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Supplementary Materials

Donald J. Weidner

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College of Law
Florida State University
Tallahassee, Florida

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March 11, 2007

Crisis Looms in Market for Mortgages

By GRETCHEN MORGENSON

Correction Appended

On March 1, a Wall Street analyst at Bear Stearns wrote an upbeat report on a company that specializes in making mortgages to cash-poor homebuyers. The company, New Century Financial, had already disclosed that a growing number of borrowers were defaulting, and its stock, at around $15, had lost half its value in three weeks.

What happened next seems all too familiar to investors who bought technology stocks in 2000 at the breathless urging of Wall Street analysts. Last week, New Century said it would stop making loans and needed emergency financing to survive. The stock collapsed to $3.21.

The analyst's untimely call, coupled with a failure among other Wall Street institutions to identify problems in the home mortgage market, isn't the only familiar ring to investors who watched the technology stock bubble burst precisely seven years ago.

Now, as then, Wall Street firms and entrepreneurs made fortunes issuing questionable securities, in this case pools of home loans taken out by risky borrowers. Now, as then, bullish stock and credit analysts for some of those same Wall Street firms, which profited in the underwriting and rating of those investments, lulled investors with upbeat pronouncements even as loan defaults ballooned. Now, as then, regulators stood by as the mania churned, fed by lax standards and anything-goes lending.

Investment manias are nothing new, of course. But the demise of this one has been broadly viewed as troubling, as it involves the nation's $6.5 trillion mortgage securities market, which is larger even than the United States treasury market.

Hanging in the balance is the nation's housing market, which has been a big driver of the economy. Fewer lenders means many potential homebuyers will find it more difficult to get credit, while hundreds of thousands of homes will go up for sale as borrowers default, further swamping a stalled market.

"The regulators are trying to figure out how to work around it, but the Hill is going to be in for one big surprise," said Josh Rosner, a managing director at Graham-Fisher & Company, an independent investment research firm in New York, and an expert on mortgage securities. "This is far more dramatic than what led to Sarbanes-Oxley," he added, referring to the legislation that followed the WorldCom and Enron scandals, "both in conflicts and in terms of absolute economic impact."

While real estate prices were rising, the market for home loans operated like a well-oiled machine, providing ready money to borrowers and high returns to investors like pension funds, insurance companies, hedge funds and other institutions. Now this enormous and important machine is sputtering, and the effects are reverberating throughout Main Street, Wall Street and Washington.

Already, more than two dozen mortgage lenders have failed or closed their doors, and shares of big companies in the mortgage industry have declined significantly. Delinquencies on loans made to less creditworthy borrowers — known as subprime mortgages — recently reached 12.6 percent. Some banks have reported rising problems among borrowers that were deemed more creditworthy as well.

Traders and investors who watch this world say the major participants — Wall Street firms, credit rating agencies, lenders and investors — are holding their collective breath and hoping that the spring season for home sales will reinstate what had been a go-go market for mortgage securities. Many Wall Street firms saw their own stock prices decline over their exposure to the turmoil.

"I guess we are a bit surprised at how fast this has unraveled," said Tom Zimmerman, head of asset-backed securities research at UBS, in a recent conference call with investors.

Even now the tone accentuates the positive. In a recent presentation to investors, UBS Securities discussed the potential for losses among some mortgage securities in a variety of housing markets. None of the models showed flat or falling home prices, however.

The Bear Stearns analyst who upgraded New Century, Scott R. Coren, wrote in a research note that the company's stock price reflected the risks in its industry, and that the downside risk was about $10 in a "rescue-sale scenario." According to New Century, Bear Stearns is among the firms with a "longstanding" relationship financing its mortgage operation. Mr. Coren, through a spokeswoman, declined to comment.

Others who follow the industry have voiced more caution. Thomas A. Lawler, founder of Lawler Economic and Housing Consulting, said: "It's not that the mortgage industry is collapsing, it's just that the mortgage industry went wild and there are consequences of going wild.

"I think there is no doubt that home sales are going to be weaker than most anybody who was forecasting the market just two months ago thought. For those areas where the housing market was already not too great, where inventories were at historically high levels and it finally looked like things were stabilizing, this is going to be unpleasant."

Like worms that surface after a torrential rain, revelations that emerge when an asset bubble bursts are often unattractive, involving dubious industry practices and even fraud. In the coming weeks, some mortgage market participants predict, investors will learn not only how lax real estate lending standards became, but also how hard to value these opaque securities are and how easy their values are to prop up.

Owners of mortgage securities that have been pooled, for example, do not have to reflect the prevailing market prices of those securities each day, as stockholders do. Only when a security is downgraded by a rating agency do investors have to mark their holdings to the market value. As a result, traders say, many investors are reporting the values of their holdings at inflated prices.

"How these things are valued for portfolio purposes is exposed to management judgment, which is potentially arbitrary," Mr. Rosner said.

At the heart of the turmoil is the subprime mortgage market, which developed to give loans to shaky borrowers or to those with little cash to put down as collateral. Some 35 percent of all mortgage securities issued last year were in that category, up from 13 percent in 2003.

Looking to expand their reach and their profits, lenders were far too willing to lend, as evidenced by the creation of new types of mortgages — known as "affordability products" — that required little or no down payment and little or no documentation of a borrower's income. Loans with 40-year or even 50-year terms were also popular among cash-strapped borrowers seeking low monthly payments. Exceedingly low "teaser" rates that move up rapidly in later years were another feature of the new loans.

The rapid rise in the amount borrowed against a property's value shows how willing lenders were to stretch. In 2000, according to Banc of America Securities, the average loan to a subprime lender was 48 percent of the value of the underlying property. By 2006, that figure reached 82 percent.

Mortgages requiring little or no documentation became known colloquially as "liar loans." An April 2006 report by the Mortgage Asset Research Institute, a consulting concern in Reston, Va., analyzed 100 loans in which the borrowers merely stated their incomes, and then looked at documents those borrowers had filed with the I.R.S. The resulting differences were significant: in 90 percent of loans, borrowers overstated their incomes 5 percent or more. But in almost 60 percent of cases, borrowers inflated their incomes by more than half.

A Deutsche Bank report said liar loans accounted for 40 percent of the subprime mortgage issuance last year, up from 25 percent in 2001.

Securities backed by home mortgages have been traded since the 1970s, but it has been only since 2002 or so that investors, including pension funds, insurance companies, hedge funds and other institutions, have shown such an appetite for them.

Wall Street, of course, was happy to help refashion mortgages from arcane and illiquid securities into ubiquitous and frequently traded ones. Its reward is that it now dominates the market. While commercial banks and savings banks had long been the biggest lenders to home buyers, by 2006, Wall Street had a commanding share — 60 percent — of the mortgage financing market, Federal Reserve data show.

The big firms in the business are Lehman Brothers, Bear Stearns, Merrill Lynch, Morgan Stanley, Deutsche Bank and UBS. They buy mortgages from issuers, put thousands of them into pools to spread out the risks and then divide them into slices, known as tranches, based on quality. Then they sell them.

The profits from packaging these securities and trading them for customers and their own accounts have been phenomenal. At Lehman Brothers, for example, mortgage-related businesses contributed directly to record revenue and income over the last three years.

The issuance of mortgage-related securities, which include those backed by home-equity loans, peaked in 2003 at more than $3 trillion, according to data from the Bond Market Association. Last year's issuance, reflecting a slowdown in home price appreciation, was $1.93 trillion, a slight decline from 2005.

In addition to enviable growth, the mortgage securities market has undergone other changes in recent years. In the 1990s, buyers of mortgage securities spread out their risk by combining those securities with loans backed by other assets, like credit card receivables and automobile loans. But in 2001, investor preferences changed, focusing on specific types of loans. Mortgages quickly became the favorite.

Another change in the market involves its trading characteristics. Years ago, mortgage-backed securities appealed to a buy-and-hold crowd, who kept the securities on their books until the loans were paid off. "You used to think of mortgages as slow moving," said Glenn T. Costello, managing director of structured finance residential mortgage at Fitch Ratings. "Now it has become much more of a trading market, with a mark-to-market bent."

The average daily trading volume of mortgage securities issued by government agencies like Fannie Mae and Freddie Mac, for example, exceeded $250 billion last year. That's up from about $60 billion in 2000.

Wall Street became so enamored of the profits in mortgages that it began to expand its reach, buying companies that make loans to consumers to supplement its packaging and sales operations. In August 2006, Morgan Stanley bought Saxon, a $6.5 billion subprime mortgage underwriter, for $706 million.

And last September, Merrill Lynch paid $1.3 billion to buy First Franklin Financial, a home lender in San Jose, Calif. At the time, Merrill said it expected First Franklin to add to its earnings in 2007. Now analysts expect Merrill to take a large loss on the purchase.

Indeed, on Feb. 28, as the first fiscal quarter ended for many big investment banks, Wall Street buzzed with speculation that the firms had slashed the value of their numerous mortgage holdings, recording significant losses.

As prevailing interest rates remained low over the last several years, the appetite for these securities only rose. In the ever-present search for high yields, buyers clamored for securities that contained subprime mortgages, which carry interest rates that are typically one to two percentage points higher than traditional loans. Mortgage securities participants say increasingly lax lending standards in these loans became almost an invitation to commit mortgage fraud. It is too early to tell how significant a role mortgage fraud played in the rocketing delinquency rates — 12.6 percent among subprime borrowers. Delinquency rates among all mortgages stood at 4.7 percent in the third quarter of 2006.

For years, investors cared little about risks in mortgage holdings. That is changing.

"I would not be surprised if between now and the end of the year at least 20 percent of BBB and BBB- bonds that are backed by subprime loans originated in 2006 will be downgraded," Mr. Lawler said.

Still, the rating agencies have yet to downgrade large numbers of mortgage securities to reflect the market turmoil. Standard & Poor's has put 2 percent of the subprime loans it rates on watch for a downgrade, and Moody's said it has downgraded 1 percent to 2 percent of such mortgages that were issued in 2005 and 2006.

Fitch appears to be the most proactive, having downgraded 3.7 percent of subprime mortgages in the period.

The agencies say that they are confident that their ratings reflect reality in the mortgages they have analyzed and that they have required managers of mortgage pools with risky loans in them to increase the collateral. A spokesman for S.& P. said the firm made its ratings requirements more stringent for subprime issuers last summer and that they shored up the loans as a result.

Meeting with Wall Street analysts last week, Terry McGraw, chief executive of McGraw-Hill, the parent of S.& P., said the firm does not believe that loans made in 2006 will perform "as badly as some have suggested."

Nevertheless, some investors wonder whether the rating agencies have the stomach to downgrade these securities because of the selling stampede that would follow. Many mortgage buyers cannot hold securities that are rated below investment grade — insurance companies are an example. So if the securities were downgraded, forced selling would ensue, further pressuring an already beleaguered market.

Another consideration is the profits in mortgage ratings. Some 6.5 percent of Moody's 2006 revenue was related to the subprime market.

Brian Clarkson, Moody's co-chief operating officer, denied that the company hesitates to cut ratings. "We made assumptions early on that we were going to have worse performance in subprime mortgages, which is the reason we haven't seen that many downgrades," he said. "If we have something that is investment grade that we need to take below investment grade, we will do it."

Interestingly, accounting conventions in mortgage securities require an investor to mark his holdings to market only when they get downgraded. So investors may be assigning higher values to their positions than they would receive if they had to go into the market and find a buyer. That delays the reckoning, some analysts say.

"There are delayed triggers in many of these investment vehicles and that is delaying the recognition of losses," Charles Peabody, founder of Portales Partners, an independent research boutique in New York, said. "I do think the unwind is just starting. The moment of truth is not yet here."

On March 2, reacting to the distress in the mortgage market, a throng of regulators, including the Federal Reserve Board, asked lenders to tighten their policies on lending to those with questionable credit. Late last week, WMC Mortgage, General Electric's subprime mortgage arm, said it would no longer make loans with no down payments.

Meanwhile, investors wait to see whether the spring home selling season will shore up the mortgage market. If home prices do not appreciate or if they fall, defaults will rise, and pension funds and others that embraced the mortgage securities market will have to record losses. And they will likely retreat from the market, analysts said, affecting consumers and the overall economy.

A paper published last month by Mr. Rosner and Joseph R. Mason, an associate professor of finance at Drexel University's LeBow College of Business, assessed the potential problems associated with disruptions in the mortgage securities market. They wrote: "Decreased funding for residential mortgage-backed securities could set off a downward spiral in credit availability that can deprive individuals of home ownership and substantially hurt the U.S. economy."

Correction: March 20, 2007

A chart with a front-page news analysis article on March 11 about a looming crisis in the mortgage market mislabeled the size of the market that trades mortgage-backed securities. It trades in hundreds of billions of dollars a day, not hundreds of millions.

THE WALL STREET JOURNAL.
WSJ.com

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Banks Go on Subprime Offensive

HSBC, Others Try to Force Struggling Smaller Players To Buy Back Their Loans

By CARRICK MOLLENKAMP, JAMES R. HAGERTY RANDALL SMITH

Amid mounting defaults in the market for subprime mortgages, some big banks and mortgage companies are striking out in their efforts to wrest compensation from originators of those high-risk, high-return loans.

Led by HSBC Holdings PLC, banks and others are trying to force small mortgage lenders to buy back some of the same loans the banks eagerly bought in 2005 and 2006, by enforcing what the industry calls repurchase agreements. Squeezed by the onslaught of defaults, many originators are saying they can't afford to buy back their loans or are pursuing bankruptcy protection.

Yesterday, New Century Financial Corp., one of the nation's biggest subprime-mortgage lenders, said its bank lenders were pulling their funding and that it didn't expect to meet the repayment demands of its creditors. The bank funding allowed New Century to finance loans while waiting to sell them to investors. Last week, under pressure from creditors, the company ceased making new loans.

Subprime mortgages are home loans made to borrowers with weak credit. Subprime-loan originations totaled about $605 billion last year, or about a fifth of the overall market for U.S. home loans, according to trade publication Inside Mortgage Finance.

New Century said yesterday that, starting last Wednesday, it had received a wave of default notices from its major Wall Street creditors, and may owe creditors a combined $8.4 billion for mortgage repurchases. It said if all its lenders demand repurchases, it can't afford to pay. That could force the company into bankruptcy proceedings, where it would join scores of others hurt by the industry meltdown.

A spokeswoman for the Irvine, Calif., company declined to comment on whether it was preparing a bankruptcy filing.

Audio Clips

On March 2, in federal bankruptcy court in Atlanta, American Freedom Mortgage President Tamara Burch held a meeting with a trustee as well as creditors, including HSBC Holdings PLC. American Freedom had filed for bankruptcy proceedings in January. HSBC has asked American Freedom to repurchase two loans that quickly soured.

HSBC attorney Suzanne Scheuing of Freeborn & Peters begins her questions of Ms. Burch during the meeting.

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The largest debt listed by New Century, owed to Morgan Stanley, was $2.5 billion. New Century said that after Citigroup Inc. demanded additional collateral of $80.3 million to cover a "margin deficit" on some of the company's debt last Tuesday, Goldman Sachs Group Inc. filed a default notice on Wednesday, seeking repayment of roughly $100 million. In a filing yesterday, New Century also listed outstanding debts of about $900 million to Credit Suisse Group Inc., $800 million to IXIS Real Estate Capital Inc. and $600 million to Bank of America Corp.

A person close to Morgan Stanley said the Wall Street firm believes its debt is "fully collateralized," meaning the value of the assets backing the debt equals or exceeds the debt's face value.

Ms. Scheuing asks Ms. Burch how American Freedom generated revenue.

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Morgan Stanley advanced New Century a fresh $265 million last week but notified the company on Friday it was "discontinuing financing."

On Thursday, the fresh financing from Morgan Stanley was used to help pay back $717 million that New Century owed Citigroup, the company said yesterday. The same day, default notices came in from Bank of America, Citigroup and IXIS.

Robert Napoli at Piper Jaffray said assuming a 20% loss rate on loans it is forced to buy back from its creditors, New Century "would have to absorb $1.6 billion of losses, essentially wiping out shareholders equity." As of Sept. 30, the company listed $25 billion in assets, about $23 billion in liabilities and $2 billion in shareholders' equity.

Although the specifics vary from deal to deal, repurchase agreements obligate the mortgage originator, under some circumstances, to buy back a troubled loan sold to a bank or investor. That obligation sometimes kicks in if the borrower fails to make payments on the loan within the first few months or if there was fraud involved in obtaining the original mortgage. The total volume of mortgages nationwide that might meet those criteria isn't known, but such agreements cover billions of dollars in mortgages.

HSB is dispatching lawyers to U.S. courts to try to collect from mortgage originators, fighting over often-small amounts in a myriad of cases. A few weeks ago, the British bank had a lawyer in Atlanta at the bankruptcy hearing of American Freedom, a mortgage seller that operated from an Atlanta suburb and advertised loans on its Web site called getfree.com. HSBC has demanded American Freedom buy back two loans totaling $255,000 because the borrowers didn't make initial payments.

More

At a Mortgage Lender, Rapid Rise, Faster Fall

Graphic: Who loses when subprime loans go bad

Outlook: Fallout May Not Infect Broader Market

The first meeting for American Freedom creditors was held March 2 in the federal bankruptcy building in downtown Atlanta. American Freedom President Tamara Burch's lawyer, and Ms. Burch herself, who barely spoke above a whisper, both said American Freedom faced a slew of repurchase requests.

An HSBC spokeswoman said the bank doesn't comment on pending litigation.

Such demands are helping speed up the sudden downturn in the subprime-mortgage business. Banks like HSBC bought mortgages from ever-smaller brokers and originators to increase their loan volume when the subprime mortgage industry was booming in 2005 and 2006.

HSBC's borrowers included people who couldn't make their first mortgage payments as well as people who misrepresented their income or employment on their mortgage applications, interviews and HSBC's court filings show.

When it is unable to claim its money or believes it will be unable to, HSBC must write off the loans. In 2006, the bank said the loan-impairment cost totaled $6.68 billion for its main U.S. consumer finance business. That was 34% higher than in 2005. The bank has said it may take two to three years to work through its problem loans.

HSBC's top finance chief acknowledges the difficulties in trying to enforce repurchase agreements. "It's proving quite difficult in the sense that many of the parties...don't have the wherewithal" to repurchase the loans, said HSBC Finance Director Douglas Flint.

In one case, HSBC sued a Michigan mortgage company, LFM Services Inc., to force it to buy back five loans HSBC purchased in 2005, according to court documents filed this month in federal court in Illinois. LFM has refused HSBC's repurchase request, the documents show.

Several loans went to what bank executives call "straw borrowers," people who obtain the loan for another home buyer. One borrower, who HSBC said lied about his income in loan documents, turned out to be a straw borrower for a man whose real-estate dealings are being investigated by the Federal Bureau of Investigation, according to court documents. The FBI didn't return telephone calls for comment.

LFM head David Piccinini said, in an interview, that he, too, was defrauded. He said he bought the loans from brokers who wrote the contracts with straw men. "I did not originate these loans. I am a collective victim along with HSBC of fraud that has been perpetrated on me," he said.

American Freedom, Marietta, Ga., made $10 million in revenue in 2005 by originating loans and taking a fee, before selling them on to investors such as HSBC and mortgage-finance company Countrywide Financial Corp. Both of those companies are demanding buybacks of at least some of those loans, court documents show. Countrywide couldn't be reached for comment.

Write to Carrick Mollenkamp at carrick.mollenkamp@wsj.com

SmartMoney Glossary: buy back, mortgage, bankruptcy, PLC,

The New York Times
nytimes.com

November 2, 2007

HIGH AND LOW FINANCE

Being Kept in the Dark on Wall Street

By FLOYD NORRIS

It's time for sunlight on Wall Street.

The securitization markets came to be critical for the financing of America — everything from corporate loans to credit cards — and were amazingly profitable for the investment banks over the last decade. Only the banks seemed to understand what was going on, and their profit margins were high.

That was fine with the customers, too. The products that were being sold, an alphabet soup that included, C.D.O., SIV, M.B.S. and so many more, had what seemed to be the great virtue of not having real market prices. They could be valued according to models, which made for nice, consistent profit reports.

No one seemed to be bothered by the lack of public information on just what was in some of these products. If Moody's, Standard & Poor's or Fitch said a weird security deserved an AAA, that was enough.

And then they blew up.

Now we are learning that the investment banks did not know what was going on either, and they ended up with huge pools of securities whose values are, at best, uncertain. As the losses are estimated, confidence has vanished.

"This is sort of like a confessional where the priest delivers a public opinion on the extent of your virtues or sins, and your spouse has to guess what a AAA or BBB means about your fidelity," David Einhorn, a hedge fund manager, said in a speech at Columbia.

"One clear improvement to the current structure of the debt markets would be to insist that all information shared with rating agencies be shared with the whole market," Mr. Einhorn said.

Rating agency downgrades do not destroy markets for corporate bonds, simply because enough information is disseminated that other analysts can reach their own conclusions. But the securitization markets collapsed when it became clear the rating agencies had been overly optimistic. When a security goes from AAA to junk within a few weeks, it does not inspire confidence in the rating process.

Every financial disaster deserves a scapegoat, because someone must be blamed when bad investments are made. Such scapegoats are seldom without fault, but their venality can easily be overstated. Equity analysts and corporate crooks took the blame after the technology bubble burst.

This time it could be the credit rating agencies. The Securities and Exchange Commission is now investigating them to see if their ratings complied with their own published standards.

It is hard to know which conclusion would be worse. If the agencies violated their own policies, they will be vilified for the conflicts of interest inherent in their being paid by the issuers of the securities. If they did not, they will be derided as fools who could not see how risky the securities clearly were. (In hindsight, of course.)

Mr. Einhorn thinks the S.E.C. should force the publication of information given to the rating agencies, by ending their exemption from Regulation FD, which generally bars selective disclosures by companies. But investors could accomplish the same thing just by refusing to buy securities unless adequate information was available to prospective purchasers.

The so-called M-LEC (Master Liquidity Enhancement Conduit), which was dreamed up by big banks with the encouragement of Henry Paulson, the Treasury secretary, has been criticized as an effort to hide real market prices. That could be turned around if the M-LEC simply said it would not buy any security where information given to the rating agencies had not been made public.

Wall Street would normally resist proposals for shining light on the weird products it produces. Profit margins in such markets are much higher, and the success of securitizations is one reason that an index of investment banking and brokerage stocks has outperformed the Standard & Poor's 500-stock index in every year since 1998. But that string is on its way to being broken this year.

For now, the panic has been restricted to the opaque securitization markets. The more transparent stock market has held its own since the crisis began, albeit with plenty of nervousness. Investors want to believe that the Federal Reserve can cure all problems by cutting the overnight bank lending rate.

But it is the collapse of the securitization market that made credit hard to obtain for many, and a change in the Fed funds rate will not offset that. The United States may consider itself to be the world's bastion of free enterprise, but it has become very difficult to get a home mortgage without some kind of government-backed guarantee.

The old securitization market died because it turned out that what an investor does not know can be devastating. A new one is unlikely to develop unless something is done to make it much easier for professional investors to evaluate the risks they are taking.

E-mail: norris@nytimes.com

The Economist

Securitisation

When it goes wrong...

A generation has prospered from the wholesale transfer of risk through securitisation. Now it is paying the price

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"THE medium-term outlook for the company is very positive," declared Northern Rock's chief executive, Adam Applegarth, unveiling its first-half results in July. He spoke of a credit book that was "robust". Who would have guessed that less than two months later Britain's fifth-largest mortgage lender would be fighting for its life, its branches besieged by customers demanding their savings back?

The run on Northern Rock is the most dramatic symptom of the contagion gripping the financial markets. Here was a bank that had grown rich from the innovations of recent years, using abundantly stocked wholesale markets to fund its lively growth, using those same markets to offload bits of its loan book as and when they became unattractive.

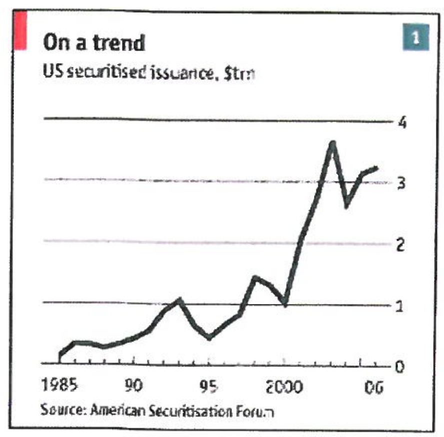
But the very innovations on which Northern Rock thrived have savaged its business. The company does no lending to speak of overseas. Nevertheless, its fate was determined by the distant turmoil in America's mortgage market. When that spilled over into the securities markets, the money markets that Northern Rock had depended on for years dried up in a single day at the start of August.

The brave new world that enabled banks like Northern Rock to grow so fast is founded on "securitisation"—the process that transforms mortgages, credit-card receivables and other financial assets into marketable securities—and the innovation it spawned in "structured" products. This was a revolution that brought huge gains. But across the financial world investors and regulators are asking themselves whether it also brought costs that are only now becoming clear.

Investigations begin

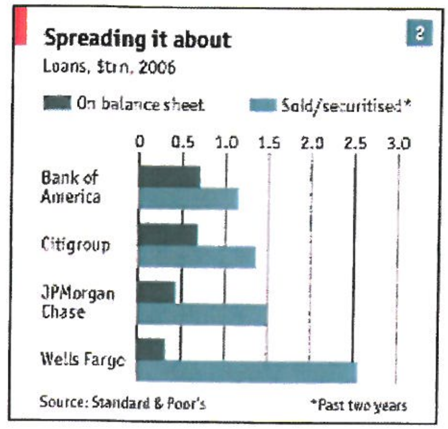
In America the President's Working Group on Financial Markets, which includes the Federal Reserve and the Treasury, has launched a probe into securitisation and the rating agencies, which monitor it. IOSCO, a global regulators' body, has begun an investigation of its own. And the two biggest securitisation clubs on either side of the Atlantic held an emergency summit this week to look for ways to coax investors back into moribund asset-backed markets.

It is hard to overstate the extent of this reversal in fortunes, if only because it is hard to overstate the effect that securitisation has had on financial markets. Until the early 1980s, finance hewed to an "originate and hold" model. Banks generally held loans on their balance sheets to maturity; some debts were sold on loan-by-loan, but this market was small and lumpy. This began to give way to an "originate and distribute" model after America's government-sponsored mortgage giants issued the first bonds with payments tied to the cash flows from large pools of loans.



Wall Street built on this innovation, and securitisation took off soon after, then paused before exploding in the 1990s (see chart 1). It was given a lift by America's savings-and-loan crisis, which encouraged mortgage lenders to jettison their riskier loans, and by new technologies, such as credit-scoring, that facilitated loan-pooling. Around 56% of America's outstanding residential mortgages were packaged in this way, including more than two-thirds of the subprime loans issued in 2006. Thanks largely to securitisation, global private-debt securities are now far bigger than stockmarkets.

Banks have come to see securitisation as an indispensable tool (see chart 2). Global lenders use it to manage their balance sheets, since selling loans frees up capital for new business or for return to shareholders. Small regional banks benefit too. Gone are the days when they had no choice but to place concentrated bets on local housing markets or industry. Now they can offload credits to far-away investors such as insurers and hedge funds, which have an appetite for them.



Michael Milken, of junk-bond fame, called securitisation the "democratisation of capital". Studies suggest that the explosion of this "secondary" market for bank debt has helped to push down borrowing costs for consumers and companies alike. There are other "systemic" gains, too. Subjecting bank loans to valuation by capital markets encourages the efficient use of capital. And the broad distribution of credit risk reduces the risk of any one holder going bust.

Even in the midst of turmoil, it is hard to find a banker, regulator or academic who wants to see the clock turned back. But the crisis has exposed cracks in the new model that were hidden or ignored during the credit bubble. The three most glaring are complexity and confusion, a fragmentation of responsibility and the gaming of the regulatory system. Take each in turn.

Too clever by 50 basis points

The past few weeks have shown that financiers did not fully understand what they were trading. The boom in derivatives was one of those moments when financial engineering raced ahead of back offices and risk-management departments, leaving them struggling to value or account for their holdings. Pierre Pourquery, of Boston Consulting Group, says it is not uncommon for investors to break their exotic purchases into smaller pieces in order to feed them into their risk-management systems. This brings new risks, particularly that the parts will behave differently from the whole under stress.

Steven Schwarcz, a professor at Duke University and writer on securitisation, has come across contracts which are so convoluted that it would be impractical for investors to try to understand them: they would have to spend more money hiring experts to deconstruct them than they could ever hope to earn in extra returns.

In a recent paper* on credit derivatives, David Skeel and Frank Partnoy concluded that collateralised debt obligations (CDOs), one of the most common derivatives, are too clever by half. The transaction costs are high, the benefits questionable. They conclude that CDOs are being used to transform existing debt instruments that are accurately priced into new ones that are overvalued.

Complexity confuses investors about the risks they are taking on. The more eclectic CDOs bind together the fate of assets that have few real economic links. Imagine a lowly rated energy bond and top-notch bank paper in the same structure. Separately, they would not normally move in tandem. Put them in a CDO, however, and in a credit squeeze they fall together, by virtue of being in the same murky structure, as investors rush for the exit or seek to hedge their risks.

The lack of transparency plagues the bundling of loans into securities, too. These days, for instance, lenders are less likely to foreclose on defaulting borrowers: in America, less than a quarter of loans 90 days late or more are in foreclosure, compared with three-quarters in the late 1990s, points out Charles Calomiris, of Columbia University. When a late payer gets back on track his loan is once again labelled "current", and his chequered history does not have to be fully disclosed when the loan goes into a securitised pool. So even the most diligent buyer would struggle to spot that some of the "prime" collateral of mortgage-backed bonds was, in fact, of questionable quality.

Investors seeking redress have encountered unforeseen problems. Securitisations are generally structured as "true sales": the seller wipes its hands of the risk. In practice buyers have some protection. Many contracts allow them to hand back loan pools that sour surprisingly quickly. Some have done just this with the most rancid subprime mortgages, requesting an injection of better-quality loans into the pool. But there were so many bad loans that originators could not oblige. "What we thought was an effective secondary-market punishment mechanism turns out to be faulty when the problem grows beyond a certain size," says Anthony Sanders, a subprime expert.

The second lesson of the past few weeks is that securitisation has warped financiers' incentives. It is sometimes portrayed as bank "disintermediation", but in fact it replaces one middleman with several. In mortgage securitisation, for instance, the lender is supplanted by the broker, the loan originator, the servicer (who collects payments), the investor and the arranger, not to mention the rating agencies and mortgage-bond insurers.

This creates what economists call a principal-agent problem. The loan originator has little incentive to vet borrowers carefully because it knows the risk will soon be off its books. The ultimate holder of the risk, the investor, has more reason to care but owns a complex product and is too far down the chain for monitoring to work. For all its flaws, the old bank model resolved the incentives in a simple way. Because loans were kept in-house, banks had every reason both to underwrite cautiously and also to keep tabs on the borrower after the money left the vault.

