SECURITIES REGULATION OF CONDOMINIUM
OFFERINGS

With the deluge of condominium housing development in the United States since 1960¹ there has been a corresponding growth of concern for the possibilities for fraud and other abuses in the offering of condominium units for sale. Accordingly, a number of commentators have speculated on the conceivable application of the Federal Securities Acts of 1933 and 1934 and state "Blue Sky Laws" to the sale of condominium units.² This note is designed to explain the theory behind such possible regulation, action taken to date, and the limitations, both actual and inherent, of securities regulation of condominium offerings.

Because the Securities Division of the Illinois Secretary of State’s office follows the definitional and regulatory lead of the Securities and Exchange Commission,³ the following discussion will, except where inappropriate, treat both agencies as one, acting under the same theory and method of regulation. In order to understand the possibilities of including cooperative and condominium housing within the aegis of securities regulation, an attempt first must be made to describe the legal nature of a condominium development and its practical uses.

DEFINING THE CONDOMINIUM

Its Legal Nature

Ownership of a condominium unit involves two combined interests in real property.⁴ The unit purchaser owns his "apartment," usually defined by the inside surfaces of the floor, ceiling and four walls, in fee simple.

1. In 1960 condominiums were first "recognized" by an amendment to the Federal Housing Act authorizing FHA loans for their purchase. By early 1974 Mr. Carl Sheleen, Vice-President of Talman Federal Savings and Loan in Chicago, Illinois was able to state in a speech before the Chicago Mortgage Attorneys' Association on February 14, 1974 that an estimate had been made to the effect that in 1973 56% of the online market zoning applications in DuPage County, Illinois were for condominiums, as opposed to 13% for single family dwellings.


4. A cooperative is significantly different from a condominium in that unit owners of the former do not hold legal title to their unit. Rather, a corporation or trust is formed and unit purchasers receive shares of stock or certificates of beneficial interest evidencing their voting rights in the corporation or trust. The corporation or trust then holds legal title to the whole property and each unit purchaser is issued a proprietary lease.
Concurrently, he owns the "common elements" of the condominium as a tenant in common with all other unit owners. The common elements are essentially all property in the development not owned in fee simple and are both specifically and generally defined in the condominium declaration. The declaration is made of record and acts as a restriction on the unit owner’s possible use of the property. The common elements are then managed by a board of managers elected by an association of all unit owners. A management firm is often retained to oversee the day to day operations of the development. The voting interests of each unit owner are determined by a prearranged plan embodied in the declaration and are usually based on the percentage of ownership of the common elements. Assessments made by the association for maintenance of the common elements are made according to proportionate voting interests.

Subject to the restrictions contained in his deed, the declaration and bylaws of the condominium association, each unit owner has sole control over and responsibility for his unit. The board of managers controls the common elements and determines the policy for and restrictions on their use. The managers act as rental agents or lessors of any income producing common elements. They may, with the consent of the association as a whole, develop that property for further income production. The income or dividends are usually kept in the association treasury for the purpose of financing the maintenance of the common elements; thereby, reducing the maintenance assessments against each unit owner. While standard concepts regarding the legal nature of condominium development have been established, modern usage has created a variety of different condominium forms.

**Modern Uses of the Condominium Concept**

It is to the credit of the drafters of the Illinois Condominium Property Act that the concept of condominium has remained flexible and is not restricted to single structure developments. It is also to the credit of developers and their attorneys that ingenuity knows no bounds in the use of the condominium regime. Variations on the basic condominium theme, however, are predominately responsible for the possibility of extending securities regulation to various forms of cooperative housing development.

Developers are faced with the immediate problem of marketability of


the development even in the planning stage. To augment a unit's marketability, the developer will devise a form of condominium that will increase the development's attractiveness to a particular community, adding "unique" features to distinguish it from the myriad, otherwise identical developments in the community. These "unique" features may, under new SEC regulations and judicial theories, create the indicia of a security within the terms of both the Illinois and federal acts. Such modern uses of the condominium concept are being used extensively in suburban Cook County and DuPage County, Illinois. The most prominent of these developments are the quadrominium, the expandable, or add-on condominium, and the rental pool concept of condominium. In recent developments, management contracts with a professional building manager have been required by the declaration, forcing the unit owner to accept the arrangement as part of his sales agreement. Many more innovations have surfaced in the past few years as competition among developers has grown. A frequent ploy is to include income producing property as a common element.

