Are Condos Securities? How to Determine When You Have a Security

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INTRODUCTION

CONDOMINIUM HOTELS, CONVERTED HOTEL/APARTMENT condos, resort condos, and even exclusive-occupancy luxury passenger ships are some of the ventures attracting real estate investors today. At the outset, it is necessary to distinguish among other real estate ventures, e.g., cooperatives (co-ops), or tenancy-in-common (TIC) interests. Cooperatives are single, non-profit corporations with the corporation, rather than shareholders, holding title to the property. Shareholders have a proprietary lease to their units, in addition to shares in the corporation. Conversely, condo owners have a fee simple in their interest.[1] With TICs, the title is held by a separate legal entity, e.g., a corporation, partnership or limited liability company (LLC).[2] On Jan. 14, 2009, the Securities and Exchange Commission (SEC) responded to a "no action request," holding TICs to be securities.[3] However, this article will discuss more traditional condo interests in hotels and apartments where relevant law is yet to be settled.

Unfortunately every deal is not as good as it may first appear to be. In a weak economy, real estate purchasers increasingly seek ways to void purchases, as deals become less attractive because of factors such as falling prices or costlier financing. One recent pretext to void such purchases is to claim securities fraud. If the real estate venture in question is a security, a purchaser can claim that the seller should have registered it as such under state or federal securities law, unless an exemption applies. If the seller did not do so, the purchaser may be able to void a now-undesirable deal by claiming securities fraud. Moreover, the person controlling the selling company and those involved in the sale may be personally liable.

It is often more difficult than one might suppose to determine whether something is a security. Not only are stocks and bonds securities, but many other things are as well. For example, a company in Florida once sold parts of orange groves mainly to out-of-state investors. Another company proposed to nurse the trees and sell the fruit for a share of the proceeds. In *Securities and Exchange Commission v. W. J. Howey Co.*,[4] the United States Supreme Court found that the companies had offered and sold securities in the form of an "investment contract."

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While investment contracts do not exist in the real world, this was the name the court coined for a transaction that it deemed should be considered a security. It also devised a formula for determining when these transactions exist. Since the *Howey* case, courts have found investment contracts involving all kinds of things, including contracts for raising earthworms, cutting demo records and even certain real estate sales involving resort condominiums.[5] This article will addresses the characteristics of a security under the *Howey* test, and analyze how this might apply to various real estate transactions, e.g., those involving condominium hotels.

The *Uniform Securities Act,* which has been adopted by a majority of states, is modeled after Section 2(1) of the *Securities Act of 1933* ("the Act").[6] Thus, state judges following the *Uniform Act* often refer to federal securities cases even when analyzing state cases. Accordingly, several federal securities cases involving real estate transactions will be addressed in this article, as well as *Securities and Exchange Release No. 33-5347,*[7] which concerns criteria for whether the offering of condominiums or similar units will be considered securities. Finally some recent lawsuits will be discussed.

ANALYSIS OF A SECURITY

Is it Called Stock?

It appears that one of the most self-evident cases for coverage by the Act is where the instrument is called a stock. Sections 2(1) of the 1933 Act and 3(a) (10) of the *Securities Exchange Act of 1934* define a "security" to include "stock" and some other instruments.[8] However, the U.S. Supreme Court in *Landreth Timber Company v. Landreth* found the label "stock" insufficient to establish coverage under the Act.[9] Specifically it found that, even if an instrument were labeled as stock, coverage could only be invoked when the instrument also possessed all the usual characteristics of stock (enumerated below), as identified in *United Housing Foundation, Inc. v. Forman*.[10] Then, investors may assume that federal securities laws apply, with all their investor protections.

If the instrument is called stock and also has the characteristics of stock, the *Landreth* Court found that no further analysis was necessary. However, if these criteria are not satisfied, the analysis should continue to consider the "economic realities," which calls for the *Howey* investment contract analysis.

DOES IT POSSESS THE CHARACTERISTICS OF STOCK?

Dividends

Does the instrument have properties to warrant the name "stock?" Is there a right to receive dividends, dependent upon the proportional distribution of profits derived from the efforts of others?

Negotiability

Is the instrument negotiable? Are there limitations on transferability, e.g., qualifications for membership or requirement for the approval of transfers by the Board or general members? Under the *Uniform Securities Act* an instrument is not a security if a transfer is coupled with an assignment of a proprietary lease.

Ability to be Pledged or Hypothecated

Can the instrument be given as security to a creditor without losing title or possession?

