT CONTRACT

##### 1. The *Howey* Economic Reality Test

The definitions of security provided by Congress in the 1933 Act<sup>31</sup> and the 1934 Act<sup>32</sup> list a host of transactions and are intended to give the federal securities laws the broadest possible scope.<sup>33</sup> By authorizing an expansive interpretation of the term

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30. *Hocking v. Dubois*, 852 F.2d 503 (9th Cir. 1988).

31. The term "security" is defined in § 2(1) of the 1933 Act, 15 U.S.C. § 77b(1) (1982), as follows:

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 of 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, guarantee of, or warrant or right to subscribe or purchase, any of the foregoing.

32. The term "security" is defined in § 3(a)(10) of the 1934 Act, 15 U.S.C. § 78c(a)(10) (1982), as follows:

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

33. Congress cast the definition of security "in sufficiently broad and general terms so as to include the many types of instruments that fall in our commercial world within the ordinary concept of security." *Hocking v. Dubois*, 839 F.2d at 560, 563 (9th Cir.) (quoting H.R. Rep. No. 85, 73 Cong., 1st Sess. 11 (1933)), *reh'g granted en banc*, 852 F.2d 503 (1988). The remedial purposes of the 1933 Act were "to prevent further exploitation of the public by the sale of unsound, fraudulent and worthless securities through misrepresentation; to place adequate and true information before the investor;

“security,” Congress sought to prevent fraudulent promoters from eluding the provisions of the securities laws through “countless and variable schemes”<sup>34</sup> that utilize technical distinctions in the form of the investment opportunity offered.<sup>35</sup> The principal catchall provision in the definitional sections of both the 1933 Act and the 1934 Act, and consequently, the provision that generates the most litigation, is the term “investment contract.”<sup>36</sup>

The definition of the term “investment contract” was developed by state courts in litigation involving “blue sky laws.”<sup>37</sup> While neither the 1933 Act, the 1934 Act, nor the state blue sky laws defined an investment contract,<sup>38</sup> state courts defined the term as a contract or scheme for the placing of capital or laying out of money in a way intended to secure income or profits from its employment.<sup>39</sup> The state courts emphasized economic reality and substance over form by broadly construing the definition of investment contract to afford the public a full measure of

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and to protect honest enterprise seeking capital from the competition afforded by dishonest securities offered to the public through crooked promotion.” *Hocking*, 839 F.2d at 564 n. 3 (quoting S. Rep. No. 47, 73d Cong., 1st Sess. 1 (1933)).

34. *Hocking*, 839 F.2d at 564 (quoting *SEC v. W.J. Howey Co.*, 328 U.S. 293, 299 (1946)).

35. *Id.*

36. Karjala, *Federalism, Full Disclosure, and the National Markets in the Interpretation of Federal Securities Laws*, 80 *Nw. U.L. Rev.* 1473, 1507 (1986). While the term “certificate of interest or participation in any profit sharing agreement” also qualifies as a general catchall provision in the definitional sections of the 1933 Act and the 1934 Act, it has been treated identically to the term investment contract. *Id.* at 1507 n.138.

37. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298 (1945). Certain state statutes were termed “Blue Sky Laws” because their provisions were aimed at regulating speculative investment schemes that had no more basis than so many feet of blue sky. *State v. Gopher Tire & Rubber Co.*, 146 Minn. 52, 56, 177 N.W. 937, 938 (1920). The “Blue Sky Laws predated either the 1933 Act or the 1934 Act. *See, e.g., Id.* (*Gopher Tire* decided in 1920).

38. *Howey*, 328 U.S. at 298.

39. *Gopher Tire*, 146 Minn. at 56, 177 N.W. at 938 (certificate entitling holder to commission from the sale of tires was an investment contract because it involves the laying out of money to secure profit from its employment as an investment).

As the definition of investment contract evolved, the blue sky laws were applied wherever individuals were led to invest money in a common enterprise with the expectation that they would earn a profit solely through the efforts of the promoter or of some one other than themselves. *Howey*, 328 U.S. at 298. The definition developed by the blue sky laws and adopted by *Howey* is now considered to be the classic definition of an investment contract. *Id.* *See Hocking*, 839 F.2d at 564.

protection.<sup>40</sup>

There are two fundamental types of real estate investments that can qualify as investment contracts. The first category consists of investments in land that are expected to appreciate in value as neighboring parcels are improved. The second category consists of investments in land that can be managed to produce crops or rental income.

The United States Supreme Court examined the first category of real estate investment in *SEC v. C. M. Joiner Leasing Corp.*,<sup>41</sup> where assignments of oil leases sold in conjunction with a promise to drill a nearby test well were held to qualify as investment contracts.<sup>42</sup> The Court did not attempt to define an

40. *Howey*, 328 U.S. at 298. *Howey* cited the following state court decisions as finding investment contracts to exist in a variety of situations where individuals were led to invest money in a common enterprise with the expectation that they would earn a profit solely through the efforts of the promoter or a third person: *Moore v. Stella*, 52 Cal. App. 2d 766, 127 P.2d 300 (1942) (agreement to sell mineral rights is an investment contract if investors were led to expect that they would lease the rights to an oil company sometime in the future); *Klatt v. Guaranteed Bond Co.*, 213 Wis. 12, 250 N.W. 825 (1933) (oral agreement to purchase bonds and payment in cash or property constitutes contract for purchase or sale); *People v. White*, 124 Cal. App. 548, 12 P.2d 1078 (1932) (contract promising payment of \$7,500 one year after investment of \$5,000 as earnings from purchase and resale of trust deeds, bankrupt stocks, and foreclosures was investment contract); *Stevens v. Liberty Packing Corp.*, 111 N.J. Eq. 61, 161 A. 193 (1932) (contract to lease rabbits and buy back offspring is security); *State v. Heath*, 199 N.C. 135, 153 S.E. 855 (1930) (contract to use vendor's copyrighted realty transfer system and to receive 80% of receipts not a certificate of interest in a profit sharing agreement); *State v. Evans*, 154 Minn. 95, 191 N.W. 425 (1922) (installment contract to purchase land subject to various surrender options held to be an investment contract). *Howey*, 328 U.S. at 298 n.4.

41. 320 U.S. 344 (1943). In *Joiner*, defendants distributed literature offering to sell assignments of oil and gas leases. As part of the sale, defendants promised to drill a test well that would test the oil-producing possibilities of the offered leaseholds. *Id.* at 346.

42. *Id.* at 351. The SEC brought an action in district court to restrain C. M. Joiner Leasing Corp. from further violation of § 5(a) of the 1933 Act, 15 U.S.C. § 77e(a) (1982) (prohibiting use of the mails in the offer and sale of unregistered and non-exempt securities), *infra* note 186, § 17(a)(2) of the 1933 Act, 15 U.S.C. § 77q(a)(2) (1982) (prohibiting fraud in connection with an offer of the sale of securities), *infra* note 190 and § 17(a)(3) of the 1933 Act, 15 U.S.C. § 77q(a)(3) (1982) (prohibiting fraud in connection with an offer of the sale of securities), *infra* note 190. *Joiner*, 320 U.S. at 345. The district court and the Court of Appeals for the Fifth Circuit both found evidence of fraud concerning the location of the properties with respect to the producing territory, *Id.* at 347 n. 4, but refused to order an injunction on the ground that the leases did not qualify as securities and therefore were not covered by the 1933 Act. *Id.* at 347-48.

The Supreme Court held that the undisputed facts seemed to establish the conclusion that defendants were not, as a practical matter, offering naked leasehold rights. *Id.* at 348. Acceptance of the offer made a contract in which payments were timed and con-

investment contract, but indicated that the term should be given an expansive interpretation<sup>43</sup> emphasizing the economic substance of a given transaction rather than its form.<sup>44</sup> Since the literature distributed by Joiner characterized the purchase as an investment and as participation in an enterprise,<sup>45</sup> the Court found the offer to contain the evil inherent in the types of security transactions which the 1933 Act was intended to prevent.<sup>46</sup> The Court refused to exclude the oil lease transactions from the scope of the 1933 Act merely because they were interests in real property.<sup>47</sup> The Court noted that in construing the securities laws, trial courts have not been guided by the nature of the assets underlying a particular document.<sup>48</sup> According to the Court in *Joiner*, an investment contract is identified by 1) the character that the instrument is given in commerce, 2) the plan of distribution, and 3) the terms of the offer and the economic induce-

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tingent upon completion of the well. *Id.* at 349. The sales literature made no mention of drilling conditions which the purchaser would meet or costs which he would incur if he attempted to develop his own property. *Id.* at 346. The literature assured the prospect that the Joiner Company would complete the drilling of test wells so located as to test the oil-producing possibilities of the offered leaseholds. *Id.*

43. *Joiner*, 320 at 351. The Court held that the reach of the 1933 Act did not stop with the obvious or the commonplace. *Id.* Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it is proved that they were widely dealt in under terms or courses of dealing which established their character in commerce as "investment contracts." *Id.*

Such a broad and expansive definition of investment contract has enabled the courts to find an exotic variety of transactions to qualify as investment contracts. See *Glen Arden Commodities, Inc. v. Constantino*, 493 F.2d 1027 (2nd Cir. 1974) (sale of scotch whiskey combined with arrangements for cooperage, storage during maturation period, insurance, and assistance with eventual resale constitute an investment contract); *Continental Marketing Corporation v. SEC*, 387 F.2d 466 (10th Cir. 1967) (offer to sell live beavers combined with offer of beaver boarding facilities and offer to buy baby beavers constitutes an investment contract).

44. Subsequent Supreme Court Cases have offered clarification of the *Joiner* analysis. See *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 688 (1984) (economic substance analysis used in *Joiner* is only proper when determining whether unusual transactions qualify as investment contracts, not whether any instrument can qualify as a "security."); *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 852-53 (1974) (profits refer to capital appreciation resulting from the development of the initial investment as in *Joiner* and not to the benefits derived by consumption of the item purchased); *Howey*, 328 U.S. at 299 (definition of investment contract as a 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 underlies the decision in *Joiner*).

45. *Joiner*, 320 U.S. at 346.

46. *Id.* at 349.

47. *Id.* at 352.

48. *Id.*

ments held out to the prospect.<sup>49</sup>

The Supreme Court examined the second category of real estate investment in *SEC v. W. J. Howey Co.*<sup>50</sup> where it held that tracts of citrus acreage offered for sale in conjunction with service contracts qualified as investment contracts because the seller was offering an opportunity to invest in a large citrus fruit enterprise rather than a mere fee simple interest in land.<sup>51</sup> The Court articulated what is now the classic definition of "investment contract" as a contract, transaction, or scheme comprising of three elements: 1) an investment of money; 2) a common enterprise; and 3) an expectation of profits produced solely<sup>52</sup> from the efforts of the promoter or a third party.<sup>53</sup> The Court noted that the definition had been enumerated and applied many times by lower federal courts.<sup>54</sup>

49. *Id.* at 352-53.

50. 328 U.S. 293 (1946). The Securities and Exchange Commission instituted an action to restrain W. J. Howey Co. ("Howey") from using the mails and the instrumentalities of interstate commerce in the offer and sale of unregistered and non-exempt securities in violation of § 5(a) of the 1933 Act, 15 U.S.C. § 77b(1) (1982), *infra* note 184. *Howey*, 328 U.S. at 294. The district court denied the injunction and the Court of Appeals for the Fifth Circuit affirmed. *Id.*

51. *Howey*, 328 U.S. at 299.

52. There has been considerable controversy over the Court's use of the term "solely." See e.g., Murphy & Wagner, *Looking Through Form To Substance: Are Montana Resort Condominiums "Securities"?*, 35 MONT. L. REV. 265 (1974); Note, *The Economic Realities of Condominium Registration Under the Securities Act of 1983*, 19 GA. L. REV. 747 (1985).

In *SEC v. Glen Turner Enterprises*, 476 F.2d 476 (9th Cir.), *cert. denied*, 421 U.S. 821 (1973), the court stated: "the word 'solely' should not be read as a strict or literal limitation on the definition of an investment contract." *Id.* at 482. See also *infra* notes 91-101 and accompanying text.

53. *Howey*, 328 U.S. at 298-99.

54. *Id.* at 299. *Howey* cited the following federal court decisions as having applied the definition of investment contract adopted in *Howey*: *Penfield Co. v. SEC*, 143 F.2d 746 (9th Cir. 1944) (bottling contracts received in exchange for whisky warehouse receipts containing an agreement that whisky would be bottled and sold for benefit of contract holders was an investment contract because the purchaser looked entirely to the efforts of promoters to make their investment profitable); *Atherton v. United States*, 128 F.2d 463 (9th Cir. 1942) (partial assignment of oil and gas leases constituted a security where purchasers looked entirely to the efforts of promoter to make the investment profitable); *SEC v. Universal Service Assn.*, 106 F.2d 232 (7th Cir. 1939) (application forms which entitled a "charitable" donor to 30% of the profits from agricultural operations in which the donor took no active part were securities because the substance of a transaction rather than its form was controlling); *SEC v. Crude Oil Corp.*, 93 F.2d 844 (7th Cir. 1937) (purported bill of sale and contract for delivery of oil which provided that buyer would not receive oil but the proceeds from sale thereof was a security because the lure held out to the investor was ability to speculate on a possible rise in the price of oil over the next 25 years); *SEC v. Bourbon Sales Corp.*, 47 F. Supp. 70 (W.D. Ky. 1942) (con-

The Court held that it was immaterial whether shares in an enterprise are evidenced by formal certificates or by nominal ownership interests in the physical assets employed in the enterprise.<sup>55</sup> The fact that some purchasers chose not to accept the offer of an investment contract by declining to enter into a service contract was also found irrelevant<sup>56</sup> because an offer of unregistered, non-exempt securities was also prohibited by section 5(a) of the 1933 Act.<sup>57</sup> It also did not matter that the enterprise was not speculative or promotional in character.<sup>58</sup>

### The Supreme Court reaffirmed the *Howey* definition of in-

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tracts selling bulk whisky represented by warehouse receipts where payment was based on price received by seller after aging was an investment contract because money was entrusted to another with the expectation of profits or income through the efforts of others); *SEC v. Bailey*, 41 F. Supp. 647 (S.D. Fla. 1941) (tracts containing groves of tung trees sold in conjunction with a development contract were securities because investors paid money with the expectation of deriving a profit or income created through the efforts of others); *SEC v. Payne*, 35 F. Supp. 873 (S.D.N.Y. 1940) (contracts for sale of silver foxes together with agreements to care for foxes constituted securities because the transaction involved the investment of money to share in the profits of a business venture conducted by others); *SEC v. Pyne*, 33 F. Supp. 988 (D. Mass. 1940) (shares in the ownership of fishing boats are investment contracts because such ship shares involve the investment of money and offer prospective purchasers the right to receipt of profits through efforts other than their own); *SEC v. Timetrust, Inc.*, 28 F. Supp. 34 (N.D. Cal. 1939) (engraved trust certificates that entitle the holder to the income from shares of Bank of America stock owned by the trust are investment contracts because the trust agreement is a contract involving the laying out of money in a way intended to secure income or profit from its employment as an investment); *SEC v. Wickham*, 12 F. Supp. 245 (D. Minn. 1935) (contract which created a business engaged in securities and commodities speculation whereby one party provided the money, received 60% of the profits and all of the losses while the other party provided skill in such speculation was an investment contract because it involved the investment of money for profits through the efforts of someone other than the investor).

The SEC has used the same definition in its administrative proceedings. *See, e.g.*, *In re Natural Resources Corp.*, 8 S.E.C. 635 (1941) (oil and gas leases sold in five acre parcels are investment contracts where the expectation that such parcels will increase in value is based on the result of drilling operations conducted by seller).

55. *Howey*, 328 U.S. at 299.

56. *Id.* at 300-01.

57. 15 U.S.C. 77e(a) (1982). *See infra* note 184. Each prospective customer was offered both a land sales contract and a service contract after having been told that it was not economically feasible to invest unless service arrangements were made. *Howey*, 328 U.S. at 295. The representatives of *Howey* recommended the services of *Howey-in-the-Hills*, a sister-corporation under common control and management with *Howey*. *Id.* While purchasers were free to make arrangements with other companies, 85% used the services of *Howey-in-the-Hills*. *Id.* The land sales contract provided for a uniform price per acre, the only variation being between areas containing trees of different ages. *Id.* Purchases were made in narrow strips of land, an acre comprising a row of 48 trees. *Id.*

58. *Howey*, 328 U.S. at 301.

vestment contract in *Tcherepnin v. Knight*.<sup>59</sup> In applying the *Howey* definition to an action concerning definition of "investment contract" under the 1934 Act,<sup>60</sup> the Court held that the definitions of "security" in the 1933 Act and the 1934 Act are substantially identical.<sup>61</sup> "[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

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59. 389 U.S. 332 (1967). The Supreme Court held that while a withdrawable capital share in an Illinois savings and loan association fit several of the types of instruments designated as securities under § 3(a)(10) of the 1934 Act, 15 U.S.C. § 78c(a)(10) (1982), *see supra* note 32, they most closely resembled investment contracts. *Tcherepnin*, 389 U.S. at 338. The Court noted that the instruments met the *Howey* definition of investment contract because they involved an investment of money in a common enterprise, a money-lending operation, with profits coming solely from the efforts of others, the skilled management and employees of the savings and loan institution. *Id.*

60. Plaintiff's claim stated a cause of action for rescission on the ground that sales of the shares to plaintiff would be void under § 29(b) of the 1934 Act, 15 U.S.C. § 78cc(b) (1982), if plaintiff relied on the false and misleading statements in printed solicitations delivered via mail in violation § 10(b) of the 1934 Act, 15 U.S.C. 78j(b) (1982), *see infra* note 159, and of Rule 10b-5, 17 C.F.R. § 340.10b-5 (1988), *see infra* note 161. *Tcherepnin*, 389 U.S. at 333-34.

The text of § 29(b) of the 1934 Act, 15 U.S.C. 78cc(b) (1982), provides as follows:

(b) Every contract made in violation of any provision of this title or of any rule or regulation thereunder, and every contract (including any contract for listing a security on an exchange) heretofor or hereafter made the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this title or any rule regulation thereunder, shall be void (1) as regards the rights of any person who, in violation of any such provision, rule, or regulation, shall have made or engaged in the performance of any such contract, and (2) as regards the rights of any person who, not being a party to such contract, shall have acquired any right thereunder with actual knowledge of the facts by reason of which the making or performance of such contract was in violation of any such provision, rule or regulation: *Provided*, (A) That no contract will be void by reason of this subsection because of any violation of any rule or regulation prescribed pursuant to paragraph (2) or (3) of subsection (c) of section 15 of this title, and (B) that no contract shall be deemed void by reason of this subsection in any action maintained in reliance upon this subsection, by any person to or for whom any broker or dealer sells, or from or for whom any broker or dealer purchases, a security in violation of any rule or regulation prescribed pursuant to paragraph (1) of subsection (c) of section 15 of this title, unless such action is brought within one year after the discovery that such sale or purchase involves such violation and within three years of such violation.

61. *Tcherepnin*, 389 U.S. at 335-36.

reality.”<sup>62</sup> The elements of the *Howey* definition of investment contract eventually became known as the economic reality test.<sup>63</sup>

Generally, there is little difficulty in determining whether a given transaction involves an investment of money and therefore satisfies the first element of the *Howey* economic reality test.<sup>64</sup> Even when there is no question that money has changed hands, however, there may be a dispute as to whether the money represented a loan as opposed to an investment.<sup>65</sup> The courts examine various criteria to determine the economic reality of the transaction.<sup>66</sup>

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62. *Id.* at 336 (citing *Howey*, 328 U.S. at 298 (when interpreting investment contracts under blue sky laws, form was disregarded for substance and emphasis was placed upon economic reality)).

63. See *infra* note 86.

64. In *Joiner*, 320 U.S. 344 (1943), *Howey*, 328 U.S. 293 (1946), *Tcherepnin*, 389 U.S. 332 (1967), and *Forman*, 421 U.S. 837 (1974), there was no issue as to whether an investment was involved. In *Joiner*, investors paid cash for oil leases. *Joiner*, 320 U.S. at 346 (\$10 per acre paid for rights). In *Howey*, cash was paid per acre for title to land. *Howey*, 328 U.S. at 295 (price per acre varied with age of citrus trees). In *Tcherepnin*, cash was paid by the plaintiff class for withdrawable capital shares of City Savings Association. *Tcherepnin*, 389 U.S. at 332 n.2 (5,000 investors were alleged to have paid between fifteen and twenty million dollars for the shares). In *Forman*, shares of stock in a cooperative housing venture were paid in cash. *Forman*, 421 U.S. at 842 (purchasers paid \$25 per share for stock).

