

DEFINITION OF SECURITY

Hocking v. Dubois

885 F.2d 1449 (9th Cir. 1989)

GOODWIN, Chief Judge: Gerald M. Hocking, a disappointed purchaser of a unit in a condominium complex in Hawaii, sued the brokers who sold the unit, claiming violations of the antifraud provisions of the Securities Exchange Act of 1934. He appeals a summary judgment in favor of the brokers.

* * *

As best we can ascertain from the present record, and reading it in the light most favorable to Hocking, the facts are as follows:

Hocking was a resident of Las Vegas, Nevada. Following a visit to Hawaii, Hocking became interested in purchasing a condominium there as an investment. Dubois was a real estate agent licensed in Hawaii, employed by defendant Vitousek & Dick Realtors, Inc. Dubois met Hocking through her husband, one of Hocking's co-workers.

Dubois agreed to search for a condominium for Hocking, and in the spring of 1979 proposed that Hocking purchase a condominium in the resort com-

plex at 2121 Ala Wai, Honolulu, which had been listed with Vitousek & Dick. The resort complex was developed by Aetna Life Insurance Company, and was still under construction at that time. Hocking had told Dubois that he wanted to buy a condominium directly from the developer, to be a "first person buyer." In fact, the condominium unit sold to Hocking was owned by Tovik and Yaacov Liberman, who had purchased from the developer. Hocking did not independently inquire into who was developing the complex at 2121 Ala Wai, but relied on Dubois' assurances that he would be purchasing directly from the developer. Hocking had no contact with Aetna, and he knew of no connection between defendants and the builders of the condominium complex.

Dubois told Hocking, according to his deposition, that "the investment would be handled [for him] by a local company, or her company or someone that she would help [him] get in touch with." She informed Hocking that a rental pool arrangement (RPA) would be available to Hocking if he were to purchase the condominium. She also told him that the condominiums were renting for an average of \$100 a day, from which he calculated the monthly income would be \$2,000 to \$3,000 per month. He relied on the expected rental income to cover his monthly payments and provide additional income. While Dubois expressed no requirement that Hocking participate in the rental pool arrangement, Hocking testified that but for the availability of the rental pool arrangement he would not have purchased the condominium.

Hocking entered into an agreement to purchase the condominium from the Libermans. He signed the agreement on June 23, 1979 in Nevada, and Tovik Liberman signed on July 2, 1979 in Hawaii. Hocking also entered into several agreements with Hotel Corporation of the Pacific (HCP) concerning rental of the condominium.

On June 29, 1979 he signed a rental management agreement (RMA) appointing HCP exclusive agent to manage his condominium. He also entered into an Individual Agency Rental Agreement for Pooled Operation, the RPA, executed on July 5, 1979, to become effective on December 20, 1979. This agreement placed Hocking's condominium in HCP's rental pool.

* * *

Hocking alleges that his investment was entirely passive, and that he relied on Dubois to select, manage, and protect his investment. He relinquished control of his investment at the time he purchased it and had

access to his unit for only two weeks each year. He knew that approximately fifty other condominium owners participated in the rental pooling arrangement. When he visited the building in Hawaii, he observed that it was operated like a hotel, and he received copies of brochures and advertisements which HCP distributed on the mainland.

Hocking purchased the condominium for \$115,000, with a down payment of \$24,000 and installment payments on the remaining portion of the purchase price through June 1982, at which time all unpaid amounts were to become due. Hocking's complaint states that he "cancelled" his investment when this balloon payment came due. The failure to make the payment apparently caused the forfeiture of his prior payments. He claims the loss of his investment was caused by the failure to receive the expected rental income, and by further misrepresentations of Dubois concerning appreciation in the value of the condominium and her efforts to resell the condominium in 1981 and 1982.

* * *

In order for Hocking to make a claim under the securities laws, he must show that Dubois' alleged misrepresentations were made in connection with the purchase or sale of a security. Both section 2 of the Securities Act of 1933 and section 3 of the Securities Exchange Act of 1934 define the term "security" to include any "investment contract."

* * *

In *Howey*, [*SEC v. W. J. Howey Co.*, 328 U.S. 293 (1946)] the Supreme Court found that the combined sale of land and a land service contract, under which the purchaser relinquished all control over the land for a 10-year period, was an investment contract. The Court there put forward the definition of an 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.

We must therefore determine whether Hocking's purchase of a condominium and rental pool was (1) an investment of money, (2) in a common enterprise, (3) with an expectation of profits produced by the efforts of others.

In *Howey*, as here, the investors purchased real estate and at the same time relinquished much of the right to use or enter the property. In *Howey*, as here, the investors were not obligated to purchase the service contracts, and in fact some decided to purchase the land without a service contract. In *Howey*, as here, the investors were generally nonresidents who lacked the skill, knowledge and equipment necessary to manage the investment.

There is no doubt that, had Hocking purchased the condominium and the rental pool directly from the developer and an affiliated rental pool operator, and had the rental pool been for a long term without any provision for early termination, Hocking would have purchased a security. If that were the case, we would merely substitute Hocking's Hawaiian condominium for *Howey's* Floridian citrus grove.

Hocking, however, did not purchase the condominium in the initial offering from the developer. He purchased in the secondary market from the Libermans. Further, Hocking entered into the rental pool agreement with HCP, and has, defendants argue, failed to demonstrate any link between HCP and the developer. Finally, unlike the investors in *Howey*, Hocking could legally terminate the RPA according to its terms and regain control over the condominium. We must determine therefore whether these differences from *Howey* make Hocking's alleged transaction into an ordinary real estate purchase or whether it nevertheless could prove to be the purchase of a security.

THE HOWEY TEST

A. Investment of Money

Defendants attempt to pull apart the package into two separate transactions. They argue that even if Hocking did invest money in the condominium, he did not invest money in the RPA, and it is the RPA which provides the elements necessary to satisfy the *Howey* test's other requirements. Therefore, they claim, Hocking did not satisfy this first requirement.

Admittedly, there would be an argument as to whether the "investment of money" requirement had been met if someone who already owned a condominium decided to place the condominium into a rental arrangement, independent of the decision to purchase the condominium. If, however, the condominium and

rental agreements were offered as a package, there can be no serious argument that Hocking did not invest money in the package. Since Hocking has created an issue of fact over whether the condominium and RPA were sold as a package, he has met this first requirement of *Howey* for purposes of summary judgment.

B. Common Enterprise

The participants [in the RPA] pool their assets; they give up any claim to profits or losses attributable to their particular investments in return for a pro rata share of the profits of the enterprise; and they make their collective fortunes dependent on the success of a single common enterprise.

Of course, whether Hocking can prove [his case] at trial will depend on whether he can show that Dubois offered a package which included the RPA. As discussed above, Hocking has raised a genuine issue of fact as to that question.

C. Expectation of Profits Produced by the Efforts of Others

This third prong of *Howey* forms the greatest hurdle for Hocking, assuming he can prove at trial that the condominium and rental agreements were part of one package. He must show an expectation of profits produced by the efforts of others, that the efforts of others are "those essential managerial efforts which affect the failure or success of the enterprise." *Glenn W. Turner Enters.*, 474 F.2d at 482.

The crux of defendants' argument on this point is that the rental agreements allowed Hocking to maintain a high degree of control over his condominium, thus making any managerial efforts of Dubois or HCP non-essential to the success of Hocking's investment.

[Because Hocking raised issues of fact with regard to this prong, as well as the "investment of money" and "common enterprise" factors, the court reversed the summary judgment for the brokers and remanded the case.]

Source: United States Court of Appeals, Ninth Circuit.