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Securities Regulation—DEFINITION OF A SECURITY—A SHARE OF A NONPROFIT COOPERATIVE HOUSING CORPORATION IS NOT A SECURITY—*United Housing Foundation, Inc. v. Forman*, 95 S. Ct. 2051 (1975).

Co-op City, a massive cooperative housing development in New York City, is reputed to be the largest such project in the United States.[1] Its construction was initiated and sponsored by United Housing Foundation (UHF), a nonprofit corporation consisting of labor unions, civic groups, and other housing cooperatives. The purpose of Co-op City is to provide "decent" housing for persons in middle- and lower-income brackets; hence, prospective residents must meet certain financial eligibility requirements.[2] Prospective residents purchase shares of common stock in the cooperative corporation organized by UHF.[3] The literature initially promoting that stock, distributed in 1965, estimated that the average monthly carrying charge (rent) would be $23.02 per room. Because of increased construction costs, the monthly carrying charge was periodically increased; by 1973-74, it was $35.27.

Outraged by the increased cost of their apartments, 57 residents, on behalf of all other apartment owners, sued UHF. Their principal claim was that the information bulletin failed to disclose several material facts and falsely represented that the corporation would bear the cost of inflation. Specifically, the plaintiffs charged that the defendants had sold them securities and were in violation of the antifraud provisions of the Federal Securities Acts of 1933 and 1934 (Securities Acts).[4] The district court,

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1. The district court described the magnitude of the project in these terms: "[T]he project . . . houses some 45,000 people. The complex is located on a 200-acre site, includes more than 30 high-rise buildings and more than 230 townhouses, which in total provide about 15,400 apartment units ranging from three to seven rooms." Forman v. Community Services, Inc., 366 F. Supp. 1117, 1121 (S.D.N.Y. 1973).

2. The maximum annual earnings of a family of three or less eligible for a four-room apartment was initially $6,624; for a family of four or more, $7,728. Brief for Respondents at 6, United Housing Foundation, Inc. v. Forman, 95 S. Ct. 2051 (1975). It should also be noted that from 1965 to 1973 the income eligibility requirements were increased to almost double the initial requirements. *Id.* "[A]ll of this is of little solace to the elderly and the handicapped, or anyone on a fixed or sluggish income, or indeed, anyone who arranged his affairs based on a belief that the earlier Co-op City estimates would remain unaffected by changes in the economy." Forman v. Community Services, Inc., 366 F. Supp. 1117, 1124 (S.D.N.Y. 1973).

3. To secure the right to occupy his apartment, the prospective resident had to complete a Subscription Agreement and Apartment Application form. In so doing, he had to agree to subscribe to 18 shares of Riverbay common stock (Riverbay Corporation is a mutual company organized by UHF) for each room in his apartment. Each share had a par value of $25.00. 366 F. Supp. at 1122.

4. The plaintiffs also asserted violations of their civil rights under 42 U.S.C. §§ 1983,

in granting defendants' motion to dismiss, held that a share of a "state-financed and supervised, nonprofit cooperative housing corporation" is not a security under the federal securities laws and hence, the federal courts had no jurisdiction.[5] The United States Court of Appeals for the Second Circuit reversed, holding that the definitional sections of the Securities Acts literally apply since the shares were specifically denominated "stock," and alternatively, that the transaction was an investment contract within the meaning of the Securities Acts.[6] The Supreme Court reversed, holding that shares in a nonprofit housing cooperative corporation are not securities as defined by the Securities Acts.

I. BACKGROUND

A. Cooperative Housing

1. The history and status of cooperative housing

Housing cooperatives date back to the late 19th century[7] but did not become a popular form of housing until the 1920's.[8] Before the 1950's, apartment cooperatives were designed principally for upper-income persons.[9] By the end of World War II, however, a new trend in cooperative housing emerged as cities tried to cope with the housing shortage caused by increased population. Cooperative housing units were constructed for middle- and lower-income groups, the groups most seriously affected by the postwar housing shortage.[10] This trend was accelerated when Congress enacted legislation providing for public financing and mortgage insurance to private developers of apartments and cooperative housing corporations.[11] The New York State Legislature responded to the postwar housing shortage in that state by enacting

1988 (1971). The Supreme Court agreed with the district court's conclusion that the civil rights claim should be dismissed since it was "vague and conclusory." 95 S. Ct. at 2064 n.24.