Sample Condominium Offering

For the purposes of later discussion and to further elucidate condominium organization, let us construct the following condominium development and offering for sale. This situation is common to other condominium offerings in all respects except that few developments incorporate all of the features mentioned.

10. Interview with Robert Goldstine, Attorney at Law, March 12, 1974. Mr. Goldstine represents several condominium developers and is a partner in the firm of Goldstine and Siegel.
11. In a quadrominium, the units consist either of four flat buildings or are arranged in groups of four townhouses. Each unit may consist of the whole building or group, or may be one of the divisions of that group or building, i.e., flat or townhouse.
12. An expandable or add-on condominium is one in which the developer builds only a portion of the development at a time, selling units in stages as he completes them. The initial unit purchaser agrees in his contract of sale to allow his percentage of unit ownership in the common elements to diminish with the growth of the development. The add-on condominium is the easiest and most often used method of assuring financing for a large development.
13. This is a method whereby the unit purchaser agrees to occupy his unit for only a certain length of time each year and gives the manager the right to rent his unit to others. The receipts from such rental are then pooled and divided among all unit owners pro rata.
15. Such income producing property may be a cooperative grocery, vending machines, other commercial property, or parking facilities leased to the public.
16. This has been the author's personal experience both in the study of condominium transactions and in shopping the condominium market.
A site is selected offering easy access to shopping and transportation. Preliminary documents such as a survey and declaration are drawn. The type of development contemplated for the purposes of illustration is an expandable quadrominium. Stage I will be forty four flat buildings and a goal of 18 months is set for completion. Each unit owner will own a building containing four apartments and it is expected that the unit owner will occupy one apartment and rent the other three. Stage II contemplates the addition of parking facilities, an enclosed pavilion, tennis courts, a swimming pool, cabana, snack bar and, as a further convenience, facilities for a small "general store." Stage III calls for the construction of forty additional four flat buildings. Financing is secured on the basis of the above plans. The mortgagee is to receive a certain percentage of the initial income from the sale of units until the mortgage note is paid.

Once a model is completed the sales effort begins with an advertising campaign undertaken to describe the various features of the development. Prospective purchasers receive copies of the declaration and bylaws. Estimates of the real property taxes and annual maintenance assessments are made by the developer, and the stage construction is explained. In effect, the developer is selling the finished (three stages) development at the initial offering when there is only one stage to show. At this time condominium living is described. The prospective purchaser is told the association must employ a professional manager and that the developer will manage the condominium for one year or until the association becomes organized. Additionally, the annual return to the unit owner from rental of the remaining three flats is estimated. An offer is made by the management firm, possibly a subsidiary of the developer, to act as rental agent for the unit purchaser's other three flats. Estimates concerning the amount of income to be realized from income producing common elements and the percentage of annual maintainance charges that will be offset by them are made. A mortgage is usually secured for the unit purchaser from the mortgagee holding the blanket mortgage on the development.

The developer, having sold a number of units, returns to his mortgagee and secures another mortgage for the construction of Stages II and III based on his performance shown in Stage I. If a different mortgage arrangement was made for Stage I, it is possible for the developer to pay less than the required percentage of the various purchase prices and to use the income generated by Stage I sales to finance Stages II and III directly.

While this shorthand description of a condominium development and sale is typical in many respects, it is not all inclusive. It will, however, serve to raise questions of possible securities regulation. Before direct application

17. ILL. REV. STAT. ch. 30 § 322 (1973).
18. ILL. REV. STAT. ch. 30 § 318.2 (1973).
of those regulations are made, it is necessary to discuss the interpretations of the acts which make the concept of regulation feasible.