65. *C.N.S. Enterprises, Inc. v. G & G Enterprises, Inc.*, 508 F.2d 1354, (7th Cir.), *cert. denied*, 423 U.S. 825 (1975). The court stated:

In one sense, every lender of money is an investor since he places money at risk in anticipation of profit in the form of interest. Also, in a broad sense every investor lends his money to a borrower who uses it for a price and is expected to return it one day.

*Id.* at 1359.

66. *Union Planters Nat. Bank v. Commercial Credit Business Loans, Inc.*, 651 F.2d 1174, 1182 (6th Cir. 1981). Under the risk capital test, courts focus on six criteria to determine whether a transaction is an investment or a loan: 1) time; 2) collateral; 3) form of the obligation; 4) circumstances of issuance; 5) relationship between amount borrowed and size of borrower's business; and 6) intended use of the funds. *Id.*

The first factor, time, examines the length of time that the funds are to be retained by the borrower. *Id.* The longer the funds are to be held, the more likely that an investment, rather than a loan, is involved. *Id.* The second factor, collateral, examines whether the loan was secured by collateral when executed. *Id.* The existence of collateral is strongly suggestive of a commercial loan. *Id.* The third factor examines the form of an investment. *Great Western Bank & Trust v. Kotz*, 532 F.2d 1252, 1257 (9th Cir. 1976). The fourth factor examines the circumstances of issuance. *Union Planters Nat. Bank*, 651 F.2d at 1182. An investment is often procured through a public offering with an indication that there is an opportunity for speculation or investment. *Id.* The fifth factor compares the size of the amount borrowed with the size of the business. *Great Western Bank & Trust*, 532 F.2d at 1257. Where the amount borrowed is large compared to the size of the business, the transaction is more likely a loan. *Id.* The sixth factor examines

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The presence of an investment of money was also called into question in *International Brotherhood of Teamsters v. Daniel*.<sup>67</sup> The Supreme Court held that a pension plan did not involve an investment of money because employees sold their labor primarily to make a livelihood, not to make an investment.<sup>68</sup> In most real estate transactions, however, where title to land passes from one party to another in return for a payment of money, there is no dispute as to whether the transaction involves an investment.<sup>69</sup>

The courts of appeals disagree as to what constitutes a common enterprise.<sup>70</sup> Some circuits require a pooling of the interests

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the intended use of the proceeds. *Union Planters Nat. Bank*, 651 F.2d at 1182. A loan will often be used to finance current operations while an investment will be used to acquire new productive assets. *Id.*

67. 439 U.S. 551, 560 (1979).

68. In *International Brotherhood of Teamsters*, the Supreme Court held that a pension fund was not an investment contract because an employee makes no cash payments to the plan. *Id.* at 559. While an employee may be viewed as allowing an employer to place a portion of his total compensation in a pension plan, the economic reality of the transaction is that the employee is selling his labor to earn a livelihood, not to make an investment. *Id.* at 560. The "investment" in a pension plan funded by an employer can also be distinguished from the investments in variable-annuity plans purchased by individuals in *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1959) (premium paid for variable- and fixed-annuity contract) and in *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202 (1967) (portion of premium paid for variable component of mixed variable- and fixed-annuity contract) because even though the interest acquired had intermingled security and non-security aspects, a substantial degree of the interest obtained involved the elements of an investment contract. *International Brotherhood of Teamsters* at 559-60.

69. See, e.g., *Hocking*, 839 F.2d at 566 (no dispute that the condominium purchased satisfied *Howey's* first requirement). In their brief submitted on rehearing en banc, the defendants in *Hocking* argue that unless there is a relationship linking the offeror of land with the offeror of management services, the purchase of the condominium and the rental arrangement were two separate transactions. Appellant's Brief On Rehearing En Banc at 47-48, *Hocking*, (9th Cir. Dec. 7, 1988) (85-1932). Defendants do not dispute that the first transaction, the purchase of the condominium, involved an investment of money, but argue that there was no common enterprise. *Id.* They further argue that the second transaction, the rental arrangement, did not qualify as an investment contract in and of itself because there was no investment of money. *Id.* at 48. The merits of defendants' linkage argument are discussed *infra* at notes 114-124 and accompanying text.

70. *Mordaunt v. Incomco*, 469 U.S. 1115, 1115-16 (1985) (White, J., dissenting from the denial of certiorari on the ground that there is a split between the circuits).

The development of the law concerning the common enterprise element of the *Howey* definition of an investment contract was mostly generated by suits for losses on discretionary commodity account. See, e.g., *SEC v. Continental Commodities Corp.*, 497 F.2d 516, 519 (9th Cir. 1974) (fraud in connection with a discretionary commodities account). The ultimate holdings of the commodities cases became moot when Congress gave the Commodity Futures Trading Commission exclusive jurisdiction over commodity

of investors, or "horizontal commonality,"<sup>71</sup> while other circuits only require a relationship between the investor and the promoter, or "vertical commonality."<sup>72</sup> With vertical commonality,

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accounts. *See* *Mallen v. Merrill Lynch, Pierce, Fenner, & Smith, Inc.*, 605 F. Supp. 1105, 1109 (N.D. Ga. 1985) (statements to the effect that discretionary commodity accounts may be a "security" are no longer valid). Courts continue to cite the commodities cases as authority for the common enterprise requirements of the various circuits. *See, e.g., Hocking*, 839 F.2d at 566 (citing *SEC v. Continental Commodities Corporation*, 497 F.2d 516 (5th Cir. 1974) as authority for commonality requirement in Fifth Circuit).

71. The Third, Sixth, and Seventh Circuits of the Courts of Appeal have adopted horizontal commonality, requiring that several investors pool their investments. *See, e.g., Wasnowic v. Chicago Board of Trade*, 352 F. Supp. 1066, 1070 (M.D. Pa 1972) (discretionary commodity account did not involve pooling of funds with other investors and therefore did not involve a common enterprise), *aff'd*, 491 F.2d 752 (3rd Cir. 1973), *cert. denied*, 416 U.S. 994 (1974). *See also* *Curran v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 622 F.2d 216, 222 (6th Cir. 1980) (individual discretionary commodity account not an investment contract because pooling of investors is essential to finding of common enterprise), *aff'd on other grounds*, 456 U.S. 353 (1982); *Hirk v. Agri-Research Council, Inc.*, 561 F.2d 96, 100-01 (7th Cir. 1977) (as common enterprise requires both multiple investors and a pooling of their funds, separate discretionary commodity accounts were not investment contracts). While the First Circuit has not yet addressed the issue, a district court in the First Circuit has adopted horizontal commonality. *See Holtzman v. Proctor, Cook, & Co., Inc.*, 528 F. Supp. 9, 15 (D. Mass. 1981) (*Howey* held to require horizontal commonality).

72. The Fifth, Eighth, Ninth, and Tenth circuits have adopted vertical commonality which does not require that investors pool their funds. A common enterprise is deemed to exist if the fortunes of the investor are interwoven with and dependent upon the efforts 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. 1973), *citing* *Los Angeles Trust Deed & Mortgage Exchange v. SEC.*, 285 F.2d 162, 172 (9th Cir.), *cert. denied*, 366 U.S. 919 (1961). *See Brodt v. Bache & Co.*, 595 F.2d 459, 461 (9th Cir. 1978) (although common enterprise does not require strict pooling of interests but may be achieved if fortunes of investor are interwoven with those seeking the investment, a discretionary commodities account is not an investment contract because defendant earned flat commission regardless of whether investment flourished or perished); *McGill v. American Land & Exploration Co.*, 776 F.2d 923, 925 (10th Cir. 1985) (as horizontal commonality has never been a part of the law of this circuit joint venture for development of subdivision qualified as an investment contract); *SEC v. Continental Commodities Corp.*, 497 F.2d 516, 522 (5th Cir. 1974) (discretionary commodities account was investment contract because congruity of investment not a prerequisite to common enterprise so long as fortuity of investments collectively is essentially dependent on promoter expertise); *Commercial Iron & Metal v. Bache & Co.*, 478 F.2d 39, 42 (10th Cir. 1973) (if the vice president in charge of the metals department implied that he would make all investment decisions and promised plaintiff large profits then the discretionary commodities account may qualify as investment contract). While the Eighth Circuit has not expressly embraced vertical commonality, horizontal commonality was implicitly rejected in *Booth v. Peavy Co. Commodities Services*, 430 F.2d 132 (8th Cir. 1970) (action for churning of commodities account may be brought under 1933 Act) as noted in *Christensen Hatch Farms*, 505 F. Supp. 903, 906-07 (D. Minn. 1981) (as existing Eighth Circuit cases have found discretionary commodity accounts to qualify as investment contract, horizontal commonality is not necessary for a common enterprise to exist).

While there are no Eleventh Circuit decisions concerning commonality, *Taylor v.*

a venture that has but a single investor can be a common enterprise if the promoter's remuneration depends on the success of the venture.<sup>73</sup> In the Ninth Circuit, the common enterprise requirement will be met if either vertical or horizontal commonality is present.<sup>74</sup>

In *United Housing Foundation, Inc. v. Forman*,<sup>75</sup> the Supreme Court held that stock in a cooperative housing project did not meet the traditional<sup>76</sup> *Howey* definition of investment contract because the investment was premised on a desire to consume the item purchased,<sup>77</sup> not on a reasonable expectation of

Bear Stearns, 572 F. Supp. 667 (N.D. Ga. 1983), adopted vertical commonality. Note that before the Eleventh Circuit was created on Oct. 1, 1981, the courts now comprising the Eleventh Circuit were controlled by the Fifth Circuit which adopted vertical commonality in 1974. See *SEC v. Continental Commodities Corp.*, 497 F.2d 516, 522 (5th Cir. 1974).

73. *Brodt v. Bache & Co., Inc.*, 595 F.2d 459, 461 (9th Cir. 1978).

74. *El Khadem v. Equity Securities Corp.*, 494 F.2d 1224, 1229 (9th Cir.), *cert. denied*, 419 U.S. 900 (1974). While some courts view horizontal and vertical commonality as mutually exclusive, see *Curran v. Merrill Lynch, Pierce, Fenner, and Smith, Inc.*, 622 F.2d 216, 222 (6th Cir. 1980) (adopting horizontal commonality court necessarily rejects vertical commonality), *aff'd on other grounds*, 456 U.S. 353 (1982), other courts have held that the adoption of vertical commonality does not necessarily reject horizontal commonality. See *Savino v. E.F. Hutton & Co., Inc.*, 507 F. Supp. 1225, 1238 n.12 (S.D.N.Y. 1981).

Although the Ninth Circuit has adopted the comparatively liberal standard of vertical commonality, the likelihood that an investment contract will exist will often depend on whether the commonality standard is applied to the expansive but unsubstantiated representations of a promoter or limited to the terms of a collateral agreement between the parties. See *infra* notes 135-139 and accompanying text.

75. 421 U.S. 837 (1974).

76. *Id.* at 853. In *Forman*, plaintiffs urged the Court to abandon the profits element of the *Howey* definition of securities and adopt the "risk capital" approach articulated by the California Supreme Court in *Silver Hills Country Club v. Sobieski*, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961), and adopted by the Ninth Circuit in *Khadem v. Equity Securities Corp.*, 494 F.2d 1224 (9th Cir.), *cert. denied*, 419 U.S. 900 (1974). *Forman*, 421 U.S. at 837 n.24. The Court declined to apply the "risk capital" test in *Forman* noting that even if they were inclined to adopt such an approach, the doctrine would not change the result in *Forman* because the purchasers of the "stock" did not take any significant risk. *Id.*

77. The court of appeals, the Supreme Court majority opinion and the Supreme Court dissenting opinion disagreed as to whether the facts of *Forman* involved a profit. The court of appeals found that there was an expectation of profit in the following forms:

1. Rental reductions resulting from income produced by commercial facilities established for the use of the tenants, *Forman*, 421 U.S. at 846;
2. Tax deductions for the portion of the monthly rental charges allocable to interest payments on the mortgage, *Id.*; and
3. Savings based on the fact that the apartments cost substantially less than comparable nonsubsidized housing. *Id.*

profits.<sup>78</sup> As the investors in *Forman* did not purchase with the expectation of profit from the efforts of others,<sup>79</sup> they could be

The Supreme Court held that:

1. While the income from the leasing of commercial facilities might be the type of profit traditionally associated with a security investment, such income in the present case, if any, is far too speculative and insubstantial to bring the entire transaction within the securities acts, *Id.* at 856;
2. There is no basis in law for the view that payment of interest, with its subsequent deductibility for tax purposes, constitutes profit, *Id.* at 855, and even if such deductions were profits, they would not be the type associated with a security investment because they do not result from the managerial efforts of others, *Id.* at 855 n.20;
3. The low rent derives from substantial state subsidies, cannot be liquidated into cash, and does not result from the managerial efforts of others and no more embodies the attributes of profit than do welfare benefits or food stamps. *Id.* at 855.

The dissent argued that:

1. The lease of commercial and office space generates income in excess of \$1 million per year, *Id.* at 861, and even after deduction for expenses, the residue could hardly be de minimis, *Id.*;
2. The tax benefits to be derived from a cooperative housing project require that the operation be run in a certain fashion, *Id.* at 862, and the investors must depend on the project's managers to operate the project in a manner that will realize the tax advantage for them, *Id.* at 863;
3. While the majority attributes the low rent to state subsidies, it is simple common sense that management efficiency necessarily enters into the equation in the determination of the charges assessed against the residents. *Id.* at 861.

78. *Forman*, 421 U.S. at 852-53. The Court found that "there could be no doubt that investors were attracted solely by the prospect of acquiring a place to live." *Id.* at 853. The Court analyzed the Information Bulletin distributed to prospective investors, finding that while it described the advantages of living in a cooperative community, it repeatedly emphasized the nonprofit nature of the endeavor and did not hold out a prospect of profits resulting from the efforts of the promoters or third parties. *Id.* at 853-54. Consequently, the Court held that shares of stock that entitled a purchaser to lease an apartment in a state subsidized and supervised nonprofit housing cooperative, *Id.* at 840, were not securities within the contemplation of the 1933 Act and the 1934 Act. *Id.* at 847.

In *Forman*, the Supreme Court stated that the focus of the securities laws is on the capital market of the enterprise system: the sale of securities to raise capital for profit-making purposes, the exchanges on which securities are traded, and the need for regulation to prevent fraud and to protect investors. *Id.* at 849.

The Supreme Court reversed the Court of Appeals for the Second Circuit, and affirmed the district court's dismissal of the class action. *Id.* The action claimed damages, forced rental reductions, and other relief on the grounds that an information bulletin falsely represented who would bear the burden of cost increases and failed to disclose several critical facts in violation of § 17(a) of the 1933 Act, 15 U.S.C. § 77q(a) (1982), *infra* note 190, § 10(b) of the 1934 Act, 15 U.S.C. § 78j(b) (1982), *infra* note 159, and Rule 10b-5, 17 C.F.R. § 240.10b-5 (1986), *infra* note 161. *Forman*, 421 U.S. at 844-45.

79. The Court noted that in some circumstances, the investor is offered a commodity for both consumption and profit and that the application of the federal securities laws to such transactions may raise difficult questions that were not present in *Forman*. *Forman*, 421 U.S. at 853 n.17 (citing SEC Release No. 33-5347, 38 Fed. Reg. 1735 (Jan. 18, 1973) (*see infra* note 154-158 and accompanying text) and Rohan, *The Securities Law Implications of Condominium Marketing Programs Which Feature a Rental*

distinguished from the investors in *Howey* who had no desire to occupy the land or develop it themselves<sup>80</sup> and from the investors in *Joiner* who had no intention of drilling their own test wells.<sup>81</sup>

The distinction in *Forman* between consumption and an expectation of profits fueled a controversy over whether the economic substance of a purchaser's acquisition of 100% of the stock of a corporation is to consume, i.e. to acquire a business for the purchaser to manage and control, or to invest, i.e. to earn profits from the efforts of others.<sup>82</sup> The Supreme Court settled

*Agency or Rental Pool*, 2 CONN. L. REV. 1 (1969)).

In *Forman*, the Court defined profits as consisting of either capital appreciation resulting from the initial investment or a participation in earnings resulting from the use of investors funds. *Id.* at 852.

80. *Forman*, 421 U.S. at 852-53. The *Howey* Court held that the transactions in that case clearly involved investment contracts because they offered something more than a simple fee interest in land. *Howey*, 328 U.S. at 299. They offered an opportunity to contribute money and participate in the profits of a large citrus fruit enterprise, managed and partly owned by the *Howey* Co. *Id.* Where an opportunity is offered to persons who reside in distant localities and who lack the equipment and experience requisite to the cultivation, harvesting and marketing of the citrus products, such persons 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. *Id.* at 299-300.

81. *Forman*, 421 U.S. at 853 n.18. In *Joiner*, the Court held that the undisputed facts seemed to establish the conclusion that defendants were not, as a practical matter, offering naked leasehold rights. *Joiner*, 320 U.S. at 348. Had the offer mailed by defendants omitted the economic inducements of the proposed and promised exploration well, it would have been quite a different proposition. *Id.* Purchasers would have been left to their own devices, either spending \$5,000 for a test well or waiting an indefinite time until some chance exploration proved the productivity of their land. *Id.* From the standpoint of the securities law, the distinction between an offer of oil leases with or without a promise to drill a test well was critical because the exploratory drillings gave the investments "most of their value and all of their lure." *Id.* at 349.

82. In *Landreth Timber Co. v. Landreth*, 731 F.2d 1348, 1351 n.2 (9th Cir. 1982), *rev'd*, 471 U.S. 681 (1985) the Ninth Circuit compared the positions of commentators with regard to the sale of business doctrine. The court cited the following articles as endorsing the sale of business doctrine: Seldin, *When Stock is Not a Security: The "Sale of Business" Doctrine Under the Federal Securities Laws*, 37 BUS. LAW. 637 (1982); Thompson, *The Shrinking Definition of a Security: Why Purchasing All of a Company's Stock is Not a Federal Securities Transaction*, 57 N.Y.U. L. REV. 225 (1982); Comment, *Acquisition of Businesses Through Purchase of Corporate Stock: An Argument for Exclusion from Federal Securities Regulation*, 8 FLA. ST. L. REV. 295 (1980); Note, *The Security Status of Stock Transfers Incident to the Purchase or Sale of a Business: The "Sale of Business" Controversy in the Aftermath of Golden v. Garafalo*, 47 ALB. L. REV. (1983); Note, *The Sale of Business Doctrine: A Decade After Forman*, 49 BROOKLYN L. REV. 1325 (1983); Note, *Function Over Form: The Sale of Business Doctrine and the Definition of "Security,"* 63 B.U. L. REV. 1129 (1983); Note, *The Sale of Business Doctrine—Golden v. Garafalo*, 1983 B.Y.U. L. REV. 201 (1983); Note, *The Second Circuit Rejects the Sale of Business Doctrine*, 57 TUL. L. REV. 715 (1983).

the dispute in *Landreth Timber Co. v. Landreth*.<sup>83</sup> After reviewing the *Joiner*, *Howey*, and *Forman* decisions, the Court determined that the economic substance of a transaction need only be examined in cases involving unusual instruments that are not easily characterized as securities.<sup>84</sup> As the sale of traditional stock is not an unusual transaction, but plainly within the statutory definition of a security, there was no need to look beyond the character of the instrument to determine if the securities laws applied.<sup>85</sup> The Court held that the economic reality

The court also cited the following articles as repudiating the sale of business doctrine: Black, *Is Stock a Security? A Criticism of the Sale of Business Doctrine in Securities Fraud Litigation*, 15 U.C.D. L. REV. 325 (1983); Hazen, *Taking Stock of Stock and the Sale of Closely Held Corporations: When is Stock Not a Security?*, 61 N.C.L. REV. 393 (1983); Karjala, *Realigning Federal and State Roles in Securities Regulation through the Definition of a Security*, 1982 U. ILL. L. REV. 413; Prentice & Rozkowski, *The Sale of Business Doctrine: Relief from Securities Regulation or a New Haven for Welshers?*, 44 OHIO ST. L. J. 473 (1983); Rapp, *Federal Securities Laws Should Protect Some Purchases of All or Substantially All of a Corporation's Stock*, 32 CASE W. RES. 595 (1982); Comment, *A Criticism of the Sale of Business Doctrine*, 71 CALIF. L. REV. 974 (1983); Note, *Repudiating the Sale-of-Business Doctrine*, 83 COLUM. L. REV. 1718 (1983); Note, 61 WASH. U. L. Q. 659 (1983).