5. Forman v. Community Services, Inc., 366 F. Supp. at 1120-21.

6. Forman v. Community Services, Inc., 500 F.2d 1246, 1252-53 (2d Cir. 1974).

7. Goldstein, *Introduction to Cooperatives*, in COOPERATIVES AND CONDOMINIUMS, 4 REAL ESTATE LAW AND PRACTICE TRANSCRIPT SERIES 79, 81 (J. McCord ed. 1969) [hereinafter cited as Goldstein]. One of the earliest cases discussing cooperatives (though not using that term) was Barrington Apt. Ass'n v. Watson, 45 Sup. Ct. 545 (N.Y. 1886), enjoining a tenant-shareholder from subletting his apartment to someone "objectional" to the other members of the association.

8. Miller, *Cooperative Apartments: Real Estate or Securities?*, 45 B.U.L. REV. 465 (1965) [hereinafter cited as Miller].

9. *See* Goldstein, *supra* note 7, at 82-85.

10. *See* Miller, *supra* note 8, at 466.

11. Note, *Co-operative Apartment Housing*, 61 HARV. L. REV. 1407, 1413-14 (1948).

the Limited Profit Housing Companies Law, popularly known as the Mitchell-Lama Act.[12] The Mitchell-Lama Act provided that qualified housing corporations could borrow on mortgage from the state or municipality up to 90 percent of the cost of the project at an interest rate similar to that paid by the state on its own obligations.[13]

In addition to providing quality housing for lower- and middle-income families, there are a number of reasons why cooperative housing is an attractive alternative to conventional home ownership or apartment renting.[14] For example, members in a housing cooperative are able to share the burden of maintenance costs.[15] Also, cooperative apartment housing today may be less expensive than renting.[16] Further, the tenant-shareholder of a cooperative corporation receives an income tax deduction for his share of the mortgage interest payments and property tax if his cooperative meets the requirements of section 216 of the Internal Revenue Code.[17]

Despite the many advantages of cooperative housing, however, tenant-shareholders face some possible problems. Since they do not hold fee simple title to their apartment, refinancing is not available if the shareholder has need of cash.[18] The possibility also exists that the corporation may not be able to meet its

12. Mitchell, *Forward* to N.Y. PRIV. HOUS. FIN. at IX (McKinney 1962).

13. *Id.* at X.

14. *See* Smadbeck, *Basic Features of the Cooperative Trend*, in COOPERATIVES AND CONDOMINIUMS, 4 REAL ESTATE LAW AND PRACTICE TRANSCRIPT SERIES 88, 89 (J. McCord ed. 1969).

15. *See generally* Miller, *supra* note 8.

16. Note *Co-operative Apartment Housing*, 61 HARV. L. REV. 1407 (1948). "In addition, [tenant-shareholders] have learned that elimination of the landlord's profit and some of his expenses may make a co-operative apartment more economical than ordinary renting." *Id.* (citation omitted).

17. INT. REV. CODE OF 1954, § 216 allows a deduction for the tenant-shareholder's contribution to the property tax, mortgage interest, and business depreciation of the cooperative housing corporation.

> The tax advantages are best seen by comparing the tax positions of the tenant in a conventional apartment house with those of the . . . tenant-stockholders in a cooperative corporation. The former does not have an income tax deduction for any part of his rental unless the premises are used for business purposes or for the production of income. . . . The tenant-stockholder will be entitled to an income tax deduction for a proportionate share of the real estate taxes included in the so-called "Maintenance" charge for a cooperative . . . .

Kaster, *Tax Aspects of Cooperatives and Condominiums*, in COOPERATIVES AND CONDOMINIUMS, 4 REAL ESTATE LAW AND PRACTICE TRANSCRIPT SERIES 30, 31 (J. McCord ed. 1969).