Proportionate Voting Rights

Are voting rights awarded in proportion to the number of shares owned? In *Grenader v. Spitz*, voting rights depended upon the number of shares owned. The number of shares (and thus voting rights) that members of a cooperative could purchase depended upon the size and location of their apartments.[11]

Price Appreciation

Can the instrument rise (or fall) in value? In *Grenader*, the court considered the prospect of price appreciation to be inconsequential compared with members' primary motive of acquiring a residence. Moreover, it reasoned that any such appreciation would not be the result of the efforts of others (a là *Howey*).[12]

ECONOMIC REALTIES: THE *HOWEY* INVESTMENT CONTRACT ANALYSIS

If an instrument is called a stock and has the characteristics of stock, no further analysis is necessary, according to *Landreth* (discussed below).[13] There exists a security which must be registered, unless an exemption can be found. If these conditions are not satisfied, it becomes necessary to apply the "economic realties" or *Howey* investment contract analysis.[14] The Supreme Court in *Howey* set forth a four-part test to determine the existence of an investment contract. There must be: (1) an investment of money or value in (2) a common enterprise with (3) the expectation of profit (4) through the entrepreneurial or managerial efforts of others. In the present context (and as discussed in connection with the *Forman* case below), purchases of cooperative real estate interests

are typically motivated more by the need for housing than by the prospect of making a profit.

REVIEW OF FEDERAL CASES

In *United Housing Foundation, Inc. v. Forman,* the United States Supreme Court considered the issue of whether shares in a cooperative apartment corporation were securities.[15] The cooperative had issued shares of stock that entitled the purchaser to an apartment in the complex. The court determined that merely calling an instrument "stock" was insufficient to determine whether it actually was a security under either the *Securities Act of 1933* or the *Securities Exchange Act of 1934.*

The *Forman* Court noted that the label of "stock" is used customarily, and is convenient. However, it found that closer analysis was necessary in order to determine whether these shares were securities. The court applied two tests: (1) the characteristics of stock; and (2) the economic realities of the situation, i.e., the substance of the transaction.

With regard to the first test, the *Forman* Court identified five characteristics associated with stock. These were: (1) the right to receive dividends dependent upon proportional distribution of profits; (2) negotiability; (3) the ability of the stockholder to pledge or hypothecate the stock; (4) the conferral of voting rights in proportion to the number of shares owned; and (5) the capacity of the shares to appreciate in value. It found that the shares in the cooperative were not securities within the Act because they did not possess any of the usual characteristics of stock. It then passed to the second test—the "economic realities" of the situation—laid out in the *Howey* case. This test considered "whether the scheme involved an investment of money in a common enterprise with profits to come solely from the efforts of others."[16]

Considering the economics of the situation, the *Forman* Court decided that the transactions did not involve securities:

> "What distinguishes a security transaction . . . is an investment where one parts with his money in the hope of receiving profits from the efforts of others and not where he purchases a commodity for personal consumption or living quarters for personal use."[17]

In *Grenader v. Spitz*, the Second Circuit considered whether purchasers of stock in a cooperative were issued securities.[18] The purchasers were allowed to lease the apartments, but shares were not transferable except in connection with transfer of the lease itself, which required approval by the cooperative association (the other shareholders). Voting rights depended upon the number of shares owned, which in turn depended upon the size and location of one's apartment. Purchasers could profit by selling their shares and lease.

The *Grenader* Court analyzed the instruments under the *Forman* "economic realities test" to determine that the purchasers' interests were not securities. The court noted that the tenants were motivated primarily by securing residential property for their own use rather than by profit. An examination of the offering plan, the proprietary lease and the subscriptions agreement showed that the stock purchase was connected to the lease and not to making a profit. However the court noted that this case differed from the *Forman* case because the instruments could be sold at a profit. The court reasoned that:

> "[The] transaction here essentially involves the acquisition of a residence. Just as the purchaser of a private and family residence is not unaware that he may eventually sell his property at a profit or loss depending upon the vagaries of the real estate market, so the proprietary lessee of a privately owned corporation cannot be unconscious of the fact that upon its disposal he will gain or lose depending upon the same market factors."[19]

The *Grenader* Court found the shares not to be stock, noting that no dividends were payable to tenants. Although the shares could be transferred with the underlying lease, the purchasers were not free to negotiate them separately. The shares could be pledged or hypothecated only for a loan to purchase an apartment.

Lastly, the Second Circuit discounted the argument that the interests were "investment contracts." It emphasized again that there was nothing in the record to support a finding that the investors were attracted by the prospect of earning a profit. Rather, any profit was incidental to acquiring a residence.

In *Landreth Timber Company v. Landreth*, the Supreme Court considered whether the sale of all the stock in a sawmill company involved the sale of securities.[20] Citing the *Forman* decision, it found that the label "stock" was insufficient to determine coverage under federal securities laws. It found that even if an instrument were labeled as stock, coverage could be invoked only when the

instrument also had all the usual characteristics of stock, as identified in *Forman*.[21] Then, the investor may assume the federal securities laws, with all their investor protections, apply.

