

Statute file



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ARIZONA CORPORATION COMMISSION

December 17, 1993

Michael F. Sexton, Esq.
Rooks, Pitts and Poust
Xerox Centre, 55 West Monroe Street
Suite 1500
Chicago, IL 60603-5095

RE: Atlantic Shores, a cooperative
A.R.S. § 44-1801(22)

Dear Mr. Sexton:

On the basis of the facts set forth in your letter of December 7, 1993, and in reliance upon your opinion as counsel, the Securities Division will not recommend enforcement action for violation of the Securities Act of Arizona (the "Act") should the transaction take place as set forth in your letter. This letter is limited to Phase I as discussed in your letter.

As this position is premised upon the facts set forth in your letter, it should not be relied on for any other set of facts or by any other person.

To the extent that the transactions do not take place as described in your letter of December 7, 1993, or a material change in circumstances causes these cooperative shares to be deemed to be "securities" for purposes of the Act, then the anti-fraud provisions of the Act would be applicable ab initio.

We have attached a photocopy of your letter. By doing this we are able to avoid having to recite or summarize the facts set forth therein.

Very truly yours,

DEE RIDDELL HARRIS
Director of Securities

DRH:lb
Attachment

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EUGENE H. RUARK
COUNSEL

December 7, 1993

VIA ECC

Richard M. Weinroth
General Counsel
Arizona Corporation Commission
Securities Division
1300 West Washington Street
Third Floor
Phoenix, AZ 85007

Re: Atlantic Shores, a cooperative

Dear Mr. Weinroth:

On behalf of Atlantic Shores Retirement Community, Inc., a Delaware corporation (the "Developer"), we hereby request your advice with respect to whether the Cooperative Interests (defined below) in the Atlantic Shores residential real estate housing cooperative (referred to herein as "Atlantic Shores" or the "Cooperative") located in Virginia Beach, Virginia, are "securities" as defined in the Securities Act of Arizona (the "Act") and whether the Cooperative Interests may be offered and sold in the State of Arizona without complying with the registration and other requirements of the Act. Your opinion is requested pursuant to the authority granted by Section 44-1847 of the Act. A check in the amount of \$200.00 is enclosed for payment of the requisite fee.

FACTS.

Atlantic Shores will be governed by an association of owners of the Cooperative Interests (the "Association") which will be

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incorporated as a Virginia stock corporation and organized for the mutual benefit of its members. The Association will own approximately 200 acres of land on Dam Neck Road, Virginia Beach, Virginia (the "Property"). The Cooperative is intended to be a self-contained community offering unique options for retirement living.

The Developer plans to develop and construct the Cooperative in two phases. In Phase I, 342 Cooperative Interests will be created with one residential unit being built for each Cooperative Interest. Phase I will also include the development of certain common elements. The common elements consist of the real estate (excluding the residential units themselves which are comprised of the space bounded by the walls, floor and ceiling of the unit) and improvements together with a clubhouse, health center, tennis courts, picnic area, other recreational amenities and parking areas. The clubhouse will contain dining areas, recreational facilities, a library and a store. The maintenance and operation of the common elements and facilities will be funded by assessment against each Cooperative Interest which shall be payable monthly. The assessment will be sufficient to cover the purchaser's proportionate share of the costs of real estate taxes, insurance, maintenance of common areas, common services and operation of service facilities, including health care and principal and interest payments on Association debt. The Association will attempt to match expenses to assessments. However, any excess fees will be (i) applied to reduce the amount of future assessments upon all Association members, (ii) paid into Association reserves, or (iii) rebated to Association members in proportion to their common expense liability. No dividend will be paid to Association members.

Each purchaser of a Cooperative Interest will receive, regardless of unit size, one share of stock in the Association as evidence of his ownership therein coupled with a possessory interest in a particular unit (together the "Cooperative Interest"), as evidenced by a proprietary lease. The ownership interest in the Association cannot be conveyed or encumbered separately from the possessory interest in a unit. As part of acquisition of the Cooperative Interest, a purchaser must enter into a proprietary lease with the Association entitling the purchaser to possession of the residential unit during the period of ownership; however, occupancy is subject to certain restrictions. At least one permanent occupant of a unit must be age 55 or older. Every permanent occupant of a unit must also sign a services agreement which describes services and amenities available to permanent occupants. The costs and expenses of the Association incurred in providing the services and amenities shall be included in the common expenses assessed against all Association members. Even if the owner does not occupy the unit, the owner must guarantee the obligations under the services agreement.