The Ninth Circuit also noted that the sale of business doctrine had been accepted in the Seventh, Tenth, and Eleventh Circuits and had been rejected in the Second, Third, Fourth, Fifth and Eighth Circuits. *Landreth*, 731 F.2d at 1351-52. The Ninth Circuit followed *Forman* in rejecting a literal interpretation of the definition of stock in favor of an inquiry into the economic realities of the underlying transaction. *Id.* at 1352.

83. 471 U.S. 681 (1985). The Supreme Court refused to recognize a sale of business exception to the definition of security holding that the securities laws apply to the transfer of 100% of the stock of an incorporated business. *Id.* at 697. Reversing both the district court and the Court of Appeals for the Ninth Circuit, the Court held that the plaintiffs had a valid cause of action for rescission of the sale of unregistered non-exempt securities under the 1933 Act and for damages resulting from defendant's misrepresentations and failure to state material facts as to the worth of the lumber company in violation of the 1934 Act. *Id.* at 684.

In a companion case, *Gould v. Rufenacht*, 471 U.S. 701 (1985), the Court held that under *Landreth*, the sale of business doctrine did not apply to the sale of 50% of the stock in a corporation when the stock possesses all of the characteristics typically associated with stock. *Id.* at 706.

84. *Landreth*, 471 U.S. at 690.

85. *Id.* In *Landreth*, the Court distinguished the "traditional" stock at issue in *Landreth* from "unusual instruments" such as the withdrawable capital shares at issue in *Tcherepnin*, 389 U.S. at 336-37, and the certificate of deposit and privately negotiated profit-sharing agreement at issue in *Marine Bank v. Weaver*, 455 U.S. 551 (1982). *Landreth*, 471 U.S. at 689 n.4.

In *Forman*, the Court noted that while the name given an instrument is not dispositive, neither is it wholly irrelevant. *Forman*, 421 U.S. at 850. The stock at issue in *Forman* bore none of the characteristics traditionally associated with stock. *Id.* at 851. Unlike the instruments at issue in *Landreth*, the stock in *Forman* was not negotiable, could not be pledged or hypothecated, did not confer voting rights in proportion to the number of shares owned, and could not appreciate in value. *Forman*, 421 U.S. at 851.

test<sup>86</sup> was designed to determine when a particular instrument was an investment contract, not whether it fits within any of the examples in the statutory definition of security.<sup>87</sup>

In *International Brotherhood of Teamsters v. Daniel*,<sup>88</sup> the Supreme Court used the economic reality test to identify the investment aspects of a pension plan and to compare the signifi-

The instruments at issue in *Forman* also did not qualify as investment contracts because the economic realities of the transaction showed that the purchasers had parted with their money for the purpose of purchasing a commodity for personal consumption and not for the purposes of reaping a profit from the efforts of others. *Landreth*, 471 U.S. at 689.

86. The economic reality test examines all of the relevant facts of an offering before deciding whether the buyer expected profits from the efforts of another. Note, *The Economic Realities of Condominium Registration Under The Securities Act of 1933*, 19 GA. L. REV. 747, 763-64 (1985). The term "economic reality" surfaced in *Howey* where the Supreme Court noted that the state courts had construed the term "investment contract," so that "[f]orm was disregarded for substance and emphasis was placed upon economic reality." *Howey*, 328 U.S. at 298. In *Landreth*, the Court stated that an investment contract did not exist in *Forman* "because the economic realities of the transaction showed that the purchasers had parted with their money not for the purpose of reaping profits from the efforts of others, but for the purpose of purchasing a commodity for personal consumption." *Landreth*, 471 U.S. at 689.

The economic reality test is most closely associated with the third *Howey* criterion, expectation of profits from the efforts of another, because the third criterion was the focus of the discussions in *Tcherepnin*, 389 U.S. at 339 (profit depends on skill and honesty of managers), *Forman*, 421 U.S. at 854-56 (benefits of housing do not qualify as profits), and *Landreth*, 471 U.S. at 690 (under sale of business doctrine, a purchaser seeks to use or consume a business, not to earn profits from the efforts of another). However, in *International Brotherhood of Teamsters v. Daniel*, 439 U.S. 551 (1979), the Court discussed economic reality in conjunction with the first *Howey* criterion, investment of money, where it held that "[l]ooking at the economic realities, it seems clear that an employee is selling his labor primarily to obtain a livelihood not [to be] making an investment." *Id.* at 560. The Court has not yet heard a case that turns on the second *Howey* criterion, participation in a common enterprise. See *Mordaunt v. Incomco*, 469 U.S. 1115 (1985) (White, J. dissenting) (certiorari should be granted to settle a conflict between the circuits as to whether the common enterprise requirement is satisfied by horizontal or by vertical commonality).

87. *Landreth*, 471 U.S. at 691. The Supreme Court refused to view *Forman* as requiring that the economic reality of every transaction be examined to determine whether the *Howey* test has been met. *Id.* The Court stated that "we cannot agree that the Acts were intended to cover only 'passive investors' and not privately negotiated transactions involving the transfer of control to 'entrepreneurs.'" *Id.* at 692. The Court noted that while § 4(2) of the 1933 Act, 15 U.S.C. § 77d(2) (1982), exempts transactions not involving a public offering from the 1933 Act's registration provisions, there is no comparable exemption from the antifraud provisions. *Landreth*, 471 U.S. at 692. Furthermore, the 1934 Act contains several provisions specifically governing tender offers such as § 14 of the 1934 Act, 15 U.S.C. § 78n (1982), and § 16 of the 1934 Act, 15 U.S.C. § 78p (1982), and disclosure of transactions by corporate officers or by principal shareholders. *Landreth*, 471 U.S. at 692.

88. 439 U.S. 551 (1979).

cance of investment aspects with other benefits.<sup>89</sup> The Court held that even when an investment in a common enterprise is made with an expectation of profit from the effort of a third party, the transaction may not be an investment contract if the investment aspects are too speculative or insubstantial.<sup>90</sup>

Under the *Howey* economic reality test, an arrangement that produces substantial benefits may still not qualify as an investment contract if the benefits are generated by the efforts of the investor rather than a third party.<sup>91</sup> Although *Howey* implied that an investor's efforts should be minimal, the Ninth Circuit held in *SEC v. Glen Turner Enterprises*,<sup>92</sup> that "the word 'solely'<sup>93</sup> should not be read as a strict or literal limitation on the definition of an investment contract."<sup>94</sup> The court held

89. *Id.* at 562. The Supreme Court held that the larger portion of the income of a pension plan comes from employer contributions, a source that is in no way dependent on the efforts of the fund's managers. *Id.* A pension plan's vesting requirements represent so substantial a barrier to the realization of any pension benefits that even if they were viewed as profit returned from a hypothetical investment, such profit would depend primarily on the employee's efforts to meet vesting requirements. *Id.* Consequently, the economic realities of the transaction indicate that the possibility of participating in a pension plan's earnings is far too speculative and insubstantial to bring the entire transaction within the Securities Acts. *Id.*

90. *Id.*

91. *Howey*, 328 U.S. at 299. The third criterion of the original *Howey* test required that there be an expectation of profits *solely* from the efforts of a promoter or third party. *Id.* While the "solely" requirement has been de-emphasized in subsequent cases, *see supra* note 52, an investment contract will not exist where the investors have effective control over the significant decisions of the enterprise. *See, e.g.* *Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.*, 840 F.2d 236, 240 (4th Cir. 1988).

92. 474 F.2d 476 (9th Cir.), *cert. denied*, 421 U.S. 821 (1973). Contracts that entitled the purchaser to attend self-motivation and sales courses and which also offered the purchaser the right to help sell the courses to others in return for a share of a commission were held to qualify as investment contracts. *Id.* at 478. The Ninth Circuit held that purchasers were not buying the usual self-motivation type of courses, but were buying the right to derive money from the sale of courses to individuals that the purchasers brought to "Adventure Meetings." *Id.*

93. The *Howey* definition of an investment contract required an investment of money in a common enterprise from which there is an expectation of profit *solely* from the efforts of others. *Howey*, 328 U.S. at 299.

94. *Glen Turner Enterprises*, 474 F.2d at 482. The Ninth Circuit held that the term "solely" should be construed realistically so that the definition of an investment contract will include those schemes which involved securities in substance, if not in form. *Id.* The fact that an investor is required to exert some efforts if a profit is to be achieved should not automatically preclude a finding that the plan is an investment contract. *Id.*

The more liberal interpretation of the term "solely" used by the Ninth Circuit has been adopted in nine other circuits. *See, e.g.* *Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.*, 840 F.2d 236, 240 n.4 (4th Cir. 1988); *SEC v. Professional Assoc.*, 731 F.2d 349, 357 (6th Cir. 1984); *Goodwin v. Elkins & Co.*, 730 F.2d 99, 103 (3rd Cir.), *cert.*

that the third *Howey* criterion is satisfied whenever “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.”<sup>95</sup>

Criteria for determining whether such essential managerial efforts are made by the investor or by a third person were provided in *Williamson v. Tucker*.<sup>96</sup> An investment contract will not exist when the investor retains the legal power to manage the enterprise unless he is unable to effectively assert such power.<sup>97</sup> The investor who retains such legal power has not pur-

*denied*, 469 U.S. 831 (1984); *SEC v. Aqua-Sonic Prods. Corp.*, 687 F.2d 577, 582 (2nd Cir.), *cert. denied*, 459 U.S. 1086 (1982); *Kim v. Cochenour*, 687 F.2d 210, 213 n.7 (7th Cir. 1982); *Baurer v. Planning Group Inc.*, 669 F.2d 770, 779 (D.C. Cir. 1981); *Williamson v. Tucker*, 645 F.2d 404, 418 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981); *Aldrich v. McCulloch Properties, Inc.*, 627 F.2d 1036, 1040 n.3 (10th Cir. 1980); *Fargo Partners v. Dain Corp.*, 540 F.2d 912, 914-15 (8th Cir. 1976).

In *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 852 n.16 (1974), the Supreme Court acknowledged the controversy over the “solely” requirement, but refused to express a view as to the holding of *SEC v. Glenn Turner Enterprises*, 474 F.2d at 476.

Subsequent cases have noted that the recitation of the *Howey* test in *Forman* omits the word “solely” and have determined that the Supreme Court has “read the word ‘solely’ out of the *Howey* test.” *Piambino v. Bailey*, 610 F.2d 1306, 1317 n.18 (5th Cir. 1980). *See also Williamson v. Tucker*, 645 F.2d 404, 418 (5th Cir. 1981) (word “solely” omitted altogether from Supreme Court’s definition of investment contract in *Forman*).

95. *Glen Turner Enterprises*, 474 F.2d at 482.

96. 645 F.2d 404 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981). The court stated that “[i]nsofar as the power retained by the investors is a real one which they are in fact capable of exercising, courts have uniformly refused to find securities.” *Id.* at 419.

The Fourth, Sixth, Eighth, Ninth, and Eleventh circuits appear to have adopted *Williamson*. *See, e.g., Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.*, 840 F.2d 236, 241 (4th Cir. 1988) (agreeing with *Williamson* to the extent that it does not imply that each partner’s business expertise should be evaluated separately); *Deutsch Energy Co. v. Mazur*, 813 F.2d 1567, 1570 (9th Cir. 1987) (*Williamson* quoted with approval); *Less v. Lurie*, 789 F.2d 624, 627 (8th Cir. 1986) (position of Eighth Circuit in *Fargo Partners v. Dain Corp.*, 540 F.2d 912, 915 (8th Cir. 1976), viewed as approaching position of Fifth Circuit in *Williamson*); *Odom v. Slavik*, 703 F.2d 212, 215 (6th Cir. 1983) (quoting *Williamson* with approval); *Gordon v. Terry*, 684 F.2d 736, 741 (11th Cir. 1982), *cert. denied*, 459 U.S. 1203 (*Williamson* followed).

The Second and Third circuits appear to have adopted positions that conflict with *Williamson*. *See, e.g., SEC v. Aqua-Sonic Prods. Corp.*, 687 F.2d 577, 582 (2nd Cir.), *cert. denied*, 459 U.S. 1086 (1982) (*Williamson* emphasis on legal rights held to conflict with *Howey* emphasis on substance over form); *Goodwin v. Elkins & Co.*, 730 F.2d 99, 103-04 (3rd Cir.), *cert. denied*, 469 U.S. 831 (1984) (powers expressly conferred to partners under New Jersey law prevent general partnership from ever being a security).

97. *Williamson*, 645 F.2d at 419. The court noted that cases in the Tenth and Eighth Circuits had held that the actual control exercised by the purchaser was irrelevant. *Id.* at 421. So long as the investor had the legal right to control the asset he had purchased, he was not dependent on the promoter or on a third party for those managerial efforts which affect the failure or success of the enterprise. *Id.*

chased an investment contract merely because he delegates some essential managerial duties to a third party.<sup>98</sup> As a result, courts have held that partnership<sup>99</sup> and franchise agreements<sup>100</sup> usually

Notwithstanding the fact that an investor might retain legal control of an asset, *Williamson* noted three circumstances under which such legal control could not be effectively asserted, and the investor would in fact be dependent on the efforts of another. *Id.* 422-23. The three circumstances under which control could not be effectively asserted were (1) where the investor has irrevocably delegated his powers; (2) where the investor is incapable of exercising his powers; and (3) where the investor is so dependent on the particular expertise of the promoter or manager that he has no reasonable alternative than to rely on such promoter or manager. *Id.*

98. *Williamson*, 645 F.2d at 423. An investor's delegation of rights and duties, standing alone, does not give rise to the sort of dependence on others which underlies the third prong of the *Howey* test. *Id.*

99. Courts have generally held that a general partnership or joint venture interest cannot be an investment contract because the owner has a legal right to participate in the management of the operation. *Williamson*, 645 F.2d at 421. On the other hand, a limited partnership interest may qualify as an investment contract. *Id.* at 423. *See also*, *Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.*, 840 F.2d 236, 242 (4th Cir. 1988) (investment contract does not exist where general partners have sufficient express powers giving them authority to manage and are not dependent on the irreplaceable skills of others); *Deutsch Energy Co. v. Mazur*, 813 F.2d 1567, 1570 (9th Cir. 1987) (investor in general partnership had sufficient general business expertise as to be on notice that his ownership rights are significant and that federal securities laws would not protect him from failure to exercise those rights); *Goodwin v. Elkins & Co.*, 730 F.2d 99, 102-03 (3rd Cir.), *cert. denied*, 469 U.S. 831 (1984) (general partner in brokerage firm was unavoidably a part of the operation of the enterprise); *Mayer v. Oil Field Systems Corp.*, 721 F.2d 59, 65 (2nd Cir. 1983) (where investing limited partner exercised no managerial role in partnership affairs, courts have held that such limited partnership interests qualify as securities); *Odom v. Slavik*, 703 F.2d 212, 215 (6th Cir. 1983) (managerial powers vested in general partners such as express right of inspection of documents gives them the kind of leverage and ability to protect themselves that takes them outside the scope of the securities laws); *Gordon v. Terry*, 684 F.2d 736, 742 (11th Cir. 1982), *cert. denied*, 459 U.S. 1203 (1983) (limited partnership was an investment contract with respect to only those promoters who made claims of unique entrepreneurial or managerial ability); *Frazier v. Manson*, 484 F. Supp. 449 (N.D. Tex. 1980) (limited partnership interests were not an investment contract in the hands of a general partner of the partnership that managed the properties owned by the limited partnerships).

100. *Williamson*, 645 F.2d at 420-21. The actual control exercised by a franchisee is irrelevant so long as he has the right to control the day to day operations. *Id.* *See, e.g.*, *Meyer v. Dans un Jardin, S.A.*, 816 F.2d 533, 535 (10th Cir. 1987) (while reputation and promotional expertise of beauty products franchisor are material to the success of a franchise, the franchise is not an investment contract because the day to day operations depend on the full time efforts of the franchisee); *Crowley v. Montgomery Ward & Co., Inc.*, 570 F.2d 877, 880-81 (10th Cir. 1978) (Montgomery Ward agency agreement was not an investment contract because it required full time effort of investor and granted him control over advertising, personnel, and most decisions involving day to day operations); *Bitter v. Hoby's International, Inc.*, 498 F.2d 183 (9th Cir. 1974) (restrictions on restaurant franchisee's discretion merely accommodated standardization and did not render the franchisee's efforts nominal); *Mr. Steak, Inc. v. River City Steak, Inc.*, 460 F.2d 666, 670 (10th Cir. 1972) (even though a turn-key restaurant operation was sold, it remained a business which the investor could control and included the normal risks incident to

do not qualify as investment contracts.<sup>101</sup>

## 2. The Definition Of Security Implied By The Structure of The Law

In *Landreth Timber Co. v. Landreth*<sup>102</sup> the Supreme Court used the structure of the securities law to determine which factors should *not* be included in the economic reality test.<sup>103</sup> The Court reasoned that if a factor is regulated by a provision of the securities law, a definition of "security" that eliminated the factor would contravene the purposes of the provisions regulating the factor.<sup>104</sup> Thus, the Court held that the provisions regulating tender offers prevented the sale of a business from being eliminated from the definition of a "security" and the provisions regulating private offerings prevented private transactions from being eliminated from the definition of "security."<sup>105</sup>

In *Landreth* the Court stated "we cannot agree that the

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operation of any enterprise); *Chapman v. Rudd Paint & Varnish Co.*, 409 F.2d 635, 640-41 (9th Cir. 1969) (while brochure minimized the efforts which a paint distributor need exert and described the arrangement as a turn-key operation, the distribution agreement emphasized that the success of the distributorship depended on the efforts of the distributor and therefore was not an investment contract).

A licensing arrangement was found to qualify as an investment contract because the licenses were sold to individuals who were not at all likely to attempt to manage the property themselves. *SEC v. Aqua-Sonic Products Corp.*, 687 F.2d 577, 582-84 (2nd Cir.), *cert. denied*, 459 U.S. 1086 (1982) (licenses to sell dental products packaged with sales agency agreements were investment contracts because operation was conducted by agency and nothing suggests that licensees would be likely to terminate the agency agreement and take over distribution themselves).

101. *Williamson*, 645 F.2d at 421.

102. 471 U.S. 681 (1985).

103. *Id.* at 692.

104. *Id.*

105. *Id.* The Court has always held that the definition of investment contract should be broadly construed. *See, e.g. Howey*, 328 U.S. at 298 (definition of investment contract broadly construed to afford investing public a full measure of protection). *Landreth* suggests that the definition of investment contract must be broad enough so as not to render any of the Act's exclusions superfluous. *Landreth*, 471 U.S. at 692. The Court's language implies that whenever an exclusion is deemed to exist under some provision of the securities laws, the definition of an investment contract must be broad enough to include all transactions that would qualify for such exclusion. *Id.*

While the facts of *Landreth* involved ordinary stock rather than an investment contract, the Court's discussion appears to utilize the term "security" in a generic sense that would include any of the instruments listed under the definitions of security, § 2(1) of the 1933 Act, 15 U.S.C. § 77b(1) (1982), *supra* note 31, and § 3(a)(10) of the 1934 Act, 15 U.S.C. § 78c(a)(10), *supra* note 32. *See Landreth*, 471 U.S. at 692.

[1933 and 1934] Acts were intended to cover only ‘passive investors’ and not privately negotiated transactions.”<sup>106</sup> The language of *Landreth* conflicts with an earlier position taken by the Court in *Marine Bank v. Weaver*<sup>107</sup> where the Court stated that the securities laws do not apply to a “private transaction”<sup>108</sup> involving a unique agreement.<sup>109</sup> While there may exist grounds for distinguishing *Landreth* from *Marine Bank*, the Court no longer appears to support an exception that excludes private transactions from the definition of security.<sup>110</sup> The “structure of the Acts” argument in *Landreth* appears to require that “security” be defined in a manner that will not render any of the provisions of the securities law superfluous.<sup>111</sup>

A “structure of the Acts” approach to the definition of security would tend to expand the definition of investment contract. For example, the securities laws also distinguish between primary offerings, the offering of a security by its issuer, and secondary offerings, the sale of an outstanding security by its holder to another person.<sup>112</sup> Under the “structure of the Acts”

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106. *Landreth*, 471 U.S. at 692.