**APPLICABILITY OF SECURITIES REGULATION**

The purpose of securities regulation as set forth by the Federal Securities Act of 1933 is to "compel full and fair disclosure relative to the issuance of 'the many types of instruments that in our commercial world fall within the ordinary concepts of a security.'"19 The terms of the Act have, and should be, construed liberally so as to effectuate the intent of Congress and the legislative bodies of the various states.20 The general theory of securities regulation is that by the Act's registration requirements the possible offerees of a security may be protected by administrative regulations which obviate against fraud and even fiscal instability. The severe civil and criminal penalties for failure to register encourage registration and compliance with SEC and state regulatory guidelines.

It is imperative that the attorney involved in condominium development have a working knowledge of the applicability of these security regulations to condominiums. The civil provisions of the 1933 Act provide that the purchaser of an unregistered security may, within a three year statute of limitations,21 sue the seller for rescission of the sale and succeed based solely on a *prima facie* showing of a failure to register.22 The purchaser may not only recover his reasonable attorney's fees, but interest on the purchase price.23 Both the Illinois and Federal Acts contain criminal provisions as well, further prompting attorney compliance with their provisions.24

While the SEC25 and the Illinois courts26 have been active in the regulation of cooperative apartments for some time, only recently have condominiums come under scrutiny for securities violations. Interpretive Release No. 5347,27 issued by the Securities and Exchange Commission on January 18, 1973, sought to officially bring the rental pool condominium within the purview of the registration requirements of the Act.28 This type of condo-

23. *Id.* But see 15 U.S.C.A. § 771 (attorney's fees are not recoverable under the Federal Act).
25. CCH FED. SEC. L. REP. ¶ 2357.
27. 18 FED. REG. 1735 (1973).
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... is a method whereby the unit purchaser agrees to occupy his unit for only a certain amount of time each year, giving the manager the right to rent his unit to others. The receipts from such rentals are then pooled and divided among all unit owners pro rata. In effect, any condominium offering that is made in conjunction with any one of the following will be viewed (by the SEC) as an offering of a security in the form of an investment contract.

(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 the rental of the units;

(2) The offering of a 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.

Based upon the few no-action letters issued by the SEC under this regulation, it would appear that for the present, securities regulation is limited to the highly hybrid form of rental pool condominium development.

Several interpretations of the Act itself have, however, posed possible problems for condominium species common in Illinois. Using the definition of the Federal Securities Act of 1933, a security is:

[A]ny 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, frac-

29. This kind of development has, to date, been predominantly limited to resort areas such as Florida and the skiing regions of the Rocky Mountains. L. Grimes and D. King, A Look at Condominium Offerings Under the Federal Securities Law for the Idaho Lawyer, 9 Idaho Law Rev. 149 (1973).

30. Supra, note 27, at 1736.

31. A no action letter is issued by the staff of the SEC when it is determined by them that they would not take any action against a promoter for failure to register his activity with the SEC. A no action letter must be requested by the promoter or his attorney. The SEC, however, announced on May 6, 1974 that it would no longer issue no action letters in the area of resort real estate. 1 BNA SEC. REG. L. RPTR. 252C-1 (May 15, 1974).


33. Wunder interview, supra note 3.

34. See, supra, notes 11-14.

tional 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 in 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. 36

Obviously, the most available definition applicable to condominiums is the
“investment contract.” The initial battle having been won by those seek-
ing to regulate condominiums under the securities laws by the adoption of
Release No. 5347, the investment contract is the battering ram that may
be used to break down the sacrosanct nature of the real estate transaction37
heretofore used to protect condominiums from securities regulation. 38

The Investment Contract

The preeminent case defining the investment contract for the purposes
of securities regulation is Securities and Exchange Commission v. W.J.
Howey Co. 39 The Howey Court was faced with the sale of small sections
of an orange grove, too small for single purchaser cultivation. This offer
was coupled with the seller’s offer of a service contract permitting a sub-
sidiary of the Howey Company to manage the property and pay the net
profits to the purchaser. While agreement to the service contract was not
mandatory, the two contracts were advertised in such a way that 85 percent
of the acreage sold was covered by Howey’s service contract. The Court’s
definition of an investment contract brought the above transaction well with-
in securities regulation.

