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Securities—Resale by Developer of Land Purchaser's Contracts is Investment Contract and Must be Registered—SEC May Not Be Compelled to Comment upon Registration Statements

SECURITIES—RESALE BY DEVELOPER OF LAND PURCHASER'S CONTRACTS IS INVESTMENT CONTRACT AND MUST BE REGISTERED—SEC MAY NOT BE COMPELLED TO COMMENT UPON REGISTRATION STATEMENTS—*SEC v. Lake Havasu Estates,* CCH FED. SEC. L. REP. ¶ 93,348 (D. Minn. 1972)

In the latter part of 1969 Lake Havasu Estates, a corporation, undertook a nationwide campaign to sell investors the purchase money pledges it held under land sales installment contracts.[1] Within two years this marketing device garnered approximately $3,500,000 in publicly invested monies. During this time the corporation was informed on several occasions by the Securities and Exchange Commission (SEC) that the particular contract it offered the public constituted a security and was subject to the registration requirements of the Securities Act of 1933.[2] Finally, in July of 1971 Lake Havasu filed a Form S-1 Registration Statement covering an offering of its contracts. The registration statement, as twice amended, never became effective. The SEC filed a complaint and sought injunctive relief against Lake Havasu for offering and selling unregistered securities. The corporation entered a general denial that it had violated the registration provisions of the Securities Act and counterclaimed, alleging that it had attempted to

1. Lake Havasu Estates is an Arizona corporation whose principal place of business is in that state. The corporation is engaged in the acquisition, development and sale of land. The land is sold primarily on an installment contract basis to the land purchaser who signs an Agreement for Deed (Agreement) and a Purchase Money Note (Note). Title to the land is retained by Lake Havasu until the principal and interest due under the Note are paid; the land purchaser is then conveyed title in fee simple. Subsequent to each sale, the purchaser is contacted by Lake Havasu to confirm his intention to fulfill his contract obligation, but no credit investigation is ever undertaken.

As a financing device, Lake Havasu both offers and sells the Agreement and Note to public investors at a price equal to the unpaid balance of the Note. To promote these resale activities Lake Havasu employs instruments of transportation and communication in interstate commerce and the mails. The corporation also selects the particular Note to be sold to any investor, serves without charge as the investor's collection agent and agrees to notify the investor promptly of any material default by the investor. Whenever the land purchaser's installment payment on the Note is late or in default, the corporation uses its own funds to pay the investor so as not to cause an interruption in the investor's monthly payments. If a payment is delinquent for 60 days, Lake Havasu must redeliver to the investor another contract having a comparable unpaid balance and rate of return, and accept a re-assignment of the initial contract. Selection of the replacement contract (which has the same commitments, undertakings and guarantees as the defaulted contract) is made by Lake Havasu alone.

2. Securities Act of 1933 § 5, 15 U.S.C. § 77(e) (1970).

comply with the provisions of the Act but had been thwarted by members of the Commission. The counterclaim sought an order compelling the SEC to "comment upon, process and approve" the corporation's registration statement. Moreover, Lake Havasu filed interrogatories seeking information about: (1) the facts which caused the Commission to believe that the registration provisions of the Securities were being violated, (2) what deficiencies, if any, existed in the corporation's registration statement, and (3) the normal practices of the SEC staff in processing these statements. The Commission moved to dismiss the counterclaim for failing to state a claim upon which relief could be granted and also objected to the interrogatories propounded by Lake Havasu on relevancy grounds. The district court granted the SEC's motion for a preliminary injunction, dismissed the corporation's counterclaim, and refused to compel the Commission to answer Lake Havasu's interrogatories.[3]

The note offered by Lake Havasu to prospective investors was held by the court to be an "investment contract" and therefore a "security" under section 2(1) of the Securities Act.[4] The test, as stated in *SEC v. W.J. Howey Co.*,[5] for ascertaining the existence of an investment contract is "whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others."[6] The legal terminology involved in the contract is not controlling but the totality of circumstances is.[7] In the instant case the court took note of the activities of Lake Havasu in selecting the land, the land purchaser and the specific contract to be sold the investor, in guaranteeing monthly payments and replacement of land purchase agreements upon default, and in providing collection agent services and arrangements for transfers and recording.[8] This conduct was deemed sufficient to make Lake Havasu's offering an "investment contract" within the statutory definition of a security since the investors' economic welfare hinged upon the continuing ability of the corporation to make good its commitments.[9]

