Boston College Law Review

Volume 17
Issue 2 *Number 2*

Article 7

1-1-1976

Securities Regulation —Shares of Non-Profit Cooperative Housing Developments as Securities — United Housing Foundation, lnc. v. Forman

Susan Challen Cooper

Securities Regulation—Shares of Nonprofit Cooperative Housing Developments as Securities—*United Housing Foundation, Inc. v. Forman*[1]—Co-op City is a state-subsidized, low and middle income cooperative housing development located in New York City.[2] The buildings and land constituting this mammoth development[3] are owned and operated by Riverbay Corporation [Riverbay], a nonprofit cooperative housing corporation.[4] Riverbay was organized by United Housing Foundation [UHF], a nonprofit membership corporation comprised of labor unions, housing cooperatives and civic groups, which was responsible for initiating and sponsoring the development of Co-op City.[5] Community Services, Inc. [CSI], a wholly-owned subsidiary of UHF, served as general contractor and sales agent for the project.[6]

In order to acquire housing in Co-op City, an eligible prospective tenant[7] was required to purchase, at twenty-five dollars per share, eighteen shares of Riverbay "stock" for each apartment room desired.[8] These shares could only be owned by actual or prospective occupants of Co-op City apartments. Furthermore, the shares could be neither transferred, pledged, nor encumbered; upon death of the owner they descended, along with the apartment, only to a surviving spouse. The shares did not carry any voting rights; instead, each apartment was entitled to one vote.[9] Tenants were assessed monthly rental charges based on apartment size, type, and location, rather than on the number of shares owned.[10] If a tenant vacated the apartment,[11] Riverbay was entitled to the right of first refusal of his shares at the tenant's initial purchase price.[12] If Riverbay did not re-

---

[1] 421 U.S. 837 (1975).

[2] *Id.* Co-op City was built pursuant to New York's Mitchell-Lama Act, N.Y. PRIV. HOUS. FIN. LAW §§ 10-37 (McKinney 1962), *as amended*, (Supp. 1975-76), which was designed to alleviate the scarcity of decent, low-income urban housing by encouraging private developers to build low-cost cooperative housing. *Id.* § 11. Conditioned upon state supervision, inducements such as large, long-term, low-interest loans, *id.* § 22, local property tax exemptions, *id.* § 33, and the power of condemnation by the state or municipality, *id.* § 29, were offered by the Act.

[3] Co-op City covers 200 acres containing 35 high-rise buildings and 236 townhouses which house approximately 50,000 persons. 421 U.S. at 840.

[4] *Id.* at 841.

[5] *Id.* n.2.

[6] *Id.* at 841-42.

[7] Eligible families or individuals were those whose monthly income was less than six times the monthly rental charge, or, for families of four or more, less than seven times that charge. N.Y. PRIV. HOUS. FIN. LAW § 31.2(a) (McKinney Supp. 1975-76). Preference was given to veterans, *id.* § 31.7., the handicapped, and the elderly, *id.* § 31.8.

[8] 421 U.S. at 842.

[9] *Id.*

[10] *Id.* at 843.

[11] A tenant could terminate his occupancy voluntarily or could be forced to move if he violated provisions of the lease or if his income had grown to exceed the eligibility standards. *Id.* at 842 n.5.

[12] *Id.* at 842-43. A special fund of approximately one million dollars had been established to insure that Riverbay would be able to repurchase the shares. Thus far,

purchase the shares, the tenant could then sell them only to another eligible prospective tenant at a price equal to the original purchase price plus a fraction of the mortgage principal paid during the tenancy.[13]

Plaintiffs, fifty-seven residents of Co-op City, brought an action in the United States District Court for the Southern District of New York on behalf of themselves and all other residents alleging, *inter alia,* various violations of the antifraud provisions of the Securities Act of 1933,[14] the Securities Exchange Act of 1934[15] [hereinafter the Securities Acts], and Rule 10b-5[16] in connection with the offer and sale of the shares which they had purchased in Riverbay.[17] The principal defendants—Riverbay, UHF, and CSI[18]—were alleged to have made certain material misrepresentations and omissions in the Co-op. City Information Bulletin, a circular which described and promoted the project.[19] Plaintiffs sought reduction of monthly rental charges, money damages, and other appropriate relief.[20]

To invoke the protection of the antifraud provisions of the Securities Acts, plaintiffs were required to establish that the Riverbay shares were within the statutory definition of a security. The definitional section of the 1934 Act provides in pertinent part that "unless the context otherwise requires," security includes any "stock [or] investment contract."[21] The district court granted the defendants' motion to dismiss for lack of subject matter jurisdiction, holding that a share in such a cooperative was not a "security" as defined by the

---

every family that has withdrawn from the project has had its shares repurchased by the corporation. *Id.* n.6.

[13] N.Y. PRIV. HOUS. FIN. LAW § 31-a (McKinney Supp. 1975-76).

[14] 15 U.S.C. § 77q(a) (1970).

[15] 15 U.S.C. § 78j(b) (1970).

[16] 17 C.F.R. § 240.10-b5 (1975).