18. NELSON & WHITMAN, CASES AND MATERIALS ON REAL ESTATE FINANCE AND DEVELOPMENT 776 (1976) [hereinafter cited as NELSON & WHITMAN].

mortgage obligation. If the corporation were forced into default, the interests of the shareholders could be endangered.[19] This threat has been largely mitigated, however, by the mortgage insurance provisions of the National Housing Acts.[20]

2. *The legal form of housing cooperatives*

In general, a housing cooperative is "a corporate or business trust entity holding title to the premises and granting rights of occupancy to particular apartments by means of proprietary leases or similar arrangements."[21] A cooperative housing development may take one of three legal forms:[22] (1) co-ownership,[23] (2) the trust form,[24] or (3) the corporate form.[25] The corporate form is by far the most convenient and common[26] and is also the form that gives rise to securities law questions.[27] Co-op City is a corporate-type cooperative.

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19. *Id.*

20. 12 U.S.C. § 1715e (1970).

21. 1 ROHAN & RESKIN, CONDOMINIUM LAW AND PRACTICE § 1.01[2] (1975) [hereinafter cited as ROHAN & RESKIN].

> The form of lease used by the corporation for this purpose is called a 'proprietary lease.' A proprietary lease, is, in fact, a lease and not any other variety of 'ownership document.' It is similar to an ordinary apartment lease, except that it is reasonable and except for certain provisions peculiar to the tenant-shareholder relationship with the cooperative-landlord corporation.

See Goldstein, *supra* note 7, at 81.

22. 2 ROHAN & RESKIN § 2.01[1] (1974); Comment, *A Survey of the Legal Aspects of Cooperative Apartment Ownership*, 16 U. MIAMI L. REV. 305 (1961).

23. The co-ownership form can also be broken down into three forms: (1) joint tenancy, where all the tenants own the entire premises as co-owners in fee simple. To create a cooperative of this type, there must be a conveyance to all the grantees simultaneously by a single instrument. This is highly impractical for a large cooperative; (2) tenancy in common, where the occupants own the entire premises as tenants in common but each has exclusive rights to a specific apartment; (3) the California tenancy-in-common cooperative, where the purchaser receives an undivided fractional interest in the land and building. 2 ROHAN & RESKIN § 2.01[2] (1974).

24. In the trust form, a business trust is organized in which the trustees issue either beneficial interest certificates to individual owners or the whole beneficial interest to the project's organizer who then assigns the certificates to the purchasers. The purchasers are also assigned the exclusive right to occupy an individual apartment. 2 ROHAN & RESKIN § 2.01[3] (1974); *See* Yourman, *Some Legal Aspects of Cooperative Housing*, 12 LAW & CONTEMP. PROB. 126, 127 (1947).

25. In this form, a corporation is organized by the promoter who acquires the buildings and the land; shares of the corporation are then sold to the prospective occupant who receives a proprietary lease for a specific apartment. 2 ROHAN & RESKIN § 2.01[4] (1974); Comment, *A Survey of the Legal Aspects of Cooperative Apartment Ownership*, 16 U. MIAMI L. REV. 305, 310-11 (1961).

26. Comment, *Community Apartments: Condominium or Stock Cooperative?*, 50 CALIF. L. REV. 299 (1962).

27. *See* Miller, *supra* note 8.

B. *The Securities Acts of 1933 and 1934: What is a Security?*

Both the Securities Act of 1933 (1933 Act) and the Securities and Exchange Act of 1934 (1934 Act) contain sections that purport to define a security.[28] In spite of the comprehensive nature of the definitions, however, it has been noted that "[t]he definition of the term 'security' as used in the principal federal securities laws, is for the most part one of the best kept secrets in recent legal history."[29] Commentators and the courts, however, generally agree that a flexible definition of a "security" is essential to meet the purposes of the Securities Acts. Congress in drafting the legislation appears to have intended such flexibility;[30] the courts' interpretations of the legislation have certainly promoted it.[31]

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28. The Securities Act of 1933, 15 U.S.C. § 77(b)(1) (1970), provides:

> The term 'security' means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas or other mineral rights or, in general, any interest or instrument commonly known as a 'security', or any certificate of interest or participation in, temporary or interim, certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

The Securities Exchange Act of 1934, 15 U.S.C. § 78(c)(10) (1970), provides:

> 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 . . . .