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Proprietary leases will include various restrictions with respect to the number and age of occupants and will incorporate the By-Laws' restrictions regarding use, noise, alterations and other matters to ensure operation of Atlantic Shores as a congenial residential retirement community. Of particular relevance here are the restrictions on the subleasing of the units which, among other things, require (i) each sublease to have a term of not less than one year; (ii) all sublessees to permanently occupy the unit; and (iii) at least one sublessee to be age 55 years or over.

The Cooperative Interests will be marketed in the State of Arizona by the Developer. The Developer expects to pay a flat fee per Cooperative Interest to certain of its employees directly engaged in the marketing and sale of each Cooperative Interest. Life Care Services Corporation ("LCS") will receive compensation in connection with the initial sale of the Cooperative Interests, determined, in part, as a percentage of the sales price of each Cooperative Interest as partial consideration for LCS' marketing consulting services pursuant to a Marketing and Services Agreement between LCS and the Developer. It is not contemplated that LCS will engage in direct marketing of the Cooperative Interests.

Generally, a transfer of a Cooperative Interest is subject to the Association's right of first refusal. Any transfer of a share of stock in the Association must be accompanied by an assignment of the related proprietary lease. Upon the transfer of a Cooperative Interest, an owner must pay to the Association a transfer fee equal to 5% of the gross sale price paid to the owner for the Cooperative Interest, subject to certain exceptions.

Pursuant to the provisions of the Internal Revenue Code of 1986, as amended (the "Code"), ownership of a Cooperative Interest will be treated similarly to the ownership of the underlying residential unit for federal income tax purposes. In general, Section 163 of the Internal Revenue Code of 1986, as amended (the "Code"), allows an individual to deduct interest paid with respect to debt incurred to acquire, construct or substantially improve his primary (or, in some cases, secondary) residence where the debt is secured by the residence. Also, generally, Section 164 of the Code allows an individual to deduct real property taxes imposed on real property that he or she owns. Under Virginia law, a cooperative interest is real estate for all purposes. Therefore, an individual should be able to deduct interest and real property taxes paid with respect to a Virginia cooperative interest under Sections 163 and 164 of the Code.

In addition to Sections 163 and 164 of the Code, Section 216 of the Code generally allows an owner of a cooperative interest to deduct his or her proportionate share of interest paid by a housing cooperative with respect to debt incurred to acquire, construct, alter, rehabilitate or maintain the property owned by the

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cooperative and real estate taxes paid or incurred by the cooperative on its property.

Under Virginia law, an owner of a cooperative interest may not deduct either interest or real estate taxes for Virginia income tax purposes.

The Cooperative Interests will be marketed as interests in real property to be used for residential purposes, and no emphasis in any advertising material will be placed upon the tax or economic benefits to be gained from a purchase of a Cooperative Interest other than those normally associated with ownership of residential real estate. No time sharing, rental pool, rental management or similar arrangements will be offered or authorized in connection with the Cooperative Interests.

Offers and sales of the Cooperative Interests in the State of Arizona will be made only (i) in accordance with the requirements of the Arizona Land Sales Act, Sec. 32-2181 relating to sales of real estate interests; and (ii) upon compliance with the Virginia Real Estate Cooperative Act, which requires filing of a cooperative property report.

ANALYSIS.

The definition of "security" in the Uniform Securities Act was patterned after Section 2(1) of the Securities Act of 1933. See Loss, Commentary on the Uniform Securities Act (1976), at p. 106. Consequently, states following the Uniform Act may find decisions concerning the scope of the federal securities laws helpful in construing and applying definitions of securities under state securities acts. Certain relevant decisions are summarized below.