[17] Forman v. Community Servs., Inc., 366 F. Supp. 1117, 1120 (S.D.N.Y. 1973). Plaintiffs also claimed a violation of 42 U.S.C. § 1983 (1970) by the State of New York and the State Housing Finance Agency and advanced several pendent state claims. *Id.* at 1120 & n.4. These claims, however, are not relevant to the issues discussed in this note.

[18] Also named as defendants were the State of New York, the New York State Housing Finance Agency, which financed the development, and certain individual officers and directors of the defendant organizations. 421 U.S. at 844.

[19] Plaintiffs claimed that the Information Bulletin falsely represented that CSI would bear any subsequent cost increases due to factors such as inflation. They further alleged unlawful omission of the following facts: (1) UHF and CSI had failed to adhere to cost estimates in previous Mitchell-Lama projects; (2) CSI was a wholly-owned subsidiary of UHF; (3) due to its small net worth, CSI could not have been legally held to complete its contract within the original estimates; and (4) the State Housing Commissioner had waived his own rules regarding liquidity requirements in approving CSI as the contractor. *Id.* at 844-45 n.8.

[20] *Id.* at 844.

[21] 15 U.S.C. § 78c(a)(10) (1970). The 1933 Act defines a security in virtually identical terms. 15 U.S.C. § 77b(1) (1970). *See* Tcherepnin v. Knight, 389 U.S. 332, 335-36 (1967).

Securities Acts.[22]

Plaintiffs appealed, and the Court of Appeals for the Second Circuit reversed,[23] basing its decision upon two alternative grounds. First, the court held that the shares constituted "stock" within the statutory definition since they were literally denominated by the defendants as such.[24] Second, the court determined that the transaction was an "investment contract" within the language of the Securities Acts' definitional sections, since the transaction in question involved 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.' "[25]

The Supreme Court granted certiorari.[26] Reversing the court of appeals in a 6-3 decision, the Court HELD: Shares of a nonprofit cooperative housing corporation are not securities within the definition of the federal Securities Acts when purchased without a reasonable expectation of profit.[27] In reaching its decision, the Court first rejected the "literal approach"[28] taken by the court of appeals—that interests termed "stock" are automatically securities under the definitional sections of the Securities Acts.[29] Next, the Court held that the transaction did not constitute an "investment contract" since there was no reasonable expectation of profit by the plaintiffs; their purpose in purchasing the shares was to acquire low cost residential housing for personal use rather than to invest with the expectation of a monetary return.[30] The significance of the *Forman* decision lies in the Court's rejection of a literal approach in interpreting the definitional sections of the Securities Acts and in the Court's refusal to construe monetary savings as profit for purposes of defining an investment contract. By adopting a policy of examining the primary motivation[31] for a putative investor's actions and by limiting the concept of profit to a return on an investment that is capable of liquidation,[32] the Court rejected

---

[22] Forman v. Community Servs., Inc., 366 F. Supp. 1117, 1120-21 (S.D.N.Y. 1973). The state parties had moved to dismiss on the grounds of sovereign immunity. Due to the disposition of the case, neither the district court, *see id.* at 1132, nor the Supreme Court, 421 U.S. at 860 n.27, reached this issue.

[23] Forman v. Community Servs., Inc., 500 F.2d 1246, 1248 (2d Cir. 1974).

[24] *Id.* at 1252.

[25] *See id.* at 1253-54, *quoting* SEC v. W.J. Howey Co., 328 U.S. 293, 299 (1946). The court of appeals also found that sovereign immunity had been expressly waived under N.Y. PRIV. HOUS. FIN. LAW § 32.5.(f) (McKinney Supp. 1975-76) by both the State and the State Housing Finance Agency, and that the Eleventh Amendment did not protect a state voluntarily entering a field already under federal regulation. 500 F.2d at 1255-56. *See* Parden v. Terminal Ry., 377 U.S. 184, 192 (1964).

[26] 419 U.S. 1120 (1975).

[27] 421 U.S. at 858-60.

[28] *Id.* at 848.

[29] *Id.* See text at notes 23-24 *supra.*

[30] 421 U.S. at 858.

[31] *Id.*

[32] *Id.* at 855.

what would appear to be an improper expansion of the definition of a security.

This note will briefly trace the factors which led to the adoption of the Securities Acts and examine the manner in which the current interpretation of the statutory definition of a "security" has evolved. The Court's holding in *Forman* will then be discussed in light of this background. Particular attention will be given first to the Court's rejection of the literal approach to statutory interpretation. Next, the criteria for determining the existence of an investment contract will be discussed, with special attention given to the Court's interpretation of the profit requirement. It will be submitted that the *Forman* holding is consistent with the statutory language, congressional intent, current administrative rulings, and leading court decisions.

