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SECURITIES REGULATIONS: WHEN IS A CLUB MEMBERSHIP A SECURITY?

by Donald J. Regan*

I. INTRODUCTION

The application of securities regulation laws to the development of private and semi-private recreational clubs organized for profit is an area of growing concern. Securities laws are applicable to the creation or development of a statutory "security." Once a security is present, questions concerning the need for or exemption from federal registration or state qualification arise. Therefore, in the first instance, the definitional question must be addressed. Related problems, such as potential civil liability arising from the presence of a "security,"¹ although important, are beyond the scope of this article. Moreover, even though the subject embraces federal law and federal regulatory authorities,² this discussion will be limited to pure intrastate offerings³ with sufficient planning and control of resales to fit within the intrastate "safe harbor" exemption.⁴ Finally, non-profit social clubs and non-profit organizations attached to a residential subdivision which operate solely for the benefit of members or residents do not pose the same problems as clubs organized for profit and, thus, are excluded from this discussion.

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1. Not only have the fraud provisions of the securities laws expanded the common law concepts of fraud and deceit, *see In re Cady, Roberts & Co.*, 40 SEC 907, 910 (1961), but also SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (1976), has been held to create a new private cause of action when the fraud involves a "security." *See Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971).

2. The Securities and Exchange Commission (SEC) has issued "no action" letters regarding club developments. *See, e.g., St. Johns Realty Co.* (available May 17, 1976); *Beau Monde Cheque Club* (available May 10, 1976); *Bronze Tree Club* (available March 1, 1976). For further discussion of the Bronze Tree Club matter, *see* note 41 *infra* and accompanying text.

3. *See* 15 U.S.C. § 77c (11)(1970). The intrastate offering exemption excepts from the requirement of registration for issuance of securities

[a]ny security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such State or Territory.

Id.

4. The "safe harbor" exemption refers to the objective criteria by which a company can be certain it comes within the intrastate exemption from registration of securities.

Recreational clubs organized for profit enable large scale participation in sports and recreational activities with a minimum of inconvenience.⁵ Facilities typically consist of structures, playing courts, equipment, amenities and furnishings built around a recreational theme. Normally, these clubs offer memberships to the public. The problem arises when one considers whether this offering of memberships to the public unwittingly creates a securities question. It is possible that the interest offered may be more than was advertised; it may be a security via the "investment contract" route as that term is used in section 2(1) of the Securities Act of 1933⁶ and section 25019 of the California Corporate Securities Law.⁷

II. THE NATURE OF A CLUB MEMBERSHIP

Interests in clubs are often loosely referred to as "memberships." Although this term does have a common usage definition, there is no current statutory definition. Thus, neither the words "member" nor "membership" have any independent legal significance outside those imposed by a specific organization.

Although from a securities standpoint no one knows what the term

See SEC Rule 147, 17 C.F.R. § 240.7 (1976). These criteria are set out in text accompanying notes 45-51 *infra*.

Restriction of the scope of this article to intrastate offerings will preclude consideration of clubs in border communities which generally have interstate participation in membership. *See, e.g.,* Riverview Racquet Club, Inc., [1975-76 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,276 (July 3, 1975), which involved a development in Moorehead, Minnesota, and Fargo, North Dakota, two cities on either side of the Red River which together form a single community.

5. The recent boom in recreational club development has been spurred, in part, by the growing interest in racquetball. Racquetball as a sport is perhaps thirty years old. Its recent growth as a major leisure-time activity, however, has been spectacular. In 1969, the First International Racquetball Tournament was held in St. Louis, Missouri. In 1973, a professional racquetball tour was established. In 1974, the sport counted two million active participants, and estimates are that that number has at least doubled. *See* S. KEELEY, *THE COMPLETE BOOK OF RACQUETBALL* (1976).

6. Securities Act of 1933, 15 U.S.C. § 77b(1) (1970). A security is defined as any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

Id.

7. CAL. CORP. CODE ANN. § 25019 (West Supp. 1976). The definition contained in this section is patterned after the federal definition in 15 U.S.C. § 77b(1) (1970).

"membership" means, clubs and recreational facilities have traditionally issued memberships. California has gone so far as to define the term security to include, *inter alia*, "membership in an incorporated or unincorporated association"⁸ The lack of an express legal definition of the word "membership" has led the California Commissioner of Corporations to attempt to clarify the term within the context of the definitional statute as follows:

The term "membership" as used in § 25109 refers to memberships, such as those issued by nonprofit organizations, which confer a proprietary right on the holder. A proprietary right may be defined as a right to the ownership of the assets or earnings of an organization or the right to control of such organization. A right to control is normally evidenced by voting rights, whether conferred by the charter documents or under the provisions of the Corporations Code⁹

Frequently, the term is misused in connection with clubs.¹⁰ Often, the interest sold by club developers is a license to use real property, rather than a membership. A license is defined as a

personal, revocable, and unassignable permission or authority to do one or more acts on the land of another without possessing any interest therein.¹¹

Despite the common definition of a license as revocable and non-

8. CAL. CORP. CODE ANN. § 25019 (West Supp. 1976).

9. Cal. Dept. of Corps., Release No. 15-c (revised), Series C (Oct. 7, 1970).

10. The Commissioner commented upon this misuse:

A membership sold by a profit-making organization which is a license to use the facilities constitutes a security if the proceeds from the sale of such membership are used to provide facilities necessary to the full utilization of the membership, that is, where the purchaser provides the risk capital for the enterprise, such as for the construction of a golf course and related facilities.

Not every right, privilege, benefit or license sold by a profit-making organization and which is labeled a "membership" is a membership within the meaning of Section 25019. A membership which confers upon the holder nothing more than the right to enjoy the facilities which are provided, such as key club privileges, the use of a swimming pool, or the use of golf facilities, is not a membership within the meaning of Section 25019 and, in the absence of the "risk" element, is not a security. If the sale of a right to use facilities includes a right to a return of monies paid or a right to share in the income or profits, it constitutes the sale of a security, in the nature of an evidence of indebtedness or of an investment contract.

Id.

11. *Eastman v. Piper*, 68 Cal. App. 554, 560, 229 P. 1002, 1004 (1924). See 3 H. MILLER & M. STARR, CURRENT LAW OF CALIFORNIA REAL ESTATE § 705 (1971).

A license is distinguished from a lease in that it confers a personal privilege to use another's land. The privilege may be given orally and may be revoked at the licensor's pleasure. *Shaw v. Caldwell*, 16 Cal. App. 1, 115 P. 941 (1911). A license is distinguished from an easement in that it is personal, revocable, and unassignable, and creates no interest in real property, other than the right to do an act on the property which would otherwise be a trespass. R. POWELL, REAL PROPERTY § 429 (1975).

transferable, cases permit the parties to a license agreement to provide otherwise. For example, a license may be irrevocable if coupled with an interest, as when the license is the means by which a licensee exercises rights under a specifically enforceable contract.¹² Similarly, a license can be made transferable by agreement of the parties.¹³

Since a license can be created by contract, appropriate safeguards could be built into a club contract. Thus, a license agreement which provides assurance that the licensee will not be required to pay unless and until the promised facilities are open may be the crux of the regulation of club development. However, if the interest being offered is in fact a "membership," questions of application of federal and state securities law will arise.