Investors in loan-backed securities could have pushed for tougher monitoring. But most were too taken with the alluring yields on offer—an addiction Alan Greenspan, the Fed's former chairman, has likened to cocaine abuse. Debt investors are usually sober types, but as the bubble grew, it was increasingly their urges, and not the creditworthiness of homeowners, that determined loan-underwriting standards.

Wall Street took full advantage of this appetite. It was well known that investors such as Germany's IKB, a lender to small companies which was bailed out last month, had a weakness for exotic products. The securities firms peddling mortgage-backed bonds did little to disabuse them of the notion that a CDO with a high rating must be as safe as houses—after all, the buyers were sophisticated institutions, not widows or orphans.

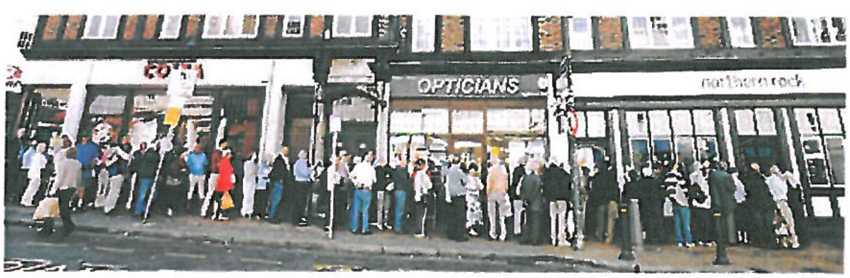
Moreover Wall Street has every reason to shovel securitised debt out as fast as it can. The loan-origination platform has high fixed costs, so it is a scale business. This can lead to trouble when there are not enough creditworthy new borrowers, as in subprime lending. Banks may be tempted to keep feeding the machine at the expense of laxer lending standards. "Once you get into it, it's a bit like heroin," says Joseph Mason, an academic who has written on securitisation. When AAA paper is repeatedly compared to Class A drugs, you know something is wrong.

Rating the raters

Complexity and warped incentives foster the third cost of securitisation: gaming the regulations. Politicians are scrutinising the role of rating agencies, as they did with auditors after the dotcom bubble burst. Regulatory dependence on ratings has grown across the board. Banks can reduce the amount of capital they have to set aside if they hold highly rated paper, for instance, and some investors, such as money-market funds, must stick to AAA-rated securities. But not all top-rated paper is the same.

The agencies appear to have been too free in giving out prized AAA badges to structured products, especially CDOs. This was partly because their models were faulty, failing to pick up correlations between different markets, and partly because of a conflict of interest: theirs is one of few businesses where the appraiser is paid by the seller, not the buyer.

This made it easier for the banks securitising and further repackaging debt to create the greatest possible number of securities with the lowest regulatory cost (that is, highest rating). Investors restricted to investment-grade paper assumed (or at least hoped) that the rating was a guarantee of strength. It might have helped if the agencies had properly monitored their ratings after issuing them. But with low fees per security there is little incentive to stay on the case.



From dodgy American mortgages to the British high street AFP

Avinash Persaud, of Intelligence Capital, a consultancy, argues that securitisation has let banks (as regulated "holders" of credit risk, with the capacity to keep it through bad times) pass it on to unregulated "traders" of risk with smaller balance sheets, such as hedge funds, which sell when trouble strikes. As a result, he says, although the risk of bank runs has fallen, the risk of market runs has increased.

In fact, some hedge funds are patient investors in illiquid assets. But Mr Persaud is right that risk changes, chameleon-like, depending on the holder. A bank with a plump capital cushion can use its balance sheet to hold on to out-of-favour credits until markets regain their balance. An investment fund that is several steps removed from the borrower, vulnerable to margin calls and constrained by daily risk models will have less room for manoeuvre. The rise of such investors has led, paradoxically, to more of a herd mentality because of "convergence in the way risk has been diversified", says Mr Schwarcz.

Fans of securitisation argue that it has made the system safer, because risk ends up with those who want to shoulder it. It is true that few banks have failed in recent years, in spite of the Asian crisis, the failure of Long-Term Capital Management, the dotcom bust and so forth. But this could have more to do with economic stability than securitisation.

Indeed, André Cappon, a consultant, warns of the "circularity of risk". The hedge funds that buy mortgage-linked debt also borrow heavily from the prime-brokerage arms of banks that originated many of the underlying loans. So a bank can push risk out of the front door, only to find it sneaking through the back.

Shine a light

What should banks and regulators do about all this? In the short run, the focus will be on transparency. Investors need to know who is holding what and how should it be valued. One idea is to force investment banks to reveal more about the performance and price of privately traded asset-backed instruments. Another is for the Securities and Exchange Commission, Wall Street's main regulator, to ensure consistent valuation of such assets across firms. More information on the vehicles that issue asset-backed commercial paper would also help.

There will also be calls for greater standardisation of structured products. This could undermine the "over the counter" (off-exchange) markets. Exchange groups like the Chicago Mercantile Exchange and Deutsche Börse have been trying to take business away from the banks, offering centrally cleared foreign-exchange trading and credit products. Regulators like these because they are more transparent than privately traded deals. The crisis could tip the balance in the exchanges' favour, says Benn Steil, a market-watcher at the Council on Foreign Relations.

If investors continue to shun the most complex products, Wall Street will have to offer simpler fare. Tom Zimmerman, head of asset-backed research at UBS, sees parallels between the CDO bust and the blow-up in collateralised mortgage obligations (CMOs) in the mid-1990s. CMOs, which pool prepayment risk, became so convoluted that investors could no longer see where the dangers lay. When they stopped buying, investment banks made the product more straightforward and it took off again.

As for the rating agencies, they have probably grown more powerful than anyone intended. Regulators will want to see their interests aligned more closely with investors, and to ensure that they are quicker and more thorough in reviewing past ratings. Moody's is thinking about adding new letter codes to cover liquidity and volatility risk for complex products.

Fixing the problem of fragmented responsibility will be a balancing act. Mr Sanders thinks subprime default rates would not have spiked if loan originators had been forced to set aside capital to cover, say, 10% of each securitised pool. But framing the terms of this sort of co-insurance would be tricky. Would 10% be enough? Or too much? Should a reputable bank have to pay as much as a small specialist-lender?

With investors, too, there is a risk of heavy-handedness. Calls for federal legislation on "assignee liability", which would hold secondary-market investors liable for loan losses, could do more harm than good. The soul-searching has led some analysts to speculate that mortgage lending could, for a time, go back to being a bank-led lend-and-hold market.

But do not expect a rush back to the ways of the 1960s. Securitisation has become far too important for that. Indeed, it has not yet fulfilled its promise. Wall Street eggheads may be licking their wounds at present, but they will soon be coming up with even more products. And, given time, there will no doubt be another wave of buying. More importantly, the transformation of sticky debt into something more tradable, for all its imperfections, has forged hugely beneficial links between individual borrowers and vast capital markets that were previously out of reach. As it comes under scrutiny, the debate should be about how this system can be improved, not dismantled.

* "The Promise and Perils of Credit Derivatives (http://lsr.nellco.org/cgi/viewcontent.cgi?article=1129&context=upenn/wps) ", by David Skeel and Frank Partnoy, University of Cincinnati Law Review, 2006

from the print edition | Briefing

The Economist

Fannie Mae and Freddie Mac

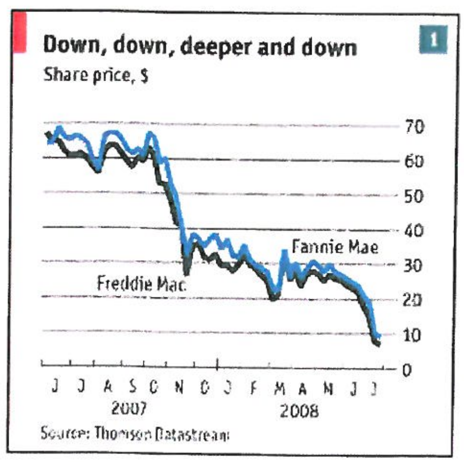
End of illusions

A series of articles on the crisis gripping the world economy and global markets starts where it all began—with America's deeply flawed system of housing finance

Jul 17th 2008 | from the print edition

THERE is a story about a science professor giving a public lecture on the solar system. An elderly lady interrupts to claim that, contrary to his assertions about gravity, the world travels through the universe on the back of a giant turtle. "But what supports the turtle?" retorts the professor. "You can't trick me," says the woman. "It's turtles all the way down."

The American financial system has started to look as logical as "turtles all the way down" this week. Only six months ago, politicians were counting on Fannie Mae and Freddie Mac, the country's mortgage giants, to bolster the housing market by buying more mortgages. Now the rescuers themselves have needed rescuing.



After a headlong plunge in the two firms' share prices (see chart 1), Hank Paulson, the treasury secretary, felt obliged to make an emergency announcement on July 13th. He will seek Congress's approval for extending the Treasury's credit lines to the pair and even buying their shares if necessary. Separately, the Federal Reserve said Fannie and Freddie could get financing at its discount window, a privilege previously available only to banks.

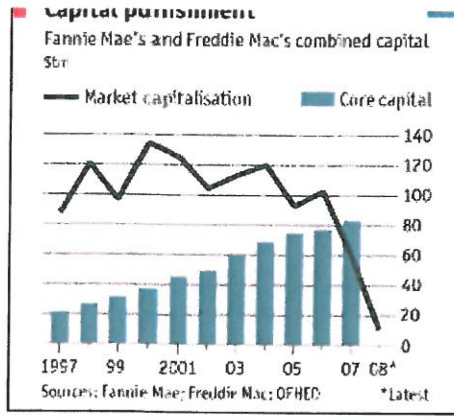
The absurdity of this situation was highlighted by the way the discount window works. The Fed does not just accept any old assets as collateral; it wants assets that are "safe". As well as Treasury bonds, it is willing to accept paper issued by "government-sponsored enterprises" (GSEs). But the two most prominent GSEs are Fannie Mae and Freddie Mac. In theory, therefore, the two companies could issue their own debt and exchange it for loans from the government—the equivalent of having access to the printing press.

Absurd or not, the rescue package notched up one immediate success. Freddie Mac was able to raise $3 billion in short-term finance on July 14th. But the deal did little to help the share price of either company or indeed of banks, where sentiment was dented by the collapse of IndyMac, a mortgage lender (see article). The next day Moody's, a rating agency, downgraded both the financial strength and the preferred stock of Fannie and Freddie, making a capital-raising exercise look even more difficult. As a sign of its concern, the Securities and Exchange Commission, America's leading financial regulator, weighed in with rules restricting the short-selling of shares in Fannie and Freddie.

The whole affair has raised questions about the giant twins. They were set up (see article) to provide liquidity for the housing market by buying mortgages from the banks. They repackaged these loans and used them as collateral for bonds called mortgage-backed securities; they guaranteed buyers of those securities against default.

This model was based on the ability of investors to see through one illusion and boosted by their willingness to believe in another. The illusion that investors saw through was the official line that debt issued by Fannie and Freddie was not backed by the government. No one believed this. Investors felt that the government would not let Fannie and Freddie fail; they have just been proved right.

The belief in the implicit government guarantee allowed the pair to borrow cheaply. This made their model work. They could earn more on the mortgages they bought than they paid to raise money in the markets. Had Fannie and Freddie been hedge funds, this strategy would have been known as a "carry trade".



It also allowed Fannie and Freddie to operate with tiny amounts of capital. The two groups had core capital (as defined by their regulator) of $83.2 billion at the end of 2007 (see chart 2); this supported around $5.2 trillion of debt and guarantees, a gearing ratio of 65 to one. According to CreditSights, a research group, Fannie and Freddie were counterparties in $2.3 trillion-worth of derivative transactions, related to their hedging activities.

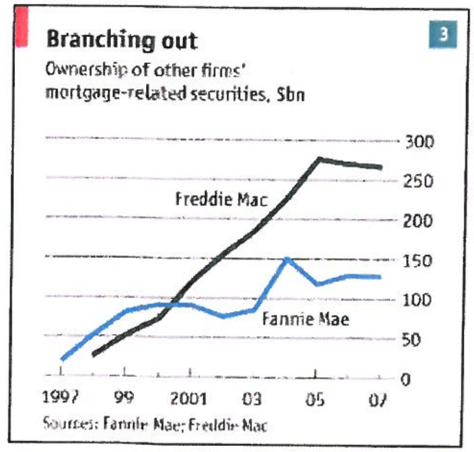
There is no way a private bank would be allowed to have such a highly geared balance sheet, nor would it qualify for the highest AAA credit rating. In a speech to Congress in 2004, Alan Greenspan, then the chairman of the Fed, said: "Without the expectation of government support in a crisis, such leverage would not be possible without a significantly higher cost of debt." The likelihood of "extraordinary support" from the government is cited by Standard & Poor's (S&P), a rating agency, in explaining its rating of the firms' debt.

The illusion investors fell for was the idea that American house prices would not fall across the country. This bolstered the twins' creditworthiness. Although the two organisations have suffered from regional busts in the past, house prices have not fallen nationally on an annual basis since Fannie was founded in 1938.

Investors have got quite a bit of protection against a housing bust because of the type of deals that Fannie and Freddie guaranteed. The duo focused on mortgages to borrowers with good credit scores and the wherewithal to put down a deposit. This was not subprime lending. Howard Shapiro, an analyst at Fox-Pitt, an investment bank, says the pair's average loan-to-value ratio at the end of 2007 was 68%; in other words, they could survive a 30% fall in house prices. So far, declared losses on their core portfolios have indeed been small by the standards of many others; in 2008, they are likely to be between 0.1% and 0.2% of assets, according to S&P.

Of course, this strategy only raises another question. Why does America need government-sponsored bodies to back the type of mortgages that were most likely to be repaid? It looks as if their core business is a solution to a non-existent problem.

However, Fannie and Freddie did not stick to their knitting. In the late 1990s they moved heavily into another area: buying mortgage-backed securities issued by others (see chart 3). Again, this was a version of the carry trade: they used their cheap financing to buy higher-yielding assets. In 1998 Freddie owned $25 billion of other securities, according to a report by its regulator, the Office of Federal Housing Enterprise Oversight (OFHEO); by the end of 2007 it had $267 billion. Fannie's outside portfolio grew from $18.5 billion in 1997 to $127.8 billion at the end of 2007. Although they tended to buy AAA-rated paper, that designation is not as reliable as it used to be, as the credit crunch has shown.



Sometimes the mortgage companies were buying each other's debt: turtles propping each other up. Although this boosted short-term profits, it did not seem to be part of the duo's original mission. As Mr Greenspan remarked, these purchases "do not appear needed to supply mortgage market liquidity or to enhance capital markets in the United States".

Joshua Rosner, an analyst at Graham Fisher, a research firm, who was one of the first to identify the problems in the mortgage market in early 2007, reckons Fannie and Freddie were buying 50% of all "private-label" mortgage-backed securities in some years—that is, those issued by conventional mortgage lenders. This left them exposed to the very subprime assets they were meant to avoid. Although that exposure was small compared with their portfolios, it could have a big impact because they have so little equity as a cushion.

Both companies make a distinction between losses on trading assets (which they take as a hit against profits) and on "available-for-sale" securities which they hold for the longer term and disregard, if they think the losses are temporary. At the end of 2007, according to

OFHEO, Fannie had pre-tax losses of this type of $4.8 billion; Freddie's amounted to $15 billion.

The companies have also been unwilling to accept the pain of market prices in acknowledging delinquent loans. When borrowers fail to keep up payments on mortgages in the pool that supports asset-backed loans, Fannie and Freddie must buy back the loan. But that requires an immediate write-off at a time when the market prices of asset-backed loans are depressed. Instead, the twins sometimes pay the interest into the pool to keep the loans afloat. In Mr Rosner's view, this merely pushes the losses into the future.

Adding to the complexity is the need for both Fannie and Freddie to insure their portfolios against interest-rate risk—in particular, the danger that borrowers may pay back their loans early, if interest rates fall, leaving the companies with money to reinvest at a lower rate. This risk caused the duo to take huge positions in the derivatives market, and was at the centre of an accounting scandal earlier this decade.

In addition, Fannie and Freddie have bought insurance against borrower defaults when the homebuyer lacks a 20% deposit. But the finances of the mortgage insurers do not look that healthy, which may mean the risk ends up back with the siblings. Just as the rescuers need rescuing, so the insurers may need insuring.

None of these practices seemed to dent the confidence of OFHEO in its charges. The regulator said as recently as July 10th that both Fannie and Freddie had enough capital. Indeed, their capital-adequacy requirement was reduced earlier this year so that they could make more of an effort to bolster the housing market.

Capital offence

By its own measure, OFHEO was right. At the end of the first quarter, the two companies exceeded their minimum capital requirements by $11 billion apiece, according to CreditSights. To fall to the "critical level", which would require OFHEO to take the agencies into "conservatorship" (a fancy word for nationalisation), CreditSights says Fannie would have to lose $16 billion of capital and Freddie $14 billion. And because neither Fannie nor Freddie has depositors, there is no danger of their suffering a run, as Northern Rock, a British bank, did last year.

So why the crisis? Given the gearing in the businesses, things only need to go slightly wrong for there to be a big problem. Freddie lost $3.5 billion in 2007; Fannie reported a $2.2 billion loss in the first quarter, having lost $2.05 billion last year. Each had credit-related write-downs of between $5 billion and $6 billion last year. On a fair-value basis, which assumes that all assets and liabilities are realised immediately, Freddie had negative net worth of $5.2 billion at the end of the first quarter.

Clearly, if the pair continue to lose money for much longer, their capital base will be eroded. And, of course, Congress wanted their businesses to expand—meaning that more, not less, capital would be needed. That would require shareholders to stump up more money. But investors tend to anticipate a big equity-raising by selling the shares, and a falling share price makes an equity issue less likely. The fall was sufficiently speedy in mid-July to prompt Mr Paulson to step in. The stockmarket had called the government's bluff.

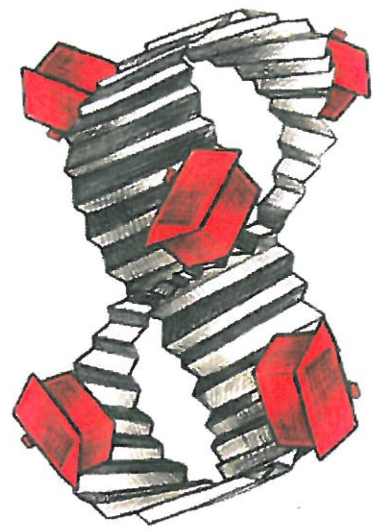


Illustration by Bob Venables

The rescue package may have reassured the creditors but it did not stop the share price of either Fannie or Freddie from falling. After all, the government is likely to extract a heavy penalty from shareholders in return for its support (creditors are another matter, especially as a lot of GSE paper is held by foreign central banks).

Nevertheless the hope is that, if confidence can be restored, Fannie and Freddie can survive without raising capital until market conditions improve. In the short term, as the success of the debt issue on July 14th showed, they should be able to go about their business.

The authorities are keen to avoid nationalisation, which would bring the whole of Fannie's and Freddie's debt onto the federal government's balance sheet. In terms of book-keeping this would almost double the public debt, but that is rather misleading. It would hardly be like issuing

$5.2 trillion of new Treasury bonds, because Fannie's and Freddie's debt is backed by real assets. Nevertheless, the fear that the taxpayer may have to absorb the GSEs' debt pushed Treasury bond yields higher. That suggests yet another irony; the debt of the GSEs has been trading as if it were guaranteed by the American government, but the debt of the government was not trading as if Uncle Sam had guaranteed that of the GSEs.

If Congress approves this package, the Fed will have more authority over the agencies. But that will give the central bank another headache. If an institution is struggling, the normal answer is to shrink its activities and wind it down slowly. But that is the last thing that the housing market needs right now.

With the credit crunch, Fannie and Freddie have become more important than ever, financing some 80% of mortgages in January. So they will need to keep lending. Nor is there scope to offload their portfolios of mortgage-backed securities, given that there are scarcely any buyers of such debt. And if the Fed has to worry about safeguarding Fannie and Freddie, can it afford to raise interest rates to combat inflation? American monetary policy may be constrained.

The GSEs are not the only liability for the government. IndyMac's recent collapse is the latest call on the Federal Deposit Insurance Corporation (FDIC). The FDIC has some $53 billion of assets, so it is better funded than most deposit-insurance schemes. But if enough banks got into trouble, the government would be on the hook for any shortfall. The same is true of the Pension Benefit Guaranty Corporation, which insures private sector benefits, but is already $14 billion in deficit.

In the end, the turtle at the bottom of the pile is the American taxpayer. But that suggests that, if Americans are losing money on their houses, pensions or bank accounts, the right answer is to tax them to pay for it. Perhaps it is no surprise that traders in the credit-default swaps market have recently made bets on the unthinkable: that America may default on its debt.

from the print edition | Finance and economics

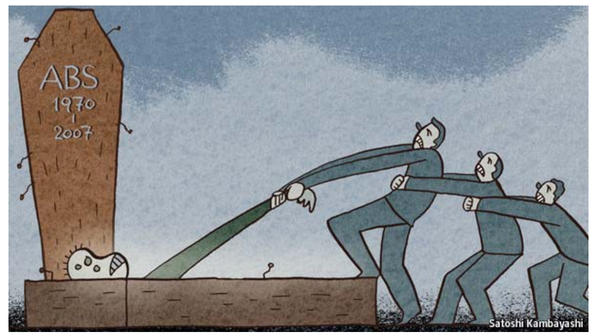
The Economist

The return of securitisation

Back from the dead

A much-maligned financial innovation is in the early stages of a comeback

Jan 11th 2014 | From the print edition



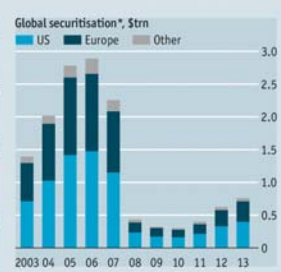
Satoshi Kambayashi

IF YOU asked regulators in 2008 which financial instrument they most wished had never been invented, odds were that they angrily splurted a three-letter acronym linked to securitisation. The practice of bundling up income streams such as credit-card and car-loan repayments, repackaging them as securities and selling them on in "tranches" with varying levels of risk once seemed like enlightened financial management. Not so after many a CDO, CLO, ABS, MBS and others (see table) turned out to be infested with worthless American subprime mortgages.

Find the same regulator today and he is probably devising a ploy to resuscitate the very financial vehicle he was bemoaning five years ago. Enthusiasm for the once-reviled practice of transforming a future income stream into a lump sum today—the essence of securitisation—is palpable. In Britain Andy Haldane, a cerebral official at the Bank of England, recently described it as "a financing vehicle for all seasons" that should no longer be thought of as a "bogeyman". The European Central Bank (ECB) is a fan, as are global banking regulators who last month watered down rules that threatened to stifle securitisation.

Old alphabet soup, new taste

ABS *(asset-backed security)*	Most generic form of securitisation, includes credit-card debt, car loans, or any packaged income stream. Making steady comeback
MBS *(mortgage-backed security)*	Backed either by commercial (CMBS) or residential (RMBS) mortgages. The most problematic in the downturn, fuelled subprime crisis
CDO *(collateralised debt obligation)*	Pre-crisis these were often invested in "tranches" of ABSs and MBSs or in other CDOs. Not popular with regulators
CLO *(collateralised loan obligation)*	Frequently filled with sliced and diced loans extended to poor-credit firms, such as those taken over by private-equity. Making a comeback



Sources: Dealogic; *The Economist*
*Excluding residential mortgages

Watchdogs will be pleased that, after once looking as if it was heading for extinction, securitisation is making a recovery. Issuance of ABSs (securities underpinned by car-loan receivables, credit-card debt and the like) are at double their 2010 nadir. Issuance of paper backed by non-residential mortgages is up from just $4 billion in 2009 to more than $100 billion last year. There have even been offerings of securities underpinned by more esoteric sources, such as cashflows from solar panels or home-rental income—the sort of gimmick once derided as a boomtime phenomenon. Excluding residential mortgages, where the American market is skewed by the participation of federal agencies, the amount of bundled-up securities globally is showing a steady rise (see chart).

The comeback of securitisation is related to the growth in economic activity: in order for car loans to be securitised, say, consumers have to be buying cars. Investors desperate for yield are also stimulating supply: securitised paper can offer decent returns, particularly at the riskier end of the spectrum. More important, though, is the regulators' enthusiasm.

Why are regulators so keen on the very product that nearly blew up the global economy just five years ago? In a nutshell, policymakers want to get more credit flowing to the economy, and are happy to rehabilitate once-suspect financial practices to get there. Some plausibly argue it was the stuff that was put into the vehicles (ie, dodgy mortgages) that was toxic, not securitisation itself. This revisionist strand of financial history emphasises that packaged bundles of debt which steered clear of American housing performed well, particularly in Europe.

The need to revive slicing and dicing is felt most acutely in Europe. Whereas in America capital markets are on hand to finance companies (through bonds), the old continent remains far more dependent on bank lending to fuel economic growth. Its banks need more capital, and absent that are the weak link in the nascent recovery because they fail to meet demand for credit from consumers and small businesses.

This is in large part because regulators want banks to be less risky, by increasing the ratio of equity to loans. As banks are reluctant to raise capital, they need to shed assets. This is where securitisation helps: by bundling up the loans on their books (which form part of their assets) and selling them to outside investors, such as asset managers or insurance firms, banks can both slim their balance-sheet and improve capital ratios.

Securitisation "airlifts assets off the balance-sheets of banks, freeing up capital, and drops them onto the balance-sheets of real-money investors," in Mr Haldane's words. That may not seem urgent now, as Europe's banks are flooded with cheap money from the ECB and have years before stricter capital ratios officially kick in. But at some point markets will have to take over financing banks. Such airlifts would neatly transform Europe's inflexible bank-led system into something more akin to America's.

Financial watchdogs are also keen on securitisation because they are confident that they can steer it along a different path from the one that ultimately wrought havoc in 2008. They believe that regulatory tweaks have made the practice safer.

One improvement is that those involved in creating securitised products will have to retain some of the risk linked to the original loan, thus keeping “skin in the game”. The idea is to nip in the bud any temptation to adopt the slapdash underwriting practices that became a feature of America’s mortgage market in the run-up to the financial crisis. Another tightening of the rules makes “re-securitisations”, where income from securitised products was itself securitised, more difficult to pull off. If regulators have their way, financial Frankenstein monsters such as the “CDO-squared”—a security underpinned by a security underpinned by a security underpinned by assets—are unlikely to make a comeback.

Perhaps the biggest change, however, is in investors’ attitudes. Before 2008, many fell for the sales pitch of the whizzes who hatched CDOs, ABSs and the like. Reassured by somnolent credit-rating agencies, which backed the bankers’ vision of handsome returns at virtually no risk, investors piled in with no due diligence to speak of. Aware of the reputational risks of messing up again, they now spend more time dissecting three-letter assets than just about anything else in their portfolio. Regulators will have to make sure that they retain this newfound discipline.

From the print edition: Finance and economics

NOTE

________________________, _______ ________________________, ____________
[Date] [City] [State]

____
[Property Address]

1. BORROWER'S PROMISE TO PAY

In return for a loan that I have received, I promise to pay U.S. $____________________ (this amount is called "Principal"), plus interest, to the order of the Lender. The Lender is ____. I will make all payments under this Note in the form of cash, check or money order.

I understand that the Lender may transfer this Note. The Lender or anyone who takes this Note by transfer and who is entitled to receive payments under this Note is called the "Note Holder."

2. INTEREST

Interest will be charged on unpaid principal until the full amount of Principal has been paid. I will pay interest at a yearly rate of _____________%.

The interest rate required by this Section 2 is the rate I will pay both before and after any default described in Section 6(B) of this Note.

3. PAYMENTS

(A) Time and Place of Payments

I will pay principal and interest by making a payment every month.

I will make my monthly payment on the ________ day of each month beginning on ___________________, _____. I will make these payments every month until I have paid all of the principal and interest and any other charges described below that I may owe under this Note. Each monthly payment will be applied as of its scheduled due date and will be applied to interest before Principal. If, on ______________________________, 20____, I still owe amounts under this Note, I will pay those amounts in full on that date, which is called the "Maturity Date."

I will make my monthly payments at ____ or at a different place if required by the Note Holder.

(B) Amount of Monthly Payments

My monthly payment will be in the amount of U.S. $______________________________.

4. BORROWER'S RIGHT TO PREPAY

I have the right to make payments of Principal at any time before they are due. A payment of Principal only is known as a "Prepayment." When I make a Prepayment, I will tell the Note Holder in writing that I am doing so. I may not designate a payment as a Prepayment if I have not made all the monthly payments due under the Note.

I may make a full Prepayment or partial Prepayments without paying a Prepayment charge. The Note Holder will use my Prepayments to reduce the amount of Principal that I owe under this Note. However, the Note Holder may apply my Prepayment to the accrued and unpaid interest on the Prepayment amount, before applying my Prepayment to reduce the Principal amount of the Note. If I make a partial Prepayment, there will be no changes in the due date or in the amount of my monthly payment unless the Note Holder agrees in writing to those changes.

5. LOAN CHARGES

If a law, which applies to this loan and which sets maximum loan charges, is finally interpreted so that the interest or other loan charges collected or to be collected in connection with this loan exceed the permitted limits, then: (a) any such loan charge shall be reduced by the amount necessary to reduce the charge to the permitted limit; and (b) any sums already collected from me which exceeded permitted limits will be refunded to me. The Note Holder may choose to make this refund by reducing the Principal I owe under this Note or by making a direct payment to me. If a refund reduces Principal, the reduction will be treated as a partial Prepayment.

6. BORROWER'S FAILURE TO PAY AS REQUIRED

(A) Late Charge for Overdue Payments

If the Note Holder has not received the full amount of any monthly payment by the end of ____________ calendar days after the date it is due, I will pay a late charge to the Note Holder. The amount of the charge will be _____% of my overdue payment of principal and interest. I will pay this late charge promptly but only once on each late payment.

(B) Default

If I do not pay the full amount of each monthly payment on the date it is due, I will be in default.

(C) Notice of Default

If I am in default, the Note Holder may send me a written notice telling me that if I do not pay the overdue amount by a certain date, the Note Holder may require me to pay immediately the full amount of Principal which has not been paid and all the interest that I owe on that amount. That date must be at least 30 days after the date on which the notice is mailed to me or delivered by other means.

(D) No Waiver By Note Holder

Even if, at a time when I am in default, the Note Holder does not require me to pay immediately in full as described above, the Note Holder will still have the right to do so if I am in default at a later time.

(E) Payment of Note Holder's Costs and Expenses

If the Note Holder has required me to pay immediately in full as described above, the Note Holder will have the right to be paid back by me for all of its costs and expenses in enforcing this Note to the extent not prohibited by applicable law. Those expenses include, for example, reasonable attorneys' fees.

7. GIVING OF NOTICES

Unless applicable law requires a different method, any notice that must be given to me under this Note will be given by delivering it or by mailing it by first class mail to me at the Property Address above or at a different address if I give the Note Holder a notice of my different address.

Any notice that must be given to the Note Holder under this Note will be given by delivering it or by mailing it by first class mail to the Note Holder at the address stated in Section 3(A) above or at a different address if I am given a notice of that different address.