The legislative history of the Securities Acts reveals that Congress was concerned with regulating manipulative and speculative practices and with curbing the various investment abuses that contributed to the ruinous depression of the Thirties.[33] Passed in the aftermath of the 1929 stock market crash, the Securities Acts were intended to protect the interests of both investors and the general public by requiring certain disclosures and by prohibiting fraud and manipulative practices.[34] To protect the investor, Congress focused on curbing stock market manipulation, margin abuses, and the reckless stock market gambling of small investors who were lured by "promises of easy wealth [which] were freely made with little or no attempt to bring to the investor's attention those facts essential to estimating the worth of any security."[35] To protect the nation's enterprises and economy, Congress focused on the changing proportion of investments made in liquid securities[36] and on the fact that this "easy liquidity of the resources in which wealth is invested is a danger rather than a prop to the stability of [the economic] system. When everything everyone owns can be sold at once, there must be confidence not to sell."[37]

In effectuating this protective spirit, Congress provided for the regulation of securities transactions and purposely defined the term "security" in "sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security."[38] Specifically, the definition includes any "stock" or "investment contract."[39]

---

[33] *See* S. REP. NO. 792, 73d Cong., 2d Sess. (1934); H.R. REP. NO. 1383, 73d Cong., 2d Sess. (1934); S. REP. NO. 47, 73d Cong., 1st Sess. (1933); and H.R. REP. NO. 85, 73d Cong., 1st Sess. (1933).

[34] *See* Securities Act of 1933, 15 U.S.C. § 77q (1970); Securities Exchange Act of 1934, 15 U.S.C. § 78j (1970).

[35] H.R. REP. NO. 85, 73d Cong., 1st Sess. 2 (1933).

[36] H.R. REP. NO. 1383, 73d Cong., 2d Sess. 3 (1934).

[37] *Id.* at 5.

[38] H.R. REP. NO. 85, 73d Cong., 1st Sess. 11 (1933).

[39] Securities Act of 1933, 15 U.S.C. § 78c(a)(10) (1970); Securities Exchange Act of 1934, 15 U.S.C. § 77b(1) (1970).

Congress also indicated, however, that it did not intend to extend federal regulation to those instruments "not regarded in the commercial world as securities offered to the public for investment purposes."[40] The commercial context of a particular instrument, therefore, may require that it not be construed as a security.

The Supreme Court has held that a share of stock evidenced by a certificate which gives the holder the right to receive payments of dividends contingent upon apportionment of profits constitutes a security under the Securities Acts.[41] The Court has also indicated, however, that restrictions on the traditional characteristics associated with stock—negotiability, ability to be pledged or hypothecated, conferral of voting rights in proportion to the number of shares owned, and possibility of appreciation[42]—will not necessarily cause a transaction to avoid classification as a security.[43] Thus, the Court has adopted a policy of examining the substance instead of the form of a particular instrument. Indeed, the Court in *Forman* expressly subscribed to the policy that " 'form should be disregarded for substance and the emphasis should be on economic reality.' "[44]

Although Congress did not specifically define "investment contract," that term was in wide use in state blue sky laws when Congress enacted its scheme of remedial legislation.[45] Its well-settled construction was that of a transaction which involved "[t]he placing of capital or laying out of money in a way intended to secure income or profit from its employment . . . ."[46] The Supreme Court's first interpretation of "investment contract" was a modification of the states' interpretation. In *SEC v. C.M. Joiner Leasing Corp.*[47] promoters sold assignments of leases to land believed to contain oil deposits and coupled such sales with an agreement to drill test wells on the leased land.[48] When the SEC sought to restrain alleged violations of the Securities Act of 1933, the promoters argued that the transactions were not covered by the Act.[49] The Court found that the contracts for the exploratory drillings imparted to the transactions "most of their value and all of their lure."[50] Since the promoters were offering the economic inducement of the exploratory well drillings, the investors were paying both for a lease and for the development of the land. The Court reasoned that in determining the scope of the Securities Acts, "[n]ovel, uncommon,

---

[40] H.R. REP. No. 85, 73d Cong., 1st Sess. 15 (1933).

[41] Tcherepnin v. Knight, 389 U.S. 332, 339 (1967).

[42] *See* 421 U.S. at 851.

[43] *See* Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128 (1972); Tcherepnin v. Knight, 389 U.S. 332 (1967).

[44] 421 U.S. at 848, *quoting* Tcherepnin v. Knight, 389 U.S. 332, 336 (1967).

[45] SEC v W.J. Howey Co., 328 U.S. 293, 298 (1946).

[46] *Id.*, *citing* State v. Gopher Tire & Rubber Co., 146 Minn. 52, 56, 177 N.W. 937, 938 (1920).

[47] 320 U.S. 344 (1943).

[48] *Id.* at 345-46.

[49] *Id.* at 350.

[50] *Id.* at 349.

or irregular devices . . . are also reached if . . . they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as 'investment contracts . . . .' "[51] Holding that this transaction did constitute an "investment contract," the Court stated that rather than being guided by the nature of the assets behind a particular document or offering, the proper test should inquire as to the "character the instrument is given in commerce by the terms of the offer, the plan of distribution, and *the economic inducements held out to the prospect.*"[52]

Three years later, in *SEC v. W.J. Howey Co.*,[53] the Court refined its definition of an "investment contract." In *Howey,* the Court held that the offering of units of a citrus grove development coupled with a contract for cultivating, marketing, and remitting the net proceeds to the investor constituted an "investment contract" under the Securities Act of 1933.[54] The Court stated that an "investment contract" exists where there is "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to *expect profits solely from the efforts of the promoter or a third party* . . . ."[55] Noting that this test was the foundation of its decision in *Joiner,*[56] the Court reasoned that such a test could be adapted to meet the variety of schemes devised by "those who seek the use of the money of others on the promise of profits."[57] Therefore, an investment contract could exist where an enterprise was not speculative in nature and where "the tangible interest which is sold has intrinsic value independent of the success of the enterprise as a whole."[58]

In determining whether an investment contract exists, the Supreme Court has applied the *Howey* test without modification since its inception.[59] This test, however, has been criticized by commentators as not being faithful to *Joiner* in its shift in focus from economic inducements offered by promoters, to profit expectations of purchasers,[60] as well as for its focus on the profit which the investor anticipates rather than on the risk which he assumes.[61] Recognizing that the element of profit in the *Howey* test demands a money return over and above the initial investment, commentators have also criti-

---

[51] *Id.* at 351.