The federal courts have on several occasions considered the question of whether interests similar to the Cooperative Interests are securities and have consistently concluded that such interests are not securities within the purview of federal securities laws. See United Housing Foundation v. Forman, 421 U.S. 837 (1975); Grenader v. Spitz, 537 F.2d 612 (2d Cir. 1976); and Mosher v. Southridge Associates, Inc., 552 F.Supp. 1231 (W.D. Penn. 1982). Moreover, under the criteria of the Securities and Exchange Commission (the "SEC") in Release No. 33-5347 (January 4, 1973) Fed. Sec. L. Rep. (CCH) par. 79,163, the Cooperative Interests are not considered securities. In Release No. 5347, the SEC stated that an offering of condominium or similar units will be viewed as an offering of securities only when coupled with any of the following: (a) the offering of participation in a rental property arrangement; (b) the offering of a rental or similar arrangement whereby the purchaser must hold his unit available for rent for any part of the year or use an exclusive renting agent, or whereby he is otherwise materially restricted in the occupancy or rent of his

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unit, or (c) the offering of a rental arrangement or other similar service with emphasis on the benefits to be derived by the purchaser from efforts of the promoter or a third party in connection with the rental of the units. The Cooperative Interests have none of these characteristics.

In the Forman case, supra, the United States Supreme Court first addressed the issue of whether shares in a cooperative apartment corporation are securities. In Forman, a housing cooperative issued shares of common stock which entitled the purchaser to an apartment in the cooperative apartment building. In Forman, the United States Supreme Court held that shares of common stock in a cooperative housing corporation were not "securities" within the scope of federal securities laws because the stock possessed none of the usual characteristics of stock and because of the economic realities of the transaction. In deciding that the shares did not constitute "stock", the Supreme Court noted that the shares lacked the most common feature of stock: the right to receive dividends contingent upon an apportionment of profits. Further the shares did not possess other characteristics traditionally associated with stock -- they were not negotiable; they could not be pledged or hypothecated; they conferred no voting rights in proportion to the number of shares owned; they could not appreciate in value. Forman, supra at 851. According to the Supreme Court, the inducement to purchase was solely the acquisition of living space and not investment for profit. Id. The Supreme Court rejected the appellate court's literal approach based upon the use of the term "stock" and found that the mere fact that the housing cooperative interests were called "stock" did not make them a "security" under federal law. Forman, supra, at 848. The Supreme Court stated that substance and economic reality should be determinative. Id. The Court also stated in a footnote that "[w]hile the record does not indicate precisely why the term stock was used for the instant transaction, it appear this form is generally used as a matter of tradition and convenience." Forman, supra at 848, n. 13.

The Forman court then examined the shares under the "investment contract" analysis set forth in SEC v. W.J. Howey Co., 328 U.S. 293 (1946). Applying the Howey test, the Supreme Court concluded that the shares in Forman were not investment contracts because the economic realities of the transaction showed that the purchasers had parted with their money not with the expectation of reaping profits solely from the efforts of others, but with the desire of purchasing living quarters for personal use. Forman, supra, at 852-853 and 858.

Within a year after the Supreme Court's Forman decision, the Second Circuit reviewed the securities issues posed by a more traditional housing cooperative in Grenader v. Spitz, 537 F.2d 612 (2nd Cir. 1976). In Grenader, the purchasers of stock in a

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privately owned apartment housing cooperative were entitled to enter into a proprietary lease for an apartment. The shares were not transferable except in connection with the transfer of the lease, and transfers required the consent of the cooperative association or other shareholders. However, unlike the situation in Forman, the (i) owners had voting rights in proportion to the number of shares owned and the number of shares owned was different for each apartment, and (ii) shares and the lease could be sold at a profit.

The Second Circuit held that the interests were not securities under the Forman "economic realities" test. Grenader, supra, at 617. The court noted that the tenants were seeking residential housing for their personal use. Id. According to the Second Circuit, a reading of the offering plan, proprietary lease and subscription agreement made it clear that the purchase of stock was completely tied to the lease and not the possibility of profits. Id.