8. OBLIGATIONS OF PERSONS UNDER THIS NOTE

If more than one person signs this Note, each person is fully and personally obligated to keep all of the promises made in this Note, including the promise to pay the full amount owed. Any person who is a guarantor, surety or endorser of this Note is also obligated to do these things. Any person who takes over these obligations, including the obligations of a guarantor, surety or endorser of this Note, is also obligated to keep all of the promises made in this Note. The Note Holder may enforce its rights under this Note against each person individually or against all of us together. This means that any one of us may be required to pay all of the amounts owed under this Note.

9. WAIVERS

I and any other person who has obligations under this Note waive the rights of Presentment and Notice of Dishonor. "Presentment" means the right to require the Note Holder to demand payment of amounts due. "Notice of Dishonor" means the right to require the Note Holder to give notice to other persons that amounts due have not been paid.

10. UNIFORM SECURED NOTE

This Note is a uniform instrument with limited variations in some jurisdictions. In addition to the protections given to the Note Holder under this Note, a Mortgage, Deed of Trust, or Security Deed (the "Security Instrument"), dated the same date as this Note, protects the Note Holder from possible losses which might result if I do not keep the promises which I make in this Note. That Security Instrument describes how and under what conditions I may be required to make immediate payment in full of all amounts I owe under this Note. Some of those conditions are described as follows:

> If all or any part of the Property or any Interest in the Property is sold or transferred (or if Borrower is not a natural person and a beneficial interest in Borrower is sold or transferred) without Lender's prior written consent, Lender may require immediate payment in full of all sums secured by this Security Instrument. However, this option shall not be exercised by Lender if such exercise is prohibited by Applicable Law.
>
> If Lender exercises this option, Lender shall give Borrower notice of acceleration. The notice shall provide a period of not less than 30 days from the date the notice is given in accordance with Section 15 within which Borrower must pay all sums secured by this Security Instrument. If Borrower fails to pay these sums prior to the expiration of this period, Lender may invoke any remedies permitted by this Security Instrument without further notice or demand on Borrower.

11. DOCUMENTARY TAX

The state documentary tax due on this Note has been paid on the mortgage securing this indebtedness.

WITNESS THE HAND(S) AND SEAL(S) OF THE UNDERSIGNED.

________________________________ (Seal)
- Borrower

________________________________ (Seal)
- Borrower

________________________________ (Seal)
- Borrower

Prepared by and Return to:
Preparer's Name
Preparer's Address
Preparer's City and State

Recording Information
Date
OR Book ____, Page ____

THIS IS A BALLOON MORTGAGE AND THE FINAL PAYMENT OR BALANCE DUE UPON MATURITY IS, TWO HUNDRED TWENTY ONE THOUSAND FOUR HUNDRED EIGHTY and 81/100 ($221,480.81) TOGETHER WITH ACCRUED INTEREST, IF ANY, AND ALL ADVANCEMENTS MADE BY THE MORTGAGEE UNDER THE TERMS OF THIS MORTGAGE.

MORTGAGE

THIS MORTGAGE DEED, made this __ day of January, 2008 , by **Borrower**, hereinafter called the "Mortgagor," in favor of **Lender**, hereinafter called the "Mortgagee," which terms, "Mortgagor" and "Mortgagee" shall include heirs, legal representatives, successors and assigns of said parties.

WITNESSETH:

IN CONSIDERATION of the aggregate sum named in the Mortgage Note hereinafter described, and other valuable considerations, receipt whereof is hereby acknowledged, Mortgagor hereby grants, bargains, sells, conveys and confirms unto Mortgagee, in fee simple, all those certain lands, situate, lying and being in the County of Leon, and State of Florida, described as follows:

> Commence at the Southwest corner of the Northwest Quarter of Section 1, Township 1 North, Range 1 East and run thence East 1690.0 feet, thence North 03 degrees 45 minutes West 422.0 feet to an iron pipe, thence North 86 degrees 15 minutes East 196.76 feet to a point on the northeasterly right-of-way boundary of State Road 123 for the POINT OF BEGINNING. From said POINT OF BEGINNING continue thence North 86 degrees 15 minutes East 210.14 feet to an iron pipe, thence South 02 degrees 48 minutes East 88.55 feet to an iron pipe, thence South 86 degrees 45 minutes West 168.20 feet to a point on the Northeasterly right-of-way boundary of said State Road No. 123, said point also being on a curve concave to the Southwesterly, thence Northwesterly along said curve 96.02 feet to the POINT OF BEGINNING.

TOGETHER with all buildings, structures and other improvements now or hereafter located on, above or below the surface of said land, or any part or parcel thereof; and

TOGETHER with all and singular the tenements, hereditaments, easements, and appurtenances thereunto belonging or in any wise appertaining, whether now owned or hereafter acquired by Mortgagor;

ALL the foregoing encumbered by this Mortgage being collectively referred to herein as the "Premises."

AND the Mortgagor covenants with Mortgagee that Mortgagor is indefeasibly seized of the Premises in fee simple and has full power and lawful right to convey the same as aforesaid and that it shall be lawful for Mortgagee at all time hereafter peaceably and quietly to enter upon, hold, occupy and enjoy the Premises; and that the Premises is free from all encumbrances; and Mortgagor will make such other and further assurances to perfect the fee simple title to the Premises in Mortgagee as may reasonably be required; and Mortgagor does hereby fully warrant the title to the Premises and will defend the same against the lawful claims of all persons whomsoever.

CONDITIONED, HOWEVER, that if the maker shall pay or cause to be paid to Mortgagee, its successors or assigns, with interest the principal sum of Two Hundred and Fifty Thousand and no/100 Dollars ($250,000.00), with final maturity, if not sooner paid, as stated in that certain Promissory Note, to Mortgagor of even date with this Mortgage, hereinafter referred to as the "Note," as well as all future advances and all other obligations for which this instrument is security, and if Mortgagor shall fully perform all the covenants, conditions and terms of this Mortgage, then these presents shall be void, otherwise to remain in full force and effect.

AND the said Mortgagor covenants with said Mortgagee as follows:

1. Payment of Indebtedness. Mortgagor shall pay all and singular the principal and interest and other sums of money payable according to the terms of the Note and this Mortgage.

2. Taxes and Assessments. Mortgagor shall pay, before they become delinquent, all taxes and assessments of every nature affecting the Premises, and all other charges and encumbrances which now or hereafter are a lien upon the Premises or any part thereof. Notwithstanding the foregoing, Mortgagor shall have the right to contest any tax or assessment made against the Premises provided that Mortgagor shall comply with the appropriate procedures for such contest established by law, ordinance or otherwise.

3. No Waste. Mortgagor will permit, commit or suffer no waste, impairment or deterioration of the Premises and will keep and maintain all improvements now or hereafter on the Premises in sound condition and good repair.

4. Insurance. Mortgagor shall keep the buildings and improvements now or hereafter on the Premises insured against loss by fire and other losses normally covered by an extended coverage endorsement. All policies of insurance which insure against any loss or damage to the Premises shall provide for loss payable to Mortgagee, without contribution by Mortgagee, pursuant to New York Standard or other mortgagee clause satisfactory to Mortgagee.

5. Right to Cure. In the case of any breach hereunder by Mortgagor, Mortgagee may, at its option, and after at least ten (10) days' notice to Mortgagor, expend any sums necessary to cure such default, and all sums so expended shall be secured hereby and shall bear interest at the rate of _% per annum.

6. Acceleration. The whole of the indebtedness hereby secured shall become due and payable, at the option of Mortgagee, after default in the performance of any covenant herein, which default remains uncured for thirty (30) days after (i) the due date, in the case of a default in payments under the Note, or (ii) notice of default, in the case of any other default, or upon institution of foreclosure proceedings of any other mortgage or lien affecting the Premises which is not dismissed within thirty (30) days thereafter, and this Mortgage may be foreclosed, and all costs and expenses of collection by foreclosure or otherwise, including attorney's fees, shall be paid by the Mortgagor and secured hereby.

7. Receiver. In the event suit is instituted to foreclose this Mortgage or to enforce payment of the Note, or the performance of any covenant or obligation hereunder, Mortgagee shall be entitled to the appointment of a Receiver to take charge of the Premises, to collect the rents, issues and profits therefrom, and to complete any construction and care for the Premises, and such appointment shall be made by the court having jurisdiction thereof as a matter of right to the Mortgagee and all rents, profits, incomes, issues and revenues of the Premises are hereby assigned and pledged as further security for payment of the indebtedness hereby secured with the right on the part of Mortgagee at any time after default hereunder, which default remains uncured upon the expiration of any applicable curative period, to demand and receive the same and apply the same on the indebtedness hereby secured.

8. Condemnation. In the event the Premises, or any part thereof, shall be condemned or taken

for public use under powers of eminent domain, the Mortgagee shall have the right to demand that all money awarded for the appropriation thereof, or damage to the Premises, shall be paid to Mortgagee up to the amount of the outstanding Indebtedness and may be applied upon the payment last payable under this Mortgage and the obligation secured hereby. Such condemnation or application shall not otherwise affect or vary the obligation of the Mortgagor to pay the Indebtedness.

9. Subordination. This Mortgage and all rights of Mortgagee hereunder shall be subject and subordinate to the lien of any and all institutional mortgages that may now or hereafter affect the Premises, or any part thereof, and to any and all renewals, modifications, or extensions of any such mortgages; provided, however, substantially all of the proceeds of any such institutional mortgages shall be utilized either in the construction and development of all or a portion of the Premises, or for the repayment of such construction and/or development loans; provided, further, that the aggregate principal amount of all mortgages to which this Mortgage is from time to time subordinated shall not exceed Five Hundred Thousand and no/100 Dollars ($500,000.00). As used herein, the term "institutional mortgage" shall mean and refer to any mortgage, held by any bank, savings and loan association, savings and loan stock company, insurance company, or licensed mortgage company, having a term of at least one (1) year and no more than thirty (30) years, and having an interest rate of at least nine percent (9%) annum. It is understood and agreed that the mortgage or mortgages to which this Mortgage shall be subordinated may encumber less than all of the Premises. In all events, this subordination provision shall be self-operative and shall continue in full force and effect without the necessity of any other agreement or writing signed by Mortgagee. Nonetheless, Mortgagee, his successors and assigns shall, on demand, from time to time, execute, acknowledge and deliver to Mortgagor, without expense to Mortgagor, any and all instruments that may be requested by any such institutional mortgagee or be necessary or proper to ratify the subordination of this Mortgage, along with all rights of the Mortgagee hereunder, to the lien of any such institutional mortgage or mortgages and each renewal, modification, or extension thereof, and if Mortgagee shall fail at any time to execute, acknowledge and deliver any such subordination instrument, Mortgagor, in addition to any other remedies available as a consequence thereof, may execute, acknowledge, and deliver the same as Mortgagee's attorney-in-fact and in Mortgagee's name. Mortgagee hereby irrevocably makes, constitutes and appoints Mortgagor, its successors and assigns, as Mortgagee's attorney-in-fact, coupled with an interest, for that purpose.

10. Second Mortgage. This mortgage is a Second Mortgage subject to that certain Mortgage from Mortgagor, to Bank recorded in O.R. Book , Page , of the Public Records of Leon County, Florida (the "First Mortgage"), and Mortgagor agrees to comply with the following:

(a) Any default under the terms of the First Mortgage shall constitute a default under the terms of this Mortgage, and the Mortgagee herein shall have all rights and privileges granted to it under the terms of this Mortgage in the event of such default.
(b) In no event shall the principal balance of the First Mortgage exceed $ 500,000.00, and Mortgagor shall not request or accept any future advances or any other increase of principal under the First Mortgage.

(c) There can be no reduction or omission of installment or other payments under the First Mortgage; all payments under the First Mortgage shall be applied toward payment of interest and principal secured by the First Mortgage.

(d) The Mortgagor shall, immediately upon receiving any knowledge of or notice of any default under the First Mortgage, give written notice thereof and shall give to the Mortgagee immediately upon receipt thereof, a true copy of each and every notice, summons or legal paper or other communication relating in any way to the First Mortgage or to the performance or enforcement thereof, or to any default thereunder.

(e) Mortgagee shall have the right to cure defaults or acceleration under the First Mortgage and to add any principal, interest, costs or expenses incurred in curing or satisfying the First Mortgage to the principal balance of this Mortgage.

(f) A cure of a default or acceleration under the First Mortgage, is not to be construed as a cure under the terms of this Mortgage.

11. Notice. Any notices permitted or required shall be deemed given when personally delivered or when mailed by certified mail, postage prepaid, return receipt requested, addressed as set forth below or as otherwise designated by written notice given in the same manner:

As to Mortgagor: Dewey, Cheatem, & Howe, P.A.

As to Mortgagee: Ewethink, Weare, Goode, P.A.

12. Joinder of Mortgagee. Mortgagee agrees, upon written request of Mortgagor and without expense to Mortgagor, to join in and execute any instruments necessary to grant easements for utilities serving the Premises, or any part thereof, or to establish a plat or plats affecting the Premises, or any part thereof, or to convert the Premises, or any part thereof, into condominium form of ownership for residential or commercial use.

13. Persons Bound. All covenants and stipulations in these presents contained shall bind the heirs, executors and administrators, successors and assigns of Mortgagor and Mortgagee, and shall inure to the benefit of and be available to the successors and assigns of Mortgagor and Mortgagee, as appropriate.

14. Usage. The use of any gender herein shall include all genders, and the word "Mortgagor," if it appears that there is more than one, shall, wherever herein used, be construed in the plural; and all the covenants, agreements and undertakings herein set forth shall be joint and several.

15. Severability. If any provision of this Mortgage shall, for any reason and to any extent, be invalid or unenforceable, neither the remainder of the instrument in which such provision is contained, nor the application of the provision to other persons, entities or circumstances, shall be affected thereby, but instead shall be enforceable to the maximum extent permitted by law.

16. Time of Essence. It is specifically agreed that time is of the essence of this contract.

17. Insolvency. Should a receiver be appointed for the Mortgagor or should Mortgagor become unable to pay its debts as they mature, then this Mortgage and the Note shall become immediately due and payable and Mortgagee shall have the right at its option to immediately foreclose this Mortgage without notice.

18. Compliance with Laws. Mortgagor warrants and represents that the Mortgagor has complied, and shall hereafter comply, with all valid laws, rules, ordinances and regulations of the Federal, state and local government, and all agencies and subdivisions thereof which laws, rules, ordinances and regulations apply or relate to the Premises.

19. Remedies Cumulative. In the event of default in payments due under the Note which remains uncured for thirty (30) days after the due date, or in the event of any other default hereunder which remains uncured for thirty (30) days after notice from Mortgagor to Mortgagees, Mortgagee shall have, in addition to the rights and remedies specified herein, all other rights and remedies provided by law or in the Note. The remedies of Mortgagee, as provided herein or in the Note, shall be cumulative and concurrent, and may be pursued singularly, successively or together, at the sole discretion of Mortgagee, and may be exercised as often as occasion therefor may arise. A waiver or release with reference to any one event shall not be construed as continuing, as a bar to, or as a waiver or release of any subsequent right, remedy or recourse as to a subsequent event.

20. Attorney's fees. As used in this Mortgage, attorney's fees shall include, but not be limited to, fees (which shall include fees of paralegals and others supervised by such attorneys) incurred in all matters of collection and enforcement, construction and interpretation, before, during and after suit, trial, proceedings and appeals, as well as appearances in and connected with foreclosure, bankruptcy

proceedings, or creditors' reorganization or arrangement proceedings. Mortgagor shall pay all attorney's fees incurred by Mortgagee in connection with the negotiation, review, or preparation of any documentation relating to any aspect of this Mortgage.

IN WITNESS WHEREOF, Mortgagor has duly signed, sealed and executed this Instrument in the presence of the subscribing witnesses the day and year first aforesaid.

THIS IS A BALLOON MORTGAGE AND THE FINAL PAYMENT OR BALANCE DUE UPON MATURITY IS, TWO HUNDRED TWENTY ONE THOUSAND FOUR HUNDRED EIGHTY and 81/100 ($221,480.81) TOGETHER WITH ACCRUED INTEREST, IF ANY, AND ALL ADVANCEMENTS MADE BY THE MORTGAGEE UNDER THE TERMS OF THIS MORTGAGE.

Signed, Sealed & Delivered in the Presence of:

____
Borrower A

____
Borrower B

STATE OF FLORIDA)

COUNTY OF LEON)

The foregoing Instrument was acknowledged before me this _________ day of January, 2008, by Borrower A and Borrower B who are either personally known to me or produced ______________ ______________________ as Identification.

____

N
otary Public
My Commission expires:

Signed______________________
Print/Type Name:

Signed______________________
Print/Type Name:

Florida Statute on Mortgage Substitutes and on Balloon Mortgages

697.05 Balloon mortgages; scope of law; definition; requirements as to contents; penalties for violations; exemptions.--

(1) Any conveyance, obligation conditioned or defeasible, bill of sale, or other instrument of writing conveying or selling real property for the purpose or with the intention of securing the payment of money, whether such instrument is from the debtor to the creditor or from the debtor to some third person in trust for the creditor, shall be deemed and held to be a mortgage and shall be subject to the provisions of this section.

(2)(a)1. Every mortgage in which the final payment or the principal balance due and payable upon maturity is greater than twice the amount of the regular monthly or periodic payment of the mortgage shall be deemed a balloon mortgage; and, except as provided in subparagraph 2., there shall be printed or clearly stamped on such mortgage a legend in substantially the following form:

THIS IS A BALLOON MORTGAGE AND THE FINAL PRINCIPAL PAYMENT OR THE PRINCIPAL BALANCE DUE UPON MATURITY IS $______, TOGETHER WITH ACCRUED INTEREST, IF ANY, AND ALL ADVANCEMENTS MADE BY THE MORTGAGEE UNDER THE TERMS OF THIS MORTGAGE.

2. In the case of any balloon mortgage securing the payment of an obligation the rate of interest on which is variable or is to be adjusted or renegotiated periodically, where the principal balance due on maturity cannot be calculated with any certainty:

a. The principal balance due upon maturity shall be calculated on the assumption that the initial rate of interest will apply for the entire term of the mortgage;

b. The legend shall disclose that the stated principal balance due upon maturity is an approximate amount based on such assumption; and

c. A legend in substantially the following form suffices to comply with the requirements of this section:

THIS IS A BALLOON MORTGAGE SECURING A VARIABLE (adjustable;

renegotiable) RATE OBLIGATION. ASSUMING THAT THE INITIAL RATE OF INTEREST WERE TO APPLY FOR THE ENTIRE TERM OF THE MORTGAGE, THE FINAL PRINCIPAL PAYMENT OR THE PRINCIPAL BALANCE DUE UPON MATURITY WOULD BE APPROXIMATELY $_____, TOGETHER WITH ACCRUED INTEREST, IF ANY, AND ALL ADVANCEMENTS MADE BY THE MORTGAGEE UNDER THE TERMS OF THIS MORTGAGE. THE ACTUAL BALANCE DUE UPON MATURITY MAY VARY DEPENDING ON CHANGES IN THE RATE OF INTEREST.

(b) This legend, including the principal balance due upon maturity, shall appear at the top of the first page or face sheet of the mortgage and also shall appear immediately above the place for signature of the mortgagor. The legend shall be conspicuously printed or stamped.

(3) Failure of a mortgagee or creditor or a third party in trust for a mortgagee or creditor to comply with the provisions of this section shall automatically extend the maturity date of such mortgage in the following manner: The mortgagor shall continue to make monthly or periodic payments until the principal and interest which has accrued prior to the time of the balloon payment of the mortgage is paid in full, and the maturity date shall be automatically extended to the date upon which said payments would cause the mortgage debt to be paid in full assuming such payments are made when due upon such monthly or periodic schedule. The mortgagor shall be entitled to prepay the mortgage without penalty during the extension period.

(4) This section does not apply to the following:

(a) Any mortgage in effect prior to January 1, 1960;

(b) Any first mortgage, excluding a mortgage in favor of a home improvement contractor defined in s. 520.61(13) the execution of which is required solely by the terms of a home improvement contract which is governed by the provisions of ss. 520.60-520.98;

(c) Any mortgage created for a term of 5 years or more, excluding a mortgage in favor of a home improvement contractor defined in s. 520.61(13) the execution of which is required solely by the terms of a home improvement contract which is governed by the provisions of ss. 520.60-520.98;

(d) Any mortgage, the periodic payments on which are to consist of interest payments only, with the entire original principal sum to be payable upon maturity;

(e) Any mortgage securing an extension of credit in excess of $500,000;

(f) Any mortgage granted in a transaction covered by the federal Truth in Lending Act, 15 U.S.C. ss. 1601 et seq., in which each mortgagor thereunder is furnished a Truth in Lending Disclosure Statement that satisfies the requirements of the federal Truth in Lending Act; or

(g) Any mortgage granted by a purchaser to a seller pursuant to a written agreement to buy and sell real property which provides that the final payment of said mortgage debt will exceed the periodic payments thereon.

History.--ss. 1, 2, 3, 4, 5, ch. 59-356; s. 1, ch. 61-472; ss. 12, 13, ch. 83-267; ss. 11, 12, ch. 83-311; s. 1, ch. 86-39; s. 69, ch. 99-3; s. 22, ch. 99-164; s. 1879, ch. 2003-261.

Junction Bit & Tool Company v. Village Apartments, Inc., 262 So. 2d 659 (Fla. 1972)

Supreme Court of Florida.
JUNCTION BIT & TOOL COMPANY, a Colorado corporation, Petitioner,
v.
VILLAGE APARTMENTS, INC., a Florida corporation, Respondent.
No. 41439.

May 3, 1972.

CARLTON, Justice:

Certiorari was granted in this cause on account of conflict between the decision rendered below by the District Court of Appeal, Fourth District, reported at 250 So.2d 349 (1971), and language employed by this Court in State ex rel. Teague v. Harrison, 138 Fla. 874, 190 So. 483 (1939).

In Teague, we said that an election to sue on a note at law acted as a bar to any subsequent suit for foreclosure of a mortgage standing as security for the note. In the instant case, the District Court determined on authority of its previous decision in Klondike, Inc. v. Blair, 211 So.2d 41 (4th D.C.A.Fla.1968), that Village could bring a foreclosure action on a certain mortgage, even though it had already obtained judgment on a note secured by the mortgage.

In Klondike, the District Court discussed Teague, and decided that it should not apply in an instance where a judgment proved to be worthless because the execution was returned unsatisfied. The District Court pointed out that the issue of an election of remedies was transparent and of no consequence when no real remedy resulted. We find that other District Courts are in agreement with Klondike: see Lisbon Holding & Inv. Co. v. Village Apartments, Inc., 237 So.2d 197 (3rd D.C.A.Fla.1970); Floorcraft Distributors, Inc. v. Horne-Wilson, Inc., 251 So.2d 138 (1st D.C.A.Fla.1971).

Having reexamined our position advanced in Teague, we now find ourselves in agreement with the District Court below that an unsatisfied judgment does not constitute a remedy, and does not bar a foreclosure action. It has been urged by petitioner that Fla.Stat. s 702.06, F.S.A., relating to deficiency suits arising out of foreclosures, suggests a contrary result, but this statute appears to have no application to a suit on a note brought independently of any attempt at foreclosure.

To the extent indicated above, State ex rel. Teague v. Harrison, Supra, is specifically receded from; certiorari having been granted, and the decision of the District Court of Appeal, Fourth District, appearing to be without error, the writ heretofore issued is discharged.

It is so ordered.

ERVIN, Acting C. J., BOYD and DEKLE, JJ., and DREW, J. (Retired), concur.
Fla. 1972.
Junction Bit & Tool Co. v. Village Apartments, Inc.
262 So.2d 659

END OF DOCUMENT

Fla.Stat. §697.07 (Assignment of Rents)

697.07 Assignment of rents.–

(1) A mortgage or separate instrument may provide for an assignment of rents of real property or any interest therein as security for repayment of an indebtedness.

(2) If such an assignment is made, the mortgagee shall hold a lien on the rents, and the lien created by the assignment shall be perfected and effective against third parties upon recordation of the mortgage or separate instrument in the public records of the county in which the real property is located, according to law.

(3) Unless otherwise agreed to in writing by the mortgagee and mortgagor, the assignment of rents shall be enforceable upon the mortgagor's default and written demand for the rents made by the mortgagee to the mortgagor, whereupon the mortgagor shall turn over all rents in the possession or control of the mortgagor at the time of the written demand or collected thereafter (the "collected rents") to the mortgagee less payment of any expenses authorized by the mortgagee in writing.

(4) Upon application by the mortgagee or mortgagor, in a foreclosure action, and notwithstanding any asserted defenses or counterclaims of the mortgagor, a court of competent jurisdiction, pending final adjudication of any action, may require the mortgagor to deposit the collected rents into the registry of the court, or in such other depository as the court may designate. However, the court may authorize the use of the collected rents, before deposit into the registry of the court or other depository, to:

(a) Pay the reasonable expenses solely to protect, preserve, and operate the real property, including, without limitation, real estate taxes and insurance;

(b) Escrow sums required by the mortgagee or separate assignment of rents instrument; and

(c) Make payments to the mortgagee.

The court shall require the mortgagor to account to the court and the mortgagee for the receipt and use of the collected rents and may also impose other conditions on the mortgagor's use of the collected rents.

(5) Nothing herein shall preclude the court from granting any other appropriate relief regarding the collected rents pending final adjudication of the action. The undisbursed collected rents remaining in the possession of the mortgagor or in the registry of the court, or in such other depository as ordered by the court, shall be disbursed at the conclusion of the action in accordance with the court's final judgment or decree.

(6) The court shall expedite the hearing on the application by the mortgagee or mortgagor to enforce the assignment of rents. The procedures authorized by this statute are in addition to any other rights or remedies of the mortgagee or mortgagor under the mortgage, separate assignment of rents instrument, promissory note, at law, or in equity.

(7) Nothing herein shall alter the lien priorities, rights, or interests among mortgagees or other lienholders or alter the rights of the mortgagee under the mortgage, separate assignment of rents instrument, at law or in equity, concerning rents collected before the written demand by the mortgagee. A mortgagee's enforcement of its assignment of rents under this statute shall not operate to transfer title to any rents not received by the mortgagee.

(8) Any moneys received by the mortgagee pursuant to this statute shall be applied by the mortgagee in accordance with the mortgage, separate assignment of rents instrument, or promissory note, and the mortgagee shall account to the mortgagor for such application.

History.--s. 1, ch. 87-217; s. 1, ch. 93-88; s. 13, ch. 93-250; s. 12, ch. 97-93; s. 1, ch. 2001-215.

This instrument was prepared by
and should be returned to:

SUBORDINATION, NON-DISTURBANCE AND ATTORNMENT AGREEMENT

This Subordination, Non-Disturbance and Attornment Agreement (this "Agreement") is made, executed, and delivered this ________ day of ________, 20__, by ____________________________, whose mailing address is __________________________ ("Tenant") and _________________, whose mailing address is __________________ ("Landlord"), to ________________, whose mailing address is ___________________ ("Lender").

Background Information:

1. Lender has made a loan to Landlord in the total principal amount of $________ (the "Loan") which Loan is secured, in part, by that certain Commercial Real Estate Mortgage given by Landlord dated ___________, 20__ and recorded in Official Records Book _____, Page ___ of the Public Records of _____ County, Florida (the "Mortgage") upon the real property described on the attached **Exhibit "A"** (the "Property").

2. On ___________, Landlord and Tenant entered into a Commercial Lease Agreement (the "Lease") with respect to certain premises totaling approximately _______ gross square feet of leasable space in____________ commonly known as ___________, Florida, and located on the Property, as more particularly identified in the Lease Agreement (the "Premises").

3. Tenant and Lender desire to confirm their understanding with respect to the Lease and the Mortgage.

Terms and Conditions:

NOW THEREFORE, in consideration of the mutual covenants contained herein, and for other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the parties agree and covenant as follows:

1. Background Information. The above Background Information is correct and is incorporated into the terms and conditions of this Agreement.

2. Representations and Warranties. Tenant and Landlord represent and warrant as follows:

   a. The Lease is in full force and effect.

   b. Tenant and Landlord have fully complied with the terms and conditions of the Lease.

   c. Neither Tenant nor Landlord is in default under the Lease, nor are there any events or conditions which, by the passage of time or giving of notice or both would constitute a default thereunder by Tenant or Landlord.

d. Notwithstanding anything to the contrary in the Lease, the Lease shall not be modified in any way without the written consent of Lender.

e. Tenant is unaware of any dispute, action, suit, condemnation proceeding, claim or right of setoff pending or threatened with respect to the Lease or the Premises.

f. There are no liens, encumbrances, mortgages, claims, boundary line or other disputes, demands or security interests in, on or against the Premises or any goods, furnishings, appliances, fixtures or equipment now installed in or affixed to the Premises except for such interests held by Lender.

g. Tenant and Landlord have the authority to enter into this Agreement and fully understand and acknowledge that Lender is relying on this Agreement, including all terms and conditions thereof, in making the Loan.

3. Subordination. Tenant hereby subordinates all of its right, title and interest in the Premises, including all improvements thereto and personal property located thereon, to Lender. The Lease, including any future amendments thereto, is hereby made subject to and subordinate to the Mortgage including all terms and conditions thereof, and all other instruments securing the Loan and shall also be subject to and subordinate to all renewals, modifications, consolidations, replacements and extensions of the Mortgage and all other instruments securing and evidencing the Loan to the full extent of the secured indebtedness. The Lease, including any future amendments thereto, shall also be subject to and subordinate to any future advances made under the Mortgage.

4. Lender's Option to Cure Landlord's Default. Tenant agrees that it will notify Lender if Landlord is in default under the Lease and will give Lender thirty (30) days after receipt of such notice in which to cure the default before Tenant invokes any of its remedies under the Lease. Lender shall have the right, but not the obligation to cure any default in Lender's sole discretion. If the nature of the default is such that more than thirty (30) days are reasonably required for its cure, then Lender shall be entitled to such additional time as is needed to cure the default provided Lender diligently prosecutes such cure to completion.

5. Non-Disturbance. Lender agrees that, so long as Tenant is not in default under the Lease or except as required by state law to effectuate Lender's rights under the Mortgage, Tenant shall not be named as a party defendant in any action for foreclosure or other enforcement of the Mortgage, nor shall the Lease be terminated in connection with the foreclosure or other proceedings for the enforcement of the Mortgage, or by reason of a transfer of the Landlord's interest under the Lease by assignment (or similar device) in lieu of foreclosure, nor shall Tenant's use or possession of the Premises be interfered with, and the rights of Tenant under the Lease shall remain in full force and effect, and Lender shall be bound to Tenant under all of the provisions of the Lease. Nothing contained herein shall be construed so as to make Lender liable for any breach or liability arising prior to the foreclosure or other proceeding for the enforcement of the Mortgage.