107. 455 U.S. 551 (1982). The Weavers pledged a \$50,000 certificate of deposit to guarantee a \$65,000 loan to the Columbus Packing Company. *Id.* at 552. In consideration for guaranteeing the loan, Columbus’ owners executed an agreement entitling the Weavers to 50% of Columbus’ net profits and \$100 per month for as long as they guaranteed the loan. *Id.* at 553. The agreement provided that Weavers could use Columbus’ barn and pasture and granted them the right to veto future borrowing by Columbus. *Id.* The bank used the proceeds of the loan to offset Columbus’ overdrawn checking account and to pay overdue obligations. *Id.* Four months later, Columbus was bankrupt. *Id.*

108. *Marine Bank*, 455 U.S. at 559.

109. *Id.* at 560.

110. While the language in *Landreth* clearly refutes an exception for private transactions, see *Landreth*, 471 U.S. at 692, the Court seemed to concentrate on private transactions involving the sale of a business rather than private transactions in general. *Id.* at 692 n.6. In *Landreth*, the Court did not discuss its holding in *Marine Bank* other than to reaffirm its position that Congress did not intend to provide a comprehensive federal remedy for all fraud. *Id.* at 687-88.

111. *Landreth*, 471 U.S. at 692. The Court reasoned that the definition of security cannot exclude the transfer of control of a corporation because such a definition would render § 14(d) of the 1934 Act, 15 U.S.C. § 78n(d) (1982) (regulation of tender offers), superfluous. *Landreth*, 471 U.S. at 692. Furthermore, a definition of security exempting private transactions from the definition of security would not only render the exemption for such transactions in § 4(2) of the 1933 Act, 15 U.S.C. § 77d(2) (1982) (provision exempting transactions not involving a public offering from registration requirements), superfluous, but would effectively exempt such transactions from the antifraud provisions. *Landreth*, 471 U.S. at 692.

112. See, e.g., § 4(6) of the 1933 Act, 15 U.S.C. § 77d(6) (1982) (exemption for securities sold as a primary offering to an accredited investor); § 4(1) of the 1933 Act, 15

approach set down in *Landreth*, the definition of security should be broad enough to include both the primary and secondary market in order to avoid rendering the exclusion for secondary markets superfluous.<sup>113</sup>

### 3. Linkage Between Promoter and Party Offering Services

One of the issues arising with respect to both categories of real estate transactions is whether there need be any linkage or relationship between the individual offering the investment and the individual responsible for providing management services or making improvements. In *Continental Marketing Corp. v. SEC*,<sup>114</sup> the court held that contracts for the sale, care, management and resale of live beavers qualified as investment contracts.<sup>115</sup> While Continental's service began and ended with the sale of the beavers, it provided promotional literature that explained the financial benefits of owning beavers and described extensive beaver care services offered by members of the North American Beaver Association.<sup>116</sup> The Continental Marketing Corp. sales literature recommended that a purchaser not take delivery of their beavers but place the beavers with one of the suggested ranchers.<sup>117</sup>

The Tenth Circuit refused to attach any importance to the fact that, unlike *Howey*,<sup>118</sup> the sales company and the management company were unrelated enterprises.<sup>119</sup> The court held that the "more critical factor is the nature of the investor's par-

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U.S.C. § 77d(1) (1982) (exemption for securities sold as a secondary offering).

113. See *Landreth*, 471 U.S. at 692.

114. 387 F.2d 466 (10th Cir. 1967).

115. *Id.* at 471.

116. *Id.* at 468-69.

117. *Id.* The literature noted that a beaver required a private swimming pool, patio, den and nesting box and that proper care required the services of a veterinarian, dental technician and breeding specialist. *Id.* at 468. The recommended ranchers made all of these services available at a cost of six dollars per month per animal. *Id.* Over 200 beavers were sold and all of the purchasers elected to contract with one of the suggested ranchers. *Id.*

118. *Howey*, 328 U.S. 293, 294-95 (1945). In *Howey*, the W.J. Howey Company owned and offered tracts of citrus acreage to investors. *Id.* Management services were offered by Howey-in-the-Hills, a second corporation under direct common control with W.J. Howey Company. *Id.*

119. *Continental Marketing Corp.*, 387 F.2d at 470. Some of the recommended beaver ranchers apparently sold live beavers in direct competition with Continental Marketing Corp. *Id.* at 468.

participation in the enterprise."<sup>120</sup> Where an investor merely provides capital with the hope of a favorable return, the transaction "begins to take on the appearance of an investment contract notwithstanding the fact that there may be more than one party . . . on the other end of the transaction."<sup>121</sup>

The Fifth Circuit held in *Roe v. United States*,<sup>122</sup> that where promoters advertised that a test well was to be drilled by a third party, oil leases offered for sale qualified as investment contracts "whether the test well [was] to be drilled by the sellers, or by third persons either under, or independent of, their control."<sup>123</sup> The primary significance of the pages of promotional material was not their extravagance or possible misleading nature, but in the fact that they promised great rewards, not from the operation of the leases, but because of the activities of individuals other than the purchasers.<sup>124</sup>

#### B. CASES APPLYING SECURITIES LAW TO REAL ESTATE TRANSACTIONS

*SEC v. C. M. Joiner Leasing Corp.*<sup>125</sup> and *SEC v. W. J. Howey Co.*<sup>126</sup> represent two distinct types of transactions in which the transfer of an interest in real estate was held to be an investment contract.<sup>127</sup> In *Joiner*, the Supreme Court held that an investment contract existed where the leasehold interests offered to investors would appreciate in value as a result of improvements the promoter promised to make on a neighboring

120. *Id.* at 470.

121. *Id.* The court held that it made no difference whether more than one party was on the other end of the transaction or whether the parties on the the other end consisted of a principal and his agent. *Id.*

122. 287 F.2d 435 (5th Cir. 1961).

123. *Id.* at 439. The court quoted Bloomenthal, *SEC Aspects of Oil and Gas Financing*, 7 Wyo. L.J. 49, 55 (1953), stating "from the standpoint of the investor, it makes little difference whether the promoter points to a well being drilled by him or whether he points to a well being drilled by someone else." *Roe*, 287 F.2d at 439 n.5.

124. *Roe*, 287 F.2d at 438.

125. 320 U.S. 344 (1943).

126. 328 U.S. 293 (1946).

127. See *Joiner*, 320 U.S. at 351 (offers to sell oil leases advertised in conjunction with a promise to drill a nearby test well came within the definition of investment contract); *Howey*, 328 U.S. at 299 (offers to sell portions of citrus orchard made in conjunction with offers to manage the land qualified as an investment contract).

parcel.<sup>128</sup> *Howey*, on the other hand, involved the sale of income producing land in conjunction with a contract to manage the land and remit the net profits to the investor.<sup>129</sup> While the Supreme Court has noted that the *Howey* definition of an investment contract applied to *Joiner*, it did not articulate exactly how the facts of *Joiner* satisfied the elements of the *Howey* definition.<sup>130</sup> Consequently, courts have differed over what is necessary before either a *Joiner*-type or *Howey*-type transaction will qualify as an investment contract.<sup>131</sup>

*Joiner*-type transactions most frequently occur when investors purchase land in a real estate development in response to a developer's representation that the land will appreciate in value as a result of improvements that the developer intends to make to *other* parcels of land.<sup>132</sup> Applying the *Howey* criteria, courts have generally held that such transactions do not qualify as investment contracts because anticipated appreciation in response to proposed improvements does not involve a common enterprise<sup>133</sup> or does not qualify as "profits."<sup>134</sup>

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128. *Joiner*, 320 U.S. at 346-48.

129. *Howey*, 328 U.S. at 299-300.

130. *Howey*, 328 U.S. at 299. The Court merely stated that "[s]uch a definition necessarily underlies this Court's decision in *S.E.C. v. Joiner Corp.*" *Id.*

131. See *infra* notes 134-146 and accompanying text.

132. See, e.g., *Aldrich v. McCulloch Properties, Inc.*, 627 F.2d 1036, 1039 (10th Cir. 1980) (developer encouraged investment purchases by promising that lots would increase in value because of his activities in developing and providing amenities); *De Luz Ranchos Investment, Ltd. v. Coldwell Banker & Co.*, 608 F.2d 1297, 1300 (9th Cir. 1979) (developer's marketing material promoted Rancho California as a passive investment which would appreciate in value as a result of Kaiser's development of commercial facilities); *Woodward v. Terracor*, 574 F.2d 1023, 1025 (10th Cir. 1978) (to promote the sale of individual building sites, the developer represented that Stansbury Park would be a self-sufficient community containing a shopping center, health and cultural facilities, transportation facilities, and abundant recreational facilities).

133. See, e.g., *De Luz Ranchos Investment, Ltd., v. Coldwell Banker & Co.*, 608 F.2d 1297, 1301 (9th Cir. 1979) (since developer did not promise to make improvements to the specific parcel purchased by plaintiff or to share the proceeds from development of other parcels there was no common enterprise); *Woodward v. Terracor*, 574 F.2d 1023, 1025 (10th Cir. 1978) (the mere fact that plaintiffs purchased lots from developer does not mean that they were thereafter engaged in a common enterprise).

Courts have held that a common enterprise exists when the purchase money accumulated from lot sales is used to finance the promised improvements. *McCown v. Heidler*, 527 F.2d 204, 211 (10th Cir. 1975).

134. See, e.g., *Dumbarton Condominium Assoc. v. 3120 R Street Assoc. Limited Partnership*, 657 F. Supp. 226, 230 (D.D.C. 1987) (purchasers were not led to expect "profits" but were led to expect a certain standard of maintenance); *Bender v. Continental Towers Limited Partnership*, 632 F. Supp. 497, 501 (S.D.N.Y. 1986) (allegation that

Some courts have held that a *Joiner*-type transaction will not qualify as an investment contract unless there is a binding collateral obligation to perform such improvements.<sup>135</sup> While the promoter in *Joiner* was obligated to drill the promised test well,<sup>136</sup> it is not clear whether such obligation was essential to an investment contract or whether the promises contained in the promotional material were sufficient to create an investment contract.<sup>137</sup> A number of subsequent cases have disregarded promises made by the seller that were not reflected in the sales contract.<sup>138</sup> Other cases have stressed the importance of the pro-

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investors purchased condominiums with the intention of reselling at a higher price does not bring these transactions within securities laws); *Happy Investment Group v. Lakeworld Properties, Inc.*, 396 F. Supp. 175, 180 (N.D. Cal. 1975) (situation in which plaintiffs will not realize any actual profits on their investment until their lots are sold is unlike other investment contract cases).

135. See, e.g., *De Luz Ranchos Investment, Ltd., v. Coldwell Banker & Co.*, 608 F.2d 1297, 1301 (9th Cir. 1979) (sale contract did not oblige the seller to do more than convey good title); *Woodward v. Terracor*, 574 F.2d 1023, 1025 (10th Cir. 1978) (developer was under no contractual obligation other than to deliver title once the purchase terms were met); *Dumbarton Condominium Assoc. v. 3120 R Street Assoc. Limited Partnership*, 657 F. Supp. 226, 231 (D.D.C. 1987) (no collateral agreements beyond the agreement to sell certain condominium properties); *Happy Investment Group v. Lakeworld Properties, Inc.*, 396 F. Supp. 175, 181 (N.D. Cal. 1975) (no actual commitments to perform specific services).

136. *Joiner*, 320 U.S. at 349. The Court held that it was unnecessary to determine whether the investors in *Joiner* acquired a legal right to compel drilling of the well because payments to the promoter were timed and contingent upon completion of the well. *Id.*

In *Roe v. United States*, 287 F.2d 435 (5th Cir. 1961), investors were only offered mineral leases. *Id.* at 437. While payments by the investors were not conditioned on the drilling of the test wells as in *Joiner*, the promoter apparently made substantial contributions to the drillers of the test wells. *Id.* at 439.

137. In *Joiner*, the Court noted that the exploration enterprise was woven into the leaseholds in both a legal and an economic sense. *Joiner*, 320 U.S. at 348. The Court noted that none of the leases had any value without the test wells and that, in an economic sense, the well-drilling enterprise gave the leasehold rights most of their value and all of their lure. *Id.* at 349.

In *Roe v. United States*, 287 F.2d 435 (5th Cir. 1961) the Fifth Circuit interpreted *Howey's* restatement of *Joiner* to overcome any imputation that *Joiner* required collateral activity be that of the seller or one under his control. *Id.* at 439 n.5.

138. See, e.g., *De Luz Ranchos Investment, Ltd., v. Coldwell Banker & Co.*, 608 F.2d 1297, 1301 (9th Cir. 1979) (seller's promotional material promised that it would develop retained land but no timetable was provided and the sales contract merely required that seller convey title); *Woodward v. Terracor*, 574 F.2d 1023, 1025 (10th Cir. 1978) (although developer represented that self-sufficient community complete with shopping center would be constructed, there was no investment contract because the only contractual agreement between developer and purchaser was sales contract providing for transfer of parcels); *McCown v. Heidler*, 527 F.2d 204, 211 (10th Cir. 1975) (factual question concerning existence of investment contract exists where allegations provide that there is more than a mere offer and sale of lots in a real estate subdivision and that sellers were

motional emphasis of the developer.<sup>139</sup>

In *Howey*-type transactions, investors purchase income producing real estate in conjunction with arrangements in which a third party manages the property and remits the net proceeds to the investor.<sup>140</sup> The existence of an investment contract will depend on whether the management arrangement satisfies the common enterprise requirement<sup>141</sup> and whether the manager or the investor is deemed to provide the essential managerial ef-

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under contractual obligation to do certain enumerated things that would enhance the individual building sites in the project); *Dumbarton Condominium Assoc. v. 3120 R Street Assoc. Limited Partnership*, 657 F. Supp. 226, 231 (D.D.C. 1987) (no investment contract existed because there were no collateral agreements to the sale of a fee simple interest); *Bender v. Continental Towers Limited Partnership*, 632 F. Supp. 497, 501 (S.D.N.Y. 1986) (neither contracts or options to purchase condominiums were investment contracts because purchasers were merely drawn by an expectation of appreciation in value rather than to earn profits from the efforts of another); *Johnson v. Nationwide Indus. Inc.*, 450 F. Supp. 948, 953 (N.D. Ill. 1978) (while developers may have suggested that condominiums were a good investment, there was no investment contract because there was no evidence of a collateral rental arrangement and reliance on the seller's management to enhance value of investment is not the type of third party effort envisioned by *Howey*), *aff'd on other grounds*, 715 F.2d 1233 (7th Cir. 1983); *Davis v. Rio Rancho Estates, Inc.*, 401 F. Supp. 1045, 1050 (S.D.N.Y. 1975) (developer's promise to build roads and other improvements are not the type of managerial services contemplated in *Howey* and does not result in an investment contract because there was no promise to run the development); *Happy Investment Group v. Lakeworld Properties, Inc.*, 396 F. Supp. 175, 180-81 (N.D. Cal. 1975) (while sales literature gave impression that defendants would build a subdivision, no concrete promise was executed with the land sales contract, no particularized skills were offered, and no services were performed after the land changed hands).

139. *See, e.g.*, *Aldrich v. McCulloch Properties, Inc.*, 627 F.2d 1036, 1039 (10th Cir. 1980) (promotional materials, merchandising approaches, oral assurances and contractual agreements were considered in testing the nature of the product in virtually every relevant investment contract case); *Timmreck v. Munn*, 433 F. Supp. 396, 403-04 (N.D. Ill. 1977) (investment contract may exist where promotional material contained a number of express promises).

In Release 5347, 17 C.F.R. § 231.5347 (1988), *infra* note 158 and accompanying text, the SEC provided that "an offer of real estate as such, without any collateral arrangements with the seller or others, does not involve the offer of a security." *Id.*

140. *See, e.g.*, *Howey*, 328 U.S. at 295.

141. *See, e.g.*, *Kaplan v. Shapiro*, 665 F. Supp. 336, 340-41 (S.D.N.Y. 1987) (Ninth Circuit rule that vertical commonality merely requires that there be a direct relationship between success or failure of promoter and investors was not satisfied where promoter received 5% of the profits because there was no interdependence of losses); *Mosher v. Southridge Associates, Inc.*, 552 F. Supp. 1231, 1233 (W.D. Pa 1982) (as there was no pooling arrangement, participation in common enterprise was limited to the actual rental of the investor's own condominium, and there was no agreement to pool rental payments). *See also supra* notes 70-74 and accompanying text (commonality standards for various circuits).

forts.<sup>142</sup> Where a real estate investor has legal control of his investment, a third party will not be deemed to provide essential managerial efforts unless one of the exceptions provided in *Williamson* applies.<sup>143</sup> Investors who purchase resort condominium in distant locations will generally be dependent on the expertise and abilities of the local manager and therefore will satisfy a *Williamson* exception to the essential managerial efforts requirement.<sup>144</sup>

### C. SEC RULES AND REGULATIONS RELATING TO CONDOMINIUMS

While most early condominium developments were almost entirely owner-occupied, condominium marketing campaigns began to emphasize the advantages of renting one's unit when not

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142. See, e.g., *Commander's Palace Park Associates v. Girard and Pastel Corp.*, 572 F.2d 1084, 1085-86 (5th Cir. 1978) (seller did not lead purchaser to expect that management provided by seller would provide either the sole or crucial efforts needed to produce profits); *Schultz v. Dain Corp.*, 568 F.2d 612, 614-15 (8th Cir. 1978) (investment did not meet Eighth Circuit's absolute reliance standard despite three-year non-negotiable management agreement for newly acquired apartment building because a new management arrangement could be negotiated after contract expired); *Fargo Partners v. Dain Corp.*, 545 F.2d 912, 914-15 (8th Cir. 1976) (purchase of apartment building in conjunction with management agreement did not meet Eighth Circuit's absolute reliance standard because investor retained managerial control through power to cancel management agreement on 30 day notice); *FDIC v. Eagle Properties, LTD.*, 664 F. Supp. 1027, 1047-48 (W.D. Tex. 1985) (essential management functions in sale and leaseback of building to limited partnership were not performed by third party because partnership issued accounting instructions to the building manager, required the manager to obtain permission before making capital improvements, and reserved the right to cancel the management agreement in the event of unsatisfactory performance by the manager); *Perry v. Gammon*, 583 F. Supp. 1230, 1233 (N.D. Ga. 1984) (where partnership merely elected to retain third party manager upon acquisition of apartment buildings there was no evidence that the partnership had no alternative to reliance on third party management services).

143. 645 F.2d 404 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981). Under *Williamson* the three circumstances in which control could not be asserted involved an irrevocable delegation of powers, lack of sufficient sophistication to exercise powers and dependence on the particular expertise of the promoter or manager. See *supra* notes 96-101 and accompanying text.

144. See *Cameron v. Outdoor Resorts of America, Inc.*, 608 F.2d 187, 193 (5th Cir. 1980) (investors could not rent out remote condominium campsites themselves and therefore were dependent on the advertising and management of seller notwithstanding the fact that the owners had a legal right to rent their own units); *Wooldridge Homes, Inc. v. Bronze Tree, Inc.*, 583 F. Supp. 1085, 1088 (D. Colo. 1983) (resort condominium qualified as an investment contract because third party operated rental pool, seller depended on presale purchase commitments for financing, and rental services provided by the pool were the undeniably significant efforts essential to the failure or success of the enterprise).

in use.<sup>145</sup> As resort and leisure-oriented developments began to comprise an ever-increasing share of the condominium market, the typical condominium owner became an individual who lived out of state, was able to visit the unit only a few times a year, and relied on the rental income to pay for his condominium unit.<sup>146</sup>

In 1966, the Attorney General of Hawaii issued a ruling that both condominium and conventional real estate projects may be subject to securities regulation if offered for sale in conjunction with a rental contract arrangement.<sup>147</sup> A year later, the SEC issued a joint release with the District of Columbia, Maryland and Virginia stating that all four authorities viewed rental and pooling promotions of real estate as investment contracts.<sup>148</sup>

In 1972, the SEC's Real Estate Advisory Committee prepared a report advising the Commission of the importance of establishing guiding principles for determining when an offering of real estate is for personal use and when the offering qualifies as a security.<sup>149</sup> An initial policy was established in a series of no-action letters issued in 1971 and 1972.<sup>150</sup>

In 1973, the SEC issued Release 5347 to "alert persons engaged in the business of building and selling condominiums and similar types of real estate developments to their responsibilities under the Securities Act."<sup>151</sup> While Release 5347 was merely in-

145. Rohan, *The Securities Law Implications of Condominium Marketing Programs Which Feature A Rental Agency Or Rental Pool*, 2 CONN. L. REV. 1 (1969).

146. *Id.* at 1-2.

147. *Id.* at 5 (citing Attorney General of Hawaii, Op. No. 66-12, issued March 29, 1966).