III. FEDERAL SECURITIES LAW

Section 2(1) of the Securities Act of 1933 defines a security to include, among other things, an "investment contract."¹⁴ After an early narrow and literal application,¹⁵ this elastic phrase lay dormant for many years and only recently has it been the spillway for a flood of litigation seeking to expand the definition of a security.¹⁶ A principal reason for the litigation is that several federal remedies are open to

12. See *Bomberger v. McKelney*, 35 Cal. 2d 607, 220 P.2d 729 (1950):

A mere license to enter or use premises may be revoked at any time by the licensor. . . . Various factors, however, may render a license irrevocable, and it is generally recognized that a license coupled with an interest is not revocable but continues to exist for the period contemplated by the license.

Id. at 618, 220 P.2d at 736 (citations omitted).

13. See *Herman v. Rohan*, 37 Cal. App. 678, 174 P. 349 (1918):

[I]t may be said that even considering the matter a personal privilege or license, there is nothing whatever in the law to prevent the defendants from making an agreement, if they saw fit, to the effect that this personal privilege might be assigned. The property was theirs; they were letting whatever privilege Herman had and whatever rights he possessed in the stall to him; and they could legally . . . agree that he might sell those rights

Id. at 681, 174 P. 350.

14. Section 2(1) of the Securities Act of 1933, 15 U.S.C. § 77b(1) (1970), is set out at note 6 *supra*.

15. *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1945). The Court in *Howey* set forth the following definition of an investment contract:

[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 interest in the physical assets employed in the enterprise.

Id. at 298-99. This definition has become commonly known as the "Howey test."

16. See notes 18-28 *infra* and accompanying text.

disenchanted buyers or sellers if they can prove that what they bought or sold¹⁷ was a security.

During the last few years the definition of a security has been constantly expanding to include such items as condominium units,¹⁸ feedlot financing arrangements,¹⁹ commercial paper,²⁰ commodity contracts,²¹ real estate lots coupled with land sales contracts,²² trust deeds,²³ animals purchased and raised but pooled for sale as a unit,²⁴ whiskey warehouse receipts,²⁵ promissory notes,²⁶ interests in pension funds,²⁷ and, most

17. See *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

18. See SEC Securities Act Release No. 33-5347 (Jan. 4, 1973) in which the SEC states that federal securities laws apply to the offering of condominium units if any one of the following three factors are present: (1) rental pool arrangement; (2) sales program based on appreciation in value rather than use of unit; or (3) buyer required to hold his unit available for rent for a certain period of time or use a designated real estate agent. *Id.*

19. See *Hector v. Wiens*, 533 F.2d 429 (9th Cir. 1976).

20. See *Zeller v. Bogue Elec. Mfg. Corp.*, 476 F.2d 795 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973); *Sanders v. John Nuveen & Co.*, 463 F.2d 1075 (7th Cir.), *cert. denied*, 409 U.S. 1009 (1972). The SEC advocates the narrowest possible definition of the term "commercial paper," which is exempted from the registration requirements of the Securities Act of 1933 by 15 U.S.C. § 77c(a)(3) (1970). See SEC Securities Act Release No. 33-4412 (Sept. 20, 1961).

21. See *Johnson v. Arthur Espy, Shearson, Hammill & Co.*, 341 F. Supp. 764 (S.D.N.Y. 1972). Cf. *SEC v. Continental Commodities Corp.*, 497 F.2d 516 (5th Cir. 1974); *Milnarik v. M-S Commodities, Inc.*, 457 F.2d 274 (7th Cir. 1972).

22. See *SEC v. Lake Havasu Estates*, 340 F. Supp. 1318 (D. Minn. 1972).

23. See *Los Angeles Trust Deed & Mortgage Exch. v. SEC*, 285 F.2d 162 (9th Cir. 1960), *cert. denied*, 366 U.S. 919 (1961). See also SEC Securities Act Release No. 33-3892 (Jan. 31, 1958).

24. See *Miller v. Central Chinchilla Group, Inc.*, 494 F.2d 414 (8th Cir. 1974), where the court looked at the economic realities of the transaction.

25. See *SEC v. Haffenden-Rimar Int'l, Inc.*, 496 F.2d 1192 (4th Cir. 1974); *Glen-Arden Commodities v. Costantino*, 493 F.2d 1027 (2d Cir. 1974); *SEC v. M.A. Lundy Associates*, 362 F. Supp. 226 (D.R.I. 1973). Looking at economic realities, these courts were able to conclude that the main reason for the purchase was investment, not consumption.

26. See *Exchange Nat'l Bank v. Touche Ross & Co.*, 544 F.2d 1126 (2d Cir. 1976). In a hotly contested case, Judge Friendly concluded that even a twelve-month promissory note was a statutory security and expanded previous definitions by stating "the best alternative now available may lie in greater recourse to the statutory language." *Id.* at 1137. The statutory language in this case contained a narrow exemption by excluding any note with a maturity of less than nine months unless the context of the Act otherwise requires. *Id.*

27. See *Daniel v. International Bhd of Teamsters*, 410 F. Supp. 541 (N.D. Ill. 1976), *appeal docketed*, No. 76-1855 (7th Cir., April 29, 1976). In *Daniel*, the plaintiff had been a twenty-two year member of Teamsters Local 705. During this time he provided twenty-two years of nearly uninterrupted employment with covered employers. When he

pertinent here, situations where the buyer must rely on the seller to produce promised financial results.²⁸

The cases cited thus far provide general background, and as commentators have charitably noted, set up a flexible standard for the definition of a security.²⁹ The nature of the interest received by one who joins a club is still on the frontier of this area of legal development. Therefore, it becomes appropriate to analyze the Supreme Court's most recent and definitive pronouncement in the area.³⁰

In *Forman v. Community Services, Inc.*,³¹ the Court of Appeals for the Second Circuit found that the right to live in a low-income cooperative apartment in New York was an interest covered by the securities laws merely because that right was represented by an instrument la-

was involuntarily laid off, the Trustees of the Union Local Pension Fund denied him benefits. *Id.* at 543. Daniel apparently tried every legal relief available to him and, as a last resort, pressed an imaginative attack under the anti-fraud provisions of federal securities laws. His theory, simply stated, was that his interest in the pension fund constituted a security. *Id.* at 550.

The court found that an interest in a pension plan satisfied the much battered, but still adhered to, *Howey* test. *Id.* at 552. See note 15 *supra* for a statement of the *Howey* test. Springing from this treacherous footing, and in an obvious attempt to do justice for the plaintiff and others similarly situated, the court went on to find that a non-contributory pension plan involved a "sale." *Id.* at 553. Section 2(5) of the Securities Act of 1933 defines a sale to include "every contract of sale or disposition of a security or interest in a security, for value." 15 U.S.C. § 77b(3) (1970).