The Second Circuit then concluded that the shares did not possess the normal attributes of stock. Grenader, supra, at 617. The Second Circuit specifically focused upon the lack of dividends payable to the tenants. Further, the shares were not freely negotiable absent transfer of the underlying lease, nor could they be pledged or hypothecated except as security for a loan to purchase the apartment.

In addressing the issue that, unlike in Forman, the holders of instruments in Grenader could sell their interests for a profit, the Second Circuit stated:

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

Id. at 617.

Finally, in rejecting the argument that the interests were "investment contracts", the Second Circuit said that the profit motive, if any, was purely incidental and that there was nothing in the record to support the contention that the investors were attracted by the prospect of realizing a profit. Id. at 618-619.

The Supreme Court commented upon the application of its Forman decision in the case of Landreth Timber Co. v. Landreth, 471 U.S.

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681 (1985), a case that did not involve a housing cooperative interest or other facts analogous to Forman or the instant case. In Landreth, the Supreme Court clarified the analysis used to determine whether an instrument is a "security". The Landreth decision, just as Forman, found that the fact that an instrument bears the "stock" label is not in itself sufficient to invoke coverage of the federal securities laws. Inquiry must first be made to determine whether the interest possesses some of the significant characteristics typically associated with stock.

The Landreth case involved the sale of all the stock in a sawmill company. The Supreme Court initially considered the attributes of the stock involved. In Landreth, unlike the stock in the Forman case, the Supreme Court found that the stock at issue had the characteristics typically associated with "stock" (i.e., negotiability, voting rights, the right to share in profits through dividends and appreciation, and the ability to be pledged or hypothecated). Moreover, the Court found that, unlike Forman, the transaction involved in Landreth was more typical of the kind of context that involves a "security". Landreth, *supra*, at 687. The Supreme Court concluded that since the stock possessed the characteristics traditionally associated with stock no further analysis was necessary. In Landreth, the Court found that Forman does not require an examination of the economic reality in all situations. Instead the Court interpreted Forman as requiring such an analysis only when the instrument at issue does not possess the common attributes of stock. If so, an examination of the economic realities is appropriate to determine whether the instrument is a security by virtue of being an investment contract, according to the Court.

Landreth essentially concluded that stock can be found to be a security simply because it is what it purports to be. Forman does not require a different result. Forman, while rejecting a literal approach based upon use of the word "stock", does not preclude a court from holding that an instrument is subject to the federal securities laws when its characteristics bear out the label given to it. The Landreth analysis seems appropriately applied to instruments falling within the usual concept of a security while the Forman analysis would be more appropriately applied to instruments with characteristics which do not conform to the traditional "stock" label given to them.

While the foregoing analysis addresses the issue of federal securities law compliance, it is necessary to consider the compliance issue from a state perspective as well. State securities agencies had the opportunity to address the application of the Forman analysis of a security in the case of USAA Residential Towers. In that case, which has facts substantially similar to those here, the United States Automobile Association ("USAA") offered for sale interests in a residential housing

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cooperative which was located in Texas for retired military personnel.

We understand that USAA contacted all fifty-three American securities jurisdictions to seek clearance for its offering. See Blue Sky Law §2.03[2][d] at p. 2-77. A substantial majority of the states either held no securities were involved or took a no-action position. Id. at pp. 2-78 - 2-79. The remaining states, except for New York, concluded that the interests were securities but either took a no-action position or found the interests were exempt from registration. Blue Sky Law, supra, at pp. 2-78 - 2-79.

The states issuing no-action letters in USAA focused upon the fact that purchasers of the USAA cooperative interests were motivated to obtain an alternate form of residential housing, with conveniently available services in a community of retired individuals, rather than an economic investment. This rationale is consistent with that of the Supreme Court in Forman, where the Court noted that "[w]hat distinguishes a security transaction ... is an investment where one parts with his money in the hope of receiving profits from the efforts of others and not where he purchases a commodity for personal consumption or living quarters for personal use." Forman, supra at 858.