6. Continuation of Lease and Attornment. In the event of a foreclosure of the Mortgage or upon a sale or transfer of the Premises by deed in lieu of foreclosure, then provided Tenant is not in default under any of the terms, covenants or conditions of the Lease beyond any applicable cure period, the Lease shall continue in full force and effect as a direct lease and agreement between Lender or any such successor of Lender or Landlord and Tenant. Tenant agrees to (i) attorn to and accept Lender or any such successor of Lender or Landlord, as a result of foreclosure or deed in lieu thereof, as the landlord under the Lease and (ii) be bound by and perform all of the obligations imposed upon the Tenant under the Lease.

7. Governing Law. This Agreement shall be governed by and construed in accordance with the laws of the State of Florida. Venue for any and all litigation involving this Agreement shall be in Leon County, Florida.

8. Successors. All of the terms, covenants and conditions of this Agreement shall be binding upon and inure to the benefit of the respective successors and assigns of the parties hereto, including the future owners of the Property.

9. Attorneys' Fees. In the event of litigation involving this Agreement, the prevailing party shall be entitled to payment by the non-prevailing party of the court costs and reasonable attorneys' fees incurred by the prevailing party in connection with such litigation, including such litigation at the trial and appellate levels.

10. Notice. Any notice, demand, consent, authorization, request, approval or other communication that any party is required, or may desire, to give to or make upon the other party pursuant to this Agreement shall be effective and valid only if in writing, signed by the party giving notice or its attorney and delivered personally to the other parties or sent by express 24-hour guaranteed courier or delivery service or by facsimile transmission or by certified mail of the United States Postal Service, postage prepaid and return receipt requested, addressed to the other party at the address set forth in the introductory paragraph of this Agreement or to such other address as any other party may give to the other in writing for such purpose. All such communications, if personally delivered, shall be conclusively deemed to have been received by a party hereto and to be effective when so delivered, or if sent by facsimile transmission, on the day of which it is transmitted, or if sent by overnight courier service, on the day after deposit thereof with such service, or if sent certified mail, on the third business day after the day on which it was deposited in the mail.

11. Miscellaneous. The agreements contained herein shall continue in force until all of Landlord's obligations to Lender are paid and satisfied in full and all financing arrangements between the Lender and Landlord have been terminated. This Agreement may only be modified by an instrument in writing signed by all parties to this Agreement. This Agreement may be executed by the parties hereto in several counterparts and each such counterpart shall be deemed to be an original, but all such counterparts together shall constitute one and the same agreement.

IN WITNESS WHEREOF, the parties have executed this Agreement as of the day first above written.

WITNESSES:	**TENANT:**
	____________________________
______________________________	
Print Name: ____________________	By: _________________________________
	Print Name: __________________________
______________________________	Its: __________________________________
Print Name: ____________________	

[TENANT NOTARY BLOCK ON SEPARATE PAGE]

WITNESSES:

LANDLORD:

____

____

Print Name: ____________________

____

Print Name: ____________________

By: ___________________________

Print Name: ____________________

Its: ___________________________

STATE OF __________

COUNTY OF _______

The foregoing instrument was acknowledged before me this ____ day of _________, 20__, by _______________, as the Manager of ___________________, on behalf of the company. He or She is (__) personally known to me or has (__) produced ___________________________ as identification.

____

NOTARY PUBLIC

Print Name: ___________________

My Commission Expires:

WITNESSES:	**LENDER:**
	____________________________
______________________________	
Print Name: ____________________	By: __________________________________
	Print Name: ___________________________
______________________________	Its: __________________________________
Print Name: ____________________	

STATE OF ______________
COUNTY OF ____________

The foregoing instrument was acknowledged before me this ____ day of _______, 20__, by __________________________________ as __________________________________ of __________________________, on behalf of the association. He or she is (__) personally known to me or has (__) produced __________________________ as identification.

____
NOTARY PUBLIC
Print Name: ____________________
My Commission Expires:

Memorandum

To: Real Estate Finance Students
From: Don Weidner
Re: Long-term "Lenders" as Notepurchasers
Dated: April 9, 2006

I. Holder in Due Course Status

One basic question is why a permanent lender might want to participate in a transaction as a special type of notepurchaser known as a holder in due course. White & Summers states: "By tradition, the defenses that a holder in due course generally takes free of are called 'personal defenses' and include: Failure or lack of consideration, breach of warranty, unconscionability and garden variety fraud (fraud in the inducement)." A holder in dues course does not take free of the so-called "real defenses" described in 3-305.

II. § 3-305 Defenses and Claims in Recoupment

A holder in due course is only subject to the following "real" defenses:

"(1) a defense of the obligor based on

(i) infancy of the obligor to the extent it is a defense to a simple contract,

(ii) duress, lack of legal capacity, or illegality of the transaction which, under other law, nullifies the obligation of the obligor,

(iii) fraud that induced the obligor to sign the instrument with neither knowledge nor reasonable opportunity to learn of its character or its essential terms, or

(iv) discharge of the obligor in insolvency proceedings;"

A holder in due course is not subject to "personal defenses" (such as breach of warranty).

III. § 3-302 Who is a Holder in Due Course

"(a) [With very limited qualification], 'holder in due course' means the holder of an instrument if:

(1) the instrument when issued or negotiated to the holder does not bear such apparent evidence of forgery or alteration or is not otherwise so irregular or incomplete as to call into question its authenticity; and

(2) the holder took the instrument

(i) for value,

(ii) in good faith,

(iii) without notice that the instrument is overdue or has been dishonored . . . ,

(iv) without notice that the instrument contains an unauthorized signature or has been altered,

(v) without notice of any claim to the instrument . . . , and

(vi) without notice that any party has a defense or claim in recoupment . . . ."

Note that § 3-104 (b) provides: "Instrument means a negotiable instrument."

IV. § 3-104 When Instrument is Negotiable

"(a) [With minor exceptions], 'negotiable instrument' means an unconditional promise or order to pay a fixed amount* of money, with or without interest or other charges described in the promise or order, if it:

(1) is payable to bearer or to order at the time it is issued or first comes into possession of a holder;

(2) is payable on demand or at a definite time; and

(3) does not state any other undertaking or instruction by the person promising or ordering payment to do any act in addition to the payment of money,

but the promise or order may contain (i) an undertaking or power to give, maintain, or protect collateral to secure payment, (ii) an authorization or power to the holder to confess judgment or realize on or dispose of collateral, or (iii) a waiver of the benefit of any law intended for the advantage or protection of an obligor.

Earlier language requiring a "sum certain" was removed. New Section 3-112(b) was added.

V. New Section 3-112(b)

Section 3-112(b) now provides:

> "(b) Interest may be stated in an instrument as a fixed or variable amount of money or it may be expressed as a fixed or variable rate or rates. The amount or rate of interest may be stated or described in the instrument in any manner and may require reference to information not contained in the instrument."

This language was added in 1990 to dispel any doubts about the negotiability of variable interest rate notes.

VI. § 3-106 When Promise or Order Unconditional

"(a) [With minor exception], for the purposes of Section 3-104(a), a promise or order is unconditional unless it states (i) an express condition to payment, (ii) that the promise or order is subject to or governed by another record, or (iii) that rights or obligations with respect to the promise or order are stated in another record. A reference to another record does not of itself make the promise or order conditional.

(b) A promise or order is not made conditional (i) by a reference to another record for a statement of rights with respect to collateral, prepayment, or acceleration, or (ii) because payment is limited to resort to a particular fund or source."

VII. Final Note on "Unconditional" Promises

What result in the 1975 Florida case in which a note stated it was "secured by a mortgage on real estate . . . The terms of said mortgage are by this reference made a part hereof?" See Holly Hill Acres, LTD. V. Charter Bank of Gainsville, 314 So. 2d 209 (Fl.App. 1975).

Introduction to Tax Shelter

The following introduction is excerpted from Weidner, *Realty Shelters: Nonrecourse Financing, Tax Reform, and Profit Purpose,* 32 SOUTHWESTERN LAW JOURNAL 711 (1978).

I. INTRODUCTION TO TAX SHELTER

The term "tax shelter" is usually used in one of two ways. One definition of a tax shelter is an investment through which an individual pays tax on a smaller amount than the amount of cash actually received. In this sense, a municipal bond is considered a tax shelter because no tax need be paid on its interest income. In an investment in depreciable real estate, a tax shelter in this broad sense exists in any year in which the depreciation deduction exceeds the amount of cash that is used to retire the principal on outstanding indebtedness. Stated differently, taxable income will be less than the net amount of cash generated by a real estate investment whenever the deduction for the noncash expense of depreciation exceeds the amount of money applied to repay principal on indebtedness, a cash expense for which there is no corresponding deduction. The essential point is that there is a gap between deductions that are available without current cash expenditures and actual cash expenditures that are not deductible.[1] For example, no matter what the other income and expense items in connection with a property, if depreciation is $100 and debt amortization is $80, taxable income will be $20 less than the net cash produced. If there is an overall cash loss, the tax loss will be $20 greater than the cash loss.

Investment advisors who specialize in real estate, however, are likely to respond that their clients who seek "tax shelter" are using the term in a more restrictive sense. High bracket investors in real estate often want more from their real estate investments than a flow of cash that is currently free from tax. They seek tax losses that can be passed through to them and used to offset, or "shelter," their income from other sources. Current cash flow, indeed, may be of little or no immediate interest. As shall be illustrated more fully below, it is extremely common for investments in depreciable real estate to produce a stream of cash flow that is currently sheltered from tax and, at the same time, generate tax losses that can be used by the investor to offset income from other sources. In effect, two different commodities are produced annually: cash benefits and tax benefits.

Tax shelter can perhaps best be demonstrated by deriving a year's tax consequences from the same year's cash consequences. The net cash flow for any year is, most basically, cash received minus cash spent. In rental properties, whether they are apartments, offices, or retailing concerns, net cash flow (NCF) consists of rent receipts (RR) minus real estate taxes (RT), maintenance expenses (ME), principal repaid on indebtedness (P), and interest paid on indebtedness (I). Consider, for example, the following statement of one year's net cash flow from Blackacre Apartments:

$$
\begin{aligned}
NCF &= RR - RT - ME - (P + I) \\
&= \$10{,}000 - 500 - 400 - (900 + 8{,}000) \\
&= \$200
\end{aligned}
$$

[1] Thus, it would be more precise to say that there will be tax shelter in the broad sense in any year in which the depreciation deduction, available without a cash outlay, exceeds the sum of the nondeductible cash outlays for debt amortization and capital improvement.

The taxable income or loss of Blackacre Apartments for the year in question can be derived by making two adjustments to the net cash flow: add back in principal repayment (P) and subtract the appropriate depreciation deduction (D). The effect of these two adjustments is to convert the year's cash reality into the same year's tax reality. Principal repayment was subtracted in the computation of net cash flow because it is an actual cash expense. It must be added back to convert net cash flow into taxable income or loss because it is a nondeductible expense. Conversely, depreciation must be subtracted from net cash flow. Depreciation did not enter into the computation of net cash flow because it is a deduction available without a current cash expense. If the Blackacre Apartments' depreciation deduction for the year in question is $1,200, the taxable income or loss is computed as follows:

$$\begin{aligned} TI &= NCF + P - D \\ &= \$200 + 900 - 1{,}200 \\ &= (\$100) \end{aligned}$$

Thus, for the year in question, Blackacre Apartments has produced a positive cash flow of $200 and a tax loss of $100.

Stating taxable income or loss in terms of net cash flow makes it clear that tax shelter depends solely on the relationship between principal repayment and the depreciation deduction. If principal repayment equals depreciation, the two cancel each other out and taxable income, or loss, is the same amount as the amount of positive, or negative, net cash flow. In other words, the owner of Blackacre Apartments must pay tax on the same amount as the amount of dollars he actually receives. Whenever the depreciation deduction is greater than principal repayment, however, he will only be required to pay tax on a lesser amount than the amount of cash actually received. Indeed, in the above example, he not only is free from paying tax currently, he also has a tax loss. An investment in depreciable real estate is a tax shelter in this more narrow sense whenever the depreciation deduction is greater than the sum of net cash flow and principal repaid on indebtedness; when, after all the net cash flow and debt amortization[2] are "sheltered" from tax, tax losses remain.

II. THE COLLAPSE OF TAX SHELTER

The extent to which a particular investment achieves tax shelter usually changes constantly over time. Typically, tax shelter diminishes, disappears, and the reverse of tax shelter becomes the case: the investment becomes one in which the investor must pay tax on a greater amount than the amount of cash actually received. The reason for this collapse of tax shelter is that the two determinants of tax shelter, principal repayment and depreciation, generally change over time. Most typically, real estate is financed with level payment mortgages that are fully amortized at the end of a regular schedule of payments. In such mortgages early debt service payments consist almost entirely of interest. As time passes, a greater portion of each payment is attributable to the nondeductible expense of principal repayment. Further, if an accelerated method of computing depreciation is used, depreciation deductions will at the same time be getting smaller. Thus, as the life of the investment progresses, principal repayment (P) will be getting larger and depreciation (D) will be getting

[2] The term "debt amortization" is used herein to refer to the repayment of the outstanding principal on indebtedness.

smaller. The tax shelter collapses when D is equal to P. Indeed, the situation deteriorates further as P becomes greater than D. Consider the above illustration of Blackacre Apartments in a year in which net cash flow is still $200. Assume, however, that the loan is much later in its life and that $8,000 of the $8,900 debt service payments for the year is attributable to principal repayment, and that only $900 is attributable to interest. Assume, further, that the depreciation deduction in this later year is only $700. Even though the cash flow remains at $200, the taxable income or loss is now computed as follows:

$$\begin{aligned} TI &= NCF + P - D \\ &= \$200 + 8{,}000 - 700 \\ &= \$7{,}500 \end{aligned}$$

Thus, although the basic cash reality remains the same, the tax reality has changed dramatically; in this subsequent year the owner of Blackacre Apartments must report ordinary income at $7,500 even though net cash flow is only $200.

47 T.C. 340
Tax Court of the United States.

MANUEL D. MAYERSON AND RHODA MAYERSON, PETITIONERS
v.
COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 2969-64. | Filed December 29, 1966.

Some of the facts have been stipulated and are found accordingly and adopted as our findings.

Petitioners are husband and wife and are residents of Cincinnati, Ohio. Their joint returns for the years involved were filed with the district director of internal revenue, Cincinnati, Ohio. Petitioner, Rhoda Mayerson, is a party herein only by reason of having filed a joint return with her husband, Manuel D. Mayerson, and the latter will hereinafter be referred to as the petitioner.

Petitioner has been a licensed real estate broker for approximately 20 years. In addition to his brokerage activities, he has owned many investments in real estate and has been instrumental in developing several shopping centers and many motel and apartment projects, remodeling older structures when necessary.

The property which is the subject of the primary controversy here is located at the northwest corner of 8th and Walnut Streets, Cincinnati, Ohio, and hereinafter will be referred to as the 8th and Walnut Building. Petitioner first became interested in acquiring this commercial property in the latter part of 1959. The building was owned by the Estate of Edith W. Balch and petitioner contacted the coexecutor of the estate, Henry W. Hobson, Jr., a Cincinnati lawyer, to discuss the possible site of the building. At the outset petitioner was informed that the estate wanted $275,000 cash for the property, and that if he was not able to pay cash the price would go up to a top price of $332,000.

The history of the building relative to its net profits over the years was discussed in detail during the sales negotiations. At one time the building had produced a relatively good income but toward the last years of Edith Balch's life and during the period of administration of the Balch Estate the building had not been profitable.

Another concern of petitioner was the existence of 72 outstanding building orders against the building imposed by municipal authorities in order to insure conformance with the Cincinnati Building Code. Petitioner considered these building orders carefully since the exact costs for necessary corrective action could not be precisely ascertained, and they could have involved tens of thousands of dollars.

Petitioner was only interested in the purchase of the 8th and Walnut Building and the Balch Estate was only interested in selling the building. The Balch Estate was not interested in leasing the property to petitioner or obtaining a new manager.

Petitioner was particularly interested in remodeling this older property in order to enhance its profit potential. Several alternative possibilities for the building were discussed, including conversion into a ***342** motel or hotel, development into a downtown apartment project or a major garage installation, or attraction of a single user for the entire property.

Petitioner's lack of available funds made it impossible for him to pay cash for the building. Conventional mortgage financing was investigated but it was found that such financing was unavailable due to the building's age, condition, and the outstanding building orders. After extensive negotiations, representatives of the Balch Estate agreed to convey the title to the building with financing based upon a purchase-money note in the face amount of $332,500 secured by a long-term mortgage. If the purchase-money obligation was paid off within the first year, or the 2 succeeding years, the price would be reduced to $275,000 or $298,750, respectively. Thereafter, the price would increase to the face amount of the mortgage note, a maximum of $332,500.

A valid warranty deed was executed and the property was conveyed to petitioner on December 31, 1959. The deed was presented to the Hamilton County, Ohio, county auditor on December 31, 1959, where it was noted for transfer, and the formal registration with the recorder of Hamilton County, Ohio, was completed on January 5, 1960.

In connection with the transaction, petitioner on the same date executed and delivered to the sellers documents entitled 'Mortgage Note' and 'Purchase Money Real Estate Mortgage.' The document entitled 'Mortgage Note' provided as follows:

FOR VALUE RECEIVED, on or before ninety-nine (99) years from date, the undersigned, Manuel D. Mayerson, Trustee, promises to pay to the order of DeWitt W. Balch and Henry W. Hobson, Jr., Co-Executors of the Estate of Edith W. Balch, deceased, their successors or assigns, whose present address is 1232 Federal Reserve Bank Building, Cincinnati 2, Ohio, the principal sum of Three Hundred Thirty-two Thousand Five Hundred Dollars ($332,500.00), under the conditions contained herein and subject to the limit of liability as provided for herein; Five Thousand Dollars ($5,000.00) of principal shall be payable on December 31, 1959, and Five Thousand Dollars ($5,000.00) of principal shall be payable on January 4, 1960. There shall be no obligation on the maker to make any further payments of principal at any particular time prior to due date, but he shall have the privilege of making payments, but shall not be obligated to, on account of principal at any interest payment date as hereinafter provided, but any such principal payment shall not be in an amount of less than Twenty-five Thousand Dollars ($25,000.00).

Interest shall be the sum of Eighteen Thousand Dollars ($18,000.00) per year, payable in monthly installments of Fifteen Hundred Dollars ($1500.00) each on the last day of each month, beginning January 31, 1960. When and if the principal owing on this note shall have been reduced below the sum of Three Hundred Thousand Dollars ($300,000.00), interest on the remaining balance shall be calculated at the rate of 6% per annum on the unpaid principal, and shall be payable in equal monthly installments monthly at the times hereinbefore started.

It is further agreed that if the two payments aggregating Ten Thousand Dollars ($10,000.00), payable on December 31, 1959 and January 4, 1960, as ***343** aforeprovided, and all interest shall have been paid, the principal amount of this note may be fully satisfied at any time after January 5, 1960, and before December 31, 1960, by the payment of Two Hundred Seventy-five Thousand Dollars ($275,000.00), the said Two Hundred Seventy-five Thousand Dollars ($275,000.00) to be reduced by any payments that may have been made in addition to the Ten Thousand Dollars ($10,000.00) paid on December 31, 1959, and January 4, 1960, and upon such payment this note shall be cancelled.

It is further agreed that if the two payments aggregating Ten Thousand Dollars ($10,000.00), payable on December 31, 1959 and January 4, 1960, as aforeprovided, and all interest shall have been paid as herein provided, the principal amount of this note may be fully satisfied at any time after December 31, 1960, and before December 31, 1962, by the payment of Two Hundred Ninety-eight Thousand Seven Hundred and Fifty Dollars ($298,750.00), the said Two Hundred Ninety-eight Thousand Seven Hundred and Fifty Dollars ($298,750.00) to be reduced by any payments that may have been made in addition to the Ten Thousand Dollars ($10,000.00) paid on December 31, 1959, and January 4, 1960, and upon such payment this note shall be cancelled.

This note is secured by a mortgage of even date herewith on real estate situate in Cincinnati, Ohio.

In the event of default in the payment of any installment of principal or interest on this note when due, or in the event of default in the performance of any of the covenants contained in the mortgage to be performed by the mortgagor, the holder of this note may, at his option, without notice, declare the principal of this note and the interest thereon to be immediately due and payable and may proceed to enforce the collection thereof by suit to foreclose the mortgage, but his sole recourse, except for interest then due, shall be to the mortgaged property and the maker's liability for any other amounts owing hereunder, shall be limited to the loss of the real estate covered by the mortgage and there shall be no personal liability whatever on his part. The holder, by acceptance hereof, waives the right to bring an action or suit for personal judgment hereon, except for accrued interest.

The pertinent provisions of the document entitled 'Purchase Money Real Estate Mortgage' provided as follows:

And the said Grantor, for himself and his successors in trust and assigns, does hereby covenant and agree with the said Grantees, their successors and assigns, as follows:

1. To pay the note hereby secured in accordance with its terms, but subject however, to the limit of liability therein and herein provided, and all other amounts herein agreed to be paid by the Grantor when and as the same shall become due under any covenant or stipulation herein contained, subject, however, to limit of liability herein contained. * * *

In the event of loss, if permitted by Grantees' mortgagee, the proceeds of the foregoing insurance policies shall be applied at the option of the Grantor either to the reduction of the mortgage indebtedness secured hereby or to the repair and restoration of the damage. Should it be applied to such repair and restoration and there be an o verage, the overage shall be applied to the reduction of the mortgage indebtedness. It is further agreed, if permitted by Grantees' mortgagee, that if the damage be of such nature as in the opinion of the Grantor shall not warrant the application of the proceeds to the construction of a building similar to that now on the premises, the Grantor may demolish whatever is left of the present structure and either replace it with a different type of structure ***344** or none at all, provided, however, that such action shall not be taken without the consent of the Grantees, which consent shall not be unreasonably withheld. If such course is taken, proceeds of insurance shall be used to place the property in proper condition and the balance shall be applied to the reduction of the mortgage indebtedness.

4. To maintain or cause to be maintained the buildings and improvements upon said premises in good condition and to repair, renew and replace the same whenever necessary and not to commit or permit any waste thereon or thereof.

5. To improve the mortgaged property by complying with all building orders outstanding against the property as of the date hereof with due diligence and within a reasonable time and, thereafter, to keep the property free of any building orders by any public or other authority authorized to issue the same by complying therewith with due diligence and within a reasonable time. * * *

7. That upon failure of Grantor to maintain insurance as above stipulated or to deliver said renewal policies as aforesaid or to pay said premiums, the Grantees may effect such insurance and pay the premiums therefor, and upon Grantor's failure to pay any taxes, charges, rates and assessments as above stipulated or if there shall be at any time any prior liens or encumbrances on said premises, Grantees may, without notice to or demand on Grantor, pay the amount of any such taxes, charges, rates or assessments or prior liens or encumbrances and redeem the property from any tax sale with any expenses attending the same, including Attorneys' fees. In either of such events, the Grantor agrees to repay to the Grantees, with interest at the rate of six per cent (6%) per annum thereon, upon demand, any amount so paid by the Grantees, and the same shall be a lien on said premises and be secured by these presents.

8. The Grantor will comply with all laws, ordinances and regulations of all public authorities relating to the Mortgaged Premises and will not remove or demolish any buildings thereon or any of the mortgaged properties situated therein without the consent of the Grantees, which consent shall not be unreasonably withheld; nor shall Grantor sell or convey any part of the premises hereby conveyed without the written consent of Grantees, which shall not be unreasonably withheld. The foregoing limitation of conveyancing shall not be applicable to conveyances to any person for whom the Grantor is holding title and all limitations of liability provided for herein shall have like application to the Grantor and any persons for whom the Grantor holds title.

9. That the Grantor will pay to the Grantees any and all sums, including costs, expenses, reasonable Attorneys' fees, which Grantees may incur or expend in any proceeding to sustain the lien of this mortgage or its priority (except for mortgage hereinafter referred to) or to defend against the liens or claims of any person or persons asserting priority to this mortgage (except for mortgage hereinafter referred to) or in discharge of any such claim or lien or in connection with any suit at law or in equity to foreclose this instrument or to recover any indebtedness hereby secured or in which it may be necessary or proper to prove the amount thereof or for any extension of title to said premises together with interest on said sums at six per cent (6%) per annum until paid and any amounts so paid by the Grantees shall be a lien on said premises and be secured by these presents. ***

Notwithstanding anything in this mortgage or in the promissory note contained to the contrary, the sole and only personal liability of the Grantor shall be the obligation to make the two payments on December 31, 1959, and January 4, 1960, aggregating ten thousand dollars ($10,000.00), and the payments to Grantees provided for in

Paragraphs 7 and 9 above and the interest provided ***345** for in the promissory note, and the Grantees' only recourse in case of any default in any other of Grantor's obligations shall be against the mortgaged property only, and to foreclose the mortgage and in no event and under no circumstances, except as provided in this paragraph, shall a money judgment be taken against Grantor. It is further agreed and understood that Grantor's obligations under Paragraphs 7 and 9 and for interest on said note shall terminate, except as to amounts then due, upon the first to happen of the following: (1) Proceedings being commenced to foreclose this mortgage or to otherwise regain possession of the mortgaged property, or for the application of rents for the benefit of the mortgagees; or (2) upon proffer of a conveyance thereof to the Grantees by the Grantor, except for sums for costs, expenses and reasonable attorneys' fees which may accrue thereafter by reason of a proceeding described in Paragraph 9. Grantees hereby waive the right to bring or maintain any action or suit for a personal judgment, except as provided in this Paragraph.

Both of the preceding documents will hereinafter be referred to jointly as the purchase-money mortgage.

Petitioner paid $5,000 in December of 1959 and $5,000 in January of 1960 as provided for and required by the note. It was understood by the parties that petitioner would find the best use for the property as soon as possible and after finding such use seek conventional financing for the purpose of liquidating the purchase-money mortgage. The time for accomplishing the foregoing plan was indefinite, but the parties discussed the possibility of 5 to 10 years or less.

Petitioner held title to the building as trustee. An unrecorded trust agreement named his wife as the beneficiary of the trust. Under Ohio law, such an arrangement is categorized as a dry trust and subsequent purchasers are entitled to consider the trustee as the sole owner of the property.

Following the transfer of title, petitioner contacted architects and had engineering surveys made of the property. Costs of conversion were explored with several independent contracts. Apartment or motel conversions were investigated in detail. Petitioner spoke to hundreds of people in connection with the possible conversion of the building. Installation of new elevators was considered as well as refacing the entire structure.

The outstanding building orders were reduced from 72 to 25 by March 4, 1960, and were further reduced to 6 by December 16, 1964. This was done by petitioner at his expense in order to keep the building open and also to comply with the requirements of the purchase-money mortgage. Boilers were purchased by petitioner and installed in the 8th and Walnut Building in January of 1961 at a cost of $13,000.

In addition to repairs required by the building orders and normal maintenance, petitioner has made several major improvements. Garage entrances were widened, the building was rewired, the lobbies were reconditioned with the installation of new ceilings and fronts. Several thousands of dollars were spent to create offices on the second ***346** floor of the building as part of an experiment to test the potential for renting office space at highly competitive rates. Costs of repairs to the building in the amount of $9,847.67 and $8,931.11 were deducted on petitioner's income tax returns for 1960 and 1961, respectively, and these deductions have not been questioned by respondent or disallowed in the deficiency notices issued for those years.

Following the transfer of title in 1959, petitioner executed leases with tenants and paid utilities, insurance, and real estate tax bills. In late December of 1964, petitioner learned that the owner of a nearby building was contemplating another area for a garage. After discussions with the owner of this building, petitioner convinced him to lease the entire 8th and Walnut Building. By using this lease as collateral, petitioner was for the first time able to get a conventional mortgage loan from a financial institution. After securing this loan, petitioner negotiated with the Balch Estate and in January of 1965 the parties agreed to a settlement of the flat sum of $200,000. Petitioner made no payment of principal with respect to the purchase-money mortgage from the time of the initial $10,000 downpayments until the negotiated settlement resulting in payment of $200,000 to discharge this lien.

Petitioner had never dealt with Henry W. Hobson, Jr., the co-executor of the Balch Estate, prior to the negotiations concerning the 8th and Walnut Building. The two men were not even acquainted with each other prior to these dealings. Neither the Balch Estate nor the trust which succeeded to its interest claimed a deduction for depreciation on the building after December 1959.

A deed from petitioner as trustee would be necessary to transfer legal title to the 8th and Walnut Building to any person or entity. A title insurance company was willing in December of 1964 to issue a title insurance binder in support of such a conveyance in any amount desired.

In the field of mortgage lending, it is a usual practice with respect to income-producing property that mortgagors have their liability limited to the specific security that is covered by the mortgage. It is also a frequent practice in the field of mortgage lending to allow the mortgagee to waive payments of principal on income-producing properties in distress or incentive situations.

Petitioner allocated $200,000 of the alleged purchase price of the 8th and Walnut property to the depreciable building and claimed depreciation during the years in question based upon this amount. By a 30-day letter dated September 26, 1963, petitioner was advised that the Internal Revenue Service was disallowing all depreciation on the 8th and Walnut Building for the following reason:

***347** The disallowance of depreciation in full on 8th and Walnut was based on the fact that the transaction made by the taxpayer in obtaining the building was a lease and not a purchase. The taxpayer's down payment of $10,000 was determined to be cost of obtaining the lease and amortizable over the life which is 99 years.

The statutory notice of deficiency dated April 9, 1964, contained the following determination for 1960:

It has been determined that depreciation claimed (in) the amount of $18,025.00 is excessive, and not an allowable deduction in accordance with section 167 of the Internal Revenue Code of 1954. See Exhibit A for computation of the adjustments.

You are hereby allowed amortization on the $10,000.00 cost of obtaining lease on 8th and Walnut Building, in accordance with section 178 of the Internal Revenue Code of 1954. See Exhibit A for computation of the adjustment.

The determinations for 1961 relating to

depreciation on the 8th and Walnut Building contained in the same notice of deficiency were identical in all respects except for the amount disallowed. Exhibit A to the notice of deficiency showed that no depreciation attributable to the 8th and Walnut Building was allowable, but allowed an annual deduction of $101.01 as amortization over a period of 99 years for the $10,000 downpayment which was classified as the cost of obtaining a 99-year lease. The notice of deficiency did not alter petitioner's claimed interest deductions for the years 1960 and 1961 relative to the purchase-money mortgage, and did not provide for or allow any deductions for rental payments under a lease.

The parties have agreed that if it is determined that petitioner is entitled to claim depreciation with respect to the 8th and Walnut Building, then, for the purpose of determining the depreciation deduction the following shall apply:

Allocation of investment in entire property	60.15 percent building. 39.85 percent land.
Method of depreciation	150 percent declining balance.
Useful life	25 years.

* * *

ULTIMATE FINDINGS OF FACTS

The petitioner acquired the 8th and Walnut Building in an arm's-length transaction which constituted a bona fide purchase and created a valid debt obligation. Petitioner's gross investment in this property for computing depreciation for the years 1960 and 1961 was $332,500.