[52] *Id.* at 352-53 (emphasis added).

[53] 328 U.S. 293 (1946).

[54] *Id.* at 295, 299-300.

[55] *Id.* at 299 (emphasis added).

[56] *Id.*

[57] *Id.*

[58] *Id.* at 301.

[59] *See, e.g.,* Tcherepnin v. Knight, 389 U.S. 332, 338 (1967).

[60] Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?,* 18 WEST. RES. L. REV. 367, 381-82 (1967).

[61] Hannan & Thomas, *The Importance of Economic Reality and Risk in Defining Federal Securities,* 25 HAST L. J. 219, 241-49 (1973); Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation,* 24 OKLA. L. REV. 135, 167-70 (1971); Coffey, *supra* note 60, at 367.

cized *Howey* as giving inadequate attention to cases where an investment is made to capitalize a venture with the expectation of a nonmonetary economic benefit.[62]

An approach which does focus on the risk to investors has been adopted by the California Supreme Court. In *Silver Hills Country Club v. Sobieski,*[63] Justice Traynor interpreted definitional sections of the California blue sky laws,[64] which were similar to the federal Securities Acts, to include schemes where investors risked their capital with the expectation of receiving some type of general economic benefit.[65] In *Silver Hills,* the purchasers provided the capital for the construction of a country club in exchange for membership in the club which included the right to use the club's facilities.[66] The court reasoned that only by risking their capital along with others could the investors have a chance that the benefits of club membership would materialize. The court stated that the objective of the securities law was to afford those who *risk their capital* at least a fair chance of realizing their objectives whether they expect a return on their capital in one form or another.[67]

The definition of "investment contract" has also developed through SEC pronouncements, particularly with regard to housing cooperatives. In Securities Act Release 33-5347,[68] specific guidelines were set out to clarify whether offers of interests in condominiums or housing cooperatives constitute securities. Under these guidelines, an offering will be considered an "investment contract" if it includes: (1) a rental arrangement emphasizing the economic benefits to the purchaser to come from managerial efforts of a third party or the promoter; (2) a rental pooling arrangement;[69] or (3) an arrangement whereby the purchaser is required to keep his unit available for rental for part of the year or to use an exclusive rental agent, or is otherwise materially restricted in the use of his unit.[70] Where income-generating commercial facilities are part of a residential project, the conclusion that an investment contract exists is not required, provided the income from these facilities is used only to offset common area expenses and the facilities are not established as a primary source of income for the individual owners, but are merely incidental to the project.[71] The SEC, therefore, appears to have distinguished those

---

[62] Long, *supra* note 61, at 174-75;Coffey, *supra* note 60, at 377-78.

[63] 55 Cal.2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961).

[64] CAL. CORP. CODE § 25008 (West 1955), *as amended,* § 25019 (Supp. 1975).

[65] 55 Cal.2d at 815-16, 361 P.2d at 908-09, 13 Cal. Rptr. at 188-89.

[66] *Id.* at 812-13, 361 P.2d at 906-07, 13 Cal. Rptr. at 186-87.

[67] *Id.* at 815-16, 361 P.2d at 908-09, 13 Cal. Rptr. at 188-89.

[68] 38 Fed. Reg. 1735 (1973).

[69] In a typical rental pool, a promoter undertakes to rent units not being used by their owners. The rents received and the expenses of rental are combined and each individual owner receives a pro rata share of the profits regardless of whether his unit was actually rented. *Id.* at 1736.

[70] *Id.*

[71] *Id.*

types of housing units purchased for *personal use* from those that are sold with an emphasis on the *investment* benefits to the purchaser.[72]

Against this background, the Court in *Forman* was confronted with the question of whether the shares of Riverbay stock fell within the scope of the Securities Acts' definition of a security. Under the definitional sections, it was necessary for the Court to examine specifically whether the shares constituted either "stock" or "investment contracts." In considering whether the shares were "stock," the Court rejected the literal approach[73] adopted by the court of appeals—that instruments denominated "stock" automatically fall within the statutory definition.[74] The Court reasoned that such a mechanical reading of the statutory definitions would violate well-settled canons of statutory construction.[75] As early as 1892, the Court had stated: "[i]t is a familiar rule, that a thing may be within the letter of the statute and yet not within the statute, because not within its spirit, nor within the intention of its makers."[76]

In adopting the literal approach, the court of appeals had mistakenly relied on dictum from *Joiner* that "[i]nstruments may be included within any of these definitions, as matter of law, if *on their face* they answer to the name or description."[77] The *Forman* Court stated that this reliance was misplaced, reasoning that the *Joiner* Court was merely observing that most instruments using the traditional term "stock" are likely to be covered by the Securities Acts.[78] The *Forman* Court was quick to note that in *Joiner,* the Court had in fact examined the underlying economic reality of the transaction before finding that a security existed.[79]