According to the trial court, the SEC's pre-*Daniel* policy "comports neither to logic nor economic reality." 410 F. Supp. at 553. Seizing the opportunity, however, the SEC filed an amicus curiae brief emphasizing that a pension fund is an investment and, therefore, the securities laws should apply. Brief for SEC as Amicus Curiae, *Daniel v. International Bhd. of Teamsters, appeal docketed*, No. 76-1855 (7th Cir., April 29, 1976). See [Current Binder] CCH Fed. Sec. L. Rep. ¶ 95,846. The United States District Court for the Central District of California has recently disagreed with *Daniel*. In *Hurn v. Retirement Fund Trust*, [Current Binder] CCH FED. SEC. L. REP. ¶ 95,855 (C.D. Cal. Dec. 14, 1976), the court held that the Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1001 (Supp. IV, 1974), provides an exclusive remedy for disputes over trust fund benefits. The issue is of such importance that the ABA Committee on Federal Regulation of Securities, 1933 Act Study Group, has prepared an intensive report on the policy questions raised by *Daniel*. See 393 BNA SEC. REG. & L. REP. A-4 (March 9, 1977). Whether *Daniel* will withstand appeal and where it will lead in the search for a usable definition of a security is unanswered for the immediate future.

28. One example is an equity funding agreement (a life insurance contract coupled with the purchase of already registered mutual funds), where the combination of elements produces a package which transcends its component parts. SEC Securities Act Release No. 33-4491 (May 22, 1962).

29. See, e.g., Fraidín, *Developments in Federal Securities Regulation*, 30 BUS. LAW. 313 (1975), in which the standards for what is a security are called "quite flexible." *Id.* at 326.

30. *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975), *rev'g* *Forman v. Community Servs., Inc.*, 500 F.2d 1246 (2d Cir. 1974).

31. 500 F.2d 1246 (2d Cir. 1974), *rev'g* 366 F. Supp. 1117 (S.D.N.Y. 1973), *rev'd* sub nom. *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975). See also *Grenader v. Spitz*, 537 F.2d 612 (2d Cir. 1976).

belled as a share of stock.³² Fortunately, the Supreme Court rejected this literal approach and held that the label attached to an interest is not controlling.³³ The Second Circuit's decision is important, however, in that it demonstrates that even a sophisticated group of judges will adopt a strict, literal approach if they feel that the results which will flow from their decision are socially desirable.

The effect of the Supreme Court decision in *Forman* was to slow the advance of the definition of a security on at least two principle fronts. *First*, no matter what the interest is called it should not be held to be a security merely because it is labelled a share of stock. The Court in *Forman* indicated that the following features are characteristic of stock that qualifies as a security:

- (1) The right to receive dividends contingent upon an apportionment of profits;
- (2) Negotiability of the instrument;
- (3) Whether or not the instrument can be pledged or hypothecated;
- (4) Whether the instrument confers voting rights in proportion to the number of shares owned; and
- (5) Possible appreciation in value.³⁴

Second, the Court stated that there should be no distinction between an instrument commonly known as a security and an investment contract. Rather, an investment contract is only one form of a security. The Court held that, in either case, the basic test for distinguishing a security transaction from other commercial dealings³⁵

in shorthand form, embodies the essential attributes that run through all of the Court's decisions defining a security. The touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others. By profits, the Court has meant either capital appreciation resulting from the development of the initial investment, . . . or a participation in earnings resulting from the use of investors' funds In such cases the investor is "attracted solely by the prospects of a return" on his investment. . . . By contrast, when a purchaser is motivated by a desire to use or consume the item purchased—"to occupy the land or to develop it themselves," as the *Howey* Court put it, . . . —the securities laws do not apply.³⁶

32. 500 F.2d 1246, 1255 (2d Cir. 1974).

33. United Housing Foundation, Inc. v. Forman, 421 U.S. 837 (1975), *rev'g* Forman v. Community Servs., Inc., 500 F.2d 1246 (2d Cir. 1974).

34. United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 851 (1975).

35. The Court used the *Howey* test and quoted the language from SEC v. W.J. Howey Co., 328 U.S. 293 (1945).

36. 421 U.S. at 852-53 (citations omitted).

Absent precise judicial definition, the inquiry in the club membership area, therefore, can appropriately focus on the five criteria set out in *Forman*.³⁷ In the development and operation of a non-proprietary club, no dividends are paid, the license carries no voting rights, it is not negotiable and it is of no value for use as a pledge (in fact, properly drawn documents strictly prohibit the pledge or hypothecation of a license). Thus, the only one of the five criteria which realistically exists in this situation is the possibility of appreciation in value. This possibility of appreciation alone should not turn the club membership into a security. Moreover, since the potential purchaser's main motivation is a desire to use the facilities, and not to trade in or deal with his interest, (this cannot be done with a non-proprietary membership), the *Forman* policy of protecting investors seeking a profit by the efforts of others does not apply.³⁸

Federal law analysis also requires a brief review of the administrative position taken by the staff of the SEC. Until recently, when presented with the question of club memberships as "securities," the staff would focus only on the transferability of a membership and on the possibility that it might appreciate in value. As a result of this focus, there was no assurance that the staff would recommend no action to the SEC if a particular club offered and sold memberships without registration under the Securities Act of 1933.³⁹ Thus, no action letters have been issued only where a club's bylaws prohibit transfer or assignment of memberships.⁴⁰ In March of 1976, the SEC directed its staff not to issue no action letters involving club interests and to advise that no action letters issued in the past in this general field do not extend beyond the particular issues involved and should not be relied upon by any other person.⁴¹

37. See text accompanying note 34 *supra*.

38. See generally *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 856-57, where the Court noted that potential rental reductions resulting from profits derived from commercial rentals in the building complex did not attract the "investors" to buy "stock" in the complex. This did not constitute "an 'expectation of profit' in the sense found necessary in *Howey*." *Id.* at 857 (citations omitted).

39. Dells Camp Denton, Inc., SEC No-Action Letter (available April 14, 1975); Stoneridge Golf and Country Club, SEC No-Action Letter (available Feb. 2, 1975) (after this club changed its organization to make memberships non-transferable, except at cost, the SEC issued a no-action letter).

40. Riverview Racquet Club, Inc., SEC No-Action Letter (available Aug. 4, 1975).

41. Bronze Tree Club, SEC No-Action Letter (available March 1, 1976), where the Commission supported its refusal to issue a no-action letter with the following reasoning: Various proposals for the public offering and sale of interests or participations in resort real estate have been brought to the attention of the Commission. . . . While no-action letters are limited to the facts presented and do not represent an interpretation of the law, the Commission is, nevertheless, concerned that inferences may be drawn from the issuance of no-action letters in this rapidly evolving area.