In the present case, it is our position that the Cooperative Interests do not come within the definition of "security" in Section 44-1801(22) of the Act as either being "stock" or an "investment contract" because: (a) with respect to the "stock" aspect, the shares of stock in the Cooperative as described above do not possess most of the characteristics usually associated with common stock; and (b) with regard to the "investment contract" aspect, the Developer does not seek to attract purchasers by the prospect of profits traditionally associated with securities and intends to market the Cooperative Interests as interests in real property to be used for residential purposes with no emphasis on tax or economic benefits to a purchaser of a Cooperative Interest, and with no time-sharing, rental pool or other rental management arrangement to be involved.

The Forman analysis is appropriately applied here because the Cooperative Interests are not within the plain meaning of the federal statutory definition and do not have the characteristics traditionally associated with common stock. An analysis of the five characteristics usually associated with stock, as applied to the shares of stock of the Cooperative acquired incident to purchase of a Cooperative Interest, is as follows:

(1) Dividends. No dividend will be paid to any Owner of a Cooperative Interest. It is anticipated by the Association that any excess revenues generated from the monthly fees collected will be (i) applied to reduce future assessments upon all Association

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members, (ii) paid into Association reserves, or (iii) rebated to Association members in proportion to their common expense liability. Any reduction of assessments or rebating of fees paid is not equivalent to the issuance of a traditional dividend and should not cause the Cooperative Interests to fall within the definition of "security". See, e.g., 1986 Ind. Sec. No-Act. LEXIS 5 (August 4, 1986), at. p. 6.

(2) Negotiability. A transfer of the shares of Cooperative Interest is subject to a right of first refusal by the Association and must be accompanied by an assignment of the related proprietary lease.

(3) Pledges or hypothecation. The shares of stock in the Association can only be pledged along with an assignment of the related proprietary lease.

(4) Voting Rights. Each purchaser of a Cooperative Interest becomes a member of the Association and is entitled to only one vote, regardless of the size of the unit or any other factor.

(5) Appreciation of Value. The shares of stock in the Association may be transferred subject to the Association's right of first refusal incident to sale of the Cooperative Interest, at a price that may or may not be in excess of the purchase price paid by the initial purchaser. Additionally, upon the transfer of a Cooperative Interest, an owner must generally pay to the Association a transfer fee equal to 5% of the gross sale price paid to the owner for the Cooperative Interest. The Forman court noted that one of the basic qualities of a share of common stock is the possibility of that share increasing in value. Although here, unlike Forman where the stock could only be resold to the issuer for the same price as the original purchase price, no limitation on appreciation exists, and any increase or decrease will be based upon the same factors which impact upon any other residential community. Note that under Virginia law cooperative interests are considered interests in real estate.

Having considered whether the Cooperative Interests are "stock" and seeing sufficient basis for concluding they are not, it is necessary to consider whether the Cooperative Interests may be deemed "investment contracts". In this case, the Cooperative Interests offer an opportunity to secure housing in a self-contained community and will not be marketed with an emphasis on tax or economic benefits. The units will be sold for residential use only and purchasers are effectively required to occupy their own units. Moreover, no time-sharing, rental pool or other rental management arrangement will be involved. There is not, therefore, the profit incentive required for finding the Cooperative Interests to be investment contracts.

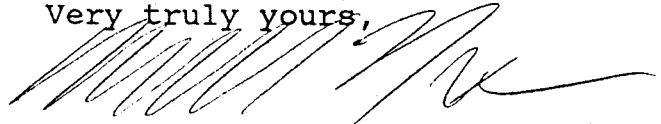
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Based upon the foregoing, we hereby request that you confirm that the Cooperative Interests will not be considered "securities", as defined in the Act, or are otherwise exempt from registration, and that the Cooperative Interests, which will be offered and sold in compliance with the Virginia Real Estate Cooperative Act, may be offered and sold in the State of Arizona without complying with the registration and other requirements of the Act.

In the event you have any questions in connection with this request or require further information or clarification in connection therewith, we would appreciate your contacting Janet A. Stiven or the undersigned by collect telephone call at (312) 372-5600.

Very truly yours,



Michael F. Sexton

MFS:alr