[A]n investment contract for the 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 sole-
ly from the efforts of the promoter or third party, it being im-
material whether the shares in the enterprise are evidenced by
formal certificates or by nominal interests in the physical assets
employed in the enterprise. 40

The purchasers here brought not only an interest in land but also, through
the service contract, an interest in “a citrus fruit enterprise managed and
partly owned by [Howey].” 41 While Howey abolished the necessity to
prove a security by the issuance of “formal certificates,” a prospective plain-
tiff must still meet the well defined test set forth above.

Each condominium is by definition a common enterprise. Even though
each unit owner is autonomous with regard to his unit, he has either directly

37. Brothers, supra note 26.
39. Howey, supra note 19.
40. Id. at 289-90.
41. Id. at 299.
or indirectly financed the construction and maintenance of common elements through the purchase price and maintenance assessments. Condominium ownership is a bifurcated state of legal title and the various unit owners must act in concert not only to fulfill the theory of cooperative living but also to effect the management of the common elements. Of course, if the applicability of securities regulation is to be determined, the common enterprise must be involved in an activity that would raise the indicia of a security.

The two most troublesome features of the Howey test are the finding of profit which must, as well, be derived solely from the efforts of a promoter or third person. Applied to non-rental pool condominium transactions, the finding of an ascertainable pecuniary profit per se is usually impossible. But later cases have significantly altered the strict test thus expanding the possibility of regulation.

In Silver Hills Country Club v. Sobieski the California court was faced with a development scheme where memberships in a yet to be built country club were sold. These memberships amounted only to a future right to use the facilities of the club upon completion. The court held the transaction a sale of a security and the purchasers were granted a recision of their contracts. The profit found in this transaction was the benefit to be given the purchasers in the form of membership in the club. This “profit” was neither a pecuniary return on the investment or a purchase of an exclusive right to the use of the club. The scheme essentially amounted to a common enterprise to build a country club which was guaranteed to supply certain facilities to the investors. In determining profit, then, the modern interpretation of Howey allows a court to find any benefit derived from the purchase or investment a “profit” for the purposes of determining a security. However to meet the full force of the Howey test this profit must be derived “solely” from the efforts of the promoter or a third person.

In most condominiums, the association or its board of managers ultimately controls the common elements so that it could not be said that the profit or benefit is gleaned solely from the efforts of the promoter or third party. More recent interpretations of Howey have diluted this requirement significantly.

42. See, e.g., McCormick v. Shively, 267 Ill. App. 91 (1932).
44. Ronald J. Coffey, The Economic Realities of a Security; Is There a More Meaningful Formula?, 18 WESTERN RESERVE LAW REV. 367 (1967). [hereinafter referred to as Coffey] "In such non-profit corporations where the shareholder does not expect monetary return, he nevertheless maintains an interest in an enterprise which he expects to see operated in a fashion that will result in some sort of continuing benefit to him." Hoisington, supra note 2.
45. Babiarz and Appleton, supra note 5. This note will not consider the securities implications of the recent tendency of condominium associations to incorporate themselves with not-for-profit status.
In S.E.C. v. Glenn W. Turner Enterprises, Inc., the Ninth Circuit held the purchase of self-improvement courses to be a pyramid fraud scheme and a security within the provisions of the Act, thereby redefining an investment contract in the process. Here, the purchasers of the self-improvement programs were given kits containing books and taped lectures. Various types of kits and courses were offered. For the purchase of the "delux" plan, the buyer was given a chance to recoup his investment and expand his income by selling the course to others. The defendant encouraged sales by such persons with "pep talks" and other motivational techniques. After his first two "sales" the buyer-turned-seller received four hundred dollars per customer. The defendant argued that because purchasers of the "delux" plan themselves created any profit they were led to expect, by their own sales efforts, the transaction did not meet the Howey "sole effort" test and was, therefore, not a security. The court rejected this contention, saying:

Regardless of the fact that the purchaser here must contribute something besides his money, the essential managerial efforts which affect the failure or success of the enterprise are those of Dare [a subsidiary of the defendant], not his own.