The Supreme Court's rejection of the literal approach in *Forman* appears to be consistent with a faithful reading of the Securities Acts

---

[72] The SEC's first pronouncement (Dec. 16, 1960) in this area was an *exemption from registration* of certain "[s]tock or other securities representing membership in any cooperative housing corporation . . . " if the principal activity of the corporation is the "ownership, leasing, management or construction of residential properties for its members . . . ." 17 C.F.R. § 230.235 (1975). It could be argued that this rule implies that all cooperative shares are otherwise included under Securities Acts coverage. This argument, however, has been characterized by Prof. Loss as "too facile." 1 L. LOSS, SECURITIES REGULATIONS 493-94 (2d ed. 1961). It has been suggested that "[a] more plausible argument is that an exemptive rule was a convenient means for the Commission to avoid the cooperative housing regulation issue." Recent Development, 62 GEO. L.J. 1515, 1527 n.62 (1974). If the exemption is read as covering only interests in cooperative units that already meet the definition of a "security," the rule is then consistent with Release 33-5347.

[73] 421 U.S. at 848.

[74] Forman v. Community Servs., Inc., 500 F.2d 1246, 1252 (2d Cir. 1974).

[75] 421 U.S. at 849.

[76] Church of the Holy Trinity v. United States, 143 U.S. 457, 459 (1892). *See* Cabell v. Markham, 148 F.2d 737, 739 (2d Cir.), *aff'd,* 326 U.S. 404 (1945), where Judge Learned Hand noted that it is an error "to make a fortress out of the dictionary . . . ."

[77] *Joiner,* 320 U.S. at 351 (emphasis added).

[78] 421 U.S. at 849-50.

[79] *Id. See Joiner,* 320 U.S. at 355.

and prior court decisions. Lower courts recently confronted with the issue have held that the literal approach is not valid in considering whether security status attaches to a particular transaction.[80] At least one circuit court has interpreted the language of the definitional sections as mandating an inquiry beyond the face of an instrument to determine whether a security exists,[81] since the named instrument may not constitute a security if "the context otherwise requires."[82] This conclusion is well-founded. The literal approach would lead to absurd and anomalous results where, for example, an interest otherwise not within the scope of the Securities Acts would be included as a security merely by denominating that interest "stock."[83] Substance would be subordinated to form, despite the long-standing, contrary practice in the securities area.[84] Therefore, it is submitted that the Court was correct in its rejection of the literal approach in determining whether an interest is a security.

The Supreme Court in *Forman* did note, however, that the label affixed to an instrument is not wholly irrelevant.[85] If an interest is termed "stock" and is coupled with significant characteristics of stock—right to dividends, negotiability, proportionate voting rights, possibility of appreciation—a purchaser might reasonably believe that the interest is a security.[86] In such cases, the Court might justifiably conclude that the Securities Acts are applicable. The Court found, however, that the Riverbay shares had none of the traditional characteristics of stock: there was no right to any dividend, the shares were not negotiable, and they could not be pledged or otherwise encumbered.[87] Voting rights were not allocated in proportion to the number of shares owned; and by law the shares could not appreciate in value.[88] Therefore, the Court reasoned that the Riverbay shares were not the type of interest which could mislead a purchaser into be-

---

[80] C. N. S. Enterprises, Inc. v. G. & G. Enterprises, Inc., 508 F.2d 1354 (7th Cir. 1975); McClure v. First Nat'l Bank, 497 F.2d 490 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975); Lino v. City Investing Co., 487 F.2d 689 (3d Cir. 1973). *But see* 1050 Tenants Corp. v. Jakobson, 503 F.2d 1375, 1378 (2d Cir. 1974), where the Second Circuit relied upon its previous decision in *Forman*, 500 F.2d 1246 (2d Cir. 1974), *rev'd*, 421 U.S. 837 (1975).

[81] Lino v. City Investing Co., 487 F.2d 689, 694-95 (3d Cir. 1973).

[82] Securities Act of 1933, 15 U.S.C. § 77b (1970); Securities Exchange Act of 1934, 15 U.S.C. § 78c(a) (1970).

[83] *Cf.* Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128 (1972), where the converse situation was presented. There, shares evidenced by certificates expressly stating that they did *not* represent ordinary corporate stock were found to come within the ambit of the Securities Acts. *Id.* at 137-38.

[84] *See* Tcherepnin v. Knight, 389 U.S. 332, 336 (1967); *Howey*, 328 U.S. at 298. "[S]ubstance governs rather than form . . . just as some things which look like real estate are securities, some things which look like securities are real estate." 1 L. Loss, Securities Regulations, 493 (2d ed. 1961).

[85] 421 U.S. at 850-51.

[86] *Id.*

[87] *Id.* at 851.

[88] *Id.*

lieving he was purchasing the type of stock that constituted a security.[89]

The Court's ruling that the Riverbay shares do not constitute "stock" appears correct. While restrictions on the use of shares may not be dispositive in determining whether the shares are securities,[90] when coupled with the purchasers' intent to acquire low-cost housing for personal use these features appear sufficient to prevent the shares in Riverbay from being considered "stock." The transaction, therefore, would not be regulated by the Securities Acts unless the interest constituted an "investment contract."