OPINION

Respondent determined that petitioner's claimed deduction for depreciation of the 8th and Walnut Building was excessive and not allowable under section 167 during the years in question. A depreciation deduction is allowed for property used in a trade or business or held for the production of income. Section 167(g) of the Code provides that the basis for the depreciation deduction is the adjusted basis provided in section 1011 for the purpose of determining the gain on the sale or other disposition of such property. Generally, the adjusted basis for determining gain or loss from the sale of property is the amount paid for such property in cash or other

property. Sec. 1.1012-1, Income Tax Regs. Thus, in a

situation of outright purchase, the amount paid for the property constitutes the depreciable basis. Moreover, it is well accepted that a purchase-money debt obligation for part of the price will be included in basis. This is necessary in order to equate a purchase-money mortgage situation with the situation in which the buyer borrows the full amount of the purchase price from a third party and pays the seller in cash. It is clear that the depreciable basis should be the same in both instances.

Respondent's position is essentially that the purchase-money mortgage involved in this case was a nullity and that a capital investment in the subject property had not occurred. The $10,000 cash downpayment was treated in Exhibit A to the deficiency notice as the cost of obtaining a 99-year lease, thus qualifying for amortization deductions over the term of the lease. This treatment gives rise to the inference ***350** that respondent determined that the transaction actually resulted in the creation of a long-term lease. On brief, respondent adds the additional contention that in effect all petitioner acquired was an option to purchase at any time during the alleged lease.

Respondent's position apparently results from his objections to certain features of the purchase-money mortgage. Petitioner was not personally liable on the mortgage, and the only recourse available to the mortgagee in case of default was foreclosure against the property; the property was the only security under the mortgage agreement. Respondent argues that when there is no enforceable and binding personal obligation with respect to the purchase price, no debt is created.

The absence of a debt is also indicated by the indefinite amount of the alleged obligation, according to respondent. This is evidently a reference to the fact that petitioner could pay off the mortgage in the first or 2 succeeding years with an amount stipulated in the purchase-money mortgage which was less than the face amount due after the expiration of 3 years. Thus, the amount due on the mortgage could fluctuate between three different sums depending upon whether payment occurred within the first year, the second, or third year, or years thereafter.

Respondent also emphasizes the fact that after two initial payments of $5,000 each, no portion of the principal of the purchase-money mortgage was due on or before 99 years from the date of the obligation. Petitioner did have the option, however, to make payments of principal at any time during the term of the mortgage. Petitioner was obligated to pay a fixed sum of $18,000 per year, designated as interest, in monthly installments. If the principal due on the mortgage was reduced below $300,000, the interest was payable at the rate of 6 percent per year on the unpaid balance.

It is undisputed that petitioner became the owner of legal title to the 8th and Walnut Building. There is no hint of a sham transaction in the transfer of title to the building and respondent makes no contention that the transaction was a sham or rigged to appear to be a sale and mortgage back when it was in fact something else. We are concerned with an arm's-Length transaction entered into between knowledgeable strangers for business motives. It is well accepted, however, that depreciation is not predicated upon ownership of property but rather upon an investment in property. Gladding Dry Goods Co., 2 B.T.A. 336 (1925). It therefore follows that the benefit of the depreciation deduction should inure to those who would suffer an economic loss caused by wear and exhaustion of the business property. See Thomas W. Blake, Jr., 20 T.C. 721 (1953).

***351** Respondent relies upon the preceding cases and general statements in Weiss v. Wiener, 279 U.S. 333 (1929), to the effect that only a capital investment is depreciable, to support his view that the petitioner did not have a depreciable interest in the 8th and Walnut Building.

We must first decide whether the absence of personal liability with respect to the purchase-money mortgage precludes the inclusion of any amount attributable to the mortgage in the depreciable basis of the property. If this is true, depreciation based on the purchase-money mortgage should be denied regardless of the existence of a bona fide debt obligation for the mortgage. An analysis of this question must begin with the Supreme Court's landmark decision in Crane v. Commissioner, 331 U.S. 1 (1947). The Crane case involved the question of what the proper basis of inherited property was for the purpose of computing the taxable gain on the sale of the property.

The property was received subject to an unassumed mortgage and was sold still so encumbered. The Court held that the basis of the property was the value at the date of death undiminished by the mortgage. The inclusion of the indebtedness in basis was balanced by a similar inclusion of the indebtedness in amount realized upon the ultimate sale of the property to a nonassuming grantee.

The relevance of the Crane case to the issue of depreciable basis arises due to section 167(g) which states that the basis for depreciation shall be the same as the basis for gain or loss on a sale or exchange under section 1011. Thus, the Crane case constitutes strong authority for the proposition that t e basis used for depreciation as well as the computation of gain or loss would include the amount of an unassumed mortgage on the property.

This position was expressly adopted by this Court in Blackstone Theatre Co., 12 T.C. 801, 804 (1949), acq. 1949-2 C.B. 1, with the following language:

From Crane we can deduce the following applicable principles: (a) the basis for given property includes liens thereon, even though not personally assumed by the taxpayer; and (b) the depreciation allowance should be computed on the full amount of this basis. * * *

The respondent argues that the Crane case should not apply in a purchase situation since the basis in that case started with fair market value and not cost, as in the case of a purchase. The reasoning of the Crane case, however, seems equally applicable to a purchase situation and indeed was so applied in the Blackstone Theatre Co. case and Parker v. Delaney, 186 F.2d 455 (C.A. 1, 1950). It should also be applied here.

The element of the lack of personal liability has little real significance due to common business practices. As we have indicated in our findings it is not at all unusual in current mortgage financing of income-producing properties to limit liability to the property involved. ***352** Taxpayers who are not personally liable for encumbrances on property should be allowed depreciation deductions affording competitive equality with taxpayers who are personally liable for encumbrances or taxpayers who own unencumbered property. The effect of such a policy is to give the taxpayer an advance credit for the amount of the mortgage. This appears to be reasonable since it can be assumed that a capital investment in the amount of the mortgage will eventually occur despite the absence of personal liability. The respondent has not suggested any rationale that would reasonably require a contrary conclusion. The lien created by the purchase-money mortgage, like the tax liens in the Blackstone Theatre case, should be included in basis for the purpose of computing depreciation.

Having determined that the absence of personal liability with respect to a purchase-money mortgage does not preclude the inclusion of the mortgage in the depreciable basis of the property, we must decide whether the purchase-money mortgage involved in this case should be considered a bona fide debt obligation. Respondent argues that even if the usual purchase-money mortgage should be included in depreciable basis, this doctrine would be inapplicable in a situation where the alleged debt instrument does not create any obligation to pay the purchase price.

The basis for respondent’s contention that no debt obligation was created are the absence of personal liability on the mortgage and the fact that the principal of the mortgage was not due for 99 years. We have already discussed the relative unimportance of personal liability in modern business transactions. We hold that this does not affect the validity of the mortgage debt. Therefore, if we are to conclude that there was no debt it must be because of the

99-year term for maturity. Although this term does seem unusually long, after viewing the totality of the circumstances and all the evidence of record we have found and hold that a valid debt obligation was created by the purchase-money mortgage in question.

Contrary to respondent's asserted position, we do not believe that this transaction was in reality or substance a lease with an option to purchase. The uncontroverted testimony of petitioner and a representative of the Balch Estate was that a sale was intended with an understanding that there would be a conversion to institutional mortgage financing as soon as possible. These witnesses were forthright, impressive, and entirely believable. It is clear that the 99-year term was never expected to run its course, but even absent this factor, it should be realized that a definite contractual obligation was created which would have had to be fulfilled by or before a definite date in the future. The sales transaction was normal in every other way, and the actions of the parties to the transaction certainly support our conclusions ***353** that a bona fide sale occurred and a valid debt obligation for most of the purchase price was created. Petitioner invested in improvements for the building and undertook the usual duties of a property owner. He worked diligently to find the highest and best use for the property so that he could obtain conventional financing. Within a few years he succeeded and retired the mortgage as the parties understood and hoped.

As we view the evidence before us, we do not have a substance versus form situation here because substance and form coincide. Although it can be argued that the economic realities of the transaction would be the same whether the transaction was characterized as a sale with a purchase-money mortgage or a long-term lease with an option to purchase at any time, the evidence is convincing that the parties to the transaction intended a sale and mortgage and the form was consistent with this intent. We therefore hold that the transaction was in substance as well as form an effective sale and purchase-money mortgage for income tax purposes.

Respondent's final argument for denial of the depreciation deductions on the 8th and Walnut Building is based on the proposition that even though the purchase-money mortgage imposed an obligation on petitioner, the obligation cannot be considered as part of the depreciable basis since the cost of property for the purpose of determining basis for depreciation does not include any amount with respect to obligations which are contingent and indefinite in nature. Columbus & Greenville Railway Co., 42 T.C. 834 (9163); Albany Car Wheel Co., 40 T.C. 831 (1963), affirmed per curiam 333 F.2d 653 (C.A. 1, 1964); Lloyd H. Redford, 28 T.C. 773 (1957). An example of the type of contingency referred to in the preceding proposition was present in the Albany Car Wheel Co. case. In that case we found that the purchase-taxpayer's obligation under the purchase agreement to procure a release of the predecessor's liability under a union contract for severance pay was of such a contingent nature that it could not be considered a part of the cost of the assets acquired. Whether it would ever be necessary to satisfy any severance pay obligations was unknown at the time of the sale.

Similarly, in the Lloyd H. Redford case the amount of a note was held not to be includable in basis since the note was only payable from profits and it was uncertain whether there would ever be profits.

It was held in the Columbus & Greenville Railway Co. case that basis did not include any amount of a mortgage where there was no primary responsibility and no fixed indebtedness for which the taxpayer or its property was liable.

We hold that the doctrine supported by the foregoing cases is inapplicable to the subject purchase-money mortgage. Respondent contends ***354** that the amount of the obligation was indefinite because of the varying amounts due under the terms of the instrument and the fact that the purchase-money mortgage was eventually settled for the negotiated price of $200,000, a substantial reduction from the amount due under the instrument.

There were only two variables in the overall purchase price of the property, and they were specified in dollar amounts. The price depended then upon whether the purchase-money mortgage was paid within the first year, the second year, or years thereafter. We would classify such a price reduction for early payment as a bonus discount. The presence of such optional discounts does not make the purchase price indefinite. It merely provided an incentive for very early retirement of the mortgage which did not occur. The cost basis at the time of purchase should be the nondiscount price; the entire principal of the note and mortgage was due unless the discounted sums were paid in the first 2 years. It was not prepaid so as to provide for the application of the discount provisions and hence no adjustment in basis is required during the years before us. It is evident from the record that if the lien on the property provided by the mortgage were to be discharged at any time prior to its due date, the then fixed amount would necessarily have to be paid. There was nothing contingent or indefinite about the obligation here.

The subsequent settlement of the purchase-money mortgage for less than the amount due under the terms of the instrument should not affect the allowable depreciation in taxable years prior to the settlement. In the Blackstone Theatre Co. case, the taxpayer acquired real estate with outstanding tax liens exceeding $120,000. Although there was no personal liability as to these liens and although the liens were settled 5 years after the acquisition for $50,000, the depreciable basis for the intervening years was held to include the full $120,000. Here we are concerned with an arm's-length business transaction and there is no logical basis for disregarding the purchase price provided for in the purchase-money mortgage.

Since we have decided the depreciation issue involving the 8th and Walnut Building in petitioner's favor, it is unnecessary to decide whether the $10,000 downpayment should have been amortized as the cost of obtaining a lease over 25 years, the estimated life of the building, rather than 99 years, the period of the alleged lease.

Footnotes

[1] All references are to the Internal Revenue Code of 1954 unless otherwise stated.

Note
See Fass and Howard, How to Use the Service Partnership to Picture Tax Shelters, 43 J. Tax. 15 (1975).

Compare also the language in Leonard Marcus, T.C.M. 1971-299:

In each of the acquisitions in question, the term of the notes given in payment was well in excess of the useful life of the assets. * * * [E]ach of the agreements in question provided that the purchaser's liability under the promissory notes or obligations given in payment was limited to the security of the property acquired in the given transaction; and that in the event of default, the seller's only recourse was to this property. In these instances, the petitioner and his fellow purchasers could in essence turn back the property and be relieved of any further liability.

* * *

In the factual pattern of this case, the contract price in each of the agreements did not have any real meaning. Even taking each of the various contracts on its face, it is difficult to conceive of a situation where the petitioner and/or his fellow purchasers would continue to make payments under the various contracts where the property in question no longer had any useful life and where they would incur no financial liability for failure to make such payments. In fact, the purchaser did default in four of the acquisitions and the property reverted to the respective sellers. Hence, it is clear that, with respect to the acquisition of each bowling establishment, <u>the purchaser's liability and the amount of the obligation incurred were contingent and not ascertainable. The contract price</u> in each instance <u>was not an absolute and unconditional price but a contingent amount which might never be paid</u>, <u>and</u> said price is therefore <u>not determinative for purposes of establishing a basis for depreciation.</u> (emphasis added)

Rev. Rul. 69-77, * * *
1969-1 C.B. 59:

The Service emphasizes that is acquiescence in *Mayerson* is based on the particular facts in the case and will not be relied upon in the disposition of other cases except in situations where it is clear that the property has been acquired at its fair market value in an arm's length transaction creating a bona fide purchase and a bona fide debt obligation.

The Service will continue to review transactions involving purported purchases of depreciable property where, in the light of all the facts and circumstances, it appears that the transactions were designed to improperly oreate or inflate depreciation deductions. In cases of this type, the Service will disallow unwarranted depreciation deductions.

Discharge of indebtedness; prepayment of mortgage balance at discount. An individual taxpayer realizes discharge of indebtedness income under section 61(a)(12) of the Code upon the discounted prepayment to a lender of all or a portion of mortgage indebtedness. The amount of the discount is includible whether the mortgage note is recourse or nonrecourse.

Rev. Rul. 82-202

ISSUE

Does a taxpayer realize income when the taxpayer prepays the mortgage on the taxpayer's residence at less than the principal balance, under the circumstances described below?

FACTS

In order to reduce the number of its low-interest mortgages, a financial institution offered a 10-percent discount to each individual with an existing low-interest mortgage on a personal residence who would prepay the balance. The taxpayer who had borrowed money from the financial institution in order to purchase a residence from a third party paid the financial institution 18*x* dollars in full payment of the taxpayer's note and mortgage when the mortgage balance was 20*x* dollars. The fair market value of the residence was greater than the principal balance at the time of the transaction, and the taxpayer was financially solvent both before and after the mortgage prepayment. The taxpayer was not personally liable to the financial institution on the mortgage indebtedness.

LAW AND ANALYSIS

Under section 61(a)(12) of the Internal Revenue Code, gross income includes income from the discharge of indebtedness, except as otherwise provided by law.

Section 1.61-12 of the Income Tax Regulations provides that a taxpayer may realize income by the payment or purchase of the taxpayer's obligations at less than their face value.

Section 108(a)(1) of the Code excludes from a taxpayer's gross income any amount realized from the discharge of indebtedness, but only if (A) the discharge occurs in a title 11 case, (B) the discharge occurs when the taxpayer is insolvent, or (C) the indebtedness discharged is qualified business indebtedness.

In *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931), X-2 C.B. 356 (1931), which involved a corporation that purchased its own bonds at less than their issue price, the Supreme Court of the United States held that a taxpayer-debtor realizes ordinary income upon the payment or purchase of its obligation in an arm's length transaction at less than its face amount.

The cancellation or reduction of a liability incurred on the purchase of property is subject to the same rules as cancellation of other debts and is considered to produce taxable income under section 1.61-12(a) of the regulations and *Kirby Lumber* unless the transaction is specifically excepted.

The facts here do not involve the bankruptcy, insolvency, or a qualified business indebtedness of the taxpayer. Thus, the specific exclusions provided by section 108(a) do not apply.

HOLDING

The taxpayer realizes 2*x* dollars of ordinary income upon the prepayment of the principal balance on the mortgage.

The taxpayer would also realize ordinary income if (1) a discount was received for the prepayment of only a portion of the outstanding balance rather than the entire balance, or (2) the taxpayer was personally liable to the financial institution on the mortgage indebtedness.

Compare §108(e)(5):

(5) Purchase-money debt reduction for solvent debtor treated as price reduction.—If—

(A) the debt of a purchaser of property to the seller of such property which arose out of the purchase of such property is reduced,

(B) such reduction does not occur—

(i) in a title 11 case, or

(ii) when the purchaser is insolvent, and

(C) but for this paragraph, such reduction would be treated as income to the purchaser from the discharge of indebtedness,

then such reduction shall be treated as a purchase price adjustment.

59 T.C. 760
United States Tax Court

DAVID F. BOLGER AND BARBARA A. BOLGER, PETITIONER V. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 5033-68, 5755-68. | Filed March 8, 1973.

Opinion

***761** TANNENWALD, Judge:

Respondent determined the following deficiencies in petitioners' income tax:

Year	Deficiency
1963	$13,153.44
1964	$22,596.75
1965	$30,512.00
1966	$90,186.00

Certain concessions having been made, the only issue remaining for our consideration is whether petitioners are entitled to deductions for depreciation on account of certain real and personal property under the circumstances set forth herein. A decision with respect to this issue governs the allowability of rental and interest expenses and the investment credits claimed by petitioners.

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulation and exhibits attached thereto are incorporated herein by this reference.

David F. Bolger (hereinafter referred to as the petitioner) and Barbara A. Bolger are husband and wife whose legal residence was Ridgewood, N.J., at the time the petitions herein were filed. Joint returns for the years in question were filed with the district director of internal revenue for the Manhattan District, New York. Petitioner Barbara A. Bolger is a party herein solely because she filed joint returns with her husband for the years in question.

During the years in question, petitioner was actively engaged in real estate investment and finance. As a result of his experience, he became familiar with the intricacies of various real estate transactions, one form of which is the subject herein.

Petitioner's modus operandi was generally the same for all 10 transactions challenged by respondent. Typically, petitioner would form a financing corporation with an initial capitalization of $1,000. The shareholders consisted of those individuals who would ultimately receive title to the property, as explained infra.

Petitioner would then arrange to have the corporation purchase a building which some other manufacturing or commercial concern (hereinafter referred to as the user) desired to lease; on occasion, the seller was the user itself. Then within several days, and, more often, on the same day, all of the following transactions would take place: (1) The seller would convey the property to the financing corporation; (2) the financing corporation would enter into a lease with the user; and (3) the financing corporation would then sell its own negotiable interest-bearing corporate notes in an amount equal to the purchase price to an institutional lender (or lenders, as the case might be) pursuant to a note purchase agreement (as the document was usually called), which would provide that the notes be secured by ***762** a first mortgage (which sometimes took the form of a deed of trust), and by an assignment of the lease.

The mortgage notes provided for payment to be made over a period equal to or less than the primary term of the lease and the financing corporation was also obligated to pay for all of the lender's out-of-pocket expenses, including legal fees.

The mortgage was a lengthy, detailed document covering almost every conceivable contingency. It spelled out in great detail the terms of payment and right of prepayment, the rights of the parties in case of default, and the responsibilities and limitations of the financing corporation under the agreement. More specifically, the corporation promised to maintain its existence and to refrain from any business activity whatsoever except that which arose out of the ownership and leasing of the property. Payments by the lessee were to be made directly to the mortgagee (or trustee) in satisfaction of payments on the secured notes. Moneys received under the lease were to be first applied to payment on the mortgage notes with the remainder to be paid over to the financing corporation. Provision was made as to the circumstances under which the corporation could sell or transfer the property, the transferee being required to assume all obligations under the mortgage and lease except that the transferee assumed no personal financial obligation for the payment of principal and interest or any other monetary judgment, liability on such assumption being limited to the property transferred. The transferee was also required to compel the financing corporation to maintain its existence, prevent it from engaging in any business other than that arising out of the property and lease thereon, cause such corporation to maintain books available for inspection by the mortgagee, and prevent any merger or consolidation by such corporation with any other corporation.

The lease was for a primary term at least equal to, and, on occasion, in excess of, the period of the mortgage note. Provision was also made for payment by the lessee of all taxes, insurance, repairs, etc., and all costs of acquisition save the purchase price incurred by the lessor— i.e., it was a net lease. The lessee's right and interest in the property, easements, or appurtenances were subordinated to the mortgage. Payments under the lease were to continue even if the building was destroyed; the lessee had the right to purchase the property in such event for a price set in accordance with a schedule attached to the lease which approximated the amount required from the lessor to prepay the note. Refusal to accept the offer of purchase would result in the termination of the lease. The lessee further agreed to indemnify the lessor from any liability resulting from any occurrence on the premises or because of the work being done on the premises by the lessee. The lessee was permitted to sublease the premises or any portion thereof, and he was permitted to assign his interest in the lease, providing ***763** the sublessee or assignee promised to comply with the terms of the mortgage and the lease and further providing the lessee remain personally liable for the performance of all its obligations under the lease.

Upon the completion of the foregoing, the financing corporation would convey the property to its shareholders for 'One dollar and other valuable consideration,' subject to the lease and the mortgage and without any cash payment or promise thereof by the transferee. Concurrently, the transferee would execute an assumption agreement in favor of the financing corporation, promising to assume all of the financing corporation's obligations under the lease and the mortgage but limited as aforesaid.

The particulars of the various transactions, insofar as they are material to the within case, are summarized in the following chart and the qualifications thereafter set forth:

Property and (financing corporation)	Nature of improvement	Purchase price	Financing	Lessee	Lease base term (years)	Lease renewal term	Annual rental
Colton, Cal. (Stembernardino Properties, Inc.)	Bank bldg.	$260,835	$250,000—secured by 6% mortgage notes	American National	26	3 successive 10-year terms at $5,000 annually	$17,048.45
Silver Spring, Md. (Instrument Properties, Inc.)	Warehouse.	215,000	$215,000—secured by 5.25% secured notes	Beckman Properties, Inc.	25	4 successive 5-year terms at $5,375 annually	14,835.00
Kinney Shoe (Janess Properties, Inc)	Stores......	1,355,600	$1,355,600—secured by 6% mortgage notes	Kinney Shoe Affiliates	25	3 successive 5-year terms at $37,413 annually	93,528.00
Muskegon, Mich. (Georgiana Properties, Inc.)	Bank bldg.	1,650,000	$1,650,000—secured by 5.25% mortgage notes	National Lumberman's Bank	30	5 successive 5-year terms at reduced rent at % of cost	107,065.00
San Antonio, Texas (Andrean Properties, Inc.)	Warehouse	370,000	$370,000—secured by 5.20% secured notes	Shop-Rite Foods, Inc.	20	4 successive 5-year terms at reduced rent at % of cost	36,340.00
Rockford, Ill. (North Park Properties, Inc.)	Factory bldg.	935,000	$935,000—secured by 5.35% secured notes	National Can Corp.	25	4 successive 5-year terms at reduced rent at % of cost	65,544.00
Long Island City, New York (East River Properties, Inc.)	Factory bldg.	2,000,000	$2,050,000—secured by 6.125% secured notes	National Can Corp.	26	1 ten-year, 3 five-year terms at reduced rent at % of cost	158,024.00
Etiwanda, Cal. (Fontana Properties, Inc.)	Factory bldg.	1,560,000	$1,546,800—secured by 5.80% secured notes	National Can Corp.	28	5 successive 5-year terms at reduced rent at % of cost	106,950.00
Detroit, Mich. (Milk Properties, Inc.)	Milk processing plant	2,300,000	$2,300,000—secured by 6.50% mortgage notes	Borman Food Stores, Inc.	26	1 ten-year, 3 five-year terms at reduced rent at % reduction	176,120.00
IBM Computer (Bettina Properties, Inc.)	Computer.	187,935 (9/1) 58,299 (9/30)	$189,600 plus $58,300—secured by a promissory note at 5% int. per year.	Raytheon Company	8 6	5 one-year terms	40,749.00

Property and (financing corporation)	Fixed mortgage payments—principal and interest, annual	Method of depreciation used	Amount of depreciation claimed	Interest expense	Rent expense	Net loss from property	Date financing and lease arrangements completed	Petitioner's interest in (1) corporation; (2) deed; (3) date of transfer
Colton, Cal. (Stonbernardino Properties, Inc.)	$16,784	150% declining balance	1963–$2,764 1964–16,128 1965–13,505 1966–11,493	$879 8,067 7,917 7,760	$455 5,456 5,455 5,455	$2,477 12,590 9,828 7,664	May 31, 1963	(1) 100% (2) 100% (3) 11/1/63
Silver Spring, Md. (Instrument Properties, Inc.)	14,304	Straight line	1964– 2,656 1965– 3,064 1966– 2,915	1,620 2,737 2,693	-------- 219 13	1,185 2,311 1,912	Feb. 28, 1964	(1) 25% (2) 25% (3) 2/28/64
Kinney Shoe (Janess Properties, Inc.)	92,508	Straight line	1964– 6,703 1965–23,747 1966–22,876	7,924 16,621 16,288	-------- 220 62	3,542 17,206 15,844	June 12, 1964	(1) 25% (2) 25% (3) 6/12/64
Muskegon, Mich. (Georgiana Properties, Inc.)	105,824	Straight line	1965–18,912 1966–27,451	12,634 21,138	3,101 67	21,265 21,892	Sept. 24, 1963	(1) 25% (2) 25% (3) 9/24/63
San Antonio, Texas (Andrean Properties, Inc.)	35,732	Straight line	1965– 9,607 1966– 6,216	3,946 5,910	299 3	6,252 3,044	Dec. 28, 1964	(1) 25% (2) 25% (3) 12/28/64
Rockford, Ill. (North Park Properties, Inc.)	65,344	Straight line	1966–12,056	7,423	265	5,956	Mar. 31, 1966	(1) 25% (2) 25% (3) 3/31/66
Long Island City, New York (East River Properties, Inc.)	188,024	150% declining balance	1966–19,316	--------	--------	19,316	June 22, 1966	(1) 100% (2) 100% (3) 6/22/66
Etiwanda, Cal. (Fontana Properties, Inc.)	106,571	150% declining balance	1966–61,378	54,272	--------	49,242	May 17, 1966	(1) 100% (2) 100% (3) 5/17/66
Detroit, Mich. (Milk Properties, Inc.)	175,160	Double declining balance	1966–31,469	--------	--------	31,469	Aug. 19, 1966	(1) 100% (2) 25% (3) 9/19/66
IBM Computer (Bettina Properties, Inc.)	Not available	150% declining balance or double declining balance	1963–23,239 1964–56,334 1965–42,251 1966–31,688	-------- 11,812 10,615 9,105	-------- -------- -------- --------	23,239 27,398 12,117 44	Sept. 1, 1963 and Oct. 1, 1963	(1) 100% (2) 100% (3) 9/1/63 and 10/1/63

***764** In the Colton, Calif., transaction, the transfer of the property from Stonbernardino Properties, Inc., to petitioner was delayed for 5 months. Also, upon receipt of the deed, petitioner conveyed the underlying land to a third party for $83,923.91 and simultaneously leased the property back for a term equal to that of the primary lease on the building. Petitioner paid a rental equal to 32 percent of the rent received from the lessee of the building less 32 percent of any expenses incurred by Stonbernardino or petitioner in conformity with the mortgage and lease.

In the Kinney Shoe transaction, one of seven parcels acquired by Janess Properties, Inc., was not actually conveyed to it until July 29, 1964, a month and a half after the original transaction was executed. All transfers of the parcel to petitioner and his associates then proceeded as in the model transaction.

***765** In the San Antonio transaction, the initial amount of financing proved inadequate to cover the cost of the facilities built on the property. Therefore, on June 15, 1965, about 6 months after the initial transactions, an additional $100,000 was financed in a manner similar to the initial cost. The mortgage and lease agreements were amended to absorb this cost and Andrean Properties, Inc., was a party to the modification documents.

In the Etiwanda, Calif., and Rockford, Ill., transactions, a separate document was executed purporting to designate the financing corporation as the nominee of petitioner and his associates.

In each instance, the fair market value of the underlying property was at least equal to the face amount of the mortgage, or the unpaid balance thereof, at the date the financing transactions were completed and at the date of the transfers to petitioner and, in some instances, to his associates.

Petitioner reported in the tax returns for the years in question his proportionate share of the income and deductions attributable to the properties after his acquisitions.

OPINION

The dispute in this case— whether petitioner is entitled to depreciation deductions under section 167[1] with respect to certain properties—arises from a single factual pattern repeated several times, planned and executed by the petitioner, on each occasion using a different property and different persons in the supporting roles of lessee and mortgagee. In each instance, the petitioner acquired legal title to the property, subject to a long-term lease of the property and a mortgage encumbering the property in respect of which he assumed no personal liability. At the time of petitioner's acquisition, the value of each property at least equaled the unpaid principal amount of the mortgage, and petitioner neither made nor obligated himself to make any cash investment in the property out of his own pocket.

The essential facts of the several transactions are set forth in our findings and include a recital of certain variations in respect of the several properties involved. Neither party argues that these variations should produce different results for a particular piece of property.[2] The two issues upon which resolution of the basic question depends are: (1) Should the corporations from which the petitioner acquired his ownership interest in the properties be recognized as separate viable entities; and (2) if they should be so recognized, are they or ***766** the petitioner entitled to an allowance for depreciation and for other related items.

We consider first the viability of the corporations. There is no question that they were organized and utilized in the initial stages for business purposes, namely, to enable the contemplated transactions to produce maximum financing by avoiding State law restrictions on loans to individuals rather than corporate borrowers, to provide a mechanism for limiting personal liability, and to facilitate multiple-lender financing. In furtherance of these purposes, the corporations purchased the properties, entered into the leases, issued their corporate obligations, and executed mortgages and assignments of the leases as security for the payment of those obligations. At that point of time the corporations were undoubtedly separate viable entities whose separate existence could not be ignored for tax purposes. Moline Properties v. Commissioner, 319 U.S. 436 (1943). The activities of the corporations involved in Jackson v. Commissioner, 233 F.2d 289 (C.A. 2, 1956), O'Neill v. Commissioner, 170 F.2d 596 (C.A. 2, 1948), and Dallas Downtown Development Co., 12 T.C. 114 (1949), relied upon by petitioner, were far less by comparison; those cases are therefore distinguishable. Nor do we think the record herein can support petitioner's assertion that, in engaging in the aforementioned transactions, the corporations were merely acting as agents or nominees.[3] National Carbide Corp. v. Commissioner, 336 U.S. 422 (1949); Taylor v. Commissioner, 445 F.2d 455 (C.A. 1, 1971), affirming a Memorandum Opinion of this Court;

Fort Hamilton Manor, Inc., 51 T.C. 707, 719-720 (1969), affd. 445 F.2d 879 (C.A. 2, 1971). Compare Paymer v. Commissioner, 150 F.2d 334 (C.A. 2, 1945), reversing in part a Memorandum Opinion of this Court on facts distinguishable from those involved herein. Indeed, the existence of an agency relationship would have been self-defeating in that it would have seriously endangered, if not prevented, the achievement of those objectives which, in large part, gave rise to the use of the corporations, namely, the avoidance of restrictions under State laws.