This deviation from the strict interpretation of Howey is given certain credence since the SEC has cited Turner approvingly on this point in Release No. 5347.

Thus in recent cases, the definition of an investment contract has been expanded for the purposes of securities regulation. The three primary requisites of the transaction are: (1) a common enterprise; (2) from this common enterprise profits or other benefits are expected to accrue to the purchaser, investor or adventurer; and, (3) these profits or benefits are derived to a significant extent from the activities of the promoter or other persons. This formula, while much more flexible in its terms, still requires the proof of three separate elements rather than to allow investigation of the more important question of whether the basic nature of the transaction is within the avowed purpose of securities regulation.

An outgrowth of Turner is the “risk capital test.” A few courts and legal writers have determined the existence of a security in this way: if one solicits money for his use, promising a return on or a benefit from the investment made, and there is a risk involved in the use of that capital, i.e.,

47. A pyramid fraud scheme is very much like a chain letter where purchasers of the fraudulent offering are promised they can make even more money by a continued participation in the scheme.
48. Turner, supra note 46.
50. Turner, supra note 46.
51. Coffey, supra note 44.
the investor will lose his investment or will not receive a benefit from it, the
transaction is an investment contract and a security. The test is based on
the degree of risk over which the investor has no control and arises from
the established concept that a security must be found by looking at the sub-
stance of the transaction rather than at the form. As one of these writers
has said:

The well worn principle of 'looking through form to substance' is
really another way of saying that the definitive characteristics of
an activity are found in the 'risks' and 'relationships' involved and
not in the 'names' or 'labels' associated with it.\textsuperscript{52}

This new look in securities regulation is really based on the pre-\textit{Howey} case
of \textit{Securities and Exchange Commission v. Joiner Corp.}\textsuperscript{53} where the Court
said:

It is clear that an economic interest in this (enterprise) \ldots was
what \textit{brought into being} the instruments (evidencing real property
interests) that defendants were selling and gave the instruments
\textit{most of their value} and all of their lure. The trading in these
(interests) \ldots had all the evils inherent in the securities transac-
tions which it was the aim of the Securities Act to end. (emphasis
added by Coffey)\textsuperscript{54}

It is possible by this method to find a security in the sale of condominium
units when the substance of the transaction embodies a risk that the develop-
ment will not succeed, or that the development will not meet the goals ad-
tertised by the promoter and that risk is in the control of the promoter or
someone other than the investor.\textsuperscript{55}

\textsuperscript{52} Hoisington, \textit{supra} note 2, at 244.
\textsuperscript{53} Joiner, \textit{supra} note 20.
\textsuperscript{54} \textit{Id.} at 349, as quoted in Coffey, \textit{supra} note 44, at 381.
\textsuperscript{55} See 47 ALR3d 1375. Professor Coffey has designed his own risk capital test:

"A security is:

(1) a transaction in which
(2) a person (buyer) furnishes value (initial value) to another (seller); and
(3) a portion of the initial value is subjected to the risks of an enter-
prise, it being sufficient if
(a) part of the initial value is furnished for a proprietary interest
in, or debt holder claim against, the enterprise, or
(b) any property received by the buyer is committed to use by the
enterprise, even though the buyer retains specific ownership of
such property, or
(c) part of the initial value is furnished for property whose present
value is determined by taking into account the anticipated but
unrealized success of the enterprise, even though the buyer has
no legal relationship with the enterprise; and
(4) at the time of the transaction the buyer is not familiar with the op-
erations of the enterprise or does not receive the right to participate
in the management of the enterprise; and
(5) the furnishing of initial value is induced by the seller's promises or
representations which give rise to a reasonable understanding that
a valuable benefit of some kind, over and above initial value, will
accrue to the buyer as a result of the operation of the enterprise."
Coffey, \textit{supra} note 44, at 377.
Specific Application of Securities Theories to the Condominium Model

Several aspects of the sample condominium development described above raise very serious securities problems. As was discussed previously, in many instances a condominium is by nature a common enterprise for the purposes of securities regulation. The purchaser of a unit must, however, be "led, by the sales effort of the promoter, to expect certain things from his purchase beyond the ownership of his unit as a home.