The definitional section of the 1934 Act relies heavily on the 1933 Act definition, and while the two are substantially the same, there are some differences. L. LOSS, SECURITIES REGULATION 478-79 (1951). *See also* 1 A. BROMBERG, SECURITIES LAW: FRAUD, SEC RULE 10b-5 § 4.6 (312), at 82.2 (1974). These differences, however, are immaterial in the context of this case. 95 S. Ct. at 2058 & n.11. " The Securities Act of 1933 . . . contains a definition of security virtually identical to that contained in the 1934 Act. Consequently, we are aided in our task by our prior decisions which have considered the meaning of security under the 1933 Act." Tcherepnin v. Knight, 389 U.S. 332, 335-36 (1967) (footnotes omitted).

29. Hannan & Thomas, *The Importance of Economic Reality and Risk in Defining Federal Securities*, 25 HAST. L.J. 219 (1974) [hereinafter cited as Hannan & Thomas].

30. H.R. REP. No. 85, 73d Cong., 1st Sess. 11 (1933), states that "[p]aragraph (1) defines 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." *See* Douglas & Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171, 182 (1934), where the authors observe that "[t]he Act defines a 'security' in very broad terms. . . . The sweeping character of the definition was presumably dictated by a desire to prevent the use of allied forms for purposes of evasion."

31. The Court in SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1963) states: "Congress intended the Investment Advisors Act of 1940 to be construed

1. Investment contracts

One of the terms used in the Securities Acts to define a "security" is *investment contract*.[32] While the term is undefined in the statute, it had a long history of interpretation and use in state securities regulation[33] before it was adopted in the Federal Securities Acts. The United States Supreme Court first dealt with an investment contract in *SEC v. C.M. Joiner Leasing Corp.*[34] In *Joiner*, the Court found an investment contract in the sale of assignments of oil leases to specific parcels of land. Each purchaser was induced to buy his assignment by the prospect of profits from an oil well to be drilled on his parcel.[35] The Court declined to give a specific definition[36] of an investment contract but stated that "the test . . . is what 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."[37]

Three years later, in *SEC v. W.J. Howey Co.*,[38] the Court crystallized the definition of investment contract:

> [A]n investment contract, for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise.[39]

The *Howey* test thus includes four factors: (1) a person invests his money, (2) in a common enterprise, and (3) is led to expect profits (4) solely[40] from the efforts of the promoter or a third

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like other securities legislation 'enacted for the purpose of avoiding frauds,' not technically and restrictively, but flexibly to effectuate its remedial purposes."

32. Statutes cited in note 28 *supra*. " '[I]nvestment contract' . . . has become the 'catch-all that isn't otherwise caught' . . . ." 3 H. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW § 2.02, at 2-7 (1972) [hereinafter cited as H. BLOOMENTHAL].

33. L. LOSS, SECURITIES REGULATION 314 & n.34 (1951); *see, e.g.*, State v. Gopher Tire & Rubber Co., 146 Minn. 52, 177 N.W. 937 (1920).

34. 320 U.S. 344 (1943).

35. *Id.* at 345-46.

36. *Id.* at 355. ("In the present case we do nothing to the words of the Act; we merely accept them.")

37. *Id.* at 352-53.

38. 328 U.S. 293 (1946).

39. *Id.* at 298-99.

40. While the test states that profits must come solely from the efforts of others, the courts have construed the term *solely* to mean "primarily," in an effort to avoid a too restrictive definition of a "security." SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d

party.[41] The Supreme Court, recognizing that a scheme could possibly be devised that technically evades the test, later added that "in searching for the meaning and scope of the word 'security' in the [1934] Act, form should be disregarded for substance and the emphasis should be placed on economic reality."[42]

Since the *Howey* decision, courts have found the existence of of investment contracts in a variety of contexts: deferred annuity contracts,[43] fur-bearing animal breeding contracts,[44] mineral production contracts,[45] distributorship contracts,[46] scotch whiskey warehouse receipts,[47] and pyramid selling schemes.[48]

2. Form v. substance

In instances where the courts have found a security by disregarding form for substance, they have generally been expanding the reach of securities legislation.[49] This substance-over-form analysis may also be used, however, to exclude certain transactions from the scope of securities regulation. For example, some schemes or instruments may have the form of a security but, when judged in the light of "economic reality,"[50] cannot be deemed securities in substance.[51] At least three of the circuits, the Third, Fifth, and Seventh, have opted for substance over form.[52]

476, 481-82 (9th Cir. 1973), *cert. denied*, 414 U.S. 821 (1973); SEC v. Koscot Interplanetary Inc., 497 F.2d 473, 479-80 (5th Cir. 1974).