In interpreting *Forman*, the *Landreth* Court found that, as long as the instrument is called stock and possess the characteristics of stock, further analysis is unnecessary, but that absent such characteristics, the analysis should extend to the "economic realities" (*Howey*). Thus, the *Landreth* court clarified the *Forman* decision.[22]

SECURITIES AND EXCHANGE RELEASE NO. 33-5347

In Release No. 3-5347, the SEC stated that the offering of condominium units under any one of the following circumstances will cause the offering to be viewed as an offering of securities in the form of investment contracts, and thus require registration and investor protection under the Act.[23]

1. The condominiums, with any rental arrangement or other similar service, are offered and sold with emphasis on the economic benefits to the purchaser to be derived from the managerial efforts of the promoter, or a third party designated or arranged for by the promoter, from rental of the units.
2. The offering of participation in a rental pool arrangement; and,
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.

RECENT LAWSUITS

Forty investors who bought condo hotel units in Las Vegas are suing the developers of Signature, a hotel and condominium complex. The developers are a partnership of MGM Mirage and Turnberry Associates of Aventura, Florida. The hotel units convert to hotel rooms when vacated by the owners to generate revenue, but the owners claim the revenue is not what was promised by the salesmen.[24]

A similar case has been filed in Palm Beach County, Florida, by twelve buyers who bought condo units in The Resort at Singer Island. The developer in this case is WCI Communities of Bonita Springs, Florida. Here too, the rental revenues are not as promised. Investors view the hotel as competing with them for rental income. Obviously, the hotel makes more money renting out its own rooms, rather than the rooms vacated by the condo hotel owners. Thus, there appears to be a conflict of interest for the developers, who should be acting as fiduciaries for the condo hotel owners.[25]

Plaintiffs' attorneys in both of these cases assert that developers violated federal and state securities laws by selling unregistered securities. Further, they are asking that the sales be rescinded and buyers be made whole by a return of their money with damages. Under state "blue sky laws," disclosure is the primary determinant of the investor's being able to make an informed decision concerning risks. Courts might find liability based upon overstatements by the sales agents concerning the anticipated rental revenue. Additionally, they could determine that the whole condo hotel vehicle is a security, since it meets the classic *Howey* test discussed above—an investment of money in a common enterprise engaged in with the expectation of profiting from the managerial efforts of others.

These cases are still pending, and the decision to allow arbitration in the Las Vegas case was affirmed by the Nevada Supreme Court. However, in a second case filed by other Signature condo owners, which was removed by the developer to federal court, the result was different. A federal magistrate declared the arbitration clause unconstitutional, finding it too one-sided in favor of the sellers. Further, arbitration would prevent the award of punitive damages.[26] Thus, it appears that different results are possible from different forums. Attorneys and developers are monitoring these cases closely. A decision against the developers could change the market for condo hotels.[27]

AVOIDING LITIGATION

A number of states including Tennessee have enacted legislative exemptions for cooperative interests that would ordinarily be considered securities and are required to register as such. *T.C.A. 48-2-103 (a) (12)* provides such an exemption for:

> "...securities, stocks, and bonds of corporations organized pursuant to the Cooperative Marketing Law, as compiled in Title 43, Chapter 16, and domiciled within the state of Tennessee..."

Absent legislation, in order to avoid being considered a sale of securities requiring registration, a cooperative interest should be promoted as an interest in real property for residential purposes, with no emphasis

placed on its tax or economic advantages. Further, no time-share, rental pool or management service should be offered in connection with the purchase of cooperative interests. If a condo hotel unit does give the buyer an opportunity to rent the unit when he is not using it, the more restrictions that are placed upon the owner concerning when he can use the property and what possessions he can leave in the unit when he vacates, the more the property looks like a security than a home. (Plaintiff's attorney in the Singer Island case argued this.)

A builder can ask for an interpretive opinion under state as well as federal law. If positive results are obtained, the builder will not be required to register the shares under the state or federal Act or may find an exemption from registration concerning the offer, sale or issuance of the stock in the jurisdiction. These determinations are made upon specific fact situations and do not serve as precedents. Any variation in the facts can result in a different decision. States issuing no-action letters have emphasized that the cooperative interests be issued as a form of residential housing with accessible services, and not marketed as an economic interest to make a profit from the entrepreneurial efforts of others.

Different jurisdictions, of course, may draw different conclusions. This issue is not settled. Real estate professionals should stay tuned. ■

ENDNOTES

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