Even if the staff's position that the possibility of appreciation in value creates a security is accepted, the intrastate exemption from the registration requirement of the Securities Act of 1933 may be available.⁴² To clarify this exemption, the SEC recently adopted Rule 147,⁴³ which is designed to provide the "safe harbor" criteria by which a company can be sure that it is entitled to rely on the intrastate exemption. The company may rely on Rule 147 if all of the following conditions are satisfied:⁴⁴

(1) The issuer must be resident of (doing business, not domiciled) within a single state;⁴⁵

(2) The issuer must be doing business within that state. Doing business means that it receives at least eighty percent of its gross revenue from within a single state, has at least eighty percent of its assets located within that state, will use at least eighty percent of its net proceeds from the offering within that state and, finally, has its principal office located within such state;⁴⁶

(3) Each person to whom an interest in the club is offered or sold must be a resident of the issuer's state of residence;⁴⁷

(4) The entire issue must come to rest in the hands of residents of the issuer's state. "Come to rest" means that no resales may be permitted to non-residents until nine months after the last sale under the offering;⁴⁸

(5) The issuer must take precautions against interstate offers or sales. Principal among the precautions are that the issuer must place a legend on the security stating the resale limitations,⁴⁹ issue a stop transfer order⁵⁰ and must receive from each potential participant a written representation concerning residence.⁵¹

Such information could lead to misunderstandings as to the Commission's position and to contentions in future situations that the Commission had taken a position which it had not, in fact, taken. Consequently, the Commission has directed its staff not to issue no-action letters in this area, and to advise that no-action letters issued in the past in this general field do not extend beyond the particular issue involved and should not be relied upon by any other person or by the persons receiving the prior letters for any other offerings.

Id.

42. Most recreational clubs are wholly intrastate developments and can therefore come within the intrastate offering exemption of 15 U.S.C. § 77c(11) (1970). This statute is set out at note 3 *supra*.

43. SEC Rule 147, 17 C.F.R. § 230.147 (1976).

44. SEC Rule 147, Preliminary Note 3, 17 C.F.R. § 230.147 (1976).

45. SEC Rule 147(c)(1), 17 C.F.R. § 230.147(c)(1) (1976).

46. SEC Rule 147(c)(2), 17 C.F.R. § 230.147(c)(2) (1976).

47. SEC Rule 147(d), 17 C.F.R. § 230.147(d) (1976).

48. SEC Rule 147(e), 17 C.F.R. § 230.147(e) (1976).

49. SEC Rule 147(f)(1)(i), 17 C.F.R. § 230.147(f)(1)(i) (1976).

50. SEC Rule 147(f)(1)(ii), 17 C.F.R. § 230.147(f)(1)(ii) (1976).

51. SEC Rule 147(f)(1)(iii), 17 C.F.R. § 230.147(f)(1)(iii) (1976).

Proper documentation can be designed to satisfy all five of these conditions.

In conclusion, the interest evidenced by club membership has not been held to be a security by any federal court. Nevertheless, the possibility exists that some federal court might, to remedy an obvious fraud or injustice, expand the definition to include a club membership.⁵² Out of an abundance of caution and with a wary eye to the future, therefore, each intrastate development should be structured to strictly comply with Rule 147.⁵³ Interstate developments, however, can proceed only at risk, or, conceding the issue, via registration.

IV. CALIFORNIA SECURITIES LAW

The definition of a "security" under California Corporations Code section 25019⁵⁴ is patterned after section 2(1) of the Securities Act of 1933.⁵⁵ However, in response to a situation of egregious greed and unreasonable promotion, the California Supreme Court has expanded the definition of "security" into new and imaginative territory, not yet invaded by the federal judiciary.⁵⁶

52. See note 27 *supra*.

53. SEC Rule 147, 17 C.F.R. § 230.147 (1976).

54. CAL. CORP. CODE ANN. § 25019 (West Supp. 1976) provides:

"Security" means any note; stock; treasury stock; membership in an incorporated or unincorporated association; 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; certificate of interest or participation in an oil, gas or mining title or lease or in payments out of production under such a title or lease; any beneficial interest or other security issued in connection with a funded employees' pension, profit sharing, stock bonus, or similar benefit plan; or, in general, any interest or instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing. All of the foregoing are securities whether or not evidenced by a written document. "Security" does not include: (1) any beneficial interest in any voluntary inter vivos trust which is not created for the purpose of carrying on any business or solely for the purpose of voting, or (2) any beneficial interest in any testamentary trust, or (3) any insurance or endowment policy or annuity contract under which an insurance company admitted in this state promises to pay a sum of money (whether or not based upon the investment performance of a segregated fund) either in a lump sum or periodically for life or some other specified period, or (4) any franchise subject to registration under the Franchise Investment Law, or exempted from such registration by Section 31100 or 31101 of that law.

Id.

55. 15 U.S.C. § 77b(1) (1970). See 2 MARSH & VOLK, PRACTICE UNDER THE CALIFORNIA SECURITIES LAWS, app. A-1, 88.3 (1976).

The California Court of Appeal stated that California courts may look to decisions interpreting the federal definition of a security for aid. *Hamilton Jewelers v. Department of Corps.*, 37 Cal. App. 3d 330, 333 n.3, 112 Cal. Rptr. 387, 389 n.3 (1974).

56. *Silver Hills Country Club v. Sobieski*, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961). When the *Forman* district court was urged to adopt the California "risk

This expansion is most apparent in the case of *Silver Hills Country Club v. Sobieski*.⁵⁷ *Silver Hills* involved promoters who had made a \$400 down payment on the purchase of a ranch. The total cost of the property was \$75,000. These promoters proceeded to sell memberships and used the membership fees to improve the property, build swimming pools, and turn the ranch into a country club. By their projections, on the sale of all memberships, they would have raised enough money to pay the \$75,000.00 purchase price.

The definitional statute in effect at the time of *Silver Hills*⁵⁸ was broader than the present section.⁵⁹ The California Supreme Court could have based its decision on the statutory language, thereby finding the existence of a security. The court, however, went beyond the statute and made its decision a matter of policy:

We have here nothing like the ordinary sale of a right to use existing facilities. Petitioners are soliciting the risk capital with which to develop a business for profit.⁶⁰

capital" definition, it rejected this argument with the following language: "[T]his would not seem to be the case for the first federal application of this California state securities theory." *Forman v. Community Servs., Inc.*, 366 F. Supp. 1117, 1130 (1973), *rev'd*, 500 F.2d 1246 (2d Cir. 1974), *rev'd* sub nom. *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975). On appeal, the Supreme Court was also urged to accept the risk capital theory as part of federal securities law. Without totally rejecting the theory, the Court looked at it askance and handled the argument in the following manner:

Respondents urge us to abandon the element of profits in the definition of securities and to adopt the "risk capital" approach articulated by the California Supreme Court. . . . Even if we were inclined to adopt such a "risk capital" approach we would not apply it in the present case. Purchasers of apartments in Co-op City take no risk in any significant sense.

United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 857 n.24 (1975) (citations omitted).

57. 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961). For subsequent cases following the *Silver Hills* line of reasoning, see *Hamilton Jewelers v. Department of Corps.*, 37 Cal. App. 3d 330, 112 Cal. Rptr. 387 (1974); *People v. Walberg*, 263 Cal. App. 2d 286, 69 Cal. Rptr. 457 (1968).

Silver Hills evoked considerable immediate comment and speculation, see *Sobieski, Securities Regulation in California: Recent Developments*, 11 U.C.L.A. L. REV. 1, 5-7 (1963), and judicial comment, if not observance. See note 56 *supra*.