41. Courts usually think of *Howey* as a three-pronged test, combining the third and fourth factors noted here. Commentators, however, usually think of it in terms of these four factors. 3 H. BLOOMENTHAL, *supra* note 32, at § 2.04; Hannan & Thomas, *supra* note 29, at 225.

42. Tcherepnin v. Knight, 389 U.S. 332, 336 (1967). In *Tcherepnin*, the particular type of security in question was an investment contract. In fact, the only type of security the Supreme Court has concerned itself with to date has been an investment contract. Hannan & Thomas, *supra* note 29, at 219.

43. SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967).

44. Continental Marketing Corp. v. SEC, 387 F.2d 466, 470-71 (10th Cir. 1967).

45. Johns Hopkins Univ. v. Hutton, 442 F.2d 1124, 1127 (4th Cir. 1970).

46. Mitzner v. Cardet Int'l, Inc., 358 F. Supp. 1262, 1265-68 (N.D. Ill. 1973).

47. SEC v. Glen-Arden Commodities, Inc., 368 F. Supp. 1386, 1390 (E.D.N.Y. 1974), *aff'd*, 493 F.2d 1027 (2d Cir. 1974).

48. SEC v. Glen W. Turner Enterprises, Inc., 474 F.2d 476, 486 (9th Cir. 1973).

49. *See* C.N.S. Enterprises, Inc. v. G & G Enterprises, Inc., 508 F.2d 1354, 1357 (7th Cir. 1975).

50. Tcherepnin v. Knight, 389 U.S. 332, 336 (1967).

51. Bank notes have the form of a security but generally not the substance. *See* Comment, *Commercial Notes and Definition of 'Security' Under Securities Exchange Act of 1934: A Note is a Note is a Note?*, 52 NEB. L. REV. 478 (1973).

52. C.N.S. Enterprises, Inc. v. G & G Enterprises, Inc., 508 F.2d 1354 (7th Cir. 1975) (a commercial note is not a security); McClure v. First Nat'l Bank, 497 F.2d 490 (5th Cir. 1974) (a one-year promissory note and a deed of trust issued for a bank loan allegedly needed to pay the corporate obligation of a closely held corporation are not securities);

On the other hand, the Second Circuit has adopted a *literal approach*, selecting form over substance.[53] The validity of the literal approach was one of the central issues in the instant case.

II. INSTANT CASE

The respondents advanced two arguments in support of their contention that their shares in the housing cooperative are securities.[54] First, under a literal application of the Securities Acts' definitional sections, the shares are securities because they are specifically denominated "stock."[55] Second, the shares of common stock are "investment contracts" or at least "instruments commonly known as securities."[56]

The Court rejected both arguments. It first noted that acts of Congress must be construed within the framework of their intent and not be bound by a literal construction and application. The Court also noted that it is not likely that persons intending to acquire a residential apartment will think they are investing in securities "simply because the transaction is evidenced by something called a share of stock."[57] The Court rejected the Second Circuit's and respondents' reliance on the language in *Joiner* that "instruments *may* be included within [the definition of a security], as [a] matter of law, if on their face they answer to the name or description."[58] The Court termed the language dictum and reasoned that the Court in *Joiner* had not intended to establish an "inflexible rule barring inquiry into the economic realities underlying a transaction."[59]

In rejecting respondents' second argument that the shares are "investment contracts" or "instruments commonly known as

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Lino v. City Investing Co., 487 F.2d 689, 695 (3d Cir. 1973) (promissory notes are not securities where the notes are not procured for speculation or investment and where there is no indication that the franchisor was soliciting venture capital).

53. 1050 Tenants Corp. v. Jakobson, 503 F.2d 1375, 1378 (2d Cir. 1974).

54. In order to establish jurisdiction, the plaintiffs needed to establish that the shares they purchased were securities. Securities Act of 1933, 15 U.S.C. § 77(q) (1970).

55. *See* note 28 *supra*.