We still must determine however, whether the corporations should be recognized as separate viable entities after the transfers of the properties in question. At that point, they were stripped of their assets and, by virtue of their undertakings, could not engage in any other business activity. On the other hand, the corporations continued to be liable on their obligations to the lenders and were required, under the ***767** terms of those obligations, to remain in existence, to abide by certain other undertakings, and to preserve their full powers under the applicable State laws to own property and transact business. Moreover, the transferees of the properties agreed to cause the corporations to comply with their undertakings, albeit that any claim for breach of such agreement was limited to the property and could not constitute a basis for the assertion of personal liability. Finally, we note that, in the case of the San Antonio property, the corporation participated in refinancing arrangements subsequent to the transfer to petitioner.

Under the foregoing facts and based upon the record before us, the circumstances herein do not constitute an exception to the following test enunciated in Moline Properties, Inc. v. Commissioner, 319 U.S. at 438-439, and we hold that the corporations continued to be separate viable entities for tax purposes:[4]

The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity. * * * (Citations omitted.)

On the same basis, we conclude that the corporations cannot be considered as agents of the transferees during the period following the transfers.

Having held that the corporations should be treated as separate viable entities at all times pertinent herein, we are required to decide the second issue raised by the parties— whether petitioner as a transferee of the properties in question is entitled to the deduction for depreciation. Resolution of this issue depends upon who has the depreciable interest in the properties, the corporations or the petitioner,[5] and, in the event that it is the petitioner, the measure of his basis. The key to our decision ultimately lies in a determination of the extent to which the doctrine of Crane v. Commissioner, 331 U.S. 1 (1947), applies.

We turn first to a consideration of the nature of the interest which the petitioner acquired. Petitioner contends that he and his associates acquired both legal title and full beneficial ownership of the properties from the corporations. Respondent counters with the assertion ***768** that, because of the long-term leases and the commitments of the rentals to the payment of the mortgages by virtue of the assignments of the leases which were consummated prior to the execution of the deeds, the conveyances by each corporation transferred only a reversionary interest in the buildings[6] and that consequently petitioner did not acquire a present interest in the properties which may be depreciated for income tax purposes. We agree with petitioner.

Implicit in respondent's position is the concept that, by virtue of the leases and financing transactions, the corporations divested themselves of all but bare legal title to the properties. Following this concept to its logical conclusion would require a determination either that the corporations thereby deprived themselves of any presently depreciable interest or that their right to deduct the cost of the buildings should be by way of amortization over the lease terms. But both possibilities are belied by respondent's basic argument that the corporations retained such an interest in the properties as against their transferees that they, and not the latter, should be held accountable for the income from the properties and be entitled to the depreciation deduction.[7] Compare Harriet M. Bryant Trust, 11 T.C. 374 (1948). See also sec. 1.167(a)-4, Income Tax Regs. (capital expenditures for buildings by a lessor are recoverable through depreciation allowances over the life of the buildings and not the term of the lease). The assignments of the leases, like the mortgages, were transfers solely for security and did not relieve the corporations from being charged with the rents for income tax purposes. Ethel S. Amey, 22 T.C. 756 (1954). Each lease was part and parcel of the ownership of the particular property the legal and beneficial ownership of which was vested at the outset in the appropriate corporation. Cf. LeBelle Michaelis, 54 T.C. 1175 (1970). It is this critical factor which distinguishes the cases, relied upon by respondent, dealing with the right of a lessor to depreciate buildings constructed on his land by the lessee. The lessee, by virtue of his expenditure, was clearly entitled either to depreciation of the building or amortization of its costs over the term of the lease. The question presented was whether the lessor, as the legal owner of the building, could also claim depreciation. Thus, unlike the instant situation, where both parties agree that only the corporations or the transferees, but not both, are entitled to depreciation, the courts were faced with the possibility of a double deduction. The beneficial ownership of the buildings was held to be vested in the lessee and the technical vesting of legal title in the lessor by virtue of the ownership of the land ***769** was not deemed sufficient to permit the conclusion that the lessor had a depreciable interest. See the discussion in World Publishing Co. v. Commissioner, 299 F.2d 614 (C.A. 8, 1962), reversing 35 T.C. 7 (1960), and in Albert L. Rowan, 22 T.C. 865 (1954). See also Buzzell v. United States, 326 F.2d 825 (C.A. 1, 1964); Catharine B. Currier, 51 T.C. 488 (1968). Such lack of depreciable interest in the lessor has generally been the foundation for denying a depreciation allowance to the lessor's transferee— at least where the transfer was by way of inheritance. Albert L. Rowan, supra, and cases cited therein.[8]

In short, as we see the situation, the real question to be decided is what was petitioner's basis in each of the properties. Before proceeding to a discussion of this question, we need to dispose of certain preliminary contentions on the part of respondent. First, he contends that petitioner has not proved by what means he acquired his claimed interests in the properties—whether as a purchaser or as a shareholder in receipt of corporate distributions by way of dividends, in liquidation, or otherwise. Ancillary to this argument and also in an attempt to avoid the impact of Crane v. Commissioner, supra, respondent argues that petitioner has failed to prove that the fair market value of the properties, at the time of his acquisition, was equal to or in excess of the face amounts of the mortgages. In respect of the latter contention, whatever may be the state of the record herein as to the value of the properties without regard to the leases or at dates subsequent to those on which the corporations made the transfers, we are satisfied both independently on the facts revealed by the record and also on the basis of respondent's stipulation at the trial that, at the time of transfer by the corporations, the fair market value of each property, taking the existing lease into account (cf. LeBelle Michaelis, supra), at least equaled the remaining principal balance of the unassumed mortgage. Such being the case and considering the fact that neither party claims any value in excess of such unpaid balance, it seems clear to us that if that unpaid balance is deemed part of petitioner's basis, that cost and the fair market value of each property will be in the same amount and it will be immaterial whether petitioner's basis is determined under section 1012 (cost) or under section 301(d) or 334(a) (fair market value). It is, therefore, unnecessary for petitioner ***770** to prove, or for us to decide, whether petitioner took title as purchaser or shareholder.

This brings us to the final question to be considered, namely, should the unpaid balance of each mortgage be deemed part of petitioner's basis even though petitioner and his associates assumed no liability in respect thereto. Had petitioner accepted personal liability for the mortgage debt, instead of merely taking the leased property subject to the lien but without personal liability, there would be no legitimate question that the debt as assigned was part of the basis of the property. Thus, the issue is whether the absence of such personal liability should produce a different result. In Crane v. Commissioner, supra, the Supreme Court held that the amount of a mortgage encumbering inherited property should be included in the devisee's basis for such property, whether or not the devisee assumes personal liability for the mortgage. In Blackstone Theatre Co., 12 T.C. 801 (1949), we applied the doctrine of Crane to a purchase and held that the amount of an unassumed lien on acquired property should be included in the cost of the property. Cf. Parker v. Delaney, 186 F.2d 455 (C.A. 1, 1950). We reiterated this conclusion in Manuel D. Mayerson, 47 T.C. 340 (1966), where a purchase-money mortgage without personal liability was included in the amount of basis for purposes of depreciation. In so doing, we were not deterred by the fact that the taxpayer made only a nominal cash investment. We explained that the effect of the Crane doctrine is:

to give the taxpayer an advance credit for the amount of the mortgage. This appears to be reasonable, since it can be assumed that a capital investment in the amount of the mortgage will eventually occur despite the absence of personal liability. * * * (See 47 T.C. at 352. Emphasis added.)

Respondent argues that such an assumption is unreasonable under the facts of the present case. He asserts that petitioner has no reason to protect his interest in the property involved herein, since his cash flow is minimal and the property is mortgaged to the full extent of its value. Such assertion ignores the fact, however, that petitioner's equity in the property increases as the rents under the lease are paid in amortization of the mortgage. This increase in equity will benefit petitioner either by way of gain in the event of a sale or the creation of refinancing potential. Moreover, petitioner will seek to protect his interest in the property in order to retain the benefits of any appreciation in its fair market value.

To claim, as respondent does, that petitioner will be making no investment in the property during the term of the lease merely begs the question. The rents are includable in his income even though they are assigned as security for the payment of the mortgage. See Ethel S. Amey, supra. As we stated in the Mayerson case, the Crane doctrine ***771** permits the taxpayer to recover his investment in the property before he has actually made any cash investment. Every owner of rental property hopes to recoup his investment, plus a profit, from the receipt of rental income. In the normal case, he applies part of this income to the amortization of any mortgage encumbering the leased property, retaining any excess over the mortgage payments as his cash flow. As Mayerson makes clear, petitioner's case should not be treated differently merely because his acquisition of the property is completely financed and because his cash flow is minimal.

Similar reasoning disposes of respondent's argument that, under the circumstances of this case, the likelihood that petitioner will ever be called upon to make any payments on the mortgages is so speculative as to require that the mortgage obligation be characterized as a contingent obligation and not included in cost under the principle enunciated in Columbus & Greenville Railway Co., 42 T.C. 834 (1964), affd. 358 F.2d 294 (C.A. 5, 1966); Albany Car Wheel Co., 40 T.C. 831 (1963), affd, 333 F.2d 653 (C.A. 2, 1964); and Lloyd H. Redford, 28 T.C. 773 (1957). We dealt with those cases in Mayerson and distinguished them on the ground that the underlying obligations, by their terms, were contingent. See

47 T.C. at 353-354. Such is not the situation herein.

Finally, our finding that the unpaid principal balance of each mortgage was equivalent with the fair market value of the property at the time of transfer by each corporation obviates the need to consider whether the Crane doctrine should apply where that circumstance does not exist. See Crane v. Commissioner, 331 U.S. at 12, fn. 37; Parker v. Delaney, 186 F.2d at 458; compare Edna Morris, 59 T.C. 21 (1972).

The combination of the benefits of accelerated depreciation and the Crane doctrine produces a bitter pill for respondent to swallow. We see no way of sugar-coating that pill, short of overruling Crane v. Commissioner, supra, which we are not at liberty to do.[9]

Because of the various concessions made by the parties and to reflect our conclusions herein,

Decisions will be entered under Rule 50.

Reviewed by the Court.

SCOTT, J., dissenting: I respectfully disagree with the conclusion of the majority in this case since in my view petitioner and his associates ***771** were merely owners of an equity or stock interest in the various corporations.

GOFFE, J., agrees with this dissent.

QUEALY, J., dissenting: If compelled to travel the same route taken by the majority, I would nevertheless reach a different conclusion. My disagreement with the majority, however, goes deeper than that. As Appellate Judge Rives aptly observed in Davant v. Commissioner, 366 F.2d 874, 879 (C.A. 5, 1966), our decision should be compatible with the statute as a whole. He said:

We stand now at the threshold of our travel through the detailed and complex Code provisions that must govern our determination. Before we embark upon that journey it is well to restate the general principle that rules prescribed by Congress in the Code are often wholly reasonable and appropriate when taken in isolation, but that fact alone should not and must not prevent a court from harmonizing these apparently divergent elements of specific policy so that they may continue to cohabit the same body of general law which Congress has directed shall be viewed as a single plan. As Mr. Justice Frankfurter so aptly stated (Universal Camera Corp. v. NLRB, 340 U.S. 474, 71 S.Ct. 456, 95 L.Ed. 456, 489 (1951)), 'There are no talismanic words that can avoid the process of judgment.' (Fn. omitted.)

We should not be diverted by 'mere formalities' designed to make a transaction appear to be other than what it was in order to achieve a tax result. Commissioner v. Court Holding Co., 324 U.S. 331 (1945). Rather than be concerned with the separate steps in the 'paper jungle,' I would look to the position of the parties when the transaction has been completed. I would thus be guided by a long line of cases following Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179 (1942), holding that a connected series of acts must be construed as a single transaction and so judged under the internal revenue laws. Applying these principles to the facts in this case, it is my opinion that when all of the so-called paper work is considered, the interests acquired by the petitioner and his associates must be deemed to constitute an equity or stock interest in a taxable association.

The transactions which are involved in this proceeding followed a common pattern. The petitioner would contact a commercial or manufacturing corporation which either had or was in the process of acquiring a facility. Petitioner would thereupon negotiate the terms of an agreement whereby the user of the facility would sell the property and lease it back under a long-term lease at a rental adequate to support the financing of the full amount of the purchase price. The petitioner would then cause to be organized a 'financing corporation' which would take title to the property, enter into the lease with the user, and issue its notes to a lending institution, secured by a mortgage on the ***773** property and assignment of the lease, in order to obtain the funds for the purchase. As security for its notes, the financing corporation would convey to a trustee all its right, title, and interest in and to the property, including all rents and income therefrom. The financing corporation further covenanted to preserve its existence as a corporation and to keep in full force and effect its right to own such property and to transact business for so long as the notes were outstanding.

As an integral part of the transaction, the petitioner simultaneously had the financing corporation execute a deed purporting to transfer the property to the petitioner and his associates. The petitioner and his associates then entered into an assumption agreement whereby they agreed to be bound by the terms and conditions of the deed of trust, the lease and its assignment, together with any other obligations imposed on the financing corporation except that they assumed no obligation for the payment of principal and interest on the notes or any monetary judgment resulting therefrom.[1]

The use of the financing corporation enabled the petitioner inter alia (1) to obtain from institutional lenders a loan for the full amount of the purchase price, (2) to avoid any personal liability on account of such financing, (3) to increase the marketability of the financing, and (4) to avoid any restrictions applicable under State laws in the case of individual borrowers. In addition, the holding of title and the execution of the lease in the name of the financing corporation enabled the petitioner to create subordinated fractional interests which could be transferred without affecting the continuity of the mortgage, deed of trust, lease, and the like.

In the internal revenue laws, the term 'corporation' is not limited to what might be considered a corporation organized under State law. Sec. 301.7701-1, Proced.&Admin.Regs. Section 7701(a)(3) provides: 'CORPORATION.— The term 'Corporation' includes associations, joint-stock companies, and insurance companies.'

In his regulations, the respondent has enumerated the major characteristics of an entity taxable as a corporation under section 7701(a)(3), as follows:

Sec. 301.7701-2 Associations, including organizations labeled 'corporations.'— (a) Characteristics of corporations. (1) The term 'association' refers to an organization whose characteristics require it to be classified for purposes of taxation as a corporation rather than as another type of organization such as a partnership or a trust. There are a number of major characteristics ordinarily found in a pure corporation which, taken together, distinguish it from other organizations. These are: (i) Associates, (ii) an objective to carry on business and divide ***774** the gains therefrom, (iii) continuity of life, (iv) centralization of management, (v) liability for corporate debts limited to corporate property, and (vi) free transferability of interests. Whether a particular organization is to be classified as an association must be determined by taking into account the presence or absence of each of these corporate characteristics. The presence or absence of these characteristics will depend upon the facts in each individual case. In addition to the major characteristics set forth in this subparagraph, other factors may be found in some cases which may be significant in classifying an organization as an association, a partnership, or a trust. An organization will be treated as an association if the corporate characteristics are such that the organization more nearly resembles a corporation than a partnership or trust. See Morrissey et al. v. Commissioner (1935) 296 U.S. 344.

In Morrissey v. Commissioner, 296 U.S. 344 (1935), the Supreme Court not only confirmed the authority of the respondent to issue such regulations, but approved the enumerated characteristics as appropriate criteria in determining whether a business entity or association, whether incorporated or otherwise, is to be treated as a taxable entity under section 7701(a)(3), separate and apart from its shareholders or participants. It thus becomes a question whether taking the enterprise as a whole, and looking to the characteristics enumerated, it more closely resembles a corporation than a partnership, trust, or proprietorship. If so, the interests acquired by the petitioner and his associates would be that of 'stockholders' as distinguished from owners of the property. Morrissey v. Commissioner, supra; Bloomfield Ranch v. Commissioner, 167 F.2d 586 (C.A. 9, 1948).

The mechanics were such that the petitioner had provided continuity in the form of a corporation organized to take title to the property, limited liability on the part of the participants who held an undivided interest in the property, centralized management in that as the principal officer of the corporation petitioner conducted all negotiations and made all decisions; and, transferability of interest on the part of participants without affecting the obligations with respect to the property all of which had been undertaken in the name of the corporation. These objectives could only be achieved through an entity which would provide the continuity of ownership, centralization of control, and limitation of liability that are characteristic of the corporate form.

Contrary to the opinion of the majority, fractional interests were not necessarily issued upon the basis of formal ownership of the stock in the financing corporation. Under the opinion of the majority, the corporation was immediately stripped of all its assets. The stockholders of record owned mere pieces of paper. The real equity in the financing corporation was represented by the deeds transferring fractional interests to the petitioner and his associates, not by the shares of stock. Thus, when we look to the transaction as a whole, there are ***775** present all of the characteristics enumerated by the respondent in section 301.7701-2, Proced.&Admin.Regs. Such entity must be recognized under the internal revenue laws as a 'taxpayer' distinct and apart from the petitioner and his associates. Both the income and deductions reflected by the petitioner in his individual returns were chargeable to that 'taxpayer.' Morrissey v. Commissioner, supra; Kurzner v. United States, 413 F.2d 97 (C.A. 5, 1969).

I must also disagree with the opinion of the majority in its application of the law to the separate components of the transactions presented here. While Crane v. Commissioner, 331 U.S. 1 (1947), holds that a taxpayer is entitled to include in his basis for purposes of depreciation a bona fide indebtedness encumbering the property at the time acquired, it is axiomatic for the application of this rule that the indebtedness is discharged by the taxpayer either directly with his own funds or out of taxpayer's interest in the income from the property. Where a taxpayer neither puts up his own funds nor is chargeable with the income used to discharge the indebtedness, such taxpayer never acquires a basis in the property.

The identity and continued role of the financing corporation as mortgagor and lessor of the property was essential. Under the terms of the loan agreements, the mortgage notes were required to be maintained as the direct obligation of the issuing corporation. Any income designated to the payment thereof would necessarily be chargeable in the first instance, at least, to such corporation.

If the deeds granting the petitioner and his associates fractional interests in the properties effectively transferred ownership thereof from the financing corporations, those corporations would be stripped of all of their assets. The financing corporation would be an empty shell. While the majority thus purports to recognize that such corporations were at all times viable entities for tax purposes, the ultimate decision of the majority is incompatible with that principle. To put the matter simply, having transferred its entire interest in the leasehold to a trustee to collect the rents and pay its indebtedness, I would regard the documents purporting to transfer the property to the petitioner and his associates as carrying no present interest. The petitioner had no present interest in the property which was subject to depreciation. M. DeMatteo Construction Co. v. United States, 433 F.2d 1263 (C.A. 1, 1970).[2]

The position of the petitioner and his associates was no different than that of an owner of land who leases it to another under an agreement ***776** whereby the lessee will cause a building to be erected on the land. The lessee goes out and obtains a loan secured by a mortgage on his leasehold interest, including the building. The income or rents from the property are then applied, in part, to amortize this loan. When the ground lease expires, the owner of the land will get back his land, together with the building. Some day, the landowner will get it all. The petitioner has the same expectations. During the intervening period, however, the rents are not taxable to him merely because of their application to the discharge of an indebtedness which encumbers the property. Neither has sustained any depreciation. For example, see Schubert v. Commissioner, 286 F.2d 573 (C.A. 4, 1961), affirming 33 T.C. 1048 (1960); Reisinger v. Commissioner, 144 F.2d 475 (C.A. 2, 1944); Albert L. Rowan, 22 T.C. 865 (1954).

GOFFE, J., agrees with this dissent.

GOFFE, J., dissenting: As indicated, I agree with the views of Judge Quealy expressed in his dissenting opinion. I feel, however, that some additional comment is warranted as to the substance of the steps comprising the pattern utilized by petitioners.

In order to make the pattern work from a business standpoint, the corporate form had to be adopted; it was indispensable. Not only did the corporation have to be organized; it had to continue in existence until the indebtedness was extinguished. After title was transferred to the individuals, the corporation continued to own the most valuable present right in the property, the right to the income which would extinguish the indebtedness. Because of this I feel that attention should be focused on the transfer of title from the corporation to the individuals. The transfer of title served no business purpose; it transferred the only revenue-producing asset of the corporation but was not even supported by action of the board of directors in order to give the transfer an aura of respectability. It was nothing more than an integrated step in the 'paper work.' Assuming that the parties intended the transfer of title to be a dividend, they did not even carry out the necessary steps to make it look like a dividend.

After the transfer of title the corporation continued to be liable on the debt and the individuals were not monetarily liable.

I conclude that the transfer of title was for the sole purpose of passing on to the individuals a deduction for accelerated depreciation in excess of the income from the property. Furthermore, I do not see how the reporting of income by the individuals adds any strength to petitioners' case. In my view both the income and the deductions belong to the corporation.

I conclude that the transfer of title was nothing more than a device to secure for the petitioners the benefits of subchapter S status which they could not otherwise enjoy. ***777** Gregory v. Helvering, 293 U.S. 465 (1935). I do not believe petitioners should be able to accomplish by indirect means what they could not do directly. I would, therefore, disallow the deduction for depreciation to the Individuals.

Wiles, J., agrees with this dissent.

Footnotes

1 All statutory references are to the Internal Revenue Code of 1954, as amended.

2 They have simply pointed to these variations as supportive of their arguments in respect of the two indicated issues. We will accordingly treat these variations in the same fashion.

3 In the case of the Etiwanda, Calif., and the Rockford, Ill., properties, there is nominee language in the pertinent documents, but, in our opinion, such language does not overcome the numerous other elements which have a more than counterbalancing effect. See Fort Hamilton Manor, Inc., 51 T.C. 707 (1969), affd. 445 F.2d 879 (C.A. 2, 1971). In any event, as we have previously pointed out, neither party has sought separate treatment for particular transactions.

4 In so concluding, we have taken into account that, in situations such as are involved herein, the taxpayer may have less freedom than the Commissioner v. State-Adams Corporation, 283 F.2d 395, 398-399 (C.A. 2, 1960). Compare Higgins v. Smith, 308 U.S. 473 (1940); Aldon Homes, Inc., 33 T.C. 582, 596 (1959).

5 Respondent concedes that the leases involved should be recognized as such and makes no argument that the lessees are the ones to whom the benefit of a depreciation deduction should inure. Cf. Helvering v. Lazarus & Co., 308 U.S. 252 (1939).

6 Respondent does not indicate his position vis-a-vis the land involved, presumably because it is in any event not subject to an allowance for depreciation.

7 As previously pointed out, respondent does not attack the validity of the leases. See fn. 5 supra.

8 In this connection, we note that the position of the lessor is sometimes also discussed in terms of his not having any basis. What is more, such discussion sometimes confuses the two questions, i.e., existence of a depreciable interest and the measure of basis, of which respondent's briefs herein furnished an excellent example. See also. e.g., M. DeMatteo Construction Co. v. United States, 433 F.2d 1263 (C.A. 1, 1970). Where the transfer is by way of sale, the authorities are divided. Compare World Publishing Co. v. Commissioner, 299 F.2d 614 (C.A. 8, 1962), reversing 35 T.C. 7 (1960), with M. DeMatteo Construction Co. v. United States, supra. Since, in our view, the instant case is distinguishable, we need not now decide which line of authority to follow.

9 Crane has been the subject of extensive discussion, some of it critical. See Andrews, 'Personal Deductions in an Ideal Income Tax,' 86 Harv.L.Rev. 309, 379, fn. 122 (1972); Perry, 'Limited Partnerships and Tax Shelters: The Crane Rule Goes Public,' 27 Tax L.Rev. 525 (1972); Adams, 'Exploring the Outer Boundaries of the Crane Doctrine: An Imaginary Supreme Court Opinion,' 21 Tax L.Rev. 159 (1966).

1 In reality the so-called assumption agreements were little more than 'window dressing,' since the participants were not subject to any monetary liability. It is questionable whether such agreements served any useful purpose other than to bind petitioner and his associates together in a common business enterprise.

2 In this respect, the facts are distinguishable from World Publishing Co. v. Commissioner, 299 F.2d 614 (C.A. 8, 1962). In that case, the taxpayer acquired by purchase the entire interest of the lessor. Since that interest included both the land and a building erected thereon by the lessee, it was held that the taxpayer acquired a depreciable interest in the building.

COMMISSIONER OF INTERNAL REVENUE *v.* BOLLINGER ET AL.

CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

No. 86-1672. Argued January 13, 1988—Decided March 22, 1988

Because Kentucky's usury law limited the annual interest rate for noncorporate borrowers, lenders willing to provide money only at higher rates required such borrowers to use a corporate nominee as the nominal debtor and record titleholder of mortgaged property. Accordingly, respondents, who formed a series of partnerships to develop Kentucky apartment complexes, in each instance entered into an agreement with a corporation wholly owned by respondent Bollinger, which provided that the corporation would hold title to the property as the partnership's nominee and agent solely to secure financing, that the partnership would have sole control of and responsibility for the complex, and that the partnership was the principal and owner of the property during financing, construction, and operation. All parties who had contact with the complexes, including lenders, contractors, managers, employees, and tenants, regarded the partnerships as the owners and knew that the corporation was merely the partnerships' agent, if they were aware of the corporation at all. Income and losses from the complexes were reported on the partnerships' tax returns, and respondents reported their distributive share of the income and losses on their individual returns. Although the Commissioner of Internal Revenue disallowed respondents' losses on the ground that they were attributable to the corporation as the owner of the property, the Tax Court held that the corporation was the partnerships' agent and should therefore be disregarded for tax purposes, and the Court of Appeals affirmed.

Held: The partnerships were the owners of the complexes for federal income tax purposes, since in each instance the relationship between them and the corporation was, in both form and substance, an agency with the partnership as principal. It is reasonable for the Commissioner to demand unequivocal evidence of an agency relationship's genuineness in the corporation-shareholder context in order to prevent tax evasion. However, there is no merit to the Commissioner's contention that *National Carbide Corp.* v. *Commissioner*, 336 U. S. 422, requires such evidence to include arm's-length dealing between principal and agent and the payment of an agency fee. The genuineness of an agency is adequately assured, where, as here, the fact that the corporation is acting as its shareholders' agent with respect to a particular asset is set forth in a written agreement at the time the asset is acquired, the corporation functions as agent and not principal with respect to the asset for all purposes, and the corporation is held out as the agent and not the principal in all dealings with third parties relating to the asset. Pp. 344–349.

807 F. 2d 65, affirmed.

SCALIA, J., delivered the opinion of the Court, in which all other Members joined, except KENNEDY, J., who took no part in the consideration or decision of the case.

Alan I. Horowitz argued the cause for petitioner. With him on the briefs were *Solicitor General Fried, Acting Assistant Attorney General Durney, Deputy Solicitor General Lauber, Richard Farber,* and *Teresa E. McLaughlin.*

Charles R. Hembree argued the cause for respondents. With him on the brief was *Philip E. Wilson.**

JUSTICE SCALIA delivered the opinion of the Court.

Petitioner, the Commissioner of Internal Revenue, challenges a decision by the United States Court of Appeals for the Sixth Circuit holding that a corporation which held record title to real property as agent for the corporation's shareholders was not the owner of the property for purposes of federal income taxation. 807 F. 2d 65 (1986). We granted certiorari, 482 U. S. 913 (1987), to resolve a conflict in the Courts of Appeals over the tax treatment of corporations purporting to be agents for their shareholders. Compare *George* v. *Commissioner,* 803 F. 2d 144, 148–149 (CA5 1986), cert. pending, No. 86–1152, with *Frink* v. *Commissioner,* 798 F. 2d 106, 109–110 (CA4 1986), cert. pending, No. 86–1151.

I

Respondent Jesse C. Bollinger, Jr., developed, either individually or in partnership with some or all of the other respondents, eight apartment complexes in Lexington, Ken-

F. Kelleher Riess filed a brief for Gary R. Frink et al. as *amici curiae* urging affirmance.

tucky. (For convenience we will refer to all the ventures as "partnerships.") Bollinger initiated development of the first apartment complex, Creekside North Apartments, in 1968. The Massachusetts Mutual Life Insurance Company agreed to provide permanent financing by lending $1,075,000 to "the corporate nominee of Jesse C. Bollinger, Jr." at an annual interest rate of eight percent, secured by a mortgage on the property and a personal guarantee from Bollinger. The loan commitment was structured in this fashion because Kentucky's usury law at the time limited the annual interest rate for noncorporate borrowers to seven percent. Ky. Rev. Stat. §§ 360.010, 360.025 (1972). Lenders willing to provide money only at higher rates required the nominal debtor and record titleholder of mortgaged property to be a corporate nominee of the true owner and borrower. On October 14, 1968, Bollinger incorporated Creekside, Inc., under the laws of Kentucky; he was the only stockholder. The next day, Bollinger and Creekside, Inc., entered into a written agreement which provided that the corporation would hold title to the apartment complex as Bollinger's agent for the sole purpose of securing financing, and would convey, assign, or encumber the property and disburse the proceeds thereof only as directed by Bollinger; that Creekside, Inc., had no obligation to maintain the property or assume any liability by reason of the execution of promissory notes or otherwise; and that Bollinger would indemnify and hold the corporation harmless from any liability it might sustain as his agent and nominee.

Having secured the commitment for permanent financing, Bollinger, acting through Creekside, Inc., borrowed the construction funds for the apartment complex from Citizens Fidelity Bank and Trust Company. Creekside, Inc., executed all necessary loan documents including the promissory note and mortgage, and transferred all loan proceeds to Bollinger's individual construction account. Bollinger acted as general contractor for the construction, hired the necessary employees, and paid the expenses out of the construction account. When construction was completed, Bollinger obtained, again through Creekside, Inc., permanent financing from Massachusetts Mutual Life in accordance with the earlier loan commitment. These loan proceeds were used to pay off the Citizens Fidelity construction loan. Bollinger hired a resident manager to rent the apartments, execute leases with tenants, collect and deposit the rents, and maintain operating records. The manager deposited all rental receipts into, and paid all operating expenses from, an operating account, which was first opened in the name of Creekside, Inc., but was later changed to "Creekside Apartments, a partnership." The operation of Creekside North Apartments generated losses for the taxable years 1969, 1971, 1972, 1973, and 1974, and ordinary income for the years 1970, 1975, 1976, and 1977. Throughout, the income and losses were reported by Bollinger on his individual income tax returns.

Following a substantially identical pattern, seven other apartment complexes were developed by respondents through seven separate partnerships. For each venture, a partnership executed a nominee agreement with Creekside, Inc., to obtain financing. (For one of the ventures, a different Kentucky corporation, Cloisters, Inc., in which Bollinger had a 50 percent interest, acted as the borrower and title-holder. For convenience, we will refer to both Creekside and Cloisters as "the corporation.") The corporation transferred the construction loan proceeds to the partnership's construction account, and the partnership hired a construction supervisor who oversaw construction. Upon completion of construction, each partnership actively managed its apartment complex, depositing all rental receipts into, and paying all expenses from, a separate partnership account for each apartment complex. The corporation had no assets, liabilities, employees, or bank accounts. In every case, the lenders regarded the partnership as the owner of the apartments and were aware that the corporation was acting as agent of the partnership in holding record title. The partnerships reported the income and losses generated by the apartment complexes on their partnership tax returns, and respondents reported their distributive share of the partnership income and losses on their individual tax returns.