58. The former definition provided, in part, that a security included any beneficial interest in title to property. 1949 Cal. Stats., c. 384 § 1, *as amended*, 1951 Cal. Stats. c. 825 § 1.

59. CAL. CORP. CODE ANN. § 25019 (West Supp. 1976).

60. 55 Cal. 2d at 815, 361 P.2d at 908, 13 Cal. Rptr. at 188. Was this foray necessary to the decision or merely dictum? See B. CARDOZO, *THE NATURE OF THE JUDICIAL PROCESS* (1921):

[T]he judge . . . must . . . extract from the precedents the underlying principle, the *ratio decidendi* . . .

Id. at 28. See also Goodhart, *Determining the Ratio Decidendi of a Case*, 40 YALE L.J. 161 (1930).

Thus, *Silver Hills* gave birth to what is commonly known as the "risk capital" theory of a security.

In business situations such as that in *Silver Hills*, where there is obvious oppression of a participant, it is probable that a judicial remedy will be afforded. Thus, pure promotional schemes such as that recently attempted by Glenn W. Turner ("Dare to be Great")⁶¹ are likely to be harpooned by the judiciary even when a statute must be stretched. In a reasonable business situation outside the statute, however, even so formidable a proponent as the California Commissioner of Corporations has had trouble proving the existence of a security under similar circumstances.⁶² Although the California Commissioner of Corporations has broad rulemaking authority,⁶³ he has not proposed or adopted a rule concerning the status of club memberships. Perhaps because the Commissioner realizes he is in virgin territory he has chosen to regulate on a case-by-case basis when his opinion has been requested,⁶⁴ supplemented

61. See *SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476 (9th Cir. 1973).

62. Even though California has, from the inception of its securities regulations laws, been the most "active and militant" of jurisdictions, Dalton, *The California Corporate Securities Act*, 18 CALIF. L. REV. 115, 136 (1930), a legitimate sale of investment grade diamonds, with a buy-back agreement from the seller, was held to be outside the statutory definition of a security. *Hamilton Jewelers v. Department of Corps.*, 37 Cal. App. 3d 330, 112 Cal. Rptr. 387 (1974).

63. CAL. CORP. CODE ANN. § 25610 (West Supp. 1976).

64. While the Commissioner's opinion letters are persuasive, they are limited solely to the facts presented by the inquirer. The preface to a Commissioner's Opinion letter reads:

THIS INTERPRETIVE OPINION . . . is applicable only to the transaction identified in the request therefor, and may not be relied upon in connection with any other transaction.

See, e.g., Op. Cal. Comm'r of Corps. No. 75/33c (C.E.B. 1975). The trend which has evolved can best be determined by reading the opinions themselves. Among the more prominent are:

Op. Cal. Comm'r of Corps. No. 75/33c (C.E.B. 1975). No security where dues and fees used to pay current operating expenses, but not to repay encumbrances. *Id.*

Op. Cal. Comm'r of Corps. No. 74/93c (C.E.B. 1974): Sale of memberships in existing country club. Security not involved if fees are not necessary to repay any loans or make any mortgage or lease payments on the facilities or proposed facilities. *Id.*

Op. Cal. Comm'r of Corps. No. 74/82c (C.E.B. 1974): Nonprofit club, for members only, partly to benefit Lutheran High School Association of Southern California. Security involved, because a substantial part of the costs of initial construction will be paid by fees and dues. No exemption available. Letter not an interpretive opinion. *Id.*

Op. Cal. Comm'r of Corps. No. 74/75c (C.E.B. 1974): No initiation fee, monthly dues only. Developer purportedly obtained construction and permanent financing on own credit, without regard to the project. Deposits escrowed. Security involved, because net worth of developer irrelevant, escrow irrelevant, and dues will be used as necessary to repay loans security involved. *Id.*

Op. Cal. Comm'r of Corps. No. 74/59c (C.E.B. 1974): Recreational Vehicle Park, members and nonmembers. Memberships transferable and nonassessable, grant right to camp and park recreational vehicles at preferred rates. Security not involved because

members' initiation fees and dues could be used to repay bank loans and mortgages.

Op. Cal. Comm'r of Corps. No. 74/52c (C.E.B. 1974): Clubs to be built on leased grounds; no representation concerning source of construction funds. Lease payments guaranteed by Veterans Administration. Members' deposits placed in trust account, subject to refund at request and release only on completion of facilities. Absent showing that club will obtain, from sources other than members, capital required to pay taxes, insurance premiums, expenses of maintenance, costs of operations, and lease payments, Commissioner unable to render opinion that security not involved. Trust arrangement insufficient, since funds exposed to claims of developer's creditors. *Id.*

Op. Cal. Comm'r of Corps. No. 74/44c (C.E.B. 1974): Security involved. Developer's capital contribution is all that counts. Availability of borrowed funds irrelevant. *Id.*

Op. Cal. Comm'r of Corps. No. 73/134c (C.E.B. 1973): Security involved because major capital requirements are to be satisfied by borrowing, and fees and dues are to be used to repay loans. *Id.*

Op. Cal. Comm'r of Corps. No. 73/133c (C.E.B. 1973): Joint development of a \$400,000 club by developer with a \$766,000 net worth, did not demonstrate that "proposed issuer . . . has or will obtain from sources other than payments of members, the capital required to secure and maintain the facilities promised." Therefore, a security was involved. *Id.*

Op. Cal. Comm'r of Corps. 73/94c (C.E.B. 1973): Members' fees and dues necessary to finance travel events. Security involved because purchasers of memberships must have *at least a fair chance to realize their objectives.* *Id.*

Op. Cal. Comm'r of Corps. No. 73/51c (C.E.B. 1973): Nonprofit club offers memberships for \$3,750 each. Development in conjunction with eleven million dollar village. Held that securities were involved because what the members will receive is not *equivalent to the enjoyment of the club facilities promised to them.* *Id.*

Op. Cal. Comm'r of Corps. No. 73/49c (C.E.B. 1973): Sale of memberships permitting purchaser to use facilities on leased land for hunting and fishing. No showing that at the time memberships were sold, funds were available to provide the facilities and services offered. Therefore, a security is involved. *Id.*

Op. Cal. Comm'r of Corps. No. 73/45c (C.E.B. 1973): Unable to give opinion without showing that at the time memberships were sold funds were available to provide facilities and services offered without relying on the membership fees. *Id.*

Op. Cal. Comm'r of Corps. No. 73/11c (C.E.B. 1973): Members required to loan funds to club. The loan is a security because it is an "evidence of indebtedness." Risk capital theory also applies. *Id.*

Op. Cal. Comm'r of Corps. No. 72/99c (C.E.B. 1972): Security because unreasonably large portion of developer's financial requirements provided by borrowing. *Id.*

Op. Cal. Comm'r of Corps. No. 72/83c (C.E.B. 1972): Security involved because of borrowing and the fact that club promoters will receive profits. *Id.*

Op. Cal. Comm'r of Corps. No. 72/61c (C.E.B. 1972): Developer has ten million dollars in total assets, \$218,000.00 in net worth, and development incident to real estate program. Memberships not securities. *Id.*

Op. Cal. Comm'r of Corps. No. 72/76c (C.E.B. 1972): No security involved, because membership fees are not being used to provide facilities and "*payments will not substantially exceed benefits actually to be realized.*" *Id.* (emphasis added).