56. *Id.*

57. 95 S. Ct. at 2060. The court also noted that these shares lacked all the characteristics that in commerce fall within the ordinary concept of a security. Among these are: (1) the holder has a right to receive dividends, (2) the shares are negotiable, (3) they can be pledged or hypothecated, (4) they confer voting rights in proportion to the number of shares owned, and, (5) they can appreciate in value. The Court also stated that "substance governs rather than form . . . just as some things which look like real estate are securities, some things which look like securities are real estate." *Id.* at 2059 n.13 (citing 1 L. Loss, SECURITIES REGULATION 493 (2d ed. 1961)).

58. SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943).

59. 95 S. Ct. at 2059. *See* 53 TEXAS L. REV. 623, 629 (1975).

securities,"[60] the Court again examined "the substance—the economic realities of the transaction—rather than the names . . . employed by the parties."[61] The Court restated the *Howey* test, noting that there must be "the presence of an investment in a common venture *premised on a reasonable expectation of profits* to be derived from the entreprenurial or managerial efforts of others."[62]

Respondents, anticipating this last requirement, had argued that they were led to expect profits from their investment in three ways. First, the promotional literature emphasized that they were to receive an income tax deduction for the portion of their monthly rental charge applied to the mortgage interest.[63] Second, their monthly rental charges were to be substantially lower than the going rates for comparable housing. Third, net income derived from the leasing of commercial facilities, parking places, and laundry facilities was to be applied to reduce the residents' monthly rental charges. In responding to these contentions, the Court limited the definition of profits to mean "either capital appreciation resulting from the development of the initial investment . . . or . . . earnings resulting from the use of the investors' funds."[64] Applying this narrow definition of profit, the Court summarily dismissed the first two contentions but felt the third contention—the possibility of profits from the leasing of facilities—constituted a plausible argument. While this rental income is the type of profit ordinarily expected by an investor, the Court reasoned that in the present case the profit expectation was too "speculative and insubstantial to bring the entire transaction within the Securities Acts."[65]

60. The Court noted that there is "no distinction, for present purposes, between an 'investment contract' and an 'instrument commonly known as a security.'" 95 S. Ct. at 2060.

61. *Id.*

62. *Id.* (emphasis added). In this formulation of the *Howey* test, the Court removed the troublesome "solely" from the test, stating that there must be an expectation of profits derived from the efforts of others; no mention was made that the profits derive *solely* from the efforts of others.

63. *See* note 17 *supra*.

64. 95 S. Ct. at 2060.

65. *Id.* at 2062.

The SEC filed an amicus curiae brief in support of respondents' position on this issue. Ordinarily, the brief of the affected administrative agency would be entitled to great weight. But in the instant case, the Court felt that the SEC's brief was in contradiction to its previously stated position that the only real estate transactions considered by them to be investments are those "offered and sold with emphasis on the economic benefits to the purchaser to be derived from the managerial efforts [of others]." *Id.* at 2063 n.24. *See* SEC Securities Act Release No. 33-5347, 38 Fed. Reg. 1735 (1973).

Three justices dissented, arguing that the respondents were induced to purchase Co-op City shares by the prospect of economic benefits that would "come solely from the efforts of others."[66] The dissenters also argued that all the other ingredients of the *Howey* test were met and that the Court erred in its conclusion that shares of stock are not necessarily securities merely because they are so defined in the Securities Acts.

III. Analysis

By refusing to declare that shares of stock in a nonprofit cooperative housing corporation are securities, the Court clarified important aspects of securities regulation by (1) restricting the scope of the *Howey* test and (2) resolving a division among circuit courts concerning the use of the literal approach in defining securities. The Court also drew a much needed line of demarcation between securities law and real property law and at the same time avoided creating an unequal status before the law between two similar types of real estate development: cooperatives and condominiums.

A. Limiting the Howey Test

On five occasions prior to its decision in the present case, the Supreme Court has considered the definition of a security in the context of an investment contract.[67] In each of the five cases the Court has looked through the form of the transaction to its substance and found an investment contract. Since the second of those cases, the traditional test for an investment contract has been known as the *Howey* test;[68] it has consistently been applied in state and federal court decisions.[69] The Court restricted the scope of that test in the present case, however, by limiting the definition of profits. Nevertheless, it should be remembered that although the Court restricted the scope of *Howey*, it at the same time reaffirmed the validity of the *Howey* test for investment contracts. With that limitation and reaffirmation, the Court gave little, if any, satisfaction to critics of the test who have urged a

66. 95 S. Ct. at 2065-66.

67. SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967); Tcherepnin v. Knight, 389 U.S. 332 (1967); SEC v. Variable Annuity Life Ins. Co. of America, 359 U.S. 65 (1959); SEC v. W.J. Howey Co., 328 U.S. 293 (1946); SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943).

68. SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

69. Hannan & Thomas, *supra* note 29, at 225.

broader interpretation of profits and an expanded application of the test.[70]

Many have proposed that the *Howey* test should be expanded to include a "risk capital" factor,[71] an approach adopted by California in *Silver Hills Country Club v. Sobieski*.[72] The risk capital factor is present if the investor's funds are to be relied upon to provide a substantial portion of the initial capital needed to start the enterprise from which he expects some benefit.[73] The respondents in the instant case urged the Court to enlarge the *Howey* test to include the "risk capital" approach.[74] The Court, however, fully aware of the literature on the subject,[75] specifically declined to adopt the risk capital approach in this case, thus casting some doubt on the approach's viability in the future.[76]

Closely related to the risk capital approach is the "valuable benefit" concept.[77] Stated simply, if the investor is led to expect some type of benefit, tangible or intangible, as a result of his investment, the transaction constitutes a security.[78] The valuable benefit concept, urged upon the Court by commentators and the respondents in the present case as a useful enlargement on the profits factor in *Howey*, was adopted by the Second Circuit.[79] By narrowly defining *profits*, however, the Supreme Court excluded the flexible approach hoped for by those who would expand *Howey* and reaffirmed the necessity of the profit factor in the test as originally formulated.

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70. Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?*, 18 CASE W. RES. L. REV.367 (1967); *See* Hannan & Thomas, *supra* note 29; Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135 (1971); Long, *Introduction to Symposium: Interpreting the Statutory Definition of a Security: Some Pragmatic Considerations*, 6 ST. MARY'S L.J. 96 (1974).

71. *See, e.g., id.*

72. 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961).

73. State *ex rel.* Healy v. Consumer Business System, Inc., 5 Or. App. 19, 482 P.2d 549 (1971).

74. Brief for Respondents at 54.

75. 95 S. Ct. at 2063 n.23.

76. The Court did not *reject* the risk captial approach; it merely *declined* to adopt it in the present case. "Even if we were inclined to adopt such a 'risk capital' approach we would not apply it in the present case." *Id.*

77. Two commentators explain the relationship between the two theories in these terms: "[T]he valuable benefit concept and the risk capital theory are not separate and distinct; *they are, in fact, two sides of the same coin.*" Hannan & Thomas, *supra* note 29, at 245 (citation omitted & emphasis added).

78. *See* Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135, 164-65 (1971).

79. 500 F.2d at 1254.

B. The Literal Approach

Under the literal approach, a court declares an instrument a security if on its face it appears to be one of those instruments or transactions defined as a security, regardless of the substance of the transaction.[80] As noted above,[81] three of the circuits rejected the literal approach by declaring that certain notes are not securities even though the Securities Acts define securities as "any note."[82] The Second Circuit, however, explicitly adopted the literal approach in relation to shares in a cooperative housing corporation. Applying the rationale that substance, not form, should govern, the Supreme Court settled this conflict in the instant case by rejecting the literal approach.[83] In all prior decisions, the substance-over-form approach was used to *expand* the coverage of the Securities Acts.[84] The present case constitutes the first Supreme Court decision to limit the scope of the Acts by examining the substance of the transaction. This unique application of the substance-over-form approach is noteworthy in that it demonstrates the restrictive nature of the Court's decision.