3. CCH FED. SEC. L. REP. ¶ 93,348, at 91,885.
4. *Id.* at 91,879. *See* Securities Act of 1933 § 2(1), 15 U.S.C. § 77b(1) (1970).
5. 328 U.S. 293 (1946).
6. *Id.* at 301.
7. *Id.*; SEC v. Joiner Leasing Corp., 320 U.S. 344 (1943).
8. CCH FED. SEC. L. REP. ¶ 93,348, at 91,878.
9. SEC V. Joiner Leasing Corp., 320 U.S. at 348 (1943); Los Angeles Trust Deed & Mortgage Exchange v. SEC, 285 F.2d 162 (9th Cir. 1960), *cert. denied*, 366 U.S. 919 (1961).

The transactions in *Los Angeles Trust Deed*, which were held to involve the issu-

Lake Havasu argued unsuccessfully that its offering was not a security since (1) the note sold to investors stemmed from a land sales transaction which was subject to regulation by the Department of Housing under the Interstate Land Sales Full Disclosure Act,[10] and (2) the contract offered the investor was for a fixed rate of return and in no way was dependent upon the profitability of the corporation's ventures.[11] The Court made quick dispatch of these contentions.[12] Moreover, it should have been clear from the outset that under SEC Securities Act Release No. 3892 the corporation's offering constituted a security.[13]

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ance of a security, dealt with the purchase of trust deed notes by a company using funds furnished it by investors. The investors, having been led to expect ten percent earnings, placed their reliance in the continuing ability of the company to act as collection agent and to arrange the repurchase or foreclosure of the notes when necessary. Lake Havasu attempted to distinguish their situation from that of the *Los Angeles Trust Deed* case in at least two particulars. Lake Havasu asserted that the situations were dissimilar since (1) Lake Havasu did not reinvest investor's earnings in new notes, and (2) they did not obtain funds from investors *prior* to purchasing trust deeds. The court felt that these were distinctions without a difference.

10. CCH FED. SEC. L. REP. ¶ 93,348, at 91,880. In answer to Lake Havasu's argument the court stated that the Interstate Land Sales Full Disclosure Act (15 U.S.C. § 1701 *et seq.* (1970)) was directed towards the protection of the land buyer and not the subsequent note purchaser. Furthermore, the court failed to see what bearing the existence of this regulation could have on a company registering its securities under the 1933 Act. Although the court did not indicate whether Lake Havasu had in fact filed under the Land Sales Full Disclosure Act, it would seem that the similarity between the two acts might have prompted Lake Havasu's contention that the Land Sales Full Disclosure Act preempted the Securities Act. This question remains unanswered. But the court intimated that the two agencies have concurrent jurisdiction. CCH FED. SEC. L. REP. ¶ 93,348, at 91,880. However, 15 U.S.C. § 1702(a)(5) exempts from the Land Sales Full Disclosure Act the "sale of evidences of indebtedness secured by a mortgage or deed of trust." *See generally* Ellis, *Land Sales Full Disclosure Laws: Federal & Illinois*, 60 ILL. B.J. 16 (1971); Krechter, *Federal Regulation of Real Estate Sales*, 7 LAW NOTES 85 (1971).

11. CCH FED. SEC. L. REP. ¶ 93,348, at 91,880. The court, in rejecting Lake Havasu's contention, observed that "the probability that an investor will receive that rate of return and recover his principal is clearly dependent upon the success or failure of Lake Havasu's operations." The court noted that in the *Los Angeles Trust Deed* case (285 F.2d 162 (9th Cir. 1960), *cert. denied,* 366 U.S. 919 (1961); *see* note 9 *supra*), there was also a fixed rate of return.