148. Securities Act of 1933 Release No. 4877 (Aug. 8, 1967).

149. REPORT OF THE REAL ESTATE ADVISORY COMMITTEE TO THE SECURITIES AND EXCHANGE COMMISSION 1 (1972), summarized in CCH FED. SEC. L. REP. ¶ 79,265. See Rosenbaum, *The Resort Condominium and the Federal Securities Laws—A Case in Government Inflexibility*, 60 VIR. L. REV. 785, 790 (1974).

150. See, e.g., SEC No-Action Letter, In re Desert Heritage Corp. (Dec. 9, 1971) (investment contract exists where offer of condominium accompanied by with optional rental pooling agreement); SEC No-Action Letter, In re Surfides Condominiums, Inc. (Feb. 7, 1972) (definition of securities under 1933 Act does not include condominium units sold without any management or rental arrangement). See also Burton, *Real Estate Syndication in Texas: An Examination of Securities Problems*, 51 TEX. L. REV. 239, 245-46 (1973).

151. SEC Release No. 33-5347, 17 C.F.R. § 231.5347 (1988). In *Hocking*, the Ninth Circuit held that Release 5347 was controlling. *Hocking*, 839 F.2d at 566. When the

tended to clarify when an offering of condominiums should be registered as an offering of securities,<sup>152</sup> courts have applied its provisions to a variety of transactions.<sup>153</sup>

Release 5347 recognizes three scenarios<sup>154</sup> under which the sale of a condominium unit would constitute the offering of a security:

1. The condominiums are offered and sold with emphasis on the economic benefits to be derived by the purchaser from the managerial efforts of the promoter or a third party designated or arranged for by the promoter to arrange for rental of the units;<sup>155</sup>

2. The offering of participation in a rental pool arrangement;<sup>156</sup> and

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Ninth Circuit agreed to rehear *Hocking* en banc, the SEC filed a brief as amicus curiae stating that Release 5347 "does not apply to persons who resell their own individual units after the initial project is complete and [who] have no such affiliation or selling arrangement with the pool operator." Brief of the Securities and Exchange Commission, Amicus Curiae at 13, *Hocking*, (9th Cir. Dec. 7, 1988) (No. 85-1932).

152. Release 5347, 17 C.F.R. 231.5347 (1988).

153. See, e.g., *Hodges v. H & R Investments, Ltd.*, 668 F.2d 545, 550 (N.D. Miss. 1987) (SEC Release 5347 used to determine definition of investment contract for claim under antifraud provisions of securities law); *Dumbarton Condominium Assoc. v. 3120 R Street Assoc. Limited Partnership*, 657 F. Supp. 226, 330-231 (D.D.C. 1987) (SEC Release 5347 used to determine definition of security for RICO cause of action); *Bender v. Continental Towers Limited Partnership*, 632 F. Supp. 497, 501 (S.D.N.Y. 1986) (SEC Release 5347 used to determine definition of security for violations of securities registration rules); *Mosher v. Southridge Assoc., Inc.* 552 F. Supp. 1231, 1232-33 (W.D. Pa. 1982) (SEC Release 5347 used to determine definition of security for violation of securities registration rules). If an instrument qualifies as a security for purposes of registration, it should qualify as a security for other purposes as well because the attributes of the instrument deemed to qualify as a security will remain constant regardless of which provision of the securities laws is deemed to have been violated. See, e.g., *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 684 (1984) (violation of disclosure and antifraud provisions); *Tcherepnin v. Knight*, 389 U.S. 332, 333 (1967) (violation of antifraud provisions); *SEC v. W. J. Howey Co.*, 328 U.S. 293, 294 (1946) (violation of registration provisions); *SEC v. C. M. Joiner Leasing Company*, 320 U.S. 344, 345 (1943) (violations of registration and of antifraud provisions).

154. Some commentators have argued that Release 5347 is misdirected in that the guidelines are not responsive to the overall goal of securities legislation, that no consideration is given to the fact that transactions which meet the guidelines may already be regulated by alternate agencies and that they tend to reaffirm the solely requirement of the *Howey* test. Murphy & Wagner, *Looking Through Form To Substance: Are Montana Resort Condominiums "Securities"?*, 35 MONT. L. REV. 265, 275 (1974).

155. *Hocking*, 839 F.2d at 565 n.5 (quoting 38 Fed. Reg. 1735, 1736 (1973)).

156. *Id.*

3. The offering of a rental or similar arrangement whereby the purchaser must hold his unit available for rental for any part of the year, must use an exclusive rental agent, or is otherwise materially restricted in his occupancy or rental of his unit.<sup>157</sup>

Release 5347 provides that an "offer of real estate as such, without any collateral arrangements with the seller or others, does not involve the offer of a security."<sup>158</sup>

#### D. AVAILABILITY OF PRIVATE CAUSE OF ACTION

Section 10(b) of the 1934 Act<sup>159</sup> does not directly prohibit any conduct or activity, but authorizes the SEC to issue rules and regulations that condemn deceptive practices in the sale or purchase of securities.<sup>160</sup> In 1942, the SEC promulgated Rule 10b-5<sup>161</sup> pursuant to this authorization.<sup>162</sup>

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157. *Id.*

158. SEC Release No. 33-5347, 17 C.F.R. § 231.5347 (1988).

159. 15 U.S.C. 78j(b) (1982) ("§ 10(b)"). The text of § 10(b) provides as follows:  
§ 78j. Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange— . . .

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

160. *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461, 463 (2nd Cir.), *cert. denied*, 343 U.S. 956 (1952).

161. 17 C.F.R. § 240.10b-5 (1987). Rule 10b-5 provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Section 10(b) does not provide an express civil remedy in the event that it is violated and the history of section 10(b) gives no indication that Congress considered the problem of private suits under section 10(b) at the time that the 1934 Act was enacted.<sup>163</sup> Similarly, there is no indication that the SEC considered the question of a private civil remedy when it adopted Rule 10b-5.<sup>164</sup>

An implied right to a private cause of action under Rule 10b-5 was initially recognized in *Kardon v. National Gypsum Co.*<sup>165</sup> After *Kardon*, Rule 10b-5 became the primary source of an explosive growth in plaintiffs' rights under the federal securities laws.<sup>166</sup> Twenty-five years later, in *Superintendent of Insurance v. Bankers Life & Cas. Co.*,<sup>167</sup> the Supreme Court confirmed the overwhelming consensus of the district courts and courts of appeals holding that a private cause of action did exist.<sup>168</sup> Rule 10b-5 generated substantial growth in plaintiffs' rights because large numbers of plaintiffs gained standing through the implied right of private action and because the courts expanded the substantive scope of section 10(b), allowing new combinations of facts and novel causes of action to fall within the scope of section 10(b) and Rule 10b-5.<sup>169</sup>

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162. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 723 (1974).

163. *Id.* at 729-30 (citing S. Rep. No. 792, 73 Cong., 2d Sess., 5-6 (1934)).

164. *Id.* at 730 (citing SEC Securities Exchange Act Release No. 3230 (1942)).

165. 69 F. Supp. 512 (E.D. Pa. 1946). The district court permitted the Kardons to assert a private right of action claiming that the defendants had defrauded them when defendants purchased the Kardon's 50% interest in a corporation for \$504,000 without telling the Kardons that defendants had already committed the corporation to sell its plant for \$1,500,000. *Id.* The following rationale supported an implied civil remedy:

1. Allowing a private cause of action facilitates enforcement of the 1934 Act since the SEC cannot investigate and discover every violation;

2. Section 29(b) of the 1934 Act, 15 U.S.C. 78cc(b) (1982), provides that any contract made in violation of this Act is void. If this is true, there must be a private remedy to recover monies paid over pursuant to the "void" contract. *Kardon*, 69 F. Supp. at 514;

3. RESTATEMENT (SECOND) OF TORTS § 286 implies a civil remedy in favor of anyone injured in violation of a statute enacted for the protection of the class of persons of which plaintiff is a member. *Id.* at 513.

166. Lowenfels, *Recent Supreme Court Decisions Under The Federal Securities Laws: The Pendulum Swings*, 65 GEO. L. J. 891, 892 (1977) [hereinafter cited as LOWENFELS].

167. 404 U.S. 6 (1971).

168. *Blue Chip Stamps*, 421 U.S. at 730.

169. Lowenfels, *supra* note 166, at 892. Examples of original and imaginative causes of action include: *White v. Abrams*, 495 F.2d 724, 736 (9th Cir. 1974) (rule 10b-5 violated by material misrepresentation regarding promissory notes, even though defendant was

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A few years after *Kardon*, the Court of Appeals for the Second Circuit held in *Birnbaum v. Newport Steel Corp.*<sup>170</sup> that the plaintiff class for a private damage action under section 10(b) or Rule 10b-5 was limited to actual purchasers and sellers of securities.<sup>171</sup> In the twenty year period after *Birnbaum* was decided, “virtually all lower federal courts facing the issue in hundreds of reported cases”<sup>172</sup> followed *Birnbaum*.<sup>173</sup> The courts have carved

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unaware that statements were false); *Eason v. General Motors Acceptance Corp.*, 490 F.2d 654, 660-61 (7th Cir. 1973) (shareholders of corporation purchasing car-leasing business with newly issued stock may sue under 10b-5 even though not sellers or purchasers of stock), *cert. denied*, 416 U.S. 960 (1974); *Brennan v. Midwestern United Life Ins. Co.*, 417 F.2d 147, 155 (7th Cir. 1969) (plaintiff may sue corporation allegedly assisting broker’s rule 10b-5 violations), *cert. denied*, 397 U.S. 989 (1970); *A.T. Brod & Co. v. Perlow*, 375 F.2d 393, 398 (2nd Cir. 1967) (broker permissible plaintiff under 10b-5 even though not investor); *Vine v. Beneficial Fin. Co.*, 374 F.2d 627, 635, 638 (2nd Cir.) (plaintiff forced to surrender stock in short-form merger sale for purposes of rule 10b-5), *cert. denied*, 389 U.S. 970 (1967). *Lowenfels*, *supra* note 166, at 892.

170. 193 F.2d 461 (2nd Cir.), *cert. denied*, 343 U.S. 956 (1952).

171. *Birnbaum*, 193 F.2d at 463-64.

172. *Blue Chip Stamps*, 421 U.S. at 731.

173. *Id.* at 732. *See, e.g.*, *Sargent v. Genesco, Inc.*, 492 F.2d 750, 763 (5th Cir. 1974) (issuance of new common shares in refinancing plan that diluted plaintiff’s equity was not a purchase or sale giving rise to a private action under 10b-5); *Eason v. General Motors Acceptance Corp.*, 490 F.2d 654, 659 (7th Cir. 1973) (fraud relating to a guarantee of notes was not in connection with the purchase or sale of a security, but plaintiffs were entitled to bring a private action because as investors, they were a special class entitled to protection), *cert. denied*, 416 U.S. 960 (1974); *Landy v. FDIC*, 486 F.2d 139, 153 (3rd Cir. 1973) (shareholders losses due to fraudulent mismanagement of corporate affairs are not associated with the the sale or purchase of securities and therefore do not give rise to a private cause of action), *cert. denied*, 416 U.S. 960 (1974); *Haberman v. Murchison*, 468 F.2d 1305, 1311 (2nd Cir. 1972) (agreement to sell stock to third party at a price above current market rate without informing other shareholders did not give those shareholders a private cause of action under 10b-5 because they did not participate in any purchase or sale); *Mount Clemens Industries, Inc. v. Bell*, 464 F.2d 339, 344-45 (9th Cir. 1972) (false representations that stock to be sold at auction was worthless did not give rise to a private cause of action by plaintiffs who did not purchase the stock); *City National Bank v. Vanderboom*, 422 F.2d 221, 227-28 (8th Cir.) (bank’s behavior in making loans to plaintiff to facilitate purchase of stock did not fall within statutory coverage of “in connection with purchase or sale of securities” and did not give rise to a private cause of action), *cert. denied*, 399 U.S. 905 (1970); *Simmons v. Wolfson*, 428 F.2d 455, 456 (6th Cir. 1970) (fraudulent act involving stock of corporation did not give rise to a private cause of action to plaintiff who had acquired stock prior to illegal acts), *cert. denied*, 400 U.S. 999 (1971); *Jensen v. Voyles*, 393 F.2d 131, 133 (10th Cir. 1968) (plaintiff did not have a private cause of action for diminution in value of corporation’s stock purchased after the corporation rescinded an agreement to acquire stock of another corporation because the the fraudulent acts causing the rescission of the purchase agreement did not involve the purchase of a security by plaintiff); *Dasho v. Susquehanna Corp.*, 380 F.2d 262 (7th Cir.) (private derivative action by shareholders concerning fraud related to merger qualified as being in connection with the purchase or sale of securities), *cert. denied sub nom. Bard v. Dasho*, 389 U.S. 977 (1967).

a limited number of exceptions to *Birnbaum*,<sup>174</sup> that form a doctrine that prevents fraud and punishes wrongdoing in many situations that do not involve a purchaser or seller of securities in the classic sense.<sup>175</sup>

In *Blue Chip Stamps v. Manor Drug Stores*,<sup>176</sup> the Supreme Court upheld the *Birnbaum* rule based on the rule's longstanding acceptance by the courts, the failure of Congress to reject *Birnbaum*'s reasonable interpretation of the wording of section 10(b) and the similarity between the rule and the statutes involved including their legislative histories.<sup>177</sup> The Court noted

174. There are three doctrines that have acted as exceptions to the *Birnbaum* rule. They involve the aborted seller, the pledge seller, and the forced seller. *Securities Investor Protection Corp. v. Vigman*, 803 F.2d 1513, 1518 (9th Cir. 1986).

The aborted seller (or purchaser) doctrine rests on § 3(a)(13)-(14) of the 1934 Act, 15 U.S.C. § 78c(a)(13)-(14) (1982), which includes contracts to purchase or sell within the definition of purchase or sell. The doctrine provides that where a plaintiff has a contract to buy or sell a security, the contract right will satisfy the *Birnbaum* rule, even if the contract is breached. *Securities Investor Protection Corp.*, 803 F.2d at 1518. *See also Moshier v. Kane*, 784 F.2d 1385, 1389 n.5 (9th Cir. 1986) (history of abortive purchaser doctrine in Ninth Circuit).

The pledge doctrine provides that when stock is pledged as collateral for a loan, the pledgor has constructively sold the stock and the pledgee has constructively bought it, even though no foreclosure has taken place. *Securities Investor Protection Corp.*, 803 F.2d at 1518. *See also, United States v. Kendrick*, 692 F.2d 1262, 1265 (9th Cir. 1982) (pledge of securities constitutes a sale under Rule 10b-5), *cert. denied*, 461 U.S. 914 (1983).

The forced seller doctrine involves the owner of stock in a corporation which has approved a merger which will require the shareholder to either exchange or sell his stock to the acquiring corporation. *Securities Investor Protection Corp.*, 803 F.2d at 1518. *See also Moshier*, 784 F.2d at 1389 (forced seller doctrine provides that scheme whose purpose is forcing seller to convert securities to cash or other consideration gives plaintiff standing to bring action).

175. Lowenfels, *supra* note 166, at 895. Examples of private 10b-5 actions that were upheld although they did not involve a purchaser or seller include: *James v. Gerber Prods. Co.*, 483 F.2d 944, 945, 950 (6th Cir. 1973) (beneficiary of trust from which stock sold sued under rule 10b-5); *Crane Co. v. Westinghouse Air Brake*, 419 F.2d 787, 803-04 (2nd Cir. 1969) (plaintiff corporation, desiring to merge with defendant corporation, sued under rule 10b-5 alleging defendant and alternative merger partner conspired to sell shares below fair market value), *cert. denied*, 400 U.S. 822 (1970); *A.T. Brod & Co. v. Perlow*, 375 F.2d 393, 398 (2nd Cir. 1967) (broker sued under rule 10b-5 to collect from investors who ordered but failed to pay for securities); *Vine v. Beneficial Fin. Co.*, 374 F.2d 627, 637-38 (2nd Cir.) (shareholder forced to sell to acquiring corporation is seller for purposes of 10b-5), *cert. denied*, 389 U.S. 970 (1967); *Hooper v. Mountain States Sec. Corp.*, 282 F.2d 195, 208 (5th Cir.) (company induced by fraudulent means to sell its own stock is seller under 10b-5), *cert. denied*, 365 U.S. 814 (1960). *See Lowenfels, supra* note 166 at 895 n.27.

176. 421 U.S. 723 (1974).

177. *Id.* at 733.

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that in both 1957 and 1959 Congress declined to modify section 10(b) to apply to "any attempt to purchase or sell any security" as requested by the SEC.<sup>178</sup>

The Court also noted that the principal remedies created by Congress with the passage of section 10(b) were expressly limited to purchasers or sellers of securities.<sup>179</sup> Finally, the Court found that the *Birnbaum* rule served an important policy function in that it limited the amount of vexatious litigation.<sup>180</sup> The Court determined that a straightforward application of the *Birnbaum* rule was most consistent with the factors that supported its retention.<sup>181</sup> All federal courts now deny standing to a private plaintiff who brings an action under 10b-5 unless the alleged fraud is in connection with the purchase or sale of a security.<sup>182</sup>

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178. *Id.* at 732.

179. *Id.* at 736. Thus, § 11(a) of the 1933 Act, 15 U.S.C. § 77k (1982) confines the cause of action it grants to "any person acquiring such security." *Blue Chip Stamps*, 421 U.S. at 736. The remedy granted by § 12 of the 1933 Act, 15 U.S.C. § 77i (1982), *infra* note 183, is limited to the "person acquiring such security." *Blue Chip Stamps*, 421 U.S. at 736. Similarly, the remedy in § 9 of the 1934 Act, 15 U.S.C. § 78i (1982), limits the express civil remedy for a variety of fraudulent and manipulative devices to "any person who shall purchase or sell such a security," *Blue Chip Stamps*, 421 U.S. at 736, and § 18 of the 1934 Act, 15 U.S.C. § 78r (1982), prohibits false or misleading statements in reports limits such remedy to "any person . . . who . . . shall have purchased or sold a security at a price which was affected by such document." *Blue Chip Stamps*, 421 U.S. at 736.

In *Blue Chip Stamps*, the Court noted that *Kardon*, 69 F. Supp. at 514, justified a private cause of action under § 10(b) on the basis that it was implied by provisions of § 29(b) of the 1934 Act, 15 U.S.C. § 78cc(b) (1982), *supra* note 60, holding a contract made in violation of the Act to be void. *Blue Chip Stamps*, 421 U.S. at 735. That justification is absent where there is no actual purchase or sale of securities. *Id.*

180. *Blue Chip Stamps*, 421 U.S. at 740. The court noted two reasons that the possibility of vexatious litigation under Rule 10b-5 is more likely than in other complaints. *Blue Chip Stamps*, 421 U.S. at 740. First, the court noted that in the field of securities law governing the disclosure of information, a complaint which by objective standards may have little chance of success at trial may have a disproportionately high settlement value. *Id.* Second, the court noted that the abolition of the *Birnbaum* rule would throw open to the trier of fact many hazy issues of historical fact depending almost entirely on oral testimony and thereby inviting abuse. *Blue Chip Stamps*, 421 U.S. at 723.

181. *Id.* at 723.

182. *See, e.g.,* *Gurley v. Documentation Incorporated*, 674 F.2d 253, 256 (4th Cir. 1982) (allegation that plaintiff was prevented from piggybacking on public offering, i.e. reselling securities acquired from a privately held corporation during such corporation's initial public offering, does not involve purchase or sale of security and therefore is not actionable under 10b-5); *Broad v. Rockwell International Corp.*, 614 F.2d 418, 437 (5th Cir. 1980) (transactions which create encumbrances on the security without altering the underlying ownership are not purchase or sale and therefore beyond purview of 10b-5); *O'Brien v. Continental Illinois Nat. Bank and Trust Co. of Chicago*, 593 F.2d 54, 59 (7th Cir. 1979) (as defendant, not plaintiff was the purchaser of securities, plaintiff did not

Section 12 of the 1933 Act<sup>183</sup> expressly provides a private right of action for violations of the securities registration provisions of section 5 of the 1933 Act,<sup>184</sup> but requires that there be

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have a private cause of action under 10b-5); *Sacks v. Reynolds Securities, Inc.*, 593 F.2d 1234 (D.C. Cir. 1978) (transfer of security ownership necessary for a private action to lie under 10b-5); *Vervaecke v. Chiles, Heider & Co.*, 578 F.2d 713, 719 (8th Cir. 1978) (no cause of action under 10b-5 where fraud was committed after purchase and therefore was not in connection with purchase or sale); *Gaudin v. KDI Corp.*, 576 F.2d 708, 711 (6th Cir. 1978) (plaintiffs fraudulently induced into not selling stock do not have a private cause of action under 10b-5); *Williams v. Sinclair*, 529 F.2d 1383, 1389 (9th Cir. 1976) (purchase of shares before receipt of fraudulent prospectus does not give rise to 10b-5 action because purchase was not in connection with purchase of securities); *Thomas v. Roblin Industries, Inc.*, 520 F.2d 1393, 1396 (3rd Cir. 1975) (failure to suggest or contend that plaintiff was either a buyer or seller of securities is fatal deficiency to 10b-5 action); *Southeastern Waste Treatment, Inc. v. Chem-Nuclear Systems, Inc.*, 506 F. Supp. 944, 953 (N.D. Ga. 1980) (plaintiff must demonstrate that he is either a purchaser/seller or party to a legally enforceable contract to purchase securities to bring private action under 10b-5); *Wittenberg v. Continental Real Estate Partners LTD-74A*, 478 F. Supp. 504, 508-09 (D. Mass. 1979) (private 10b-5 action limited to fraud in connection with purchase or sale of securities, not fraudulent mismanagement of corporate affairs); *Walner v. Friedman*, 410 F. Supp. 29, 32 (S.D.N.Y. 1975) (no private cause of action stated under 10b-5 where the plaintiff was neither a purchaser nor a seller, and no damages flowed to the corporation in connection with such purchase or sale); *Thompson v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 401 F. Supp. 111, 113 (W.D. Okla. 1975) (misrepresentation causing plaintiff to continue to hold stock is not in connection with purchase or sale and therefore does not give rise to private cause of action under 10b-5).