The Commissioner of Internal Revenue disallowed the losses reported by respondents, on the ground that the standards set out in *National Carbide Corp.* v. *Commissioner*, 336 U. S. 422 (1949), were not met. The Commissioner contended that *National Carbide* required a corporation to have an arm's-length relationship with its shareholders before it could be recognized as their agent. Although not all respondents were shareholders of the corporation, the Commissioner took the position that the funds the partnerships disbursed to pay expenses should be deemed contributions to the corporation's capital, thereby making all respondents constructive stockholders. Since, in the Commissioner's view, the corporation rather than its shareholders owned the real estate, any losses sustained by the ventures were attributable to the corporation and not respondents. Respondents sought a redetermination in the United States Tax Court. The Tax Court held that the corporation was the agent of the partnerships and should be disregarded for tax purposes. 48 TCM 1443 (1984), ¶84, 560 P-H Memo TC. On appeal, the United States Court of Appeals for the Sixth Circuit affirmed. 807 F. 2d 65 (1986). We granted the Commissioner's petition for certiorari.

II

For federal income tax purposes, gain or loss from the sale or use of property is attributable to the owner of the property. See *Helvering* v. *Horst*, 311 U. S. 112, 116–117 (1940); *Blair* v. *Commissioner*, 300 U. S. 5, 12 (1937); see also *Commissioner* v. *Sunnen*, 333 U. S. 591, 604 (1948). The problem we face here is that two different taxpayers can plausibly be regarded as the owner. Neither the Internal Revenue Code nor the regulations promulgated by the Secretary of the Treasury provide significant guidance as to which should be selected. It is common ground between the parties, however, that if a corporation holds title to property as agent for a partnership, then for tax purposes the partnership and not the corporation is the owner. Given agreement on that premise, one would suppose that there would be agreement upon the conclusion as well. For each of respondents' apartment complexes, an agency agreement expressly provided that the corporation would "hold such property as nominee and agent for" the partnership, App. to Pet. for Cert. 21a, n. 4, and that the partnership would have sole control of and responsibility for the apartment complex. The partnership in each instance was identified as the principal and owner of the property during financing, construction, and operation. The lenders, contractors, managers, employees, and tenants—all who had contact with the development—knew that the corporation was merely the agent of the partnership, if they knew of the existence of the corporation at all. In each instance the relationship between the corporation and the partnership was, in both form and substance, an agency with the partnership as principal.

The Commissioner contends, however, that the normal indicia of agency cannot suffice for tax purposes when, as here, the alleged principals are the controlling shareholders of the alleged agent corporation. That, it asserts, would undermine the principle of *Moline Properties* v. *Commissioner*, 319 U. S. 436 (1943), which held that a corporation is a separate taxable entity even if it has only one shareholder who exercises total control over its affairs. Obviously, *Moline*'s separate-entity principle would be significantly compromised if shareholders of closely held corporations could, by clothing the corporation with some attributes of agency with respect to particular assets, leave themselves free at the end of the tax year to make a claim—perhaps even a good-faith claim—of either agent or owner status, depending upon which choice turns out to minimize their tax liability. The Commissioner does not have the resources to audit and litigate the many cases in which agency status could be thought debatable. Hence, the Commissioner argues, in this shareholder context he can reasonably demand that the taxpayer meet a prophylactically clear test of agency.

We agree with that principle, but the question remains whether the test the Commissioner proposes is appropriate. The parties have debated at length the significance of our opinion in *National Carbide Corp.* v. *Commissioner, supra.* In that case, three corporations that were wholly owned subsidiaries of another corporation agreed to operate their production plants as "agents" for the parent, transferring to it all profits except for a nominal sum. The subsidiaries reported as gross income only this sum, but the Commissioner concluded that they should be taxed on the entirety of the profits because they were not really agents. We agreed, reasoning first, that the mere fact of the parent's control over the subsidiaries did not establish the existence of an agency, since such control is typical of all shareholder-corporation relationships, *id.*, at 429–434; and second, that the agreements to pay the parent all profits above a nominal amount were not determinative since income must be taxed to those who actually earn it without regard to anticipatory assignment, *id.*, at 435–436. We acknowledged, however, that there was such a thing as "a true corporate agent . . . of [an] owner-principal," *id.*, at 437, and proceeded to set forth four indicia and two requirements of such status, the sum of which has become known in the lore of federal income tax law as the "six *National Carbide* factors":

> "[1] Whether the corporation operates in the name and for the account of the principal, [2] binds the principal by

> its actions, [3] transmits money received to the principal, and [4] whether receipt of income is attributable to the services of employees of the principal and to assets belonging to the principal are some of the relevant considerations in determining whether a true agency exists. [5] If the corporation is a true agent, its relations with its principal must not be dependent upon the fact that it is owned by the principal, if such is the case. [6] Its business purpose must be the carrying on of the normal duties of an agent." *Ibid.* (footnotes omitted).

We readily discerned that these factors led to a conclusion of nonagency in *National Carbide* itself. There each subsidiary had represented to its customers that it (not the parent) was the company manufacturing and selling its products; each had sought to shield the parent from service of legal process; and the operations had used thousands of the subsidiaries' employees and nearly $20 million worth of property and equipment listed as assets on the subsidiaries' books. *Id.*, at 425, 434, 438, and n. 21.

The Commissioner contends that the last two *National Carbide* factors are not satisfied in the present case. To take the last first: The Commissioner argues that here the corporation's business purpose with respect to the property at issue was not "the carrying on of the normal duties of an agent," since it was acting not as the agent but rather as the owner of the property for purposes of Kentucky's usury law. We do not agree. It assuredly was not acting as the owner in fact, since respondents represented themselves as the principals to all parties concerned with the loans. Indeed, it was the lenders themselves who required the use of a corporate nominee. Nor does it make any sense to adopt a contrary-to-fact legal presumption that the corporation was the principal, imposing a federal tax sanction for the apparent evasion of Kentucky's usury law. To begin with, the Commissioner has not established that these transactions were an evasion. Respondents assert without contradiction that use of agency arrangements in order to permit higher interest was common practice, and it is by no means clear that the practice violated the spirit of the Kentucky law, much less its letter. It might well be thought that the borrower does not generally require usury protection in a transaction sophisticated enough to employ a corporate agent—assuredly not the normal *modus operandi* of the loan shark. That the statute positively envisioned corporate nominees is suggested by a provision which forbids charging the higher corporate interest rates "to a corporation, the principal asset of which shall be the ownership of a one (1) or two (2) family dwelling," Ky. Rev. Stat. § 360.025(2) (1987)—which would seem to prevent use of the nominee device for ordinary home-mortgage loans. In any event, even if the transaction did run afoul of the usury law, Kentucky, like most States, regards only the lender as the usurer, and the borrower as the victim. See Ky. Rev. Stat. § 360.020 (1987) (lender liable to borrower for civil penalty), § 360.990 (lender guilty of misdemeanor). Since the Kentucky statute imposed no penalties upon the borrower for allowing himself to be victimized, nor treated him as *in pari delicto*, but to the contrary enabled him to pay back the principal without any interest, and to sue for double the amount of interest already paid (plus attorney's fees), see Ky. Rev. Stat. § 360.020 (1972), the United States would hardly be vindicating Kentucky law by depriving the usury victim of tax advantages he would otherwise enjoy. In sum, we see no basis in either fact or policy for holding that the corporation was the principal because of the nature of its participation in the loans.

Of more general importance is the Commissioner's contention that the arrangements here violate the fifth *National Carbide* factor—that the corporate agent's "relations with its principal must not be dependent upon the fact that it is owned by the principal." The Commissioner asserts that this cannot be satisfied unless the corporate agent and its shareholder principal have an "arm's-length relationship" that includes the payment of a fee for agency services. The meaning of *National Carbide*'s fifth factor is, at the risk of understatement, not entirely clear. Ultimately, the relations between a corporate agent and its owner-principal are *always* dependent upon the fact of ownership, in that the owner can cause the relations to be altered or terminated at any time. Plainly that is not what was meant, since on that interpretation all subsidiary-parent agencies would be invalid for tax purposes, a position which the *National Carbide* opinion specifically disavowed. We think the fifth *National Carbide* factor—so much more abstract than the others—was no more and no less than a generalized statement of the concern, expressed earlier in our own discussion, that the separate-entity doctrine of *Moline* not be subverted.

In any case, we decline to parse the text of *National Carbide* as though that were itself the governing statute. As noted earlier, it is uncontested that the law attributes tax consequences of property held by a genuine agent to the principal; and we agree that it is reasonable for the Commissioner to demand unequivocal evidence of genuineness in the corporation-shareholder context, in order to prevent evasion of *Moline*. We see no basis, however, for holding that unequivocal evidence can only consist of the rigid requirements (arm's-length dealing plus agency fee) that the Commissioner suggests. Neither of those is demanded by the law of agency, which permits agents to be unpaid family members, friends, or associates. See Restatement (Second) of Agency §§ 16, 21, 22 (1958). It seems to us that the genuineness of the agency relationship is adequately assured, and tax-avoiding manipulation adequately avoided, when the fact that the corporation is acting as agent for its shareholders with respect to a particular asset is set forth in a written agreement at the time the asset is acquired, the corporation functions as agent and not principal with respect to the asset for all purposes, and the corporation is held out as the agent and not principal in all dealings with third parties relating to the asset. Since these requirements were met here, the judgment of the Court of Appeals is

Affirmed.

JUSTICE KENNEDY took no part in the consideration or decision of this case.

Footnote to Tufts

Reg § 1.1001-2 Discharge of liabilities.

(a) Inclusion in amount realized--(1) In general. Except as provided in paragraph (a)(2) and (3) of this section, the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition.

(2) Discharge of indebtedness. The amount realized on a sale or other disposition of property that secures a recourse liability does not include amounts that are (or would be if realized and recognized) income from the discharge of indebtedness under section 61(a)(12). For situations where amounts arising from the discharge of indebtedness are not realized and recognized, see section 108 and § 1.61-12(b)(1).

(3) Liability incurred on acquisition. In the case of a liability incurred by reason of the acquisition of the property, this section does not apply to the extent that such liability was not taken into account in determining the transferor's basis for such property.

(4) Special rules. For purposes of this section--

(i) The sale or other disposition of property that secures a nonrecourse liability discharges the transferor from the liability;

(ii) The sale or other disposition of property that secures a recourse liability discharges the transferor from the liability if another person agrees to pay the liability (whether or not the transferor is in fact released from liability);

(iii) A disposition of property includes a gift of the property or a transfer of the property in satisfaction of liabilities to which it is subject;

(iv) Contributions and distributions of property between a partner and a partnership are not sales or other dispositions of property; and

(v) The liabilities from which a transferor is discharged as a result of the sale or disposition of a partnership interest include the transferor's share of the liabilities of the partnership.

(b) Effect of fair market value of security. The fair market value of the security at the time of sale or disposition is not relevant for purposes of determining under paragraph (a) of this section the amount of liabilities from which the taxpayer is discharged or treated as discharged. Thus, the fact that the fair market value of the property is less than the amount of the liabilities it secures does not prevent the full amount of those liabilities from being treated as money received from the sale or other disposition of the property. However, see paragraph (a)(2) of this section for a rule relating to certain income from discharge of indebtedness.

(c) Examples. The provisions of this section may be illustrated by the following examples. In each example assume the taxpayer uses the cash receipts and disbursements method of accounting, makes a return on the basis of the calendar year, and sells or disposes of all property which is security for a given liability.

Example 1. In 1976 A purchases an asset for $10,000. A pays the seller $1,000 in cash and signs a note payable to the seller for $9,000. A is personally liable for repayment with the seller having full recourse in the event of default. In addition, the asset which was purchased is pledged as security. During the years 1976 and 1977 A takes depreciation deductions on the asset in the amount of $3,100. During this same time period A reduces the outstanding principal on the note to $7,600. At the beginning of 1978 A sells the asset. The buyer pays A $1,600 in cash and assumes personal liability for the $7,600 outstanding liability. A becomes secondarily liable for repayment of the liability. A's amount realized is $9,200 ($1,600 + $7,600). Since A's adjusted basis in the asset is $6,900 ($10,000 - $3,100) A realizes a gain of $2,300 ($9,200 - $6,900).

Example 2. Assume the same facts as in example 1 except that A is not personally liable on the $9,000 note given to the seller and in the event of default the seller's only recourse is to the asset. In addition, on the sale of the asset by A, the purchaser takes the asset subject to the liability. Nevertheless, A's amount realized is $9,200 and A's gain realized is $2,300 on the sale.

* * *

Example 8. In 1980, F transfers to a creditor an asset with a fair market value of $6,000 and the creditor discharges $7,500 of indebtedness for which F is personally liable. The amount realized on the disposition of the asset is its fair market value ($6,000). In addition, F has income from the discharge of indebtedness of $1,500 ($7,500 - $6,000).

Rev. Rul. 90-16

ISSUE

A taxpayer transfers to a creditor a residential subdivision that has a fair market value in excess of the taxpayer's basis in satisfaction of a debt for which the taxpayer was personally liable. Is the transfer a sale or disposition resulting in the realization and recognition of gain by the taxpayer under sections 1001(c) and 61(a)(3) of the Internal Revenue Code?

FACTS

X was the owner and developer of a residential subdivision. To finance the development of the subdivision, *X* obtained a loan from an unrelated bank. *X* was unconditionally liable for repayment of the debt. The debt was secured by a mortgage on the subdivision.

X became insolvent (within the meaning of section 108(d)(3) of the Code) and defaulted on the debt. *X* negotiated an agreement with the bank whereby the subdivision was transferred to the bank and the bank released *X* from all liability for the amounts due on the debt. When the subdivision was transferred pursuant to the agreement, its fair market value was 10,000*x* dollars, *X*'s adjusted basis in the subdivision was 8,000*x* dollars, and the amount due on the debt was 12,000*x* dollars, which did not represent any accrued but unpaid interest. After the transaction *X* was still insolvent.

LAW AND ANALYSIS

Sections 61(a)(3) and 61(a)(12) of the Code provide that, except as otherwise provided, gross income means all income from whatever source derived, including (but not limited to) gains from dealings in property and income from discharge of indebtedness.

Section 108(a)(1)(B) of the Code provides that gross income does not include any amount that would otherwise be includible in gross income by reason of discharge (in whole or in part) of indebtedness of the taxpayer if the discharge occurs when the taxpayer is insolvent. Section 108(a)(3) provides that, in the case of a discharge to which section 108(a)(1)(B) applies, the amount excluded under section 108(a)(1)(B) shall not exceed the amount by which the taxpayer is insolvent (as defined in section 108(d)(3)).

Section 1.61-6(a) of the Income Tax Regulations provides that the specific rules for computing the amount of gain or loss from dealings in property under section 61(a)(3) are contained in section 1001 and the regulations thereunder.

Section 1001(a) of the Code provides that gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain.

Section 1001(b) of the Code provides that the amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

Section 1001(c) of the Code provides that, except as otherwise provided in subtitle A, the entire amount of the gain or loss, determined under section 1001, on the sale or exchange of property shall be recognized.

Section 1.1001-2(a)(1) of the regulations provides that, except as provided in section 1.1001-2(a)(2) and (3), the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition. Section 1.1001-2(a)(2) provides that the amount realized on a sale or other disposition of property that secures a recourse liability does not include amounts that are (or would be if realized and recognized) income from the discharge of indebtedness under section 61(a)(12). *Example (8)* under section 1.1001-2(c) illustrates these rules as follows:

Example (8). In 1980, F transfers to a creditor an asset with a fair market value of $6,000 and the creditor discharges $7,500 of indebtedness for which F is personally liable. The amount realized on the disposition of the asset is its fair market value ($6,000). In addition, F has income from the discharge of indebtedness of $1,500 ($7,500 − $6,000).

In the present situation, X transferred the subdivision to the bank in satisfaction of the 12,000x dollar debt. To the extent of the fair market value of the property transferred to the creditor, the transfer of the subdivision is treated as a sale or disposition upon which gain is recognized under section 1001(c) of the Code. To the extent the fair market value of the subdivision, 10,000x dollars, exceeds its adjusted basis, 8,000x dollars, X realizes and recognizes gain on the transfer. X thus recognizes 2,000x dollars of gain.

To the extent the amount of debt, 12,000x dollars, exceeds the fair market value of the subdivision, 10,000x dollars, X realizes income from the discharge of indebtedness. However, under section 108(a)(1)(B) of the Code, the full amount of X's discharge of indebtedness income is excluded from gross income because that amount does not exceed the amount by which X was insolvent.

If the subdivision had been transferred to the bank as a result of a foreclosure proceeding in which the outstanding balance of the debt was discharged (rather than having been transferred pursuant to the settlement agreement), the result would be the same. A mortgage foreclosure, like a voluntary sale, is a "disposition" within the scope of the gain or loss provisions of section 1001 of the Code. *See Helvering v. Hammel*, 311 U.S. 504 (1941), 1941-1 C.B. 375; *Electro-Chemical Engraving Co. v. Commissioner*, 311 U.S. 513 (1941), 1941-1 C.B. 380; and *Danenberg v. Commissioner*, 73 T.C. 370 (1979), *acq.*, 1980-2 C.B. 1.

HOLDING

The transfer of the subdivision by X to the bank in satisfaction of a debt on which X was personally liable is a sale or disposition upon which gain is realized and recognized by X under sections 1001(c) and 61(a)(3) of the Code to the extent the fair market value of the subdivision transferred exceeds X's adjusted basis. Subject to the application of section 108 of the Code, to the extent the amount of debt exceeds the fair market value of the subdivision, X would also realize income from the discharge of indebtedness.

7701(g): "[I]n determining the amount of gain or loss (or deemed gain or loss) with respect to any property, the FMV of such property shall be treated as being not less than the amount of any nonrecourse indebtedness to which such property is subject." (enacted in 1984).

Post-1986 "At Risk" Rule

The 1986 Act extended the "at risk" rules to real estate. However and except:

§ 465(b)(6):

(6) QUALIFIED NONRECOURSE FINANCING TREATED AS AMOUNT AT RISK.—For purposes of this section—

(A) IN GENERAL.—Notwithstanding any other provision of this subsection, in the case of an activity of holding real property, a taxpayer shall be considered at risk with respect to the taxpayer's share of any qualified nonrecourse financing which is secured by real property used in such activity.

(B) QUALIFIED NONRECOURSE FINANCING.—For purposes of this paragraph, the term "qualified nonrecourse financing" means any financing—

(i) which is borrowed by the taxpayer with respect to the activity of holding real property,

(ii) which is borrowed by the taxpayer from a qualified person or represents a loan from any Federal, State, or local government or instrumentality thereof, or is guaranteed by any Federal, State, or local government,

(iii) except to the extent provided in regulations, with respect to which no person is personally liable for repayment, and

(iv) which is not convertible debt.

(C) SPECIAL RULE FOR PARTNERSHIPS.—In the case of a partnership, a partner's share of any qualified nonrecourse financing of such partnership shall be determined on the basis of the partner's share of liabilities of such partnership incurred in connection with such financing (within the meaning of section 752).

(D) QUALIFIED PERSON DEFINED.—For purposes of this paragraph—

(i) IN GENERAL.—The term "qualified person" has the meaning given such term by section 49(a)(1)(D)(iv).

(ii) CERTAIN COMMERCIALLY REASONABLE FINANCING FROM RELATED PERSONS.—For purposes of clause (i), section 49(a)(1)(D)(iv) shall be applied without regard to subclause (I) thereof (relating to financing from related persons) if the financing from the related person is commercially reasonable and on substantially the same terms as loans involving unrelated persons.

(E) ACTIVITY OF HOLDING REAL PROPERTY.—For purposes of this paragraph—

(i) INCIDENTAL PERSONAL PROPERTY AND SERVICES.—The activity of holding real property includes the holding of personal property and the providing of services which are incidental to making real property available as living accommodations.

(ii) MINERAL PROPERTY.—The activity of holding real property shall not include the holding of mineral property.

§§ 49(a)(1)(D)(iv) & (v):

(iv) Qualified person.--For purposes of this paragraph, the term "qualified person" means any person which is actively and regularly engaged in the business of lending money and which is not--

(I) a related person with respect to the taxpayer,

(II) a person from which the taxpayer acquired the property (or a related person to such person), or

(III) a person who receives a fee with respect to the taxpayer's investment in the property (or a related person to such person).

(v) Related person.--For purposes of this subparagraph, the term "related person" has the meaning given such term by section 465(b)(3)(C). Except as otherwise provided in regulations prescribed by the Secretary, the determination of whether a person is a related person shall be made as of the close of the taxable year in which the property is placed in service.

MEMORANDUM

TO: Real Estate Finance Students

FROM: Don Weidner

RE: Mechanics Leins

DATED: June 20, 2006

Mechanics lien law requires close consideration of the mechanics lien statue in question. Although the text we are using quotes other relevant types of statutes, it contains limited excerpts from mechanics lien acts. I set out below a series of provisions from one mechanics lien statute for your consideration and application to hypotheticals we shall discuss in class.

> §1. Any person to whom a debt is due for labor performed or furnished or for materials furnished and actually used in the erection, alteration or repair of any building . . . by virtue of an agreement with, or by consent of, the owner of such building or structure, or any person having authority from, or rightfully acting for, such owner in procuring or furnishing such labor or materials shall have a lien upon such building or structure and upon the interest of the owner thereof in the lot of land upon which it is situated to secure the payment of debt so due to him, and the costs which may arise in enforcing such lien under this chapter. . . .

Consider, further, that this first section is encaptioned "Person furnishing labor and materials to have lien on buildings, etc."

> §2. Lien of laborer, mechanic, subcontractor or materialman. --Every laborer, mechanic, subcontractor or person furnishing material for the improvement of real estate when such improvement has been authorized by the owner shall have a lien thereon, subject to existing liens of which he has actual or constructive notice, to the value of the labor or material so furnished. Such lien may be enforced as herein provided.
>
> * * *

§4. Notice to owner when contractor employed. -- Whenever work is done or material is furnished for the improvement of real estate upon the employment of a contractor or some other person than the owner and such laborer, mechanic, contractor or materialman shall in writing notify the owner of the furnishing of such labor or material and the amount or value thereof, the lien given by §2 shall attach upon the real estate improved as against the true owner for the amount of the work done or material furnished. But in no event shall the aggregate amount of liens set up hereby exceed the amount due by the owner on the contract price of the improvement made.

§5. Lienor preferred to contractor.--Any person claiming a lien under the provisions of this chapter who shall have given the notice provided for herein shall be entitled to be paid in preference to the contractor at whose instance the labor was performed or material furnished and no payment by the owner to the contractor thereafter shall operate to lessen the amount recoverable by the person so giving the notice.

§6. Payments to be prorated when insufficient to pay all liens. --In the event the amount due the contractor by the owner shall be insufficient to pay all the lienors acquiring liens as herein provided it shall be the duty of the owner to prorate among all just claims the amount due such contractor.

§7. Lien not of force against existing mortgage. -- Such a lien shall not avail or be of force against any mortgage actually existing and duly recorded prior to the date of the contract under which the lien is claimed.

According to the old Penney & Broude casebook at 968:

[USLTA] follows prior mechanics' lien laws in allowing a lien to suppliers of materials only when they have in some way indicated that they sell with the belief that the materials are to be used on the particular real estate improvement or project. * * * Most prior acts gave a lien to materialmen only if the materials were delivered to the site. This Act relaxes that requirement somewhat . . . .

Fla. Stat. 697.04 Future advances may be secured.—

(1)(a) Any mortgage or other instrument given for the purpose of creating a lien on real property, or on any interest in a leasehold upon real property, may, and when so expressed therein shall, secure not only existing indebtedness, but also such future advances, whether such advances are obligatory or to be made at the option of the lender, or otherwise, as are made within 20 years from the date thereof, to the same extent as if such future advances were made on the date of the execution of such mortgage or other instrument, although there may be no advance made at the time of the execution of such mortgage or other instrument and although there may be no indebtedness outstanding at the time any advance is made. Such lien, as to third persons without actual notice thereof, shall be valid as to all such indebtedness and future advances from the time the mortgage or other instrument is filed for record as provided by law.

(b) The total amount of indebtedness that may be so secured may decrease or increase from time to time, but the total unpaid balance so secured at any one time shall not exceed a maximum principal amount which must be specified in such mortgage or other instrument, plus interest thereon; except that the mortgagor or her or his successor in title is authorized to file for record a notice limiting the maximum principal amount that may be so secured to an amount not less than the amount actually advanced at the time of such filing, provided a copy of such filing is also sent by certified mail to the mortgagee and, in the case of an open-end or revolving credit agreement, the mortgagor surrenders to the mortgagee all credit cards, checks, or other devices used to obtain further advances at the time of filing the notice, which notice shall be recorded and shall be effective from the date of filing. Notwithstanding the foregoing, any increase in the principal balance as a result of negative amortization or deferred interest shall be secured by the mortgage; and any disbursements made for the payment of taxes, levies, or insurance on the property covered by the lien, and any advances or disbursements made under a construction loan agreement referred to in a mortgage to enable completion of the contemplated improvement, with interest on such advances or disbursements, are secured by the mortgage or other instrument even though the mortgage or other instrument does not provide for future advances, or the advances or disbursements cause the total indebtedness to exceed the face amount stated in the instrument. This subsection does not apply to any mortgages, shipping contracts, or other instruments made and given by naval stores operators and producers to secure existing loans and future advances by naval stores factors.

(2) As against the rights of creditors or subsequent purchasers for a valuable consideration, actual notice or record notice of advances to be made at the option of the lender, under the terms of such mortgage or other instrument, shall be valid only as to such advances as are to be made within 20 years from the date of such mortgage or other instrument; however, this subsection does not apply to any mortgages, shipping contracts, or other instruments made and given by naval stores operators and producers to secure existing loans and future advances by naval stores factors. Notwithstanding anything in this section to the contrary, future advances made pursuant to the terms of a reverse mortgage loan (as defined in s. 103(bb) of the federal Truth in Lending Act, 15 U.S.C. ss. 1601 et seq.) shall be secured to the same extent as if such future advances were made on the date of execution of the mortgage, irrespective of the date of any such advance.

(3) Any such mortgage or other instrument shall be prior in dignity to all subsequent encumbrances, including statutory liens, except landlords' liens.

History.—ss. 1, 2, 3, ch. 20846, 1941; s. 1, ch. 28116, 1953; ss. 1, 2, ch. 61-135; s. 3, ch. 63-212; s. 1, ch. 70-34; s. 11, ch. 83-267; s. 10, ch. 83-311; s. 215, ch. 92-303; s. 7, ch. 96-210; s. 1761, ch. 97-102.

Roger BROWN, Appellant,

v.

Magel H. RAIRIGH and Richard C. Whiteford, as Personal Representatives of the Estate of W. Wayne Rairigh, Deceased, Appellees.

No. 77-648.

District Court of Appeal of Florida, Fourth District.

Oct. 25, 1978.

LETTS, Judge.

This case involves one friend buying from another a 10% interest in 5 harness race horses, which transaction the trial court ruled, as a matter of law, to be the sale of a "security" in violation of the Florida Blue Sky Laws. We reverse.

The appellant's primary occupation is that of a successful public relations executive in New York. However, he is a legal resident of Fort Lauderdale and spends much of his time owning, breeding, raising and racing harness horses at the Pompano track. The appellee investor was a wealthy businessman who met the appellant socially on several occasions, so that the relationship between the two grew into a hospitality swapping friendship. Inescapably the public relations executive's love of horses and his involvement with them became a topic of discussion. It is disputed as to which of the two first suggested that the investor buy an interest in some of the 15 horses then owned by the other, but it is undisputed that the public relations executive had not, with only one exception, previously sold any interest in any of his horses in the manner employed in the case at bar. As such, it is apparent from the facts that he was not in the business of promoting and selling percentage interests in race horses.

Pursuant to their discussions the investor purchased a 10% interest in 5 horses at the end of February, 1974, for $11,675. Under the terms of the agreement, the investor was to receive 10% of the winnings of any, or all, of the 5 horses and pay 10% of all bills and stake fees thereon. Meanwhile, although the agreement is silent on this aspect, it is also undisputed that the public relations executive was to retain custody and control of the horses and undertake all the work of training, caring for and racing them. The agreement further gave the investor an option to purchase a further 25% interest in the same 5 horses at the same price they were valued at on the date of the original agreement (even if the horses were very successful and obviously, therefore, more valuable). Finally, the investor was also given the privilege of selling the horses back to the public relations executive, providing he did so by January 1, 1975, (the price was to be the market value at time of resale, same to be determined mutually, or by a mutually agreeable horse assessor).

We suspect that had the horses won, the investor would have been most content, but they did not and suffered health problems besides. The investor then wanted his money back, but failed to exercise his privilege of resale on or before the cutoff date. Undismayed, he then claimed that he was sold an unregistered security in violation of Section 517.07 Florida Statutes (1977),[1] and demanded his original stake back plus interest and attorney's fees.

It has long been recognized that, absent some type of governmental control over the issuance of, and transactions in, securities, many opportunistic and often unscrupulous issuers and dealers in securities will defraud naive or unsophisticated purchasers. 69 Am.Jur.2d 591. The legislative purpose then, in enacting these so called "Blue Sky Laws," was aimed at "speculative schemes which have no more basis than so many feet of 'blue sky;'" *Hall v. Geiger-Jones Co.*, 242 U.S. 539, 37 S.Ct. 217, 61 L.Ed. 480 (1917).[2]

Like so many other regulatory statutes, just as fast as they are enacted, the same unscrupulous issuers find more and more loopholes which the legislature keeps on plugging, until the latter day result is a statute that technically might prevent two brothers from purchasing a share in their sister's business, without going through the frighteningly complicated and expensive business of registration. Thus we find, under Section 517.02(1), Florida Statutes (1977), that the word "security" spawns an 18 line definition, in which is included the term "any investment contract." However the term "investment contract" is not itself statutorily defined and we therefore are required to look to the Supreme Court case of *S. E. C. v. W. J. Howey Co.*, 328 U.S. 293, 66 S.Ct. 1100, 90 L.Ed. 1244 (1946) for the classic definition of the term. This definition, known as the *Howey* test, requires:

(1) an investment of money

(2) in a common enterprise

(3) with the expectation of profits to be derived solely from the efforts of the promoter or a third party.[3]

Adapting these three criteria to the case at bar we have no trouble in finding that there has been an investment of money and that the profits are to be derived solely from the efforts of the promoter.[4] We also can take judicial notice of the fact that joint ownership of race horses can be big business indeed, rising to astronomical levels when we consider the likes of Secretariat, Seattle Slew and Affirmed. The question however remains, do they all necessarily involve a common enterprise and more to the point, is a common enterprise to be found in the case at bar? We think not.

There are basically three lines of cases interpreting the phrase "common enterprise." First of all, there are those that require more than one investor and some kind of joint participation or dependency between investors must be present. See for example, *Milnarik v. M–S Commodities, Inc.*, 457 F.2d 274 (7th Circuit 1972). This view has been adopted by our own Third District in the last few months. See *Blacker v. Shearson Hayden Stone*, 358 So.2d 1147, opinion filed May 16, 1978.