Many elements of the sample development indicate the presence of an expected profit or benefit. It is assumed that such expectation need not be the primary consideration in the determination of the buyer to purchase a unit. The quadrominium form is an obvious inducement to the purchaser because he is told the approximate rental value of the available three apartments and he is made to see the low cost of his own apartment since the interest and principal on his mortgage may be paid from his rental income. Of course in this instance, the quadrominium is very close to being within the terms of Release No. 5347. Likewise, an income producing common element such as storefront commercial property or parking facilities with extra spaces rented to the public may be present. The developer, in selling the units, will opine the amount of income to be made from the rental of such property, using it to offset a certain percentage of the estimated yearly maintenance assessments.

Because a condominium is organized to place control of these benefits within function of the condominium association and its board of managers, another step must be taken to find a security. In search of "sole" or "primary" efforts, note must be taken of Section 318.2 of the Illinois Condominium Property Act. That section allows the developer to maintain control over the affairs of the development for one year after the recording of the declaration or until a certain percentage of the unit owners form the association and elect a board of managers. If sales efforts are non-productive, it is conceivable that the developer could keep control of the association for a longer period of time by virtue of his ownership of unsold units. Such control may result in a significant change in the philosophy of the enterprise. The developer may increase the assessments and add unwanted luxury features to further promote sales. He may control income producing common elements and commit the association to long term leases which may retard the capital appreciation of the units which may not meet with the approval of the existing unit owners for a variety of reasons.

56. Edward T. Joyce v. Ritchie Tower Properties, Civil No. 74 C 116 (D. Ill., filed January 14, 1974) [hereinafter referred to as Joyce]. The allegation that promises were made as to rental income are contained in paragraphs six and seven of the complaint.
More important is the recent tendency to require, in the declaration, the employment of a firm of professional managers to operate the development. Depending on the degree of real control given over to the manager, it could become evident that any of the benefits the purchaser was led to expect are created solely, or at least primarily, by the efforts and judgment of the third person manager. This is especially true in the quadrominium where the manager's rental agency is sold to prospective unit purchasers. While agreement with the manager for a rental agency may not be mandatory, it must be remembered that in Howey the service contract was not mandatory either. Because of the manner of offering the land for sale, however, a security was found. One must also question the degree of actual control the board of managers would have over the professional manager. An Illinois Appellate Court has found a similar arrangement for professional management services with control vested in trustees of a cooperative "illusory, not real control." Of course, the transaction must be evaluated as a whole and one factor to be weighed is the manner in which units were offered for sale.

It is often customary to advertise a condominium offering with an emphasis on the investment character of the purchase of a unit. Many times appreciation figures for similar developments are given. By such inducements, it is possible to view the condominium offering not to be so much concerned with the sale of a dwelling as with a commodity. There is a fine line between "puffing" and creating real security problems in this regard, especially under the risk capital test. Of course, advertising the value of the condominium alone will not create the indicia of a security, but if the purchaser is led by such advertising to expect benefits in addition to a place to live by the purchase of a unit, an examination of the offering may be weighted in favor of the finding of a security.

Further problems under the risk capital test could be raised by the method of financing. Supposing that Stage I was sold partially with reference to future stages, it is obvious that the unit purchasers in Stage I will be placing risk capital in the hands of the developer for construction of future accoutrements to their property. Even though the mortgagee is paid from the first income of the sales, any surplus will be used in the further development of the site. The promoter will not recover his profit until the project is completed. Therefore, the initial purchaser is obliquely financing his own swimming pool or other future construction. Even though he takes immediate possession of his unit, the initial purchaser has bargained for

57. Sire Plan, supra note 26. The court held that where purchasers of cooperative apartments were forced to sign a long term management agreement with the developer, the fact that 60% of the units of ownership could combine to oust the trustees was "illusory, not real control.", at 359.
58. Joyce, supra note 56.
59. Id. See specifically paragraphs five and six of the complaint.
more than the unit alone. He has bought into a larger, but unfinished, development and has risked his investment on the hope that all stages will be completed.