In determining whether an investment contract existed, the Court applied the *Howey* test—whether there is "an investment of money in a common enterprise with profits to come solely from the efforts of others."[91] Since a cooperative is, by definition, a common enterprise, and since in a project as massive as Co-op City[92] any "profits" would necessarily come from third party management,[93] the critical issue was whether the plaintiffs were motivated by a reasonable expectation of profit to purchase the shares. The Court stated that "profit" traditionally has been interpreted as "capital appreciation resulting from the development of the initial investment . . . or a participation in earnings resulting from the use of the investor's funds . . . ."[94] Since the Riverbay shares could not appreciate,[95] the Court had to determine whether the plaintiffs could have expected any "profits" in the form of participation in earnings.

The Court examined three possible incidents of equity participation in Co-op City for such profits: (1) the saving of rent expenses by the shareholders due to rentals at lower than the market cost; (2) the right to a personal income tax deduction as a result of cooperative ownership; and (3) the reduction in monthly rental charges due to income from commercial facilities incidental to Co-op City.[96] The Court found that the savings on rent and the right to a tax deduction could not properly represent profit since they could not be liquidated into cash.[97] The Court further found not only that any income derived from the commercial facilities which were part of the project was in-

---

[89] *Id.*

[90] See text at notes 42-43 *supra.*

[91] 328 U.S. at 301. See text at notes 53-58 *supra.*

[92] See note 3 *supra.*

[93] Although the necessity of *solely* third party efforts was not at issue in *Forman* since the requisite profit was not found, the trend is toward allowing a finding of an investment contract where the investor's efforts are involved, if the significant efforts are made by others, SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476, 482 (9th Cir.), *cert. denied,* 414 U.S. 821 (1973), or if the investors contribute only a minimal amount of participation. 1050 Tenants Corp. v. Jakobson, 503 F.2d 1375, 1378 n.5 (2d Cir. 1974).

[94] 421 U.S. at 852.

[95] *Id.* at 851.

[96] *Id.* at 854-57.

[97] *Id.* at 855.

substantial, but that no representations regarding this prospect had been made by the promoters.[98] Thus, the Court concluded that the transaction did not constitute an "investment contract."

Writing for the dissent, Justice Brennan stated that the *Forman* transaction *was* an investment contract, since low rental costs, the right to a tax deduction, and possible rental reductions did constitute "profits to come solely from the efforts of others."[99] The dissent argued that profit could assume the form not only of money earned, as in appreciation of capital or participation in earnings, but also of money saved.[100] Reasoning that the Securities Acts were intended to protect investors and should therefore be liberally construed, the dissent found the majority's distinction between types of economic benefits too restrictive.[101]

The economic benefit that must be found before the *Howey* test is met, however, is an expectation of profit. The dissent's interpretation of the *Howey* "profit" requirement to include savings in essence replaces "profit" with "benefit." Such a revision of the *Howey* test seems inappropriate in view of the Securities Acts' legislative history[102] and subsequent judicial interpretations[103] which reflect concern with transactions involving investor expectation of a monetary return over and above an initial investment.[104] As the district court stated, "it seems certain that Congress never intended to stretch the scope of the securities acts outside the commercial world and its fungible valuables, to the uncharted and unchartable realm of intangible, elusive personal values where one man's balm may very well be another's bane."[105] It is submitted, therefore, that the majority was correct in rejecting an expansion of the requisite profit element of the *Howey* test to include monetary savings.

In determining whether the *Forman* transaction constituted an investment contract, the Court therefore appears correct in finding a lack of the requisite profit element of the *Howey* test. Although the Information Bulletin circulated to the plaintiffs emphasized the reasonable price of the housing,[106] low rental rates are not productive of profit, and this savings can not be liquidated into cash. The low rental cost is certainly an economic benefit, but since *Howey* requires

---

[98] *Id.* at 855-57.

[99] *Id.* at 861-64 (Brennan, J., dissenting).

[100] *Id.* at 863-64.

[101] *Id.*

[102] *See* congressional reports cited in note 33 *supra.*

[103] *E.g., Howey,* 328 U.S. 293 (1946); *Joiner,* 320 U.S. 344 (1943).

[104] Even in cases which have been cited as adopting an expansion of profit to include general economic benefits, it is arguable that there was a possibility of a liquid return over and above the initial investment. *See, e.g.,* Davenport v. United States, 260 F.2d 591 (9th Cir. 1958), *cert. denied,* 359 U.S. 909 (1959) (salary to come from promise of job security); SEC v. American Foundation for Advanced Educ. of Ark., 222 F. Supp. 828 (W.D. La. 1963) (cost of college education).

[105] Forman v. Community Servs., Inc., 366 F. Supp. 1117, 1131 (S.D.N.Y. 1973).

[106] 421 U.S. at 853-54.

the expectation of a profit rather than a savings, the rejection of this benefit as fulfilling the *Howey* requirement seems appropriate.