Op. Cal. Comm'r of Corps. No. 71/131c (C.E.B. 1971): Charter memberships offered. Thereafter, different classes of memberships offered. Facilities completed by developer with equity capital. Money collected from members prior to opening not used to finance acquisition of property or cost of construction. Members required to pay two months' dues in advance. No security involved. Two months' pre-payment of dues "can-

by an opinion from his Office of Policy, published in July, 1975.⁶⁵ The July, 1975 newsletter states that the risk capital theory set out in *Silver Hills* controls, and that the following items are pertinent criteria under that theory:

(1) Only the funds actually contributed as equity capital by the developers can be considered in determining whether the developers have sufficient assets to provide the promised facilities. Neither the total net worth of the developers nor the availability of construction financing is relevant.

(2) If the monies received from the purchase of memberships are necessary to repay loans or make mortgage or lease payments, the monies constitute "risk capital." In other words, a high debt-equity ratio is indicative of "risk capital."

(3) Placing a purchaser's funds in trust or escrow is not determinative of the existence of a security, since such funds are beyond the purchaser's control and are exposed to mishandling and third party claims against the developer.

(4) The fact that purchasers may unilaterally withdraw funds prior to completion of the facilities is not determinative.

(5) The fact that initiation fees are to be paid in installments, or may be characterized as monthly dues is not determinative.⁶⁶

These criteria are not binding. The practitioner must either file an application in the dark or study existing files to assemble a set of criteria by which to steer. The Commissioner's unofficial administrative opinion appears to include within his regulatory ambit every club which plans to rely, in part, on the use of borrowed funds. The fact that this position is unofficial and has not yet received any judicial support is probably due to the absence of a *Silver Hills* factual setting on which to test the theory.

The Commissioner's position has also evolved from the conditions he imposes for qualification of securities under Corporations Code section 25113.⁶⁷ Together with the unofficial criteria discussed above, these

not be regarded as risk capital investment under [Silver Hills] inasmuch as payment generally will not *substantially exceed the benefits actually realized by members through the use of club facilities provided.*" *Id.* (emphasis added).

65. Cal. Dept. of Corps., Corporate Securities Newsletter, July, 1975 at 4, col. 2.

66. *Id.* at 4, col. 3.

67. CAL. CORP. CODE ANN. § 25113 (West Supp. 1976). Securities can be qualified under any of three methods depending upon the circumstances. These methods include qualification by coordination, notification, or permit. *Id.* §§ 25111-13. Therefore, not all clubs will seek qualification via the permit method.

conditions provide one of the few indications of whether and when a club membership will be deemed a security in California.

The developer may opt to take the safe route and seek to qualify the club memberships as securities. This will necessitate adherence to strict conditions imposed by the California Commissioner of Corporations. Review of the public files available at the office of the California Commissioner of Corporations reveals that the following are the more pertinent conditions currently being imposed by the Commissioner for any permit issued to authorize the sale of club memberships. The Commissioner has not published any rule; rather, he has evolved a set of conditions on a case-by-case basis. Unfortunately, some practices which were formerly permitted, such as graduated initiation fees, the owner's unilateral right to increase dues, and the owner's unilateral right to impose transfer fees, are now prohibited. The principal conditions currently being imposed, and an evaluation of those conditions follow:

1. Graduated Initiation Fees Prohibited.

1.1 The Commissioner's present policy prohibits any differential in membership fees, whether graduated or disguised in the form of a discount to early buyers, or postponed for payment as part of monthly dues. This requirement is a potential killer, as witnessed by two recent examples:

1.1.1 In late 1975, a proposed club in Palos Verdes apparently went under. The organizers placed the blame solely on the Commissioner's refusal to allow lower admission fees to the first members in.

1.1.2 A Los Angeles airport club originally filed an application to sell individual and corporate memberships at \$1,750.00 and up, and limited use family memberships at \$250.00. The application was subsequently withdrawn, and the club proceeded, without a permit, to sell corporate and individual applications under the following fee structure:

Initiation Fee _____	\$350.00
Annual Enrollment Fee _____	\$150.00
Monthly Dues _____	\$ 30.00

2. Dues.

2.1 Dues must be reasonable. Again, the Commissioner has the discretion to determine what is "reasonable."

2.2 Dues can be increased only by reference to a definable standard, such as an increase in the cost of living scale in the area. The only other way dues can ever be increased is by an affirmative vote of a majority, which, as a practical matter, could be extremely difficult to obtain. The impact of this regulation could possibly be softened by requiring an affirmative vote of a quorum and establishing a quorum at fifty percent of all members.

3. Transferability.

3.1 All memberships must be freely transferable, without unreasonable restrictions. The only restriction which the Commissioner will presently permit is approval of the proposed transferee's financial ability.

3.2 The owner is permitted to charge only a nominal transfer fee, which is now set at ten percent.

3.3 No approval by a membership committee, by reference to other club affiliations or any similar generic standard is permitted as a prerequisite to a transfer.

3.4 Transfers must be on a "first come, first served" basis.

3.5 Transfers require the Commissioner's consent. CAL. CORP. CODE ANN. § 25151 (West Supp. 1976).

4. Termination, Forfeiture, and Suspension.

4.1 The main grounds which will permit a termination of membership are the nonpayment of initiation fees or dues. Even then, the Commissioner presently requires that the delinquent party be given ninety days to cure before membership is terminated.

4.2 On any termination, even for cause or failure to pay, no forfeiture is permitted. Thus, the Commissioner apparently requires refund of the initiation fee to any member who is unwillingly terminated. (This provision seems

Under present law, with proper precautions, a California developer

unrealistic and grossly unfair. A substantial chance exists, therefore, that the Commissioner's position here may be modified.)

- 4.3 During any period of suspension, whether for nonpayment or otherwise the obligation to pay dues ceases.

5. Projections.

The owner must prepare and furnish to the Commissioner estimates of income and expenses for the first five years of operation. The purported purpose of this requirement is to convince the Commissioner that the club will have enough members to sustain long-term operations. The purely conjectural basis of the back end of these projections might be a sufficient ground to convince the Commissioner to modify this requirement.

6. Impound.

No funds received from prospective members may be released to the developer until deposits in an impound account reach a minimum amount. The Commissioner determines the amount by studying the developer's projections and deciding how many members and how much money is necessary to ensure successful club operations. (This condition is usually beneficial).

7. Membership Requirements.

The Commissioner prohibits what he terms "unreasonable" membership requirements. Thus, such things as requiring membership in other clubs, sponsorship by present members or members of other clubs, minimum educational requirements, minimum social standing, sex, race or any other category is forbidden.