AMELIORATING FACTORS

While, as seen above, it is possible to find any number of condominium offerings to be a security, it is significant that there has been no rush to do so on the part of regulatory agencies and the courts. Action taken to date seems to have been limited to rental pool condominium agreements within the terms of Release No. 5347.\(^6\) However, there are three suits for rescission of condominium purchase agreements based upon a failure to register the condominium offering as a security in litigation at the time of this writing.\(^6\) The plaintiff in each instance is apparently proceeding on the theories outlined above. The condominiums in question were advertised as an investment and have as a common element income producing property which the promoter opined would offset fifteen percent of the total maintenance costs each year.\(^6\) Management contracts were signed so that the purchasers had no real control over the operations of that rental property.

While a firm opinion as to the success of the plaintiff's contentions in the above cited suits is impossible, it should be noted that several courts have refused to carry securities regulation even as far as cooperative housing developments.\(^6\) Applying the rule that the substance of a transaction governs its form\(^6\) in determining the presence of a security, it would be, and has been, comparatively easy for a court to decide that what is really being sold is real estate—or more significantly, a home. Even though several elements of the Howey test are present, it is possible a court will say it is not within the purpose of the Securities Act to extend regulation that far. In Illinois, this is the position of the Commissioner of the Securities

\(^6\) CCH FED. SEC. L. REP., ¶ 79,4401 (1973). A recent case has, however, found a New York cooperative to be within the aegis of securities regulation. Forman v. Community Services Inc. (2d Cir. June 12, 1974) (reported in REAL ESTATE L. REP. July 1974, at 1). The court in that case said, "'To look to the substance of the term 'stock' is in essence to determine if an 'investment contract' of some sort exists,' and that in turn fundamentally depends on whether there's an expectation of profits from the efforts of the promoter or others." \(^6\) In finding an expectation of profit to the cooperative stock purchasers, the court relied on three items: 1) the existence of tax benefits to the shareholders; 2) "rent" savings, i.e., it is less expensive in the long run to own a cooperative apartment than to rent a comparable dwelling; and, 3) a share in commercial leasing of common elements of the cooperative with rental income going toward the reduction of carrying charges.

\(^6\) Joyce, supra note 56; R. Alden Jones v. 247 East Chestnut Properties, Civil No. 74 C 293 (D. Ill., filed January 30, 1974); Edward T. Joyce v. Ritchie Tower Properties, Inc., Civil No. 73 Ch 05304 (Cook Co. Circuit Court, filed September 14, 1973).

\(^6\) Id.

\(^6\) See, e.g., Brothers, supra note 26.

\(^6\) Howey, supra note 19.
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Division of the Illinois Secretary of State's Office and it finds some support in the Illinois courts.

Securities regulation proceeds on a case by case basis and the "true nature" of the transaction must be ascertained in each instance. This is how the Illinois Appellate Court distinguished Brothers v. McMahon and Sire Plan Portfolios, Inc. v. Carpentier. In Brothers, the plaintiff paid the purchase price for a cooperative apartment which the developers failed to complete. The court held the sale of shares of a cooperative to be the sale of a type of housing and not a security. In making this determination the court looked to the substance of the transaction; what was being sold and how it was sold. In Sire Plan, however, the court held deeds of trust evidencing an interest in a cooperative apartment house in New York City to be a security. The essential difference between the two developments was the amount of control vested in the purchaser. In Sire Plan each purchaser agreed as a part of the contract of sale to allow the developer to manage the building on a long term basis. There was also a difference in the type of housing in question. In Sire Plan the units were offered primarily as second homes or investments while in Brothers the plaintiffs purchased their shares as a primary place of abode. This confusion, both in the courts and at the bar, as to the practical application of securities concepts to condominium offerings is perhaps rooted in a basic distaste for the securities method of regulating real estate practices. Accordingly, other methods of regulation have been suggested.