183. 15 U.S.C. § 771 (1982). The text of § 12 provides:

Any person who—

(1) offers or sells a security in violation of section 5,

or

(2) offers or sells a security (whether or not exempted by the provisions of section 3, other than paragraph (2) of subsection (a) thereof) by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in light of the circumstances under which they are made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known of such untruth or omission,

shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

184. 15 U.S.C. § 77e (1982). The text of § 5 provides:

(a) Unless a registration statement is in effect as to a security,

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either a purchase or sale of securities.<sup>185</sup> Consequently, where a private right of action under Rule 10b-5 does not exist because there is no purchase or sale of securities, a private action under section 12 will not exist either.<sup>186</sup> While section 12 provides a

it shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the medium of any prospectus or otherwise; or

(2) to carry or cause to be carried through the mails or in interstate commerce by any means or instruments of transportation, any such security for the purpose of sale or delivery after sale.

(b) It shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to carry or transmit any prospectus relating to any security under which a registration has been filed under this title unless such prospectus meets the requirements of section 10, or

(2) to carry or to cause to be carried through the mails or in interstate commerce any such security for the purpose of sale or for delivery after sale unless accompanied or preceded by a prospectus that meets the requirements of subsection (a) of section 10.

(c) It shall be unlawful for any person, directly or indirectly, to make use of any of the means or instruments of transportation in interstate commerce or of the mails to offer to sell or offer to buy through the medium of any prospectus or otherwise any security unless a registration statement has been filed as to such security, or while the registration statement is the subject of a refusal order or stop order or (prior to the effective date of the registration statement) any public proceeding or examination under section 8.

185. See, e.g., *Wolf v. Frank*, 477 F.2d 467, 479 (5th Cir.), cert. denied, 414 U.S. 975 (1973) (purchase required for private cause of action under § 12 of the 1933 Act); *Schoenbaum v. Firstbrook*, 268 F. Supp. 385, 396 (S.D.N.Y. 1976), aff'd, 405 F.2d 200 (2nd Cir.), rev'd en banc on other grounds, 405 F.2d 215 (2nd Cir. 1968), cert. denied, 395 U.S. 906 (1969) (purchase required for action under § 12 of the 1933 Act).

The intent of the 1933 Act was to discourage high pressure salesmanship with regard to new issues by empowering the SEC to place limitations on the selling arguments employed. *Blue Chip Stamps*, 421 U.S. at 751-52 (citing H.R. Rep. No. 85, 73 Cong., 1st Sess., 2,8 (1933)). In accord with Congressional intent, the SEC requires prominent emphasis to material and adverse contingencies in prospectuses and registration statements. *Id.* at 752-53. While § 12 of the 1933 Act, 15 U.S.C. § 77l (1982), supra note 183, provides express civil remedies for misrepresentations and omissions in registration statements and prospectuses, recovery is restricted to purchasers. *Blue Chip Stamps*, 421 U.S. at 752-53. Congress did not intend to extend a private cause of action to the nonpurchasing offeree for loss of opportunity to purchase based on an overly pessimistic prospectus. *Id.* at 754.

186. See supra note 179 and accompanying text. While discussing remedies passed by Congress along with § 10b, the Court in *Blue Chip Stamps* noted that § 12 of the

private cause of action for an untrue statement of material fact,<sup>187</sup> Rule 10b-5 prohibits fraud.<sup>188</sup> While an action under section 12 need only allege that a material statement was untrue, a Rule 10b-5 action must allege scienter.<sup>189</sup>

The Ninth Circuit has ruled that a private right of action does not exist under section 17(a) of the 1933 Act<sup>190</sup> in *In re Washington Public Power Supply System Securities Litigation*.<sup>191</sup> Consequently, even if the Ninth Circuit were to hold that an investment contract exists in *Hocking*, thereby creating jurisdiction under the securities laws, and even if the Ninth Circuit were to hold that a purchase or sale had taken place, thereby permitting a private right of action under section 10b of the 1934 Act and section 12 of the 1933 Act, no private action will exist under section 17 of the 1933 Act.<sup>192</sup>

#### E. APPLICATION OF *BIRNBAUM* RULE TO INVESTMENT CONTRACTS

Generally, the rule of *Birnbaum v. Newport Steel Corp.*<sup>193</sup> is no more difficult to apply to an investment contract than to any

1933 Act, 15 U.S.C. § 77i (1982), is limited to a person acquiring such security. *Blue Chip Stamps*, 421 U.S. at 736.

187. Section 12 of the 1933 Act, 15 U.S.C. § 77i (1982). *See supra* note 183.

188. 17 C.F.R. § 240.10b-5 (1988). *See supra* note 161.

189. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976) (no private cause of action for damages under Rule 10b-5 in the absence of an allegation of "scienter"—intent to deceive, manipulate, or defraud).

190. 15 U.S.C. § 77q (1982). The text of § 17(a) provides:

(a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

191. 823 F.2d 1349, 1351 (9th Cir. 1987) (private plaintiff does not have an implied right of action under § 17(a) of the 1933 Act).

192. *See Note, A Remedy Without A Right: The Ninth Circuit Denies A Private Right of Action Under Section 17(A) of the Securities Act of 1933*, 18 GOLDEN GATE U.L. REV. 221 (1988).

193. 193 F.2d 461 (2nd Cir.), *cert. denied*, 343 U.S. 956 (1952).

other security.<sup>194</sup> Unlike other securities, however, an investment contract must meet the three elements set forth in *SEC v. W. J. Howey Co.*<sup>195</sup> and these elements may be represented by more than one instrument.<sup>196</sup> A difficult question arises as to whether each of the several instruments that comprise an investment contract must be sold or purchased to satisfy the *Birnbaum* rule and give rise to a private cause of action under Rule 10b-5.<sup>197</sup>

In *Marine Bank v. Weaver*,<sup>198</sup> the district court held that no cause of action under 10b-5 existed irrespective of whether the elements of an investment contract were present because the guarantee agreement did not involve a purchase or sale.<sup>199</sup> *Marine Bank* involved two agreements, a certificate of deposit and a guarantee agreement.<sup>200</sup> The certificate of deposit qualified as an investment of money, but was not a common venture

194. Having determined that a given arrangement, such as a commodity account qualifies as investment contract, the *Birnbaum* rule is not satisfied unless the investment contract is purchased or sold as a result of fraud. *See, e.g., Troyer v. Karcagi*, 476 F. Supp. 1142, 1148 (S.D.N.Y. 1979) (mere retention of commodity account as a result of fraud not sufficient to state private cause of action under Rule 10b-5). On the other hand, an additional investment in a commodity account or the opening of a new account would qualify as a purchase and thereby satisfy the *Birnbaum* rule. *Savino v. E.F. Hutton & Co., Inc.*, 507 F. Supp. 1225, 1239-40 (S.D.N.Y. 1981) (investment of additional funds in commodity account constitutes purchase and satisfies *Birnbaum* rule).

195. 328 U.S. 293 (1946).

196. In *Howey*, customers were offered two contracts: a land sales contract and a management contract. *Howey*, 328 U.S. at 295. While the land sales contract alone would not have qualified as an investment contract, the two instruments together were held to represent 1) an investment, 2) a common enterprise, and 3) an expectation of profits from the efforts of another. *Id.* at 298-99.

197. Where, as in *Howey*, an investment contract is comprised of a land sales contract and a management services contract, the law is not clear as to whether the customer must purchase *both* the land sales contract and the management services contract to have a private cause of action under Rule 10b-5.

In *Howey*, the SEC was held to have cause of action under § 5(a) of the 1933 Act, 15 U.S.C. § 77(e)(a) (1982), *supra* note 184, regardless of whether the management contract was purchased because the term "sale" was interpreted to include the *mere offer* of an unregistered non-exempt security. *Howey*, 328 U.S. at 301 n.6. *Birnbaum*, on the other hand, limited private actions under § 10b of the 1934 Act, 15 U.S.C. § 78b (1982), *supra* note 159, to transactions involving actual sales. *See Jones v. International Inventors Inc. East*, 429 F. Supp. 119, 127n.2 (1976).

A private party could bring an action under § 12 of the 1933 Act, 15 U.S.C. § 77i (1982), *supra* note 183, for the sale of such unregistered non-exempt securities in violation of § 5 of the 1933 Act, 15 U.S.C. § 77e (1982), *supra* note 184, but could not base a private action directly on § 5 of the 1933 Act, 15 U.S.C. § 77e (1982).

198. 455 U.S. 551 (1982).

199. *Id.* at 554.

200. *Id.* at 553. *See supra* note 102.

while the guarantee agreement involved a common venture but no investment of money.<sup>201</sup> The Supreme Court held that a private right of action existed with respect to the guarantee because it involved a pledge, one of the exceptions to the *Birnbaum* rule.<sup>202</sup>

Courts that have emphasized the actual terms (or lack thereof) of a collateral agreement in real estate cases over the representations of the seller are indirectly applying a purchase or sale requirement similar to the *Birnbaum* rule.<sup>203</sup> A more direct approach was used in *Koppel v. Wien*,<sup>204</sup> where the court held that participation interests in a real estate joint venture qualified as investment contracts,<sup>205</sup> but that a private cause of action was not available under 10b-5 because there was no purchase or sale of an investment contract.<sup>206</sup> The court found that there were no allegations that the property had been sold for cash or even that defendants had entered into substantial negotiations.<sup>207</sup>

There appears to be only one reported case in which a court attempted to apply the *Birnbaum* rule when part of an investment contract was involved in a purchase or sale and another part was merely offered. In *Jones v. International Inventors*

201. *See Id.* at 556-59.

202. *Id.* at 554 n.2. The Supreme Court ruled that under *Rubin v. United States*, 449 U.S. 424 (1981), a pledge of a security was equivalent to a sale for purposes of the antifraud provisions of the federal securities laws. *Marine Bank*, 455 U.S. at 554 n.2. *See supra* note 107 (facts of *Marine Bank*); note 174 (pledge as exception to *Birnbaum*).

Having found that a private cause of action under 10b-5 was permissible, the Supreme Court then went on to find that the elements of an investment contract were not present. *Marine Bank*, 455 U.S. at 555.

203. *See, e.g., De Luz Ranchos Investment, Ltd. v. Coldwell Banker & Co.*, 608 F.2d 1297, 1301 (9th Cir. 1979) (where private plaintiff did not enter into an agreement obligating seller to develop neighboring land as promised the court dismissed the 10b-5 action on the grounds that no common enterprise existed); *Woodward v. Terracor*, 574 F.2d 1023, 1025 (10th Cir. 1978) (while developer represented that it had financial ability to complete planned residential community such representations were not included in land sales contracts and therefore court denied fraud claim on grounds that there was no common enterprise). Either court could have reached the same result by holding that failure to enter into an agreement or failure to include terms in an agreement prevented the transaction from qualifying as a purchase or sale as required by *Birnbaum*, and therefore prevented a private action under 10b-5.

204. 575 F. Supp. 960 (S.D.N.Y. 1983).

205. *Id.* at 966.

206. *Id.* at 970-71.

207. *Id.* at 971.

*Inc. East*,<sup>208</sup> defendant argued that the purported investment contract with plaintiff consisted of two distinct and divisible parts consisting of an evaluation contract and a marketing contract.<sup>209</sup> The first contract expressly stated that defendant assumed no responsibility beyond a fair and complete evaluation of the plaintiff's invention and made no guarantee that plaintiff's invention would be produced or marketed.<sup>210</sup> While the marketing contract was offered to plaintiff, the offer was never accepted.<sup>211</sup> As the first contract did not, by itself, qualify as an investment contract, defendant argued that plaintiff should not have a private cause of action under Rule 10b-5.<sup>212</sup>

The *Jones* court found defendant's argument "intriguing,"<sup>213</sup> but held that it was "formalistic and certainly inconsistent with the umbrella of investor protection afforded by the securities laws."<sup>214</sup> The court compared the case to the facts of *Howey*, noting that in *Howey* the Supreme Court had found the optional nature of a management contract or the existence of two promoters irrelevant.<sup>215</sup> The court quoted the *Howey* Court's conclusion that because the 1933 Act prohibits the offer as well as the sale of unregistered non-exempt securities, "it is enough that respondents merely offer the essential ingredients of an investment contract."<sup>216</sup> In relying on *Howey*, the court failed to distinguish between an action by the SEC under section 5(a) of the 1933 Act,<sup>217</sup> which prohibits the offer of unregistered non-exempt securities, and Rule 10b-5, which prohibits fraud in connection with the purchase or sale of securities. The *Jones* court's reliance on *Howey* would appear to be justified only where the

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208. 429 F. Supp. 119 (N.D. Ga. 1976).

209. *Id.* at 126.

210. *Id.*

211. *Id.* at 126-27. The court stated that "it is undisputed that plaintiff never executed the second contract which contained provisions relating to the defendant's agreement to use best efforts in marketing and promoting the invention." *Id.*

212. *Id.* The court noted that *Howey* involved an action under § 5 of the 1933 Act where "sale" includes every attempt or offer to dispose of rather than rule 10b-5 which requires a purchase or sale. *Id.* at 127 n.2. For purposes of summary judgment, the court only reached the narrow issue of whether a security was involved, as required for subject matter jurisdiction, and did not determine whether plaintiff had stated a claim for a private right of action under Rule 10b-5. *Id.*

213. *Id.* at 127.

214. *Id.*

215. *Id.*

216. *Id.* (quoting *Howey*, 328 U.S. at 300-01).

217. 15 U.S.C. § 77e(a) (1982).

cause of action merely requires that there be an offer of securities rather than the purchase or sale of a security.

When the definition of investment contract developed from *Howey*-type transactions is applied to *Joiner*-type transactions, the result is an emphasis on the terms of the collateral agreement over the representations of the seller.<sup>218</sup> Whether a court denies a private cause of action because no purchase or sale took place, as in *Koppel*, or allows a private cause of action in order to avoid a “formalistic” position, as in *Jones*, the fundamental issue is still whether the terms of the agreement or the representations of the seller should control the outcome. While *Joiner* held that an investment contract is identified by the terms of the offer *and* the economic inducement held out to the prospect,<sup>219</sup> the Court has never indicated whether or not one should be weighed more heavily than the other.<sup>220</sup>

#### IV. THE COURT'S ANALYSIS

##### A. THE MAJORITY

In *Hocking v. Dubois*,<sup>221</sup> the Ninth Circuit found the sale of a condominium combined with an “option” to participate in an RPA to qualify as a security and that the second of the three scenarios discussed in Release 5347 was controlling.<sup>222</sup> The court held that the transaction qualified as an investment contract because the proposed sale included an offer to participate in an RPA.<sup>223</sup> The court reasoned that while the first of the three Release 5347 scenarios would require some finding of fact with re-

218. See *supra* notes 125-139 and accompanying text.

219. *SEC v. C. M. Joiner Leasing Co.*, 320 U.S. 344, 352-53 (1943).

220. Commentators have been noting that Supreme Court decisions are generally reducing the scope of the securities laws. See, e.g., Lowenfels, *supra* note 166, at 892.

221. 839 F.2d 560 (9th Cir.), *reh'g granted en banc*, 852 F.2d 503 (1988).

222. *Id.* at 565. The Ninth Circuit found the second Release 5347 scenario to be the only scenario applicable to RPA's. *Id.* at 565 n.6. Under this interpretation of Release 5347, a finding that no RPA was offered would apparently prevent an investment in a condominium from qualifying as a “security” for purposes of Release 5347 even though there was sufficient emphasis on economic benefits to satisfy the first Release 5347 scenario. See *Hocking*, 839 F.2d at 565.

223. *Hocking*, 839 F.2d at 565. A finding of fact was not made as to whether or not the proposed sale included an offer to participate in an RPA. For purposes of summary judgment, the proposed sale was *deemed* to include an offer to participate in an RPA. See *supra* note 15.

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gard to the benefits emphasized during the sale of the unit, the presence of an RPA automatically characterized the condominium as an investment contract under the second Release 5347 scenario.<sup>224</sup>

The district court had held that the second scenario was not controlling because the RPA at issue was optional.<sup>225</sup> The Ninth Circuit disagreed noting that in *SEC v. W. J. Howey Co.*,<sup>226</sup> it did not matter that the service contract offered to investors was optional.<sup>227</sup> Under the securities laws, it was enough that the defendants merely offered the essential ingredients of an investment contract.<sup>228</sup> The *Hocking* majority viewed participation in the Aetna RPA as an option to be exercised at any time by any owner of the condominium unit.<sup>229</sup> Consequently, the majority reasoned that an offer to sell the condominium unit would necessarily include an implied offer to transfer the option to participate in the RPA because any subsequent purchaser could elect to participate.<sup>230</sup>

The majority rejected the argument that the condominium ceased to be a security at the time the Libermans purchased it because the Libermans chose not to participate in the RPA.<sup>231</sup> The court noted that it made no sense to contend that a condominium ceased to be a security if an intermediate buyer chose not to participate in the RPA.<sup>232</sup> If a unit in a condominium project originally developed with an RPA could remain a security in the hands of successive purchasers until one chose not to participate,<sup>233</sup> then that unit could alternate between being a security and not being one if each successive purchaser were to make a different decision as to whether or not they would participate in

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224. *Hocking*, 839 F.2d at 565.

225. *Id.*

226. 328 U.S. 293, 300 (1946).

227. *Hocking*, 839 F.2d at 565 (quoting *Howey*, 328 U.S. at 300).

228. *Id.* (quoting *Howey*, 328 U.S. at 301).

229. *Hocking*, 839 F.2d at 569.

230. *Id.* The majority's use of the term "option" was not intended to connote that either *Hocking* or the Libermans had an absolute legal right to enter the RPA without the consent of the rental pool manager. *Id.* at 569 n.9. However, the court felt that it was of no significance that the pool operator retained some discretion, at least in theory, to refuse to contract with either *Hocking* or the Libermans. *Id.*

231. *Id.* at 568.

232. *Id.*

233. *Id.* at 570.

the RPA.<sup>234</sup> The court viewed such a result as absurd and far worse in effect on condominium developers and brokers than the more inclusive rule espoused by the SEC.<sup>235</sup>

The court compared the transaction to the three elements of the *Howey* definition of investment contract.<sup>236</sup> There was no dispute that the first element of the *Howey* definition of investment contract, requiring that there be an investment of money, was satisfied because the purchase of the condominium involved an investment of money.<sup>237</sup> The majority held that the third element of the *Howey* definition, the expectation of profits from the efforts of others, was satisfied, and would always be satisfied when a condominium is sold with an RPA option because there will always be an expectation of profits from the efforts of the RPA managers.<sup>238</sup>

The majority's analysis of the second element of the *Howey* definition, involving the existence of a common enterprise,<sup>239</sup> clarified the standard used by the Ninth Circuit in prior cases.<sup>240</sup> The majority noted that horizontal commonality required a strict pooling of assets by two or more investors in a single in-

234. *Id.*

235. *Id.* The SEC's position was set out in Release 5347 and developed in numerous actions. See e.g., SEC v. Marasol Properties, [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,159 (D.D.C. Sept. 28, 1973); Embarcadero, SEC No-Action Letter [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,956 (Dec. 3, 1976).