12. *See* notes 10 and 11 *supra.*

13. SEC Securities Act Release No. 3892 (January 31, 1958). In this release the Commission presented its opinion of what constitutes an "investment contract" within the meaning of section 2(1) of the 1933 Act. The Release enumerated these common services often offered in conjunction with the sale of trust deeds:

(a) Complete investigation and placing service.
(b) Servicing collection, payments, foreclosure, etc.
(c) Implied or express guarantee against loss at any time or providing a market for the underlying security.
(d) Making advances of funds to protect the security of the investment.
(e) Acceptance of small uniform or continuous investments.

A nagging question which remains is what recourse does one have when the Commission demands registration of an issue which is arguably not a security.[14] In Lake Havasu's case, where there were prior sales of the issue, the best strategy, and one followed by the defendant corporation, would be to register as a precautionary move, but refuse to admit that any of the prior sales were of securities.[15] Yet even when this is done the registrant finds himself in a conundrum. If the Commission drags its feet in processing the registration statement, the registrant may, due to financial problems,[16] decide the risk of civil and criminal sanctions appended to the issuance of a false registration statement is one worth taking.[17] The other alternative, as the court glibly points out, is for the registrant to make the registration statement

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(f) Implied or actual guarantee of specified yield or return.
(g) Continual reinvestment of funds.
(h) Payment of interest prior to actual purchase of the mortgage or trust note.
(i) Providing for fractional interests in mortgages or deeds of trust.
(j) Circumstances which necessitate complete reliance upon the seller, e.g., great distance between mortgaged property and investor.
(k) Seller's selection of the mortgage or deed of trust for the investor.

The SEC concluded in the Release that "[t]he wider the range of services offered and the more the investor must rely on the promoter or third party, the clearer it becomes that there is an investment contract." The Commission also stated that the fact "that the purchaser looks solely to his own mortgage or deed of trust for income or profits will [not] obviate the requirements for registration."

14. The determination of what constitutes a "security" has become a thorny problem with the advent of new marketing devices which cannot easily be categorized as securities but which nevertheless have been so designated by the Commission. One example of how broad the definition of security has become is seen in the SEC's reply to a request for a no-action letter from Investment Diamonds, Inc. concerning a business arrangement whereby diamonds were sold to the public with a five year option. The option granted the purchaser the choice of reselling the gem to the company at the purchase price or returning the diamond and receiving credit on the purchase of a more valuable gem. The credit was based on the purchase price plus an annual 5% "trade-in increase." The SEC rejected the corporation's assertion that the transaction did not involve a security, despite the diamond's inherent value, and opined that purchasers would be financially compelled to exercise their repurchase rights and would therefore be dependent upon the efforts of the corporation. Investment Diamonds, Inc., CCH FED. SEC. L. REP. ¶ 78,350, at 80,806 (1971).

The problem is further complicated by the difficulties one encounters in selecting the appropriate registration form. It has been urged that any extensions in the definition of a security should be promulgated by Congress and not by ad hoc decisions of the Commission. Shipley, *The SEC's Expanding Definition of a Security*, 37 N.Y.B.J. 521 (1965).

15. CCH FED. SEC. L. REP. ¶ 93,348, at 91,877.

16. Lake Havasu presented evidence indicating that suspension of its note sales (the source of the corporation's capital and object of the SEC's requested injunction) would put Lake Havasu out of business within 30 to 60 days.

17. *See* Securities Act of 1933 §§ 11, 12, 17, 15 U.S.C. §§ 77k, 77*l*, 77q (1970).

effective by withdrawing his "delaying amendment."[18] Of course, in this event the SEC would suspend the effectiveness of the registration statement by issuing a "stop order" under section 8(d) of the Securities Act.[19] Although this section makes provision for a hearing[20] which is then reviewable by a federal court,[21] these proceedings should not, contrary to the court's suggestion, determine whether the challenged issue is a security.