ALTERNATIVES TO SECURITIES REGULATION OF CONDOMINIUM OFFERINGS

It must be asked how many abuses of good faith or full disclosure there really are each year in condominium transactions. The author has no method to ascertain such figures but would suggest that they are few in number because of the participation of mortgagees and title insurance companies in the planning stages of condominium development.

Conversely, the problem for the developer created by holding the condominium offering to be a security is enormous. One condominium registration alone has cost as much as $125,000. In addition, once a security has been found, it may be sold only by licensed securities brokers registered

65. Wunder interview, supra note 3.
68. Brothers, supra note 26.
70. Ellsworth, supra note 2.
under the 1934 Act.\textsuperscript{71} It is conceivable as well that in each development there will be a possibility that an exemption from the Act may be had.\textsuperscript{72} However in order to qualify for an exemption, or even to comply with regulation, the developer may be forced to restrict his sales practice and advertising significantly.\textsuperscript{73}

Other methods exist for supervising the condominiums being offered for sale and regulating any abuses that may be found. In New York, all condominium documents must be approved by the Attorney General's office.\textsuperscript{74} By this method and other powers given the Attorney General under the statute, such as the power of subpoena and injunction, the state may require compliance with certain regulations and the submission of financing statements to insure fiscal responsibility. Thus, the state is able to protect prospective purchasers of condominium units without unduly restricting the freedom of, or financially burdening, the condominium developer.

At this writing, a law similar to New York's is under consideration in the General Assembly of Illinois.\textsuperscript{75} The bill amends the Illinois Condominium Property Act by changing the recording provisions contained in the present statute. Instead of recording the declaration of condominium with the County Clerk or Recorder, the developer would file the same documents with the Illinois Secretary of State. The Secretary is then given the power to determine what documents must be filed in support of the declaration, including balance sheets of the developer and other financial information. He may also reject the filing "if there are conditions affecting the sale which would be inequitable, or would work or tend to work a fraud or deceit."\textsuperscript{76} The Secretary is given the power of investigation supported by the power of subpoena. He may prohibit or suspend the sale of units temporarily, he may ask the Attorney General to seek an injunction against the sale of units, or he may order the proceeds of the sale of units be held in escrow until the developer meets certain conditions.

While such powers may seem overbroad, they are in effect no less so than the powers given the various agencies charged with securities regula-


\textsuperscript{72}. A number of exemptions are available under both state and federal law. These include the private offering exemption, the intra-state offering exemption, and exemptions for transactions whose cumulative value is under a certain amount. See, Gimes and King, supra note 29.

\textsuperscript{73}. E.g., a developer may limit his customers to less than a certain number per year to qualify for a private offering exemption or only to residents of the state of situs to qualify for the federal intra-state exemption.

\textsuperscript{74}. N.Y. REAL PROPERTY LAW § 339-ee (McKinney 1974) specifically includes condominiums within the regulatory provisions of N.Y. GENERAL BUS. LAW § 352-e (McKinney 1974).


\textsuperscript{76}. Id. § 4(B).
tion. It is to be remembered that the same effect would be had, i.e., regulation of condominium offerings so as to prevent fraud or faulty disclosure, without the deleterious effects of securities regulation discussed above.

CONCLUSION

This note has attempted to provide the reader with a theoretical outline of a way in which securities regulation may be extended to non-rental pool condominium offerings. The investment contract test of Howey, as modified, may in some instances be made to apply to condominium developments. The more modern risk capital test has been seen to apply to even more varied situations because of its flexibility. A cautionary note was sounded as to the immediate likelihood of extending securities regulation. It is still judicial policy to look through form to substance, but that maxim in no way lessens the technical applicability of the Security Acts to this field of activity.

It is the opinion of the author that such an extension would not only be unwieldy but also would be an unconscionable burden for the developer and an unreasonable hazard for the practicing attorney. Legislation in Illinois modeled loosely on the New York regulatory statute would be preferable to such an extension of securities regulation, if such regulation be needed at all.

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