8. Sale of Assets.

The club assets can be sold only on either of the following conditions:

8.1 Approval of a majority of owners.

8.2 The members should be given the right of first refusal to purchase what is referred to as "their own" club.

8.3 Sale to an outside buyer will be permitted only on a showing of the buyer's ability to successfully operate the club and on an enforceable agreement by the buyer to assume all liabilities and continue operation of the club without increase in dues.

The Commissioner has permitted, however, a sale and leaseback transaction where the developer was committed under the lease to continue club operations.

9. Securities Sales Licenses Required.

The Commissioner takes the position that the developer's sales force are "agents" as defined by CAL. CORP. CODE ANN. § 25003 (West 1970). Similarly, the employment of a manager or consultant to help in sales renders that person or entity a "broker-dealer" under the law. Attaching either of these labels is potentially disastrous since salesmen and broker-dealers are required to take and pass securities law examinations which few persons connected with clubs have the time or inclination to pass.

10. Management or Employment Contracts.

Management, employment or consulting contracts entered into by the club must be short-term in duration and also provide that they are terminable by a majority vote of members.

11. Escrow Deposits.

Any prospective member who deposits funds in escrow pending construction is entitled to a complete refund, without deduction or interest, at any time prior to the completion of the facilities. (This is logical and necessary).

12. House Rules.

A Rules Committee, not weighted against members, must be established. As part of the application process, the Commissioner has discretion to determine what is unreasonable. Some rules which have been disallowed by the Commissioner are:

12.1 A rule banning "swim suits, undershirts or numeraled jerseys."

12.2 Late fee charges in excess of .08 percent per month.

can build a club and sell licenses without creating a security.⁶⁸ There are at least four situations in which a security is clearly not present. They include:

(1) A facility which charges neither initiation fees nor monthly dues. Revenues are provided solely from renting court space on an hourly basis.

(2) A club which accepts no deposits and makes no contracts unless and until the facilities are ready. Even under the broadest reading of *Silver Hills*, there must be some capital put at risk.⁶⁹

(3) A club built out of equity capital, without resort to borrowed funds.⁷⁰

(4) Sale of the right to use existing facilities.⁷¹

12.3 A rule allowing ejection from the premises, and eventual ejection from the Club for "conduct unbecoming a gentleman or lady."

13. Offering Circular.

An offering circular must be prepared, approved and distributed in connection with all offers. All advertising must be filed with, and not disapproved by the Commissioner, prior to use. Monthly newsletters are advertising.

14. Operations.

Recently, the Commissioner's Staff has become concerned with how a club will operate once it is opened. Consequently, new conditions are now being imposed such as a limitation on the total membership so that a favorable "member to court" ratio is maintained. This recent condition is further evidence that regulation is evolving on a case-by-case basis.

68. For the distinction between a "membership" and a "license," see notes 10-13 *supra* and accompanying text.

69. See Op. Cal. Comm'r of Corps. No. 74/93c (C.E.B. 1974); Op. Cal. Comm'r of Corps. No. 71/131c (C.E.B. 1971).

70. See the Commissioner's July, 1975 Newsletter in which the negative side of this principle was recognized:

Only the funds actually contributed to a corporate issuer of memberships as equity capital can be considered in determining whether the issuer has sufficient assets to provide the promised facilities.

Cal. Dept. of Corps., Corporate Securities Newsletter, July, 1975, at 4, col. 3.

71. At least one court has found a club membership (not a license to use facilities) to be outside the "investment contract" definition of a security where the promised benefits are already available. In *Jet Set Travel Club v. Corporations Comm'r*, 535 P.2d 109 (Ore. Ct. App. 1975), the promoters had raised \$70,000 from the sale of memberships which was used to purchase an airplane. The memberships required payment of monthly dues and granted the member a lifetime, non-transferable right to fly on Club trips for as little as twenty dollars. The Oregon Corporations Commissioner sought to prevent unregistered sales of the memberships in Oregon. In refusing to apply the risk capital theory to the facts before it, the court stated:

[T]he benefits of the membership have materialized and have been realized by other members prior to any capital raised by the sale of Oregon memberships.

Id. at 112.

Clubs which are more interested in increased revenue through a larger roster rather than preservation of their exclusive nature advertise their facilities at bargain rates. See *Los Angeles Times*, Nov. 30, 1976, § 3 (Sports), at 2, where those interested in joining a tennis club are urged to take advantage of the present \$500 initiation fee which, the ad states in less than subtle terms, will soon be doubled to \$1,000.

The Commissioner's interpretation and extension of *Silver Hills*, while persuasive, does not have precedential value. The risk capital theory, followed to its logical extreme, would prevent many commercial dealings which rely on pre-selling as an integral part of their process.⁷² Therefore, there are limits beyond which even the risk capital theory cannot be stretched.

The final issue is whether a profit-oriented club can be developed using construction financing without creating a security. If the developer stays within the limits of the egregious greed demonstrated in *Silver Hills* and accepts the fact that the Commissioner is a potential adversary, the club can be built with borrowed funds without creating a security. Such a development should follow this plan and sequence:

(1) Obtain title, or a long-term lease, to the real property. Don't try to develop under even the most sophisticated system of options.

(2) Put as much equity capital into the project as possible.⁷³

(3) Take reservations without deposits. Alternatively, if deposits or down payments are to be accepted, even before the first advertisement, the developer should eliminate himself from any possible control over or right to the deposits. This can best be accomplished by a formal trust agreement with a commercial bank. A properly drawn trust agreement will place deposits beyond the reach of the developer and any potential claims of the developer's creditors. All costs of the trust account are borne independently by the developer. The trust arrangements themselves are simple and provide two basic contingencies:

(a) Until the facilities are ready, the applicant may unilaterally withdraw his deposit at any time merely by making a request;

(b) The funds on deposit may be turned over directly to the developer only after a physical inspection by the trust representative to determine that the promised facilities are ready for use.

(4) All advertising must be carefully reviewed to insure full disclosure of all material facts. Anti-fraud protection is essential, even when a security is not present.⁷⁴

(5) The first document which those persons wishing to join the club should sign is an application. The application should be designed

72. For example, these include attempts by a shopping center developer to line up tenants prior to obtaining construction and permanent financing pre-construction sales campaigns by developers of residential property or efforts by manufacturers to obtain firm purchase orders (backlog) to help secure the capital or financing necessary to manufacture the product for delivery against the purchase order.

73. See text accompanying note 66 *supra*.

74. See note 1 *supra*.

to provide maximum disclosure as well as facts from which the developer can limit the transaction to intrastate purchasers only. (This is not a concession that a security, under the federal definition of the term, is present, it is merely an added precaution.) If deposits or down payments are to be received, the second document the applicant should sign is the trust agreement with the bank.

(6) A license contract which clearly spells out the developer's ultimate control of all financial and operating aspects should be prepared. This agreement is the heart of the relationship. In it the licensee's rights (which are, essentially, the right to pay for the use of the facilities) are defined. Again, this agreement is an appropriate place for disclosure and inclusion of any restrictions on transfer or sale of the license which the developer may decide are economically wise and legally prudent.⁷⁵ The license agreement need not be a sales deterrent. All of the essential elements can be covered in a document which extends only to both sides of one page.