The stop order hearing required under section 8(d) is limited to ascertaining if "the registration statement includes any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading. . . ."[22] Clearly, then, the stop order hearing is not designed to decide the ultimate question of whether the registration statement involves a "security." It would seem that there should be some statutory recourse, short of a stop order proceeding, available to a reg-

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18. Securities Act of 1933 § 8(a), 15 U.S.C. § 77h(a) (1970) provides: "Except as hereinafter provided, the effective date of a registration statement shall be the twentieth day after the filing thereof. . . ." Although the statute authorizes a 20-day waiting period between the filing of the registration statement and the date it becomes effective, this is not the usual occurrence since a "delaying amendment" is typically filed. Material to the issuance of a security is a determination of its price. It is crucial to the distribution, due to possible market fluctuations during the 20 days, that the price amendment be disclosed immediately before the registration statement becomes effective. For this reason, and in order to facilitate SEC review of the statement, the delaying amendment has been authorized by the Commission. 17 C.F.R. § 230.473 (1971). Through this device the registrant waives the 20-day period. When the SEC informally approves the registration statement the underwriter and issuer submit the price amendment and through a procedure known as "acceleration," the registration statement becomes effective immediately. Section 8(a) of the Securities Act gives the Commission authority to waive the 20-day waiting period.

19. Securities Act of 1933 § 8(d), 15 U.S.C. § 77h(d) (1970) reads:

> If it appears to the Commission at any time that the registration statement includes any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading, the Commission may, after notice by personal service or the sending of confirmed telegraphic notice, and after opportunity for hearing (at a time fixed by the Commission) within fifteen days after such notice by personal service or the sending of such telegraphic notice, issue a stop order suspending the effectiveness of the registration statement.

20. *Id.* *See* 17 C.F.R. § 201 (1971).

21. Securities Act of 1933 § 9, 15 U.S.C. § 77i (1970) provides:

> Any person aggrieved by an order of the Commission may obtain review of such order in the Court of Appeals of the United States, within any circuit wherein such person resides or has his principal place of business, or in the United States Court of Appeals for the District of Columbia, by filing in such court, within sixty days after the entry of such order, a written petition praying that the order of the Commission be modified or be set aside in whole or in part.

22. Securities Act of 1933 § 8(d), 15 U.S.C. § 77h(d) (1970).

istrant who desires to know the character of the issue itself.[23] This is particularly true when the registrant has applied for but been denied a "no-action" letter.[24]

The opinion in *SEC v. Lake Havasu Estates* may be cited as precedent for the proposition that the SEC may postpone the registration process even when it has not provided responsive information to a registrant whose statement is on file. The court stated:

> While the commission's staff offers informal advisory service to registrants and others to aid them in attempting to comply with applicable legal standards, *it does not follow that any person is entitled to compel the staff to issue comments upon a registration statement.*[25]

The determination of the court in *Lake Havasu* that a member of the Commission's staff cannot be mandated to exercise his discretionary function is grounded in the Administrative Procedure Act.[26] Under section 701(a) of Title 5 of the United States Code, the discretionary functions of an agency are not judicially reviewable.[27] Only a final agency action, such as a stop order proceeding which tends to produce

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23. There are certain circumstances under which the registrant should think twice about fomenting a stop order proceeding. For example, where the Commission has announced in advance its determination, the hearing could prove psychologically as well as economically damaging to the registrant's business operations. The Commission's action in pinpointing the deficiencies in a registration statement, however, does not show one how to rectify them. It may also be, especially in the area of land sales and pooling agreements, that no suitable registration form has been promulgated by the SEC.

24. A "no-action" letter is an affirmative response by the SEC staff to a request by a petitioner that no action will be recommended to the Commission in dealing with his particular set of circumstances. *See* Lowenfels, *SEC "No-Action" Letters: Some Problems & Suggested Approaches*, 71 COLUM. L. REV. 1256 (1971).

25. CCH FED. SEC. L. REP. ¶ 93,348, at 91,884 (emphasis added).

26. 5 U.S.C. §§ 701-06 (1970).

27. Administrative Procedure Act § 10, 5 U.S.C. § 701(a) (1970):

> This chapter applies, according to the provisions thereof, except to the extent that—(1) statutes preclude judicial review; or (2) agency action is committed to agency discretion by law.