The plaintiffs' right to an income tax deduction, permitted under section 216 of the Internal Revenue Code,[107] allows tenants in a cooperative housing corporation to deduct their proportionate share of the cooperative's tax payments and interest payments made on its mortgage.[108] The size and even the existence of any tax savings thus depends in the first instance upon a tenant's own income level and whether he itemizes deductions.[109] The *Forman* Court noted that any tax savings, even if considered profit, would not meet the *Howey* requirement that profit must come solely from third party efforts.[110] This reasoning does not consider that it is only through the managerial efforts of third parties in keeping the cooperative project within the eligibility requirements of section 216 that the tenants are eligible for this deduction.[111] Nonetheless, the fact that the potential deduction is merely a potential saving rather than a liquid return over and above the initial "investment" is sufficient to prevent this aspect of cooperative membership from falling within the scope of profit.

In considering whether the commercial facilities[112] attached to the project could generate potential profit, the Court initially noted that these types of facilities are *conceptually* income generating within the scope of profit traditionally associated with an investment.[113] Since the facilities were established merely to provide essential services to the tenants, however, the Court concluded that there was nothing to indicate that the facilities were *actually* intended to be profit generating.[114] Since, under New York law, the Co-op City commercial facilities could only be appurtenant and incidental to the development,[115] the Court reasoned that any possible income would be too speculative and insubstantial to bring the transaction within the ambit of the Securities Acts.[116]

---

[107] INT. REV. CODE OF 1954, § 216.

[108] The legislative history of § 216 indicates that this benefit is an incident of home ownership designed to place tenants "in the same position as the owner of a dwelling house so far as deductions for interest and taxes are concerned." S. REP. NO. 1631, 77th Cong., 2d Sess. 51 (1942). *See* Eckstein v. United States, 452 F.2d 1036, 1047 (Ct. Cl. 1971). *Compare* INT. REV. CODE OF 1954, § 216(a) (1970), *with id.* § 163(a) *and id.* § 164(a)(1).

[109] *See* INT. REV. CODE OF 1954, § 63(b).

[110] 421 U.S. at 855 n.20.

[111] *Id.* at 862-63 (Brennan, J., dissenting).

[112] Parking spaces, laundry facilities, and professional offices were established as part of the development. 421 U.S. at 855-56.

[113] *Id.* at 856.

[114] *Id.* at 856-57.

[115] N.Y. PRIV. HOUS. FIN. LAW § 12.5. (McKinney Supp. 1975-76).

[116] 421 U.S. at 856. Justice Brennan, in dissent, argued that the income was hardly *de minimis*, since revenues in excess of one million dollars flowed into the corporation from commercial activities. *Id.* at 861 (Brennan, J., dissenting). This amount represented gross income, 421 U.S. at 856 n.22, however, and thus is of little significance absent information relating to the expenses incurred.

The Court also based its conclusion that income from the commercial facilities did not satisfy the profit expectation requirement on the fact that no representations concerning this income had been made to the purchasers in the Information Bulletin.[117] Under the *Joiner* approach of examining the economic inducements offered by the promoters,[118] the Court's decision seems correct. Since no representations were made by the defendants, there was no economic inducement of possible income from the facilities. Furthermore, with regard to the *Howey* requirement of an expectation of profit by the tenants, the Information Bulletin had merely noted that if rental charges exceeded expenses, the difference would be returned to the tenants as a rebate.[119] It appears, therefore, that the Court was correct in finding that possible income from the commercial facilities was not sufficient to instill a profit motivation in the purchasers. The existence of the commercial facilities, rather than being an inducement for an investor, served only to enhance Co-op City as a viable residential project.

The plaintiffs in *Forman* had also urged an adoption of the *Silver Hills* "risk capital" approach in determining whether their shares constituted securities.[120] The Court declined to adopt this approach, reasoning that even if it were to do so, the plaintiffs did not take any significant risk in purchasing the shares in Riverbay since they could resell their shares for the original cost and recover their initial investment.[121] Furthermore, the Court noted, the argument that the plaintiffs could lose their money if the corporation went bankrupt was not persuasive since the possibility of bankruptcy in the normal sense was unrealistic, due to the pervasive state supervision, financing, and regulation.[122]

It is submitted that the *Forman* transaction did not possess the traditional risk capital characteristics described in *Silver Hills* and subsequent judicial applications of that case. The cases in which courts have found a security using the risk capital approach have generally involved transactions where the promoters solicited a *substantial* portion of the venture capital for the development of either a profit-making business or a speculative project, in exchange for an economic benefit to the investors.[123] In the *Forman* transaction, more than ninety percent of the cost of the project's development was financed by the State.[124] Furthermore, the economic benefits to be re-

---

[117] 421 U.S. at 856.

[118] See text at notes 47-52 *supra.*

[119] 421 U.S. at 854.

[120] *Id.* at 857 n.24.

[121] *Id.* See text at notes 12-13 and note 12 *supra.*

[122] 421 U.S. at 857 n.24.

[123] *See* Silver Hills Country Club v. Sobieski, 55 Cal.2d 811, 815-16, 361 P.2d 906, 908-09, 13 Cal. Rptr. 186, 188-89 (1961); State v. Hawaii Market Center, Inc., 52 Hawaii 642, 649-50, 485 P.2d 105, 109-10 (1971); Oregon *ex rel.* Healy v. Consumer Business Sys., Inc., 5 Or. App. 19, 30-32, 482 P.2d 549, 555 (1971).