When the Ninth Circuit agreed to rehear *Hocking*, the SEC filed a brief as amicus curiae stating that Release 5347 does not apply. Brief of the Securities and Exchange Commission, Amicus Curiae at 12-13, *Hocking*, (9th Cir. Dec. 7, 1988) (No. 85-1932). The SEC argued that with the possible exception of Embarcadero, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,956 (Dec. 3, 1976), the SEC has declined to take "no-action" positions where there was no affiliation or selling arrangement between the developer and the rental pool. Brief of the Securities and Exchange Commission, Amicus Curiae at 14, *Hocking*, (9th Cir. Dec. 7, 1988) (No. 85-1932). The SEC noted that the "no-action" position taken in Embarcadero represented a statement of the SEC staff in 1976 and was not binding upon the present staff or the Commission. *Id.* at 14 n.5.

236. *Hocking*, 839 F.2d at 566-68.

237. *Id.* The purchase price of the condominium was \$115,000 of which Hocking paid \$24,000 in cash and executed an installment note in the amount of \$91,000. Joint Brief of Appellees Maylee Dubois and Vitousek & Dick Realtors, Inc. On Rehearing En Banc at 10, *Hocking*, (9th Cir. Dec. 7, 1988) (No. 85-1932).

238. *Hocking*, 839 F.2d at 567.

239. *Id.* at 566.

240. *Id.* The Ninth Circuit emphasized that when it embraced vertical commonality in *Brodt v. Bache & Co.*, 595 F.2d 459 (9th Cir. 1978), it did not replace horizontal with vertical commonality, but instead broadened the meaning of common enterprise to include either horizontal or vertical commonality. *Hocking*, 839 F.2d at 567.

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vestment fund,<sup>241</sup> while vertical commonality required a dependence on promoter expertise rather than the fortuity of collective investments.<sup>242</sup> The court stressed that the Ninth Circuit accepts both horizontal and vertical commonality.<sup>243</sup> The trial court was instructed that if, on remand, it determined that the offer to Hocking included an option to participate in an RPA, then horizontal commonality would exist.<sup>244</sup> If the trial court determined that the offer to Hocking did not include an RPA, the trial court should reexamine the offer to determine whether vertical commonality is present.<sup>245</sup>

The majority concluded that Release 5347's bright line rule reflects the only proper interpretation of *Howey* as applied to condominiums<sup>246</sup> and that the facts of *Hocking* satisfied both *Howey* and Release 5347.<sup>247</sup>

## B. DISSENT

The dissent argued that there was no connection between the Libermans and the RPA.<sup>248</sup> While conceding that the securities laws may apply to a promotion by a developer who offers a condominium with an RPA, the dissent refused to apply the securities law to the condominium offered for sale by the Libermans because Hocking merely purchased a parcel of real property and not the investment contract offered by Aetna.<sup>249</sup> The dissent distinguished the developer who offers a complete package of a condominium and RPA operated or arranged by the developer from an individual condominium owner who has no connection whatsoever with a rental pool.<sup>250</sup>

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241. *Hocking*, 839 F.2d at 566. See *supra* note 71 and accompanying text.

242. *Hocking*, 839 F.2d at 566. See *supra* note 72 and accompanying text.

243. *Hocking*, 839 F.2d at 566-67. See *Brodt v. Bache & Co.*, 595 F.2d 459, 460 (9th Cir. 1978) (9th Circuit rejects strict requirement of horizontal commonality in favor of vertical commonality).

244. *Hocking*, 839 F.2d at 567.

245. *Id.* See, e.g., *El Khadem v. Equity Securities Corp.*, 494 F.2d 1224, 1229 (9th Cir.) (court looks first for horizontal and then for vertical commonality), *cert. denied*, 419 U.S. 900 (1974).

246. *Hocking*, 839 F.2d at 568.

247. *Id.*

248. *Hocking v. Dubois*, 839 F.2d 560, 572 (9th Cir.), *reh'g granted en banc*, 852 F.2d 503 (1988) (Hug J., dissenting).

249. *Id.* at 571 (Hug J., dissenting).

250. *Id.* at 572 (Hug J., dissenting). The dissent's attention to the fact that the

The dissent argued that Release 5347 was primarily intended to provide *developers* with a bright line rule concerning when they must register their projects.<sup>251</sup> While the dissent felt that the first Release 5347 scenario was reasonably accurate,<sup>252</sup> it questioned the validity of the second Release 5347 scenario and whether the mere offer of an RPA could transform an interest in real estate into an investment contract.<sup>253</sup>

According to the dissent, Hocking was not offered an "option" to participate in an RPA when he purchased his condominium unit.<sup>254</sup> The dissent noted that the majority opinion was premised on the conclusion that a genuine issue of material fact existed as to whether the offer to Hocking included an "option" to participate in an RPA.<sup>255</sup> The dissent argued that the evidence cited by the majority did not support a finding that an "option" was offered.<sup>256</sup>

## V. CRITIQUE

The Supreme Court has noted that their cases "have not been entirely clear on the proper method of analysis for determining when an instrument is a security."<sup>257</sup> One part of the problem is that courts are using a jurisdictional issue, the definition of a security, to shape the remedies available under the securities laws.<sup>258</sup> Another part of the problem is that the courts are still struggling with the paradox that while the rights sold by a seller may not qualify as a security, the rights purchased by a buyer may qualify as a security.<sup>259</sup> An additional part of the

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Libermans had no authority to commit Aetna or Hotel Corporation of the Pacific implies that the dissent would require some type of linkage between the sellers and the party offering management services. *See supra* notes 114-124 and accompanying text.

251. *Hocking*, 839 F.2d at 572 (Hug J., dissenting).

252. *Id.*

253. *Id.*

254. *Id.* Judge Hug stated that "I found no evidence in the record that even suggests an option was offered." *Id.*

255. *Id.*

256. *Id.*

257. *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 688 (1984).

258. *See, e.g., Lowenfels, supra* note 166 at 906-11 (1977) (use of definition of security to circumscribe federal securities laws).

259. *See, e.g., Note, The Economic Realities of Condominium Registration Under The Securities Act of 1933*, 19 GA. L. REV. 747, 769-72 (1985) (conflict between economic reality and economic emphasis).

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problem is that courts are being asked to follow "doctrines" that reflect common themes, but are not in harmony with the securities laws as a whole.<sup>260</sup> Finally, when the courts have examined real estate transactions, they have not settled on the significance of SEC Release 5347<sup>261</sup> and their decisions often fail to consider that two fundamentally different types of real estate transactions may not yield a uniform and interchangeable line of precedents.<sup>262</sup> *Hocking v. Dubois*<sup>263</sup> confronts the Ninth Circuit with all of these issues at once.

## A. USE OF JURISDICTIONAL ISSUES TO TAILOR REMEDIES

Both majority and dissent were faced with a dilemma in that any net that is cast wide enough to catch all potentially crooked promoters will also snare a lot of innocent Libermans. Each rule or qualification intended to exclude the innocent Libermans provides a potential loophole that unscrupulous promoters may exploit. One solution to the dilemma is to broadly interpret the *Howey*<sup>264</sup> definition of investment contract to include all real estate transactions associated with management agreements<sup>265</sup> while severely limiting private causes of action under 10b-5 through application of a strict interpretation of *Birnbaum*.<sup>266</sup>

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260. See, e.g., *supra* notes 102-111 and accompanying text (distinctions between private and public transactions); *supra* notes 112-113 and accompanying text (distinctions based on primary and secondary market); *supra* notes 114-124 and accompanying text (linkage between promoter and party offering services).

261. See *supra* notes 145-158 and accompanying text.

262. See *supra* notes 125-144 and accompanying text.

263. 839 F.2d 560 (9th Cir.), *reh'g granted en banc*, 852 F.2d 503 (1988).

264. 328 U.S. 293 (1946).

265. SEC v. W. J. Howey Co., 328 U.S. 293, 299-301 (1946) (offer or sale of real estate and management contract is an investment contract).

This note does not discuss the various problems that arise when a real estate transaction is found to constitute an investment contract. For example, when a real estate transaction qualifies as a security, the law may require the involvement of a licensed securities broker instead of, or in addition to, a licensed real estate broker. See Rosenbaum, *The Resort Condominium And The Federal Securities Laws—A Case Study In Governmental Inflexibility*, 60 VA. L. REV. 785 (1974) (application of broker-dealer rules and regulation T to condominium sales); Burton, *Real Estate Syndication in Texas: An Examination of Securities Problems*, 51 TEX. L. REV. 239 (1973) (issue registration and broker-dealer registration requirements).

266. *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2nd Cir.), *cert. denied*, 353 U.S. 956 (1952). See also *supra* notes 159-192 and accompanying text.

A “broad *Howey*/strict *Birnbaum*” policy would reduce the number of private actions<sup>267</sup> while assuring that the SEC retains jurisdiction to pursue abusive transactions.<sup>268</sup> Such a policy appears to be consistent with the positions of both majority and dissent in *Hocking*. If a legally enforceable right to participate in the RPA had been transferred with the sale of the Libermans’ condominium unit, the nexus sought by the dissent would exist and there would presumably be no objection to the private action brought by *Hocking*.<sup>269</sup> While the majority does not appear to have considered whether *Birnbaum* would permit the action in *Hocking*, they conceded that *Hocking*’s action should be dismissed if nothing was transferred.<sup>270</sup>

*Hocking* involved an investment in land and an “opportunity” to solicit an offer to participate in an RPA.<sup>271</sup> Thus, the *Hocking* transaction may be too attenuated to qualify for a private action even if an investment of money combined with an offer of management services were to qualify for a private action

267. In *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1974) the Supreme Court recognized that a widely expanded class of private plaintiffs under Rule 10b-5 might promote vexatious litigation. *Id.* at 740. *See supra* note 180 and accompanying text. Thus, the primary disadvantage with a broad definition of investment contract is that no matter how strictly the *Birnbaum* rule is applied, the potential number of vexatious actions that can be brought under 10b-5 will increase. While a broad definition of security allows the SEC to exercise its administrative discretion in bringing actions, the SEC has no direct control over law suits brought by private plaintiffs. The SEC can recommend policies in its Amicus Briefs, but the rights of private plaintiffs are controlled by Congress and the courts.

268. If courts adopt a rule that excludes the *Hocking* transaction from the definition of investment contract, then the SEC would have no jurisdiction over the crooked used Condo dealer who fraudulently promotes investment opportunities in second hand condominium units whose owners qualify to participate in RPA agreements. While the position taken by the SEC in its *Hocking* Amicus Brief suggests that the commission is not currently interested in regulating condominium sales, *see* Brief of the Securities and Exchange Commission, Amicus Curiae, On Rehearing En Banc at 3, *Hocking*, (9th Cir. Dec. 7, 1988) (No. 85-1932), there is a major difference between exercising discretion not to regulate and defining jurisdiction so as to deprive the SEC of the ability to regulate.

269. *Hocking v. Dubois*, 839 F.2d at 560 (9th Cir.), *reh'g granted en banc*, 852 F.2d 503 (1988) (dissent’s basic disagreement with majority is that the Libermans only sold a parcel of land and had no authority to commit Aetna or Hotel Corporation of the Pacific to allow *Hocking* to participate in the RPA).

270. In *Hocking*, the majority remanded the case to the trial court to determine whether the offer to *Hocking* included an option to participate in a rental pool agreement. *Hocking*, 839 F.2d at 562 n.1. The majority stated that the presence of an option represented a material question of fact which would require a trial, implying thereby that if no option was transferred, the case should be dismissed. *Id.*

271. *See supra* note 14-17 and accompanying text.

under 10b-5.<sup>272</sup> By insisting that the transaction does not qualify as an investment contract under *Howey*, however, the dissent may go too far.

In *SEC v. W. J. Howey Co.*,<sup>273</sup> the Supreme Court held that the 1933 Act prohibits the offer as well as the sale of unregistered non-exempt securities.<sup>274</sup> The Court stated that "it is enough that the [defendants] merely offer the essential ingredients of an investment contract."<sup>275</sup> Since a transaction could not possibly violate section 5 of the 1933 Act<sup>276</sup> unless it involved a security, the mere offer to sell land combined with an offer of management services must necessarily be sufficient to define an investment contract.<sup>277</sup> In *Landreth Timber Co. v. Landreth*,<sup>278</sup> the Supreme Court used a "structure of the Acts" argument as basis for refusing to exclude private transactions from the definition of investment contract because such a definition would render section 4(2) of the 1933 Act<sup>279</sup> superfluous.<sup>280</sup> By analogy, it would appear that the "structure of the Acts" require that the definition of investment contract include *offers* of land and management contracts as well as *sales* of land and management contracts because to exclude such offers from the definition of investment contract would render provisions distinguishing between offers and sales superfluous.<sup>281</sup>

*Hocking* adopted the "mere offer is sufficient" language of

272. See *Jones v. International Inventors Inc. East*, 429 F. Supp. 119, 126 (N.D. Ga. 1976) (private action under 10b-5 where investment is accompanied by an offer of a management contract).

273. 328 U.S. 293 (1946).

274. *Id.* at 301. In *Howey*, the SEC instituted an action under § 5 of the 1933 Act, 15 U.S.C. § 77e (1982), *supra* note 184. *Howey*, 328 U.S. at 294. The Court noted that while the registration requirement of § 5 refers to sales of securities, § 2(3) defines "sale" to include every "attempt or offer to dispose of, or solicitation of an offer to buy a security for value. *Id.* at 301 n.6.

275. *Howey*, 328 U.S. at 301 n.6.

276. 15 U.S.C. § 77e (1982); *supra* note 184.

277. See *Howey*, 328 U.S. at 293. Since an action cannot be brought unless jurisdiction exists, the circumstances that determine jurisdiction must necessarily be as broad as the circumstances that determine that a cause of action exists.

278. 471 U.S. 681 (1985).

279. 15 U.S.C. § 77d(2) (1982).

280. *Id.* at 692. See *supra* note 113 and accompanying text.

281. See, e.g., § 5(c) of the 1933 Act, 15 U.S.C. § 77e(c) (1982), *supra* note 184 (offer to buy or offer to sell securities) and § 5(a)(1) of the 1933 Act, 15 U.S.C. § 77e(a)(1) (1982), *supra* note 184.

*Howey*<sup>282</sup> under circumstances where a management contract was not offered, but merely available.<sup>283</sup> A court may nonetheless find that acts performed by Dubois qualified as a solicitation of an offer under the 1933 Act.<sup>284</sup> Having found jurisdiction to exist through application of a liberal definition of the term "investment contract," the Ninth Circuit may wish to tailor the remedy available for real estate transactions under 10b-5 by adopting a strict interpretation of the *Birnbaum* rule that denies a private cause unless there is a purchase or sale with respect to each element of an investment contract.<sup>285</sup>

## B. THE PARADOX OF WHAT IS SOLD VERSUS WHAT IS PURCHASED

The Court in *SEC v. C. M. Joiner Leasing Corp.*<sup>286</sup> focused upon the offers and promises received by the investor and implied that almost anything could be a security if sufficient emphasis was placed on the economic benefits of an investment.<sup>287</sup> In *SEC v. W. J. Howey Co.*,<sup>288</sup> the Court emphasized the managerial efforts that would be assumed by the promoter.<sup>289</sup> *Hock-*

282. *Howey*, 328 U.S. at 301.

283. *Hocking*, 839 F.2d at 569 n.9 (court acknowledged that neither buyer nor seller had an absolute legal right to enter into the RPA without the consent of the RPA manager).

284. *Howey* interpreted the definition of "sale" in § 2(3) of the 1933 Act, 15 U.S.C. § 77b(3) (1982), as including "every attempt or offer to dispose of, or solicitation of an offer to buy." *Howey*, 328 U.S. at 301.

285. For purposes of jurisdiction, the court could define investment contract as the offer of an investment, the offer to participate in a common enterprise and the offer to share profits earned by the efforts of third parties. See *Howey*, 328 U.S. at 298-99. For purposes of determining that a private right of action exists under 10b-5, the court could define a sale or purchase of an investment contract as an actual investment of money, actual participation in a common enterprise, and actual sharing of profits earned by the efforts of a third party. See *Blue Chip Stamp*, 421 U.S. at 731.

286. 320 U.S. 344 (1943).

287. *Id.* at 346. See *supra* notes 41-49 and accompanying text.

288. 328 U.S. 293 (1946).

289. *Id.* at 299. See *supra* notes 50-58 and accompanying text. The Court noted that *Howey Company* and *Howey-in-the-Hills* were offering an opportunity to share in the profits of a large citrus fruit enterprise managed and partly owned by *Howey Co.* The property and management contracts were offered to persons who resided in distant localities and who lacked the equipment and experience to manage their own property. *Id.* at 299-300.

The third element of the test advocated in *Joiner* was "the plan of distribution and the economic inducements held out to the prospect." *Joiner*, 320 U.S. at 352-53. In *Joiner*, the Court analyzed the sales brochures distributed to offerees as well as the substance of the contractual obligations assumed by seller. *Id.* at 348-49. See *supra* note 49 and accompanying text.

*ing v. Dubois*<sup>290</sup> presented the Ninth Circuit with a real estate broker who offered Hocking property owned by the Libermans, management services provided by an unrelated RPA manager, and who emphasized the economic benefits of the package.<sup>291</sup> Hocking's lawsuit is not aimed at the seller of property or the manager of the RPA, but seeks relief from the broker and her employer.<sup>292</sup>

The Ninth Circuit attempted to reconcile the difference between what the seller sold and what the buyer was offered through the use of a hypothetical option to support the notion that rights with respect to participation in Aetna's RPA were transferred with the condominium unit to Hocking.<sup>293</sup> Thus, the Ninth Circuit in *Hocking* focused on the bundle of rights actually offered to the buyer.<sup>294</sup>

The Ninth Circuit's option analysis significantly expands the possibility that an investment contract might exist.<sup>295</sup> Op-

290. 839 F.2d 560 (9th Cir.), *reh'g granted en banc*, 852 F.2d 503 (1988).

291. *Hocking*, 839 F.2d at 563. *See supra* notes 15 and accompanying text.

292. *Hocking*, 839 F.2d at 562. *See supra* notes 19-28 and accompanying text. Note, however, that an agency relationship normally exists between a real estate broker and a seller. If the Libermans had been named as defendants in *Hocking*, they may have been held vicariously liable for violations of the securities laws by their agent, Maylee Dubois.

293. *Hocking*, 839 F.2d at 569. The *Hocking* court expressly noted that the term option as used in the opinion did not connote that either Hocking or the Liberman's had an absolute right to enter into the pooling arrangement. *Id.*

The court's use of a hypothetical option skates past the controversy concerning whether a binding collateral agreement is a necessary element of an investment contract or whether the unsupported representations of the offeror are sufficient. *See supra* notes 135-139. Since *Hocking* recognized that no absolute right was transferred, the hypothetical option appears to be nothing more than a convenient label for the unsupported representations of the broker. The Ninth Circuit's willingness to base an investment contract on such an option implies that a binding collateral agreement is not a necessary element of an investment contract.

294. *Id.* The court stated that any distinction based on the fact that elements of the investment contract were offered by two separate entities rather than one single entity was precisely the form over substance interpretation that Congress, the SEC and the courts have sought to avoid. *Id.* While the investment contract at issue in *Hocking* involved a condominium unit offered by the Libermans and a RPA offered by Aetna, the *Hocking* court noted that in *Howey*, the land was offered by one Company and the management contract was offered by a separate company. *Hocking*, 839 F.2d at 569.

295. *Id.* at 569. Hocking alleged that the rental pool arrangement was an option available to anyone buying a unit in the condominium project. *Id.* Consequently, anyone purchasing a condominium unit would be deemed to have acquired the option to participate in the rental pool when they purchased the unit and will therefore have satisfied the three criteria of the *Howey* test. *Id.* at 568.

tion analysis is built on an implicit assumption that RPA's are limited to individual condominium developments.<sup>296</sup> If somebody were to create an RPA in which every condominium owner in the U.S. was entitled to participate, then every condominium in the U.S. would qualify as an investment contract under *Hocking* because the sale of any such unit would include an option to participate in the nationwide RPA.<sup>297</sup>

Note also that by shifting focus from the promotional efforts of the seller to the actual rights offered to the buyer the court implies that neither the buyer nor the seller<sup>298</sup> need have actual knowledge of the RPA at the time of sale.<sup>299</sup> The "option" to participate in an RPA is transferred at the time of sale regardless of whether the seller is aware that the RPA exists or whether the seller tells the buyer that the RPA exists and regardless of whether the buyer is aware that he is receiving an "option" in addition to the condominium unit.<sup>300</sup> The notion that parties can transfer rights even when they are unaware that the rights exist is a logical extension of the option concept, but greatly exceeds the intended scope of the securities laws.<sup>301</sup>

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296. *Id.* The court noted that according to *Hocking*, the RPA was an optional arrangement available to anyone buying a unit in the condominium project. *Id.*

297. *See supra* note 268 and accompanying text.