See Dyer v. SEC, 291 F.2d 774 (8th Cir. 1961). In *Dyer* the plaintiff sought to compel the SEC to investigate matters he deemed relevant to the SEC's review of a proxy statement. The court denied plaintiff's request stating that in this area the Commission had been given "absolute discretion as to exercise and exclusive judgment as to field and scope. . . . What is involved is wholly internal administrative power and function, which the courts have no jurisdiction to compel the exercise of." *Id.* at 781. *See also* Leighton v. SEC, 221 F.2d 91 (D.C. Cir. 1955), *cert. denied*, 350 U.S. 825 (1956) (although an action of the SEC in declining to entertain a request to investigate and regulate the issuance and sale of travelers checks constituted a final order of the Commission, it was discretionary and hence unreviewable).

a legal wrong, is reviewable under the Act.[28] In the instant case the court denominated as discretionary the need for the SEC to comment upon a registration statement.[29] Therefore a registrant, perhaps one interested in determining whether his proposed issuance is a security, must cause the SEC to take affirmative action, i.e., a stop order or injunctive proceeding, before he can obtain judicial review. As was earlier noted, the review entailed in such a proceeding might not assist the registrant seeking knowledge of the nature of his offering.[30]

The court did not announce under what authority the SEC has the power to defer review of a registration statement and thereby refuse to register it, and the Securities Act itself does not grant the Commission such power under the guise of disclosure.[31] Earlier cases involving the Commission's responsibility for providing responsive comments on registration statements are distinguishable from the court's approach in *Lake Havasu.* These decisions had precluded a registrant from compelling the SEC to comment upon his registration statement when the statement was materially deficient for purposes of disclosure.[32] Whether such comment could be compelled when the statement was less deficient than this has not been decided. Moreover, in prior cases where the Commission argued that the registration statement was grossly defective, the court invariably examined and discussed the par-

28. Administrative Procedure Act § 10(c), 5 U.S.C. § 704 (1970). *See also* Securities Act of 1933 § 9, 15 U.S.C. § 77(i) (1970).

29. CCH FED. SEC. L. REP. ¶ 93,348, at 91,884. *See generally* note 35 and accompanying text *infra.*

30. See note 23 *supra.*

31. Securities Act of 1933 § 8, 15 U.S.C. § 77h (1970). 17 C.F.R. § 202.3 (1971) does not authorize deferred review without comment either. The section reads in part:

> This informal procedure (notice of deficiency by letter) is not generally employed where the deficiencies appear to stem from careless disregard of the statutes and rules or a deliberate attempt to conceal or mislead or where the Commission deems formal proceedings necessary in the public interest.

Section 202.3 gives no hint about what particular procedure will be followed. *Cf.* SEC Securities Act Release No. 4934 (November 21, 1968) which reports that the Commission's policy for handling registration statements which are poorly prepared or contain material misrepresentations is to issue no oral or written comment. The statutory basis underlying the establishment of this policy is not clear. See note 41 *infra.*

32. *See, e.g.,* Boruski v. Division of Corp. Finance of U.S. Sec. & Ex. Comm'n, 321 F. Supp. 1273 (S.D.N.Y. 1971). Boruski sought to compel SEC approval of his registration statements. The district court examined the documents in question and held that the SEC was justified in its position that parts of the registration statement were "incomprehensible." "With the registration statements so palpably deficient, the Commission was not required to comment upon and specify their shortcomings." *Id.* at 1276.

ticulars in which the statement was defective.[33] In *Lake Havasu* the court accepted without question the assertion of the SEC that the registration statement was faulty.[34] Additionally, the court concluded by implication that a registrant may not force the Commission staff to issue comment upon his statement even if its defects are minor ones.[35]

The non-reviewability conclusion reached by the court in *Lake Havasu* is difficult to reconcile with the decision rendered in *Medical Committee for Human Rights v. SEC.*[36] The latter case arose under the Securities and Exchange Act of 1934[37] and involved a petition to review the refusal of the SEC to compel the inclusion in a proxy statement of a resolution which urged the corporation to cease manufacturing napalm. There, the court concluded that a no-action letter, despite its discretionary nature, was reviewable notwithstanding the absence of a formal evidentiary hearing by the SEC. The court trenchantly declared:

> "[D]iscretion" can be merely another manifestation of the venerable bureaucratic technique of exclusion by attrition, of disposing of controversies through calculated non-decisions that will eventually cause eager supplicants to give up in frustration and stop "bothering" the agency.[38]

A distinction between *Lake Havasu* and *Medical Committee* may be drawn, albeit a tenuous one. In *Medical Committee* the shareholders were precluded any review by the SEC's issuance of a no-action letter which indicated that there would be no further administrative hearing. In *Lake Havasu*, however, the deficiency letter was merely an informal expression of the commission's discontent with the registration statement and the corporation still could exercise the option of withdrawing its delaying amendment and proceeding with registration. Of course, this would lead to the entirely unsatisfactory forum of a stop order proceeding, as has already been discussed.[39]

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33. *Id.*

34. CCH FED. SEC. L. REP. ¶ 93,348, at 91,884.

35. *Id.*

36. 432 F.2d 659 (D.C. Cir. 1970), *overruled on grounds of mootness,* 92 S. Ct. 577 (1972). The Supreme Court failed to reach the substantive issues in vacating and dismissing the court of appeals decision. The views of the second circuit concerning the reviewability of no-action letters thus remain the undisturbed opinion of that distinguished court and should not be given short shrift in future relevant controversies.

37. Securities Exchange Act of 1934, 15 U.S.C. § 78 (1970).

38. 432 F.2d at 674.

39. See text accompanying notes 17-23 *supra.*

The Securities Act makes no allowance for the deferred review of a registration statement by the Commission.[40] Although the practice of deferred review is well established, the only authority for it is a self-promulgated SEC ruling released subsequent to the decision in *Lake Havasu*.[41] It would appear then, that the court in the instant case could have disallowed deferred review as action taken in excess of the SEC's statutory jurisdiction. The court declined to do this and instead rendered a decision which can be used as a peg on which to hang the new SEC release which justifies deferred review. The result reached is consonant with the continuing viability of the SEC.[42] Recognizing that the preservation of the Commission's energies demands that it not be forced to challenge unique and exhausting metaphysical questions, the court prescribed preventive law.

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40. *See* 15 U.S.C. § 77h (1970).

41. SEC Securities Act Release No. 5231 (Feb. 3, 1972). In this release the Commission set forth certain review procedures which would be used to reduce the backlog of registration procedures being processed. Four distinct categories of review were established and the designation of category was made determinative of the type of examination a registration statement would receive. Under "deferred review" a registrant is notified that his registration statement is "so poorly prepared" that further staff time cannot be delegated to curing its defects. The registrant receives no comments regarding problem areas and should the registrant decide to go forward without amending, the staff will recommend appropriate action to the Commission. In the "cursory review" procedure the staff makes no written or oral comments but upon receipt of certain signed declarations by the issuer, accountants, and managing underwriter detailing their awareness of their statutory obligations under the Securities Act, the staff will recommend that the statement be declared effective. Acceleration, however, may or may not be granted. In the "summary" and "customary" review procedures the registrant is sent comments that have arisen from an accounting, financial and legal review by the SEC's staff. The registration statement is declared effective upon compliance with the staff's recommendations and the receipt of letters from the issuer, accountant and underwriter, which are similar to those solicited in the course of a "cursory review."

The categorizing of registration statements is a potential source of abuse of administrative power that could go unchecked by the courts. Should a registrant's statement be classified as deserving of only "deferred review" he is left uninformed as how to correct its deficiencies. The registrant cannot force the SEC to reveal why its statement is entitled to no more than "deferred review." The staff's review procedures are entirely within the discretion of the Commission's Division of Corporate Finance. Therefore, the category of "deferred review" could conceivably be based upon totally impermissible factors. It might serve as a punitive device to retaliate for some real or imagined offense, to make an example of a certain company for the benefit of an entire industry, or to invidiously discriminate against a particular group.

42. A minor issue raised by Lake Havasu was given short shrift by the court in order to preserve the integrity of the SEC. The court held that the Commission may not be sued as an entity. CCH FED. SEC. L. REP. ¶ 93,348, at 91,885.