[124] 421 U.S. at 857 n.24.

ceived under risk capital cases have generally included the expectation of a possible monetary profit by the investor.[125] The benefits received by the plaintiffs, however, were those of money saved incidentally through the use of residential property.[126]

Moreover, in considering the economic context of the transaction in *Forman,* the Court approved the essential distinction between a purchase of a commodity for *personal use* and an investment for *financial gain.*[127] The SEC in Release 33-5347[128] recognized this in drawing careful distinctions between housing units which are used for producing income and those used primarily as residences.[129] It is not suggested that where this element of personal use is involved a transaction should automatically be excluded from Securities Acts coverage. In such a case, exclusion should be the rule only if there is no reasonable profit motivation on the part of the purchasers.[130] The plaintiffs in *Forman,* however, were purchasing housing, not investments. Thus, the Court was correct in ruling that the Riverbay shares were not securities.

CONCLUSION

In holding that the federal Securities Acts do not apply to shares in a cooperative housing project not held for investment purposes and

---

[125] In *Silver Hills* it appears that purchasers could resell their shares for a profit. 55 Cal.2d at 813, 361 P.2d at 907, 13 Cal. Rptr. at 187. The Ninth Circuit adopted a risk capital approach in El Khadem v. Equity Sec. Corp., 494 F.2d 1224 (9th Cir.), *cert. denied,* 419 U.S. 900 (1974), where the investor borrowed money from Nationwide Investment Corporation to invest in mutual funds. In exchange, she signed a note, pledged the mutual funds and other cash as collateral, and prepaid the interest on the loan. *Id.* at 1225. The court held that this transaction constituted an investment contract because the investor risked her capital in return for the economic benefits of investment leverage and the tax deduction resulting from the prepaid interest. *Id.* at 1229. Her overall objective in the transaction, however, was to make a monetary profit on the mutual funds. *Id.*

[126] See text at notes 102-106 *supra.*

[127] 421 U.S. at 858; *see id.* at 864 (Brennan, J., dissenting).

[128] See text at notes 68-72 *supra.*

[129] The SEC filed an amicus brief in *Forman* urging application of the Securities Acts. Brief for SEC as Amicus Curiae at 5-7, *Forman.* The views of the agency charged with administering a statute are traditionally entitled to considerable weight. Investment Co. Institute v. Camp, 401 U.S. 617, 626-27 (1971). However, since this position contradicted the Commission's statements in Release 33-5347, the Court accorded no special weight to the Commission's views. 421 U.S. at 858-59 n.25. *See* Recent Development, 62 GEO. L.J. 1515, 1527 n.62 (1975) and Note, 53 TEX. L. REV. 623, 628 (1975), agreeing that under the SEC guidelines, the Commission would not be asserting jurisdiction over shares such as those in Riverbay.

[130] *See* 1050 Tenants Corp. v. Jakobson, 503 F.2d 1375 (2d Cir. 1974); Grenader v. Spitz, [Current] CCH FED. SEC. L. REP. ¶ 95,300 (S.D.N.Y. 1975). In both cases, shares of a cooperative housing corporation were found to be "investment contracts" where purchasers had dual motives of consumption and investment. *1050 Tenants Corp., supra,* at 1378; *Grenader, supra,* ¶ 95, 300, at 98,528. Those shares, unlike the Riverbay shares, were capable of appreciation. *Compare Forman,* 421 U.S. at 851, *with Grenader, supra,* ¶ 95,300, at 98,528 *and 1050 Tenants Corp.,* 503 F.2d at 1378.

incapable of returning a traditional monetary profit during ownership or upon resale, the Court leaves the plaintiffs in *Forman* to pursue possible state remedies.[131] Certainly purchasers of shares in housing cooperatives of any type should be protected against fraud by the developers. The issue in *Forman,* however, was not whether they should be so protected, but whether they were protected by federal legislation. The Court's distinction between consumption and investment, and its limitation that profit must constitute a liquid return over and above the investment are appropriate since the Securities Acts were intended to protect investors and not consumers in general.[132]

SUSAN CHALLEN COOPER

[131] Under N.Y. GEN. BUS. LAW § 352-e (McKinney Supp. 1975-76), the shares in a cooperative housing corporation are considered securities. *See* People v. Cadplaz Sponsors, Inc., 69 Misc.2d 417, 330 N.Y.S.2d 430 (Sup. Ct. 1972). Other state courts in considering whether cooperative housing corporation shares are securities have found that security status does not attach. *See* Willmont v. Tellone, 137 So.2d 610, 612 (Fla. Dist. Ct. App. 1962); Brothers v. McMahon, 351 Ill. App. 321, 328-29, 115 N.E.2d 116, 119 (1953); State v. Silberberg, 166 Ohio 101, 106-08, 139 N.E.2d 342, 346 (1956).

[132] It has been suggested that the disclosure protections of the Securities Acts do not provide the best method for insuring that cooperative purchasers are acting on a well-informed basis; rather, some type of substantive regulation is needed. *See* Comment, *Condominium Regulation: Beyond Disclosure,* 123 U. PA. L. REV. 639, 669-75 (1975).