(7) Club operating rules should be drafted and given to each licensee before, or at least concurrently with, execution of the license agreement. The operating rules (sometimes referred to as bylaws) establish those areas in which the developer has the financial and operational control necessary to preserve the integrity of the development. The operating rules should not be the subject of any debate.

(8) House rules, which establish committees of licensees and grant authority to establish dress codes, game rules and make other decisions not essential to the financial or operating integrity of the club, should be prepared and distributed with the operating rules. House rules can safely be subject to alteration by a vote of licensees.

(9) As a final protective step, release of trust account funds should be permitted only after a physical inspection by the trustee to determine whether the promised facilities are ready for use. The developer should deposit any funds received from the trust account directly into the club operating account. None of these funds should be used to pay any secured debt. Projections should permit debt service out of post-opening dues and other sources of operating revenues.

75. In *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975), the cooperative's enabling documents prohibited resale of an apartment at more than its initial cost. Appreciation in value and the opportunity to sell a unit at a profit, therefore, are elements which each developer must consider. See also *1050 Tenants Corp. v. Lakoleson*, 365 F. Supp. 1171 (S.D.N.Y. 1973), *aff'd*, 453 F.2d 1375 (2d Cir. 1974).

The steps set out above are intended to insure the development of a club without inadvertently creating a security. In California, however, a developer is faced with an initial command decision: Should he concede the issue and apply for a permit, accepting the Commissioner's conditions, or should he plan his finances so that the project can be built without creating a security? The first course, while certainly the safest, consumes more time and expense. More critically, however, under current administrative policies, it denies to the developer the right to use incremental increases in initiation fees as a sales tool. In a competitive market, one of the most compelling sales points is the possibility of a price increase. Without this real and psychological incentive, the sales program may be severely hindered. On the other hand, the inability to use or rely on deposits should not inhibit a real estate developer. The main reason in obtaining deposits and applications should be to sample the market, not to provide initial capital.

V. A SUGGESTION FOR APPROPRIATE REGULATION

Not all developments will be properly planned and there is no way to predict where *Silver Hills* might strike again. New clubs are being planned, constructed and opened. The market has not reached saturation. It is possible that a current developer of a failing club could be dipping into "escrow" deposits in an effort to complete construction. As is usual on the frontiers of the developing area of law, one bad apple spoils the whole legal barrel by providing those perfect facts for a test case. Thus, given bad facts, such as misuse or misappropriation of depositors' money, the California Commissioner of Corporations might obtain judicial support for his current, unofficial administrative position.

Assuming, therefore, that regulation is inevitable and that it will be prophylactic, encompassing legitimate, non-risk developments as well as risk capital ventures, the question becomes who should regulate and under what theory?

In theory and in practice, in California, the Real Estate Commissioner and his staff should be given the task and opportunity to develop appropriate standards. Ideally this jurisdiction should be conferred after the fact-finding process which leads to the adoption of a series of statutes. A new Chapter 5 could be added to Division 4, Part 2 of the California Business and Professions Code.⁷⁶ Part 2 is now aptly titled "Regulations of Transactions."⁷⁷ The process which has evolved

76. CAL. BUS. & PROF. CODE ANN. §§ 11000-709 (West 1964).

77. *Id.*

under the statute provides the logical precedent and administrative machinery for regulation of club development. For example, under Business and Professions Code section 11013.2 a developer must provide a completion bond, or impound funds until completion of the project.⁷⁸ Under the California Administrative Code,⁷⁹ the Real Estate Commissioner has adopted a series of comprehensive regulations which, with slight modification, could evenly and properly control club development. For example, a public report⁸⁰ coupled with the control of advertising⁸¹ and the licensing of salesmen⁸² forms an appropriate regulatory pattern.

The adoption of appropriate legislation, however, without any organized effort, is probably wishful thinking. Expansion by the Real Estate Commissioner of existing regulatory patterns, therefore, would be a more appropriate response to the problem than would a further, unwarranted expansion of *Silver Hills*. A case could be made that a club license or membership fits within the definition of an interest subject to the regulations of the Real Estate Commissioner.⁸³ Once within the statutory ambit, the regulatory pattern of the California Administrative Code⁸⁴ could then be applied.

If the bargain between the developer or operator of a private club organized for profit is to be regulated, that regulation should come from the appropriate source. The California Commissioner of Corporations deals with stocks, commodities and other investments. The Real Estate Commissioner, on the other hand, deals with and has developed a regulatory pattern more suited to clubs which are, in essence, real estate projects designated for use and not investment. If the problem is serious enough to require state supervision, it should be under the agency which has developed expertise in protecting users of land rather than investors of money.

VI. CONCLUSION

The economic bargain in the club membership situation is different from arrangements designed to provide passive investors a profit. Presently, the normal bargain is payment in return for a place to play.

78. *Id.* § 11013.2.

79. 10 Cal. Adm. Code §§ 2790-2819.

80. *Id.* §§ 2795-95.3.

81. *Id.* § 2799.1.

82. *Id.* §§ 2750-55.

83. CAL. BUS. & PROF. CODE ANN. § 1104.5(e)(1) (West Supp. 1976).

84. 10 Cal. Adm. Code §§ 2700-3004.

Whether the place to play is supplied by the payment of an initiation fee and monthly dues, or merely by hourly payments, is irrelevant. Once the club facilities are ready for use, neither the method by which they were financed nor the source of revenue is material in analyzing whether or not licensees need protection.

At the federal level, the expansion of the investment contract facet of the definition of a security should make club developers wary. Though it would appear that the club will rarely meet the *Forman* criteria for the definition of a security,⁸⁵ the SEC has recently refused to issue no action letters in the club membership area.⁸⁶ As a result, the developer who ignores the possibility that his membership plan creates a security is risking the success of his venture. The prudent developer will take advantage of the "safe harbor" offered by Rule 147⁸⁷ to obtain an intra-state offering exemption⁸⁸ or, alternatively, to seek registration.

At the state level, no one can safely predict the extent of the risk capital theory. The California Commissioner of Corporations has issued criteria in an attempt to clarify that theory.⁸⁹ However, these criteria do not carry the force of law. Hence, the developer's attempt to define the extent of the risk capital theory or to rely on the Commissioner's criteria leaves him on precarious ground. It would seem that governmental regulation is necessary. If such regulation should issue, the line defining the outer boundaries of what constitutes a security should be drawn not at *Silver Hills'* extreme outer limits, but rather somewhere on this side of a prudently financed development.

The present furious pace of club development could logically lead to an over-saturated market, thereby producing a failure. If a failing club produces the loss of capital put at risk, *Silver Hills* may apply, but only after a protracted trial and appeals period. If the state has an interest in club development, it should ideally be defined through the fact finding process which leads to the adoption of a statute, and not by unofficial administrative regulation or by an after-the-fact judicial response to a failure.

85. See text accompanying notes 34-38 *supra*.

86. See note 41 *supra* and accompanying text.

87. SEC Rule 147, 17 C.F.R. § 230.147 (1976).

88. See notes 42-51 *supra* and accompanying text.

89. See text accompanying note 66 *supra*.