298. There is no real need to attempt to imply that a seller sold a security if the seller is not a defendant to the action. Dubois is the defendant and is alleged to have made fraudulent representations with respect to the sale of a security. *Hocking*, 839 F.2d at 562-563. If the "bundle of rights" offered by Dubois to *Hocking* qualified as an investment contract, it should not matter that the rights were acquired from several sources, none of which qualified as an investment contract in and of themselves.

299. *Id.* The dissent argued that all that the Libermans were selling was a parcel of property. *Id.*

300. *Id.* at 569. The court noted that there was no reason to assume that the option to participate in the RPA somehow mysteriously disappeared from the scene just because the Libermans did not exercise the option and enter the RPA. *Id.* Similarly, there would be no reason to assume that an option to participate in an unaffiliated RPA should disappear merely because none of the parties are aware that it exists. As the *Hocking* court sought to avoid a definition of investment contract that would make the status of a given condominium unit dependent on whether the preceding owner had elected to participate in an RPA, *Id.* at 570, it is unlikely that they would support a definition that made the status of a given condominium unit dependent on either the buyer's or seller's subjective knowledge at the time of sale.

301. *See Howey*, 328 U.S. at 301 n. 6. The Court noted that the registration requirements of § 5 of the 1933 Act, 15 U.S.C. § 77e(a) (1982), *supra* note 184, refers to sales of securities and that § 2(3) of the 1933 Act, 15 U.S.C. § 77b(3) (1982), defines "sales" to include every "attempt or offer to dispose of, or solicitation of an offer to buy," a security. *Howey*, 328 U.S. at 301 n.6. While there is no authority to support the notion that availability, in and of itself, constitutes an offer, any method by which knowledge of such

## C. DOCTRINES OFFERED TO THE COURTS

In *Hocking*, the Ninth Circuit was asked to incorporate several doctrines into the definition of investment contract to reflect certain policy considerations. The court was asked to modify the definition of investment contract to exclude private, as opposed to public transactions,<sup>302</sup> to exclude transactions involving secondary as opposed to primary markets,<sup>303</sup> and to exclude transactions in which there was no linkage between the parties offering property and management services.<sup>304</sup> However reasonable the doctrines may appear in the context of *Hocking*, they are either unsupported or in direct or apparent conflict with established authority<sup>305</sup> and represent potential loopholes through which fraudulent promoters might seek to evade the reach of SEC and the securities laws.

The doctrine distinguishing between public and private transactions was developed in *Marine Bank v. Weaver*<sup>306</sup> and apparently rejected in *Landreth Timber Co. v. Landreth* using a "structure of the Acts" analysis.<sup>307</sup> In *Hocking*, the dissent distinguished between a promoter offering to the general public and the owner of an individual condominium unit offering his property for sale.<sup>308</sup> The dissent argued that the fact that a prospective buyer might be able to reach an arrangement with the developer's rental pool should not make every sale by an individual unit owner a security.<sup>309</sup> The dissent's position would ap-

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availability was made known, however, may constitute an "attempt or offer to dispose of" and therefore come under the definition of a sale in § 2(3) of the 1933 Act, 15 U.S.C. § 77b(3) (1982).

302. See *supra* notes 102-111 and accompanying text.

303. See *supra* notes 112-113 and accompanying text.

304. See *supra* notes 114-124 and accompanying text. The brief filed by the SEC as Amicus Curiae on rehearing en banc argues that unless there is an affiliation or selling arrangement between the seller of a condominium and the rental pool operator, the condominium sale and the procurement of management services are two separate transactions. Brief of the Securities and Exchange Commission, Amicus Curiae, On Rehearing En Banc at 8, *Hocking*, (9th Cir. Dec. 7, 1988) (No. 85-1932).

305. See *supra* notes 102-124 and accompanying text.

306. 455 U.S. 551 (1982). See *supra* notes 102-106 and accompanying text.

307. 471 U.S. 681 (1985). See *supra* notes 107-111 and accompanying text.

308. See *Hocking*, 839 F.2d at 571 (Hug J. dissenting).

309. *Id.* If the bundle of rights offered or sold by individual condominium owners satisfy the definition of an investment contract, there is no reason that the transaction should not qualify as a security merely because of its size or because it is privately negotiated. See *Id.* Note that the fact that a transaction qualifies as a security does not neces-

pear to conflict with the *Landreth* Court's refusal to exempt privately negotiated transactions from the securities laws.<sup>310</sup>

There does not appear to be any authority supporting a doctrine that incorporates the distinction between primary and secondary markets into the definition of investment contract.<sup>311</sup> However, the *Landreth* "structure of the Acts" argument would reject distinctions that render provisions of the securities law superfluous.<sup>312</sup> Furthermore, if a secondary market exemption was read into the definition of investment contract, a fraudulent promoter might succeed in evading the securities laws altogether by passing title through an intermediary before selling the security on the "secondary" market.<sup>313</sup>

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sarily mean that the securities laws will be applied. *See, e.g.*, § 3(b) of the 1933 Act, 15 U.S.C. § 77c(b) (1982) (SEC may exempt certain classes of transactions from registration under the 1933 Act). Fears that *Hocking* might require every condominium owner to comply with the registration provisions of the 1933 Act are foolish given the express exemption in § 4(1) of the 1933 Act, 15 U.S.C. § 77d(1) (1982) (exemption for any person other than an issuer, underwriter, or dealer from the registration provisions) and § 4(2) of the 1933 Act, 15 U.S.C. § 77d(2) (1982) (exempting private transactions from the registration provisions).

310. *See Landreth*, 471 U.S. at 692. The law distinguishing between public and private transactions has been fairly well developed through litigation involving the registration exemption for an issue that is not a public offering, Section 4(2) of the 1933 Act, 15 U.S.C. section 77d(2) (1982). *See, e.g.*, *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953) (availability of the private offering exemption under section 4(2) of the 1933 Act).

If the definition of investment contract is deemed to exclude certain private transactions, the courts would have to settle the meaning of "not a public offering" for purposes of determining jurisdiction in addition to applying existing law defining "not a public offering" for purposes of the exemption from registration of transactions that qualify as securities.

311. The amicus brief filed by the Hawaii Association of Realtors argues that SEC Release 5347, 17 C.F.R. § 231.5347 (1988), does not apply to secondary transactions, but does not cite any authority other than a statement in Release 5347 providing that it was issued "to alert persons engaged in the business of building and selling condominiums and similar types of real estate developments to their responsibilities under the Securities Act and to provide guidelines for a determination of when an offering of condominiums or other units may be viewed as an offering of securities." Amicus Curiae Brief of the Hawaii Association of Realtors In Support of Defendants/Appellees In Rehearing En Banc at 5-6, *Hocking*, (9th Cir. Dec. 7, 1988) (No. 85-1932).

There is a logical flaw to the association's argument. Release 5347 cannot compel condominium developers to comply with securities registration laws unless the underlying transaction qualifies as a security. Given that the transactions described in Release 5347 qualify as securities for registration purposes, they do not suddenly stop qualifying as securities for other purposes or because Release 5347 ceases to apply.

312. *See supra* note 112-113 and accompanying text.

313. Section 2(11) of the 1933 Act, 15 U.S.C. § 77b(11) (1982) would classify such an intermediary as an underwriter and hold him strictly liable for the omission of any material fact under § 11(a)(5) of the 1933 Act, 15 U.S.C. § 77k(a)(5) (1982). If a transaction

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When the sale of real estate in conjunction with management services is held to constitute an investment contract, there is often a relationship or linkage between the party selling the property and the party offering management services.<sup>314</sup> While there do not appear to be any cases that require such relationship or linkage,<sup>315</sup> both the Fifth and Tenth Circuits have expressly rejected the notion that an investment contract will not exist unless there is some sort of linkage between the individual selling property and the individual offering management services.<sup>316</sup> If the Ninth Circuit were to adopt a linkage requirement, a crooked promoter could evade the securities laws altogether by offering either the land or the management services through an appropriate intermediary.<sup>317</sup>

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passing through such an intermediary does not qualify as a security because of an exclusion read into the definition of investment contract, then neither § 2 nor § 11 of the 1933 Act would apply. The courts would have to develop rules defining the circumstances under which a transaction following the sale through an intermediary would qualify as a "secondary" market.

314. The amicus brief filed by the SEC argues that there is a linkage requirement and cites the following cases in support of the proposition that real estate transactions have been found to qualify as investment contracts in cases where linkage existed: *Howey*, 328 U.S. at 294-95 (W. J. Howey Co., offeror of land sales, and Howey-in-the-Hills, offeror of land management contracts, under common control); *Cameron v. Outdoor Resorts of America, Inc.*, 608 F.2d 187, 191 (5th Cir. 1979) (promoter had exclusive right to rent condominium campsites in the absence of the owner); *Hodges v. H & R Investments*, 668 F. Supp. 545, 548 (N.D. Miss. 1987) (promoter sold condominium and guaranteed rental income); *Wooldridge Homes v. Bronze Tree*, 558 F. Supp. 1085, 1087 (D. Colo. 1983) (promoter sold property and offered managerial services). Brief of the Securities And Exchange Commission, Amicus Curiae, On Rehearing En Banc at 9-10, *Hocking*, (9th Cir. Dec. 7, 1988) (No. 85-1932).

315. While the amicus brief filed by the SEC argues that there is a linkage requirement and cites cases in which linkage existed, *see supra* note 314, no cases are cited as requiring linkage before a real estate transaction will be found to qualify as an investment contract. *See* Brief Of The Securities And Exchange Commission, Amicus Curiae, On Rehearing En Banc at 10-11, *Hocking*, (9th Cir. Dec. 7, 1988) (No. 85-1932).

316. *See* *Continental Marketing Corp. v. SEC*, 387 F.2d 466 (10th Cir. 1967); *Roe v. Wade*, 287 F.2d 435 (5th Cir. 1961). *See supra* notes 114-124 and accompanying text.

317. Just as an intermediary could be used to convert a transaction from the primary market to the secondary market, *see supra* 313 and accompanying text, an intermediary could also be used to avoid a linkage requirement. The courts would have to develop case law defining the types of relationships that would or would not establish sufficient linkage for a transaction in which property and management services are offered by different entities. *See*, *SEC v. W.J. Howey Co.*, 328 U.S. 293, 294-5 (1945) (property and management services offered by separate corporations under common control qualified as an investment contract).

## D. NINTH CIRCUIT INTERPRETATION OF RELEASE 5347

In *Hocking*, the Ninth Circuit adopted Release 5347<sup>318</sup> as controlling in 10b-5 actions involving condominiums,<sup>319</sup> but failed to clarify the effect that the representations of an offeror bear on a condominium's status as an investment contract. The Ninth Circuit held that condominium investments satisfying the second scenario of Release 5347<sup>320</sup> will also satisfy the *Howey*<sup>321</sup> definition of investment contract,<sup>322</sup> but did not consider the converse, that investments that fail to qualify under the second Release 5347 scenario may still qualify as securities under *Howey*. Where there is ample emphasis on the economic benefits to be derived by the purchaser through the effort of a third party, the fact that an RPA exists but is not deemed to have been offered will not prevent the condominium from meeting the *Howey* criteria and qualifying as a security.<sup>323</sup>

The Ninth Circuit stated that the bright line rule of Release 5347 provides the only proper interpretation of *Howey* as applied to condominiums and that the second Release 5347 scenario is meant to provide exclusive coverage for transactions that involve an RPA.<sup>324</sup> While the court's statement may represent an accurate analysis of the SEC's intent, it results in an unnecessarily restrictive interpretation of *Howey*, given the Ninth Circuit's willingness to accept vertical commonality.<sup>325</sup> If the

318. 17 C.F.R. § 231.5347 (1988). See *supra* note 154-158 and accompanying text.

319. *Hocking*, 839 F.2d at 568.

320. 17 C.F.R. § 231.5347 (1988). See *supra* note 154-158 and accompanying text.

321. 328 U.S. 293 (1946).

322. *Hocking*, 839 F.2d at 566.

323. See *Howey*, 328 U.S. at 298-299. The *Howey* definition of an investment contract involves a scheme where 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. *Id.* Assuming that a common enterprise is deemed to exist, it would appear that any purchaser of property who is led to believe that he can receive profits through the efforts of others has purchased an investment contract even if no opportunity actually exists.

324. *Hocking*, 839 F.2d at 565 n.6. The court stated that while the language of the first Release 5347 scenario "is general, ostensibly covering 'any rental arrangement,' giving that phrase an all inclusive interpretation would render meaningless the language of [the second Release 5347 scenario]." *Id.*

325. The court's statement implies that the criteria of the first Release 5347 scenario, emphasis on economic benefits, are irrelevant if an RPA is involved. While economic emphasis will not matter if an RPA is offered or sold in a manner that qualifies as the offer or sale of an investment contract, economic emphasis could be very important where, as in *Hocking*, there is some question as to whether the RPA has been offered in a

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Libermans' offer to sell did not include an RPA and therefore lacked horizontal commonality, vertical commonality should be examined.<sup>326</sup> Similarly, if the second Release 5347 criteria fails because an RPA was available but not offered, or offered on terms that were not sufficiently binding, then the facts should be analyzed under the first Release 5347 scenario to determine if there was sufficient economic emphasis to create an investment contract.

Although *Hocking* involves an action brought under the antifraud provisions of Rule 10b-5,<sup>327</sup> the Ninth Circuit found the Release 5347 guidelines concerning registration of condominium developments under section 5 of the 1933 Act<sup>328</sup> to be controlling.<sup>329</sup> By applying Release 5347 to a action under Rule 10b-5, the Ninth Circuit implies that statements in Release 5347 purporting to limit its scope to the registration of developers are of no import.<sup>330</sup> One explanation for the court's position is that a transaction cannot be required to register under the securities law unless it qualifies as a security.<sup>331</sup> Once a transaction qualifies as a security, it will not suddenly cease to be a security merely because a different section of the securities laws is applied or because a broker or owner rather than a promoter is involved.<sup>332</sup> While it is possible to back into logic that supports the Ninth Circuit's view of the status of Release 5347, the status of the release would be clearer if the court had explained why it

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manner that will qualify the transaction as an investment contract.

The interplay between the "bundle of rights" transferred and the nature of the "promises made by the offeror" has not yet been settled with respect to real estate transactions. See *supra* note 135-139 and accompanying text. Release 5347 appears to embrace both "the bundle of rights" (second scenario focusing on RPA) and "promises made by the offeror" (first scenario focusing on economic emphasis). In *Hocking*, the majority relied solely on the second scenario and found it to be controlling. *Hocking*, 839 F.2d at 565. On the other hand, the dissent argued that the first Release 5347 scenario appeared to be "reasonably accurate" but that the second Release 5347 scenario "moved away from *Howey*." *Id.* at 572.

326. *Hocking*, 839 F.2d at 567. See *supra* note 245 and accompanying text.

327. 17 C.F.R. 240.10b-5 (1987). See *supra* note 161.

328. 15 U.S.C. § 77e (1982). See *supra* note 184.

329. *Hocking*, 839 F.2d at 566.

330. Release 5347 provides that it was issued "to alert persons engaged in the business of building and selling condominiums and similar types of real estate developments to their responsibilities under the Securities Act and to provide guidelines for a determination of when an offering of condominiums or other units may be viewed as an offering of securities." Release 5347, 17 C.F.R. 231.5347 (1988).

331. See § 5 of the 1933 Act, 15 U.S.C. § 77e (1982). See *supra* note 184.

332. See *supra* note 153 and accompanying text.

was disregarding the statements in the release purporting to limit its application.<sup>333</sup>

#### E. CONFLICT BETWEEN FUNDAMENTALLY DIFFERENT REAL ESTATE TRANSACTIONS

*SEC v. C. M. Joiner Leasing Co.*<sup>334</sup> and *SEC v. W. J. Howey Co.*<sup>335</sup> each reflect a distinct type of real estate transaction that should be carefully distinguished by the courts.<sup>336</sup> In *Hocking v. Dubois*,<sup>337</sup> there is little question that an RPA qualifies as a pooling arrangement involving the expectation of profits from the efforts of others.<sup>338</sup> Where the purchaser voluntarily joins an RPA, the question arises as to whether the RPA arrangement merely involves a delegation of managerial rights held by the owner or evidence of the buyers dependence on other parties.<sup>339</sup> When a tourist purchases a Hawaiian resort condominium from his home in Las Vegas, the RPA may represent the only practical way that the purchaser can realize the profits promised by his realtor.<sup>340</sup>

*Hocking* involves a *Howey*-type transaction where the management services at issue would be performed on the income producing property purchased by Hocking, rather than on a neighboring piece of property as in *Joiner*. Consequently, the holdings in *Joiner*-type cases requiring a collateral agreement<sup>341</sup> or disregarding promises that were not reflected in the sale con-

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333. On rehearing, the en banc court will probably elaborate on the status of the provisions in Release 5347 that attempt to limit its application. The defendants, the SEC and the Hawaiian Association of Realtors all raised the issue in their briefs on rehearing en banc. See Joint Brief of Appellees Maylee Dubois and Vitousek & Dick Realtors, Inc. On Rehearing En Banc at 43, *Hocking* (9th Cir. Dec. 7, 1988) (No. 85-1932); Brief of the Securities And Exchange Commission, Amicus Curiae, On Rehearing En Banc at 13, *Hocking* (9th Cir. Dec. 7, 1988) (No. 85-1932); Brief of the Hawaiian Association of Realtors In Support of Defendants/Appellees In Rehearing En Banc at 5-6, *Hocking* (9th Cir. Dec. 7, 1988) (No. 85-1932).

334. 320 U.S. 344 (1943).

335. 328 U.S. 293 (1946).

336. See *supra* notes 125-144 and accompanying text.

337. 839 F.2d 560 (9th Cir.), *reh'g granted en banc*, 852 F.2d 503 (1988).

338. See *Id.* at 565 (an offering of a condominium with an RPA will automatically qualify as an investment contract).

339. See *supra* notes 96-101 and accompanying text; *supra* notes 140-144 and accompanying text.

340. See *supra* note 144 and accompanying text.

341. See *supra* note 135.

tract<sup>342</sup> are distinguishable and should not necessarily apply to *Hocking*.<sup>343</sup> The Ninth Circuit could greatly improve the clarity of the case law defining investment contracts with respect to real estate transaction if it would distinguish precedent involving *Howey*-type transactions from precedent involving *Joiner*-type transactions.

## VI. CONCLUSION

*Hocking v. Dubois*<sup>344</sup> provides the Ninth Circuit with an opportunity to map one of the most complex and uncharted regions of the securities law. Since *Hocking* addresses such a wide range of unresolved investment contract issues, the Ninth Circuit's en banc decision upon rehearing is likely to exert a major influence on subsequent investment contract cases. Whether the Ninth Circuit's decision serves to settle the law or to set off a wide ranging controversy that must ultimately be settled by the Supreme Court will depend on how successfully the court provides guidelines to the disposition of the issues discussed in this note. Regardless of whether *Hocking*'s condominium is found to be an investment contract, the one goal that investors, developers, real estate brokers and the courts all have in common is a desire for rules that will advise them of where they stand when investors come seeking profits in paradise.

*Peter A. MacLaren\**

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342. See *supra* note 138.

343. See *supra* notes 140-144 and accompanying text. Although *Hocking* involves a *Howey*-type transaction, the following *Joiner*-type transactions were cited in *Hocking* as examples of real estate transactions that did not qualify as investment contracts: *De Luz Ranchos Inv. Ltd. v. Coldwell Banker & Co.*, 608 F.2d 1297, 1300 (9th Cir. 1979) (no investment contract even though the developer's marketing plan promoted appreciation to be realized from neighboring development because developer was only obligated to transfer title); *Woodward v. Terracor*, 574 F.2d 1023, 1025 (10th Cir. 1978) (no investment contract although developer represented that self sufficient community would be built nearby because promoter only had to deliver title); *Happy Investment Group v. Lakeworld Properties, Inc.*, 396 F. Supp. 175, 180-81 (N.D. Cal. 1975) (no investment contract where literature gave impression that subdivision would be built because no concrete promise was made). See *Hocking*, 839 F.2d at 564.

344. 839 F.2d 560 (9th Cir.), *reh'g granted en banc*, 852 F.2d 503 (1988).

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