On public policy grounds, the Court's refusal to follow the literal approach and thus bring cooperative housing developments within the scope of federal securities regulation is correct. If the Court had construed the Securities Acts to include cooperatives, those developments would be subjected to the burdensome registration requirements of the Securities and Exchange Commission. Arguably, a developer would forego construction altogether rather than comply with those requirements. More likely, the developer would adopt a form of development, such as condominiums, that generally do not fall within the scope of the Securities Acts.[85] At the very least, if the developer opted to take advantage of state and federal incentives to construct cooperatives, the costs of compliance with securities regulations would necessarily be passed on to residents of the cooperatives. Regulation, by generating these consequences, would thus frustrate the public policy underlying state and federal legislative enactments: cooperatives to provide housing for middle- and lower-income families are needed and should be encouraged.[86]

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80. *Id.* at 1252.

81. *See* text accompanying note 52 *supra*.

82. *See* note 28 *supra*.

83. 95 S. Ct. at 2058.

84. C.N.S. Enterprises, Inc. v. G & G Enterprises Inc., 508 F.2d 1354, 1357 (7th Cir. 1975).

85. *See* notes 87 & 88 and accompanying text *infra*.

86. *See* notes 10-13 and accompanying text *supra*.

C. *Regulation of Cooperative Housing Corporation*

1. *Excluding cooperative housing ventures from securities regulation*

By refusing to bring shares of nonprofit cooperative housing corporations within the ambit of federal securities regulation, the Court avoided creating an unequal status before the law between cooperatives and condominiums. The end result of both forms of real estate development are essentially the same although the mode of ownership in each case is much different.[87] In the most common type of housing cooperative, a corporation must be created in which the tenant-shareholders buy stock and thereby effectively "own" their apartments. Condominium developers, on the other hand, sell individual apartments in fee simple. If the literal approach were applied, the *stock* of a cooperative corporation would be a security but the evidence of fee simple title to a condominium would not. If securities questions are raised by the sale of condominiums, it is not because of the form of the transaction but rather because the sale in substance constitutes a security.[88]

2. *Subjecting cooperative housing ventures to securities regulation*

The Court's rationale in the instant case does not mean that the Securities Acts in all cases do not reach cooperative housing corporations. The Court merely ruled that the "profits" claimed by the respondents from the lease of Co-op City's commercial facilities were too "speculative and insubstantial" to bring the transaction within the scope of those Acts.[89] A cooperative, however, could be created where the profits were not so "speculative and insubstantial." For example, a large building could be constructed in an urban area with only a few residential apartments in the upper floors and the rest of the building leased for commercial use. Such a building could easily take the form of a cooperative corporation where almost all of the cost to the residents is met by the rental income from the commercial users.

A difficult task in future cases will be, therefore, to determine at what point the profits of a cooperative become sufficiently substantial to render the cooperative housing transcation a security. The Internal Revenue Code offers a possible guideline

87. NELSON & WHITMAN, *supra* note 18, at 775.
88. *See generally* 1A ROHAN & RESKIN §§ 18.01-.06 (1975).
89. 95 S. Ct. at 2062.

for making that determination. Section 216 of the Code requires that 80 percent or more of a cooperative's gross income be derived from tenant-shareholders in order for the cooperative to qualify for a tax deduction.[90] Courts might be persuaded that if a cooperative corporation receives more than 20 percent of its gross income from sources other than the tenant-shareholders, such income is not "speculative and insubstantial." That "excessive" income would render the cooperative housing transaction an investment contract subject to federal securities regulation.

Shares in a cooperative housing corporation could also be classified as securities if the corporation did not have a right of first refusal as to its outstanding shares.[91] The absence of such a right would enable the tenant-shareholders to sell their shares to the highest bidder. In a cooperative the size of Co-op City that has a waiting list several years long,[92] a thriving market could emerge. It is not at all unlikely that speculators would begin buying cooperative shares with the hope of profits. Were that to happen, the shares would clearly be securities and the cooperative would have to comply with the requirements of the Securities Acts.

The Court, in holding that shares of a nonprofit cooperative housing corporation are not securities, has left the regulation of such cooperatives to real estate development laws and state blue sky laws. It has not, however, closed the door of federal regulation on schemes that have the form of a cooperative housing corporation but the substance of an investment contract.

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90. *See* note 17 *supra*.

91. *See* 2 ROHAN & RESKIN at § 2.01[4][f] (1974); Whitebook, *The Cooperative Apartment*, 9 PRAC. LAW. April 1963, at 25, 29.

92. 366 F. Supp. at 1123 n.24.