There is a second line of cases that finds a common enterprise even though there is no joint participation or dependency among the investors. The courts reason that, even though there is no actual interaction between investors, the fortunes of all of them are inextricably tied to the effectiveness of the promoter in securing multiple recruits, so that in truth they are not independent of each other. See for example, *S. E. C. v.*

1. We agree this does not qualify as an isolated sale under § 517.06(3). The vendor here must, by definition in § 517.02(5), be an issuer. However, we doubt that the legislature intended that a sale such as this could not be considered as an isolated sale.

2. There is no concomitant protection for unsophisticated sellers who are persuaded to sell part of their businesses by purchasers, the latter knowing full well that they have an absolute out, plus interest and attorneys fees, if the business flounders.

3. The word "solely" has been modified in several cases and expanded to cover those who control the essential managerial conduct. *S. E. C. v. Koscot Interplanetary, Inc.* (infra).

4. The statute defines promoter in a roundabout way. § 517.02(5) says: "Issuer" shall mean and include every person who proposes to issue, has issued, or shall hereafter issue any security. Any person who acts as a promoter for and on behalf of a corporation, trust, or unincorporated association or partnership of any kind to be formed shall be deemed as issuer.

Koscot Interplanetary, Inc., 497 F.2d 473 (5th Circuit 1974).

The third line of cases simply holds that a common enterprise exists even where there is only a one-on-one relationship between the promoter and investor. *Huberman v. Denny's Restaurants, Inc.*, 337 F.Supp. 1249 (N.D.Cal.1972). In *Huberman* the court found a common enterprise even though only two parties were involved because both of them had an interest in the success of the venture and "were going to benefit from the productive operation of the [isolated transaction]."

[1] To us, this *Huberman* case goes too far because it reduces the word "common" to mere surplusage and the word "enterprise" is all that is left. Obviously even one single promoter and one investor are inevitably involved in a mutual project, or enterprise, hopefully for profit, unless the promoter plans to abscond with the funds. Moreover, every applicable situation is going to involve at least one investor and one promoter. Therefore, if this single union is all that is required to constitute a "common enterprise," then the definition set forth in the *Howey* test is meaningless. We choose to believe it must have *some* meaning and thus we adopt the view that not only should there be more than one investor, but there should be some form of interaction between the investors, or, in the alternative, if there is no such interaction between investors then the success of the enterprise should be dependent upon obtaining a number of investors.[5]

[2] The Supreme Court in *Howey*, supra, also seems to suggest that investment contracts require multiple investors. *Howey* stated:

> A common enterprise managed by respondents or third parties with adequate personnel and equipment is therefore essential if the *investors* are to achieve their paramount aim of a return on their investments.
>
> 66 S.Ct. at 1103.

All this being so, the case at bar is not a common enterprise for there is only one investor. There being no common enterprise, the sale involved was not that of a security and Section 517, of the Florida Statutes is not applicable. In so holding, we have not forgotten the case of *Marshall v. Harris*, 276 Or. 447, 555 P.2d 756 (1976) which is another case of percentage investment in race horses. There the court found the investment to be an "investment contract" and therefore a "security." However the court, either accidently or on purpose, never got around to discussing the required common enterprise element of an investment contract as defined by the *Howey* test. Nonetheless we note that there were five investors in *Marshall v. Harris* and at least some participation by the investors in one and the same horse. For this reason we would distinguish it.

We are fortunate to be able to decide this case upon the relatively simple premise that there was only one investor. However by doing so we do not mean to preclude the possibility that we might have arrived at the same result if the appellee's wife and or brother had similarly purchased additional fractional interests. Section 517.21 provides that sales made in violation of the chapter are "voidable" rather than void. This being so, we note, for example, the language of *Dokken v. Minnesota-Ohio Oil*, 232 So.2d 200 (Fla. 2nd DCA 1970) wherein the court stated,

> . . . the courts have held that the purchaser of securities sold in violation of the [statute] may be estopped *by his conduct* from asserting the invalidity of the transaction.
>
> * * * * * *
>
> Estoppel depends upon the facts and circumstances of each case.

As was noted by the dissent in *Marshall v. Harris*:

> It is going to be a shock to a rancher who sells a fractional interest in a horse or a registered bull to his neighbors to learn

5. For a scholarly discourse on the ever expanding regulatory field of securities, see Mofsky, *Some Comments On The Expanding Definition of "Security,"* 27 U. of Miami L.Rev. 395.

that his sale is considered in the same category as the sale of a worthless corporate stock or security and subject to the Blue Sky Law.

I do not believe the legislature intended the plaintiffs' sale in the case at bar to be subject to the [Oregon] Securities Law.

We are in sympathy with the underlying thought in this dissent and if a similar issue is presented to us, we will carefully evaluate the attendant facts and circumstances to see if estoppel would be applicable. If an investor is fully informed as to all aspects of his investment prior to purchase, and if he is fully aware of the use to which his proceeds will be put, then in such event his conduct, when considered together with other facts and circumstances, may well estop him from seeking relief under the Blue Sky Laws, providing however that the promoter or issuer is not in the business of promoting or issuing and providing further that the sale has not been made with any direct or indirect intent to violate or evade the provisions of Section 517 of the Florida Statutes.

REVERSED AND REMANDED FOR ENTRY OF A JUDGMENT IN ACCORDANCE HEREWITH.

DOWNEY, C. J., and DAUKSCH, J., concur.

United Housing Foundation v. Forman, 421 U.S. 837,
95 S.Ct. 2051, 44 L.E.2d 621 (1975).

Syllabus

UNITED HOUSING FOUNDATION, INC., ET AL. *v.* FORMAN ET AL.

CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

No. 74-157. Argued April 22, 1975—Decided June 16, 1975*

MR. JUSTICE POWELL delivered the opinion of the Court.

The issue in these cases is whether shares of stock entitling a purchaser to lease an apartment in Co-op City, a state subsidized and supervised nonprofit housing cooperative, are "securities" within the purview of the Securities Act of 1933 and the Securities Exchange Act of 1934.

I

Co-op City is a massive housing cooperative in New York City. Built between 1965 and 1971, it presently houses approximately 50,000 people on a 200-acre site containing 35 high-rise buildings and 236 town houses. The project was organized, financed, and constructed under the New York State Private Housing Finance Law, commonly known as the Mitchell-Lama Act, enacted to ameliorate a perceived crisis in the availability of decent low-income urban housing. In order to encourage pri-

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†*William J. Brown,* Attorney General, *William G. Compton,* Assistant Attorney General, *Jon M. Sebaly,* Special Assistant Attorney General, and *Michael R. Merz* filed a brief for the State of Ohio as *amicus curiae* urging reversal.

vate developers to build low-cost cooperative housing, New York provides them with large long-term, low-interest mortgage loans and substantial tax exemptions. Receipt of such benefits is conditioned on a willingness to have the State review virtually every step in the development of the cooperative. See N. Y. Priv. Hous. Fin. Law §§ 11–37, as amended (1962 and Supp. 1974–1975). The developer also must agree to operate the facility "on a nonprofit basis," § 11–a (2a), and he may lease apartments only to people whose incomes fall below a certain level and who have been approved by the State.[1]

The United Housing Foundation (UHF), a nonprofit membership corporation established for the purpose of "aiding and encouraging" the creation of "adequate, safe and sanitary housing accommodations for wage earners and other persons of low or moderate income,"[2] Appendix in Court of Appeals 95a (hereafter App.), was responsible for initiating and sponsoring the development of Co-op City. Acting under the Mitchell-Lama Act, UHF organized the Riverbay Corporation (Riverbay) to own and operate the land and buildings constituting Co-op City. Riverbay, a nonprofit cooperative housing corporation, issued the stock that is the subject of this litigation. UHF also contracted with Community Services, Inc. (CSI), its wholly owned subsidiary, to serve as the general contractor and sales

[1] Eligibility is limited to families whose monthly income does not exceed six times the monthly rental charge (or for families of four or more, seven times the rental charge). N. Y. Priv. Hous. Fin. Law § 31 (2) (a) (Supp. 1974–1975). Preference in admission must be given to veterans, the handicapped, and the elderly. § 31 (7)–(9).

[2] UHF is composed of labor unions, housing cooperatives, and civic groups. It has sponsored the construction of several major housing cooperatives in New York City.

agent for the project.[3] As required by the Mitchell-Lama Act, these decisions were approved by the State Housing Commissioner.

To acquire an apartment in Co-op City an eligible prospective purchaser[4] must buy 18 shares of stock in Riverbay for each room desired. The cost per share is $25, making the total cost $450 per room, or $1,800 for a four-room apartment. The sole purpose of acquiring these shares is to enable the purchaser to occupy an apartment in Co-op City; in effect, their purchase is a recoverable deposit on an apartment. The shares are explicitly tied to the apartment: they cannot be transferred to a nontenant; nor can they be pledged or encumbered; and they descend, along with the apartment, only to a surviving spouse. No voting rights attach to the shares as such: participation in the affairs of the cooperative appertains to the apartment, with the residents of each apartment being entitled to one vote irrespective of the number of shares owned.

Any tenant who wants to terminate his occupancy, or who is forced to move out,[5] must offer his stock to Riverbay at its initial selling price of $25 per share. In the extremely unlikely event that Riverbay declines to repurchase the stock,[6] the tenant cannot sell it for more than

[3] CSI is a business corporation that has acted as the contractor on several UHF-sponsored housing cooperatives.

[4] Respondents are referred to herein variously as "purchasers," "owners," or "tenants." Respondents do not hold legal title to their respective apartments, but they are purchasers and owners of the shares of Riverbay which entitles them to occupy the apartments. By virtue of their right of occupancy, respondents are usually described as tenants.

[5] A tenant can be forced to move out if he violates the provisions of his "occupancy agreement," which is essentially a lease for the apartment, or if his income grows to exceed the eligibility standards.

[6] To date every family that has withdrawn from Co-op City has received back its initial payment in full. Indeed, at the time this

the initial purchase price plus a fraction of the portion of the mortgage that he has paid off, and then only to a prospective tenant satisfying the statutory income eligibility requirements. See N. Y. Priv. Hous. Fin. Law § 31–a (Supp. 1974–1975).

In May 1965, subsequent to the completion of the initial planning, Riverbay circulated an Information Bulletin seeking to attract tenants for what would someday be apartments in Co-op City. After describing the nature and advantages of cooperative housing generally and of Co-op City in particular, the Bulletin informed prospective tenants that the total estimated cost of the project, based largely on an anticipated construction contract with CSI, was $283,695,550. Only a fraction of this sum, $32,795,550, was to be raised by the sale of shares to tenants. The remaining $250,900,000 was to be financed by a 40-year low-interest mortgage loan from the New York Private Housing Finance Agency. After construction of the project the mortgage payments and current operating expenses would be met by monthly rental charges paid by the tenants. While these rental charges were to vary, depending on the size, nature, and location of an apartment, the 1965 Bulletin estimated that the "average" monthly cost would be $23.02 per room, or $92.08 for a four-room apartment.

Several times during the construction of Co-op City, Riverbay, with the approval of the State Housing Commissioner, revised its contract with CSI to allow for increased construction costs. In addition, Riverbay incurred other expenses that had not been reflected in the

suit was filed there were 7,000 families on the waiting list for apartments in this cooperative. In addition, a special fund of nearly $1 million had been established by small monthy contributions from all tenants to insure that those wanting to move out would receive full compensation for their shares.

1965 Bulletin. To meet these increased expenditures, Riverbay, with the Commissioner's approval, repeatedly secured increased mortgage loans from the State Housing Agency. Ultimately the construction loan was $125 million more than the figure estimated in the 1965 Bulletin. As a result, while the initial purchasing price remained at $450 per room, the average monthly rental charges increased periodically, reaching a figure of $39.68 per room as of July 1974.[7]

These increases in the rental charges precipitated the present lawsuit. Respondents, 57 residents of Co-op City, sued in federal court on behalf of all 15,372 apartment owners, and derivatively on behalf of Riverbay, seeking upwards of $30 million in damages, forced rental reductions, and other "appropriate" relief. Named as defendants (petitioners herein) were UHF, CSI, Riverbay, several individual directors of these organizations, the State of New York, and the State Private Housing Finance Agency. The heart of respondents' claim was that the 1965 Co-op City Information Bulletin falsely represented that CSI would bear all subsequent cost increases due to factors such as inflation. Respondents further alleged that they were misled in their purchases of shares since the Information Bulletin failed to disclose several critical facts.[8] On these bases,

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[7] As the rental charges increased, the income eligibility requirements for residents of Co-op City expanded accordingly. See n. 1, *supra*.

[8] Respondents maintained that the following material facts were omitted: (i) the original estimated cost had never been adhered to in any of the previous Mitchell-Lama projects sponsored by UHF and built by CSI; (ii) petitioners knew that the initial estimate would not be followed in the present project; (iii) CSI was a wholly owned subsidiary of UHF; (iv) CSI's net worth was so small that it could not have been legally held to complete the contract within the original estimated costs; (v) the State Housing Commissioner

respondents asserted two claims under the fraud provisions of the federal Securities Act of 1933, as amended, § 17 (a), 48 Stat. 84, 15 U. S. C. § 77q (a); the Securities Exchange Act of 1934, as amended, § 10 (b), 48 Stat. 891, 15 U. S. C. § 78j (b); and 17 CFR § 240.10b-5 (1975). They also presented a claim against the State Financing Agency under the Civil Rights Act of 1871, 42 U. S. C. § 1983, and 10 pendent state-law claims.

Petitioners, while denying the substance of these allegations,[9] moved to dismiss the complaint on the ground that federal jurisdiction was lacking. They maintained that shares of stock in Riverbay were not "securities" within the definitional sections of the federal Securities Acts. In addition, the state parties moved to dismiss on sovereign immunity grounds.

The District Court granted the motion to dismiss. *Forman* v. *Community Services, Inc.*, 366 F. Supp. 1117 (SDNY 1973). It held that the denomination of the shares in Riverbay as "stock" did not, by itself, make them securities under the federal Acts. The court further ruled, relying primarily on this Court's decisions in *SEC* v. *C. M. Joiner Leasing Corp.*, 320 U. S. 344 (1943), and *SEC* v. *W. J. Howey Co.*, 328 U. S. 293 (1946), that the purchase in issue was not a security transaction since it was not induced by an offer of tangible material profits, nor could such profits realistically be expected. In the District Court's words, it was

had waived his own rule regarding liquidity requirements in approving CSI as the contractor; and (vi) there was an additional undisclosed contract between CSI and Riverbay.

[9] Petitioners asserted that the Information Bulletin warned purchasers of the possibility of rental increases, and denied that it omitted material facts. They also argued that prior to occupancy all tenants were informed that rental charges had increased. In any event, petitioners claimed that respondents have suffered no damages since they may move out and retrieve their initial investments in full.

"the fundamental nonprofit nature of this transaction" which presented "the insurmountable barrier to [respondents'] claims in th[e] federal court." 366 F. Supp., at 1128.[10]

The Court of Appeals for the Second Circuit reversed. *Forman* v. *Community Services, Inc.*, 500 F. 2d 1246 (1974). It rested its decision on two alternative grounds. First, the court held that since the shares purchased were called "stock" the Securities Acts, which explicitly include "stock" in their definitional sections, were literally applicable. Second, the Court of Appeals concluded that the transaction was an investment contract within the meaning of the Acts and as defined by *Howey*, since there was an expectation of profits from three sources: (i) rental reductions resulting from the income produced by the commercial facilities established for the use of tenants at Co-op City; (ii) tax deductions for the portion of the monthly rental charges allocable to interest payments on the mortgage; and (iii) savings based on the fact that apartments at Co-op City cost substantially less than comparable nonsubsidized housing. The court further ruled that the immunity claims by the state parties were unavailing.[11] Accordingly, the

[10] The District Court also dismissed the § 1983 claim finding that the "federal securities allegations represent the only well-pleaded underlying basis for jurisdiction under the Civil Rights Act." 366 F. Supp. 1117, 1132 (1973). In view of these rulings the court did not reach the sovereign immunity claims.

[11] The Court of Appeals held that the state agency was independent and distinct from the State itself and therefore was a "person" for purposes of § 1983, that both the agency and the State had waived immunity under § 32 (5) of the Private Housing Finance Law, and that the State had also implicitly waived its immunity by voluntarily participating in the sale of securities, an area subject to plenary federal regulation. See *Parden* v. *Terminal R. Co.*, 377 U. S. 184 (1964). In view of our disposition of these cases we do not reach these issues.

case was remanded to the District Court for consideration of respondents' claims on the merits.

In view of the importance of the issues presented we granted certiorari. 419 U. S. 1120 (1975). As we conclude that the disputed transactions are not purchases of securities within the contemplation of the federal statutes, we reverse.

II

Section 2 (1) of the Securities Act of 1933, 15 U. S. C. § 77b (1), defines a "security" 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." [12]

In providing this definition Congress did not attempt to articulate the relevant economic criteria for distinguishing "securities" from "non-securities." Rather, it sought to define "the term 'security' in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world

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[12] The definition of a security in § 3 (a)(10) of the 1934 Act, 15 U. S. C. § 78c (a)(10), is virtually identical and, for present purposes, the coverage of the two Acts may be considered the same. See *Tcherepnin* v. *Knight,* 389 U. S. 332, 336, 342 (1967); S. Rep. No. 792, 73d Cong., 2d Sess., 14 (1934).

fall within the ordinary concept of a security." H. R. Rep. No. 85, 73d Cong., 1st Sess., 11 (1933). The task has fallen to the Securities and Exchange Commission (SEC), the body charged with administering the Securities Acts, and ultimately to the federal courts to decide which of the myriad financial transactions in our society come within the coverage of these statutes.

In making this determination in the present case we do not write on a clean slate. Well-settled principles enunciated by this Court establish that the shares purchased by respondents do not represent any of the "countless and variable schemes devised by those who seek the use of the money of others on the promise of profits," *Howey*, 328 U. S., at 299, and therefore do not fall within "the ordinary concept of a security."

A

We reject at the outset any suggestion that the present transaction, evidenced by the sale of shares called "stock,"[13] must be considered a security transaction simply because the statutory definition of a security includes the words "any . . . stock." Rather we adhere to the basic principle that has guided all of the Court's decisions in this area:

> "[I]n searching for the meaning and scope of the word 'security' in the Act[s], form should be disregarded for substance and the emphasis should be on economic reality." *Tcherepnin* v. *Knight*, 389 U. S. 332, 336 (1967).

See also *Howey*, *supra*, at 298.

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[13] While the record does not indicate precisely why the term "stock" was used for the instant transaction, it appears that this form is generally used as a matter of tradition and convenience. See P. Rohan & M. Reskin, Cooperative Housing Law & Practice § 2.01 (4) (1973).

The primary purpose of the Acts of 1933 and 1934 was to eliminate serious abuses in a largely unregulated securities market. The focus of the Acts is on the capital market of the enterprise system: the sale of securities to raise capital for profit-making purposes, the exchanges on which securities are traded, and the need for regulation to prevent fraud and to protect the interest of investors. Because securities transactions are economic in character Congress intended the application of these statutes to turn on the economic realities underlying a transaction, and not on the name appended thereto. Thus, in construing these Acts against the background of their purpose, we are guided by a traditional canon of statutory construction:

> "[A] thing may be within the letter of the statute and yet not within the statute, because not within its spirit, nor within the intention of its makers." *Church of the Holy Trinity* v. *United States*, 143 U. S. 457, 459 (1892).

See also *United States* v. *American Trucking Assns.*, 310 U. S. 534, 543 (1940).[14]

Respondents' reliance on *Joiner* as support for a "literal approach" to defining a security is misplaced. The issue in *Joiner* was whether assignments of interests in oil leases, coupled with the promoters' offer to drill an exploratory well, were securities. Looking to the economic

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[14] With the exception of the Second Circuit, every Court of Appeals recently to consider the issue has rejected the literal approach urged by respondents. See *C. N. S. Enterprises, Inc.* v. *G. & G. Enterprises, Inc.*, 508 F. 2d 1354 (CA7 1975); *McClure* v. *First National Bank of Lubbock*, 497 F. 2d 490 (CA5 1974), cert. denied, 420 U. S. 930 (1975); *Lino* v. *City Investing Co.*, 487 F. 2d 689 (CA3 1973). See also 1 L. Loss, Securities Regulation 493 (2d ed. 1961) ("substance governs rather than form: . . . just as some things which look like real estate are securities, some things which look like securities are real estate").

inducement provided by the proposed exploratory well, the Court concluded that these leases were securities even though "leases" as such were not included in the list of instruments mentioned in the statutory definition. In dictum the Court noted that "[i]nstruments *may* be included within [the definition of a security], as [a] matter of law, if on their face they answer to the name or description." 320 U. S., at 351 (emphasis supplied). And later, again in dictum, the Court stated that a security *"might"* be shown "by proving the document itself, which on its face would be a note, a bond, or a share of stock." *Id.*, at 355 (emphasis supplied). By using the conditional words "may" and "might" in these dicta the Court made clear that it was not establishing an inflexible rule barring inquiry into the economic realities underlying a transaction. On the contrary, the Court intended only to make the rather obvious point that, in contrast to the instrument before it which was not included within the explicit statutory terms, most instruments bearing these traditional titles are likely to be covered by the statutes.[15]

In holding that the name given to an instrument is not dispositive, we do not suggest that the name is wholly irrelevant to the decision whether it is a security. There may be occasions when the use of a traditional name such as "stocks" or "bonds" will lead a purchaser justifiably to assume that the federal securities laws apply.

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[15] Nor can respondents derive any support for a literal approach from *Tcherepnin* v. *Knight, supra,* which quoted the *Joiner* dictum. Indeed in *Tcherepnin* the Court explicitly stated that "form should be disregarded for substance," 389 U. S., at 336, and only after analyzing the economic realities of the transaction at issue did it conclude that an instrument called a "withdrawable capital share" was, in substance, an "investment contract," a share of "stock," a "certificate of interest or participation in [a] profit-sharing agreement," and a "transferable share."

This would clearly be the case when the underlying transaction embodies some of the significant characteristics typically associated with the named instrument.

In the present case respondents do not contend, nor could they, that they were misled by use of the word "stock" into believing that the federal securities laws governed their purchase. Common sense suggests that people who intend to acquire only a residential apartment in a state-subsidized cooperative, for their personal use, are not likely to believe that in reality they are purchasing investment securities simply because the transaction is evidenced by something called a share of stock. These shares have none of the characteristics "that in our commercial world fall within the ordinary concept of a security." H. R. Rep. No. 85, *supra,* at 11. Despite their name, they lack what the Court in *Tcherepnin* deemed the most common feature of stock: the right to receive "dividends contingent upon an apportionment of profits." 389 U. S., at 339. Nor do they possess the other characteristics traditionally associated with stock: they are not negotiable; they cannot be pledged or hypothecated; they confer no voting rights in proportion to the number of shares owned; and they cannot appreciate in value. In short, the inducement to purchase was solely to acquire subsidized low-cost living space; it was not to invest for profit.

B

The Court of Appeals, as an alternative ground for its decision, concluded that a share in Riverbay was also an "investment contract" as defined by the Securities Acts. Respondents further argue that in any event what they agreed to purchase is "commonly known as a 'security' " within the meaning of these laws. In considering these claims we again must examine the substance—the economic realities of the transaction—rather than the names that may have been employed by the parties. We perceive no distinction, for present purposes, between an "investment contract" and an "instrument commonly known as a 'security.'" In either case, the basic test for distinguishing the transaction from other commercial dealings is

> "whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others." *Howey*, 328 U. S., at 301.[16]

This test, 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, as in *Joiner, supra* (sale of oil leases conditioned on promoters' agreement to drill exploratory well), or a participation in earnings resulting from the use of investors' funds, as in *Tcherepnin* v. *Knight, supra* (dividends on the investment based on savings and loan association's profits). In such cases the investor is "attracted solely by the prospects of a return" on his investment. *Howey, supra*, at 300. By contrast, when a purchaser is motivated by a

[16] This test speaks in terms of "profits to come *solely* from the efforts of others." (Emphasis supplied.) Although the issue is not presented in this case, we note that the Court of Appeals for the Ninth Circuit has held that "the word 'solely' should not be read as a strict or literal limitation on the definition of an investment contract, but rather must be construed realistically, so as to include within the definition those schemes which involve in substance, if not form, securities." *SEC* v. *Glenn W. Turner Enterprises*, 474 F. 2d 476, 482, cert. denied, 414 U. S. 821 (1973). We express no view, however, as to the holding of this case.

desire to use or consume the item purchased—"to occupy the land or to develop it themselves," as the *Howey* Court put it, *ibid.*—the securities laws do not apply.[17] See also *Joiner, supra.*[18]

In the present case there can be no doubt that investors were attracted solely by the prospect of acquiring a place to live, and not by financial returns on their investments. The Information Bulletin distributed to prospective residents emphasized the fundamental nature and purpose of the undertaking:

> "A cooperative is a non-profit enterprise owned and controlled democratically by its members—the people who are using its services. . . .
>
> . . . . .
>
> "People find living in a cooperative community enjoyable for more than one reason. Most people join, however, for the simple reason that it is a way to obtain decent housing at a reasonable price.

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[17] In some transactions the investor is offered both a commodity or real estate for use and an expectation of profits. See SEC Release No. 33-5347, 38 Fed. Reg. 1735 (Jan. 18, 1973). See generally Rohan, The Securities Law Implications of Condominium Marketing Programs Which Feature a Rental Agency or Rental Pool, 2 Conn. L. Rev. 1 (1969). The application of the federal securities laws to these transactions may raise difficult questions that are not present in this case.

[18] In *Joiner*, 320 U. S., at 348, the Court stated:

"Undisputed facts seem to us, however, to establish the conclusion that defendants were not, as a practical matter, offering naked leasehold rights. Had the offer mailed by defendants omitted the economic inducements of the proposed and promised exploration well, it would have been a quite different proposition."

This distinction was critical because the exploratory drillings gave the investments "most of their value and all of their lure." *Id.*, at 349. The land itself was purely an incidental consideration in the transaction.

> However, there are other advantages. The purpose of a cooperative is to provide home ownership, not just apartments to rent. The community is designed to provide a favorable environment for family and community living. . . .
>
> "The common bond of collective ownership which you share makes living in a cooperative different. It is a community of neighbors. Home ownership, common interests and the community atmosphere make living in a cooperative like living in a small town. As a rule there is very little turnover in a cooperative." App. 162a, 166a.

Nowhere does the Bulletin seek to attract investors by the prospect of profits resulting from the efforts of the promoters or third parties. On the contrary, the Bulletin repeatedly emphasizes the "nonprofit" nature of the endeavor. It explains that if rental charges exceed expenses the difference will be returned as a rebate, not invested for profit. It also informs purchasers that they will be unable to resell their apartments at a profit since the apartment must first be offered back to Riverbay "at the price . . . paid for it." [19] *Id.*, at 163a. In short, neither of the kinds of profits traditionally associated with securities was offered to respondents.

The Court of Appeals recognized that there must be an expectation of profits for these shares to be securities, and conceded that there is "no possible profit on a resale of [this] stock." 500 F. 2d, at 1254. The court cor-

[19] This requirement effectively insures that no apartment will be sold for more than its original cost. Consonant with the purposes of the Mitchell-Lama Act, whenever there are prospective buyers willing to pay as much as the initial purchase price for an apartment in Co-op City, Riverbay will repurchase the apartment and resell it at its original cost. See App. 138a. If, for some reason, Riverbay does not purchase the apartment the tenant still cannot make a profit on his sale. See *supra*, at 842–843.

rectly noted, however, that profit may be derived from the income yielded by an investment as well as from capital appreciation, and then proceeded to find "an expectation of 'income' in at least three ways." *Ibid.* Two of these supposed sources of income or profits may be disposed of summarily. We turn first to the Court of Appeals' reliance on the deductibility for tax purposes of the portion of the monthly rental charge applied to interest on the mortgage. We know of no basis in law for the view that the payment of interest, with its consequent deductibility for tax purposes, constitutes income or profits.[20] These tax benefits are nothing more than that which is available to any homeowner who pays interest on his mortgage. See § 216 of Internal Revenue Code, 26 U. S. C. § 216; *Eckstein* v. *United States,* 196 Ct. Cl. 644, 452 F. 2d 1036 (1971).

The Court of Appeals also found support for its concept of profits in the fact that Co-op City offered space at a cost substantially below the going rental charges for comparable housing. Again, this is an inappropriate theory of "profits" that we cannot accept. The low rent derives from the substantial financial subsidies provided by the State of New York. This benefit cannot be liquidated into cash; nor does it result from the managerial efforts of others. In a real sense, it no more embodies the attributes of income or profits than do welfare benefits, food stamps, or other government subsidies.

The final source of profit relied on by the Court of Appeals was the possibility of net income derived from the leasing by Co-op City of commercial facilities, pro-

[20] Even if these tax deductions were considered profits, they would not be the type associated with a security investment since they do not result from the managerial efforts of others. See Rosenbaum, The Resort Condominium and the Federal Securities Laws—A Case Study in Governmental Inflexibility, 60 Va. L. Rev. 785, 795–796 (1974); Note, 62 Geo. L. J. 1515, 1524–1526 (1974).

fessional offices and parking spaces, and its operation of community washing machines. The income, if any, from these conveniences, all located within the common areas of the housing project, is to be used to reduce tenant rental costs. Conceptually, one might readily agree that net income from the leasing of commercial and professional facilities is the kind of profit traditionally associated with a security investment.[21] See *Tcherepnin* v. *Knight, supra.* But in the present case this income—if indeed there is any—is far too speculative and insubstantial to bring the entire transaction within the Securities Acts.

Initially we note that the prospect of such income as a means of offsetting rental costs is never mentioned in the Information Bulletin. Thus it is clear that investors were not attracted to Co-op City by the offer of these potential rental reductions. See *Joiner,* 320 U. S., at 353. Moreover, nothing in the record suggests that the facilities in fact return a profit in the sense that the leasing fees are greater than the actual cost to Co-op City of the space rented.[22] The short of the matter is

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[21] The "income" derived from the rental of parking spaces and the operation of washing machines clearly was not profit for respondents since these facilities were provided exclusively for the use of tenants. Thus, when the income collected from the use of these facilities exceeds the cost of their operation the tenants simply receive the return of the initial overcharge in the form of a rent rebate. Indeed, it could be argued that the "income" from the commercial and professional facilities is also, in effect, a rebate on the cost of goods and services purchased at these facilities since it appears likely that they are patronized almost exclusively by Co-op City residents. See Note, 53 Tex. L. Rev. 623, 630–631, n. 38 (1975).

[22] The Court of Appeals quoted the gross rental income received from these facilities. But such figures by themselves are irrelevant since the record does not indicate the cost to Co-op City of providing and maintaining the rented space.

that the stores and services in question were established not as a means of returning profits to tenants, but for the purpose of making essential services available for the residents of this enormous complex.[23] By statute these facilities can only be "incidental and appurtenant" to the housing project. N. Y. Priv. Hous. Fin. Law § 12 (5) (Supp. 1974–1975). Undoubtedly they make Co-op City a more attractive housing opportunity, but the possibility of some rental reduction is not an "expectation of profit" in the sense found necessary in *Howey*.[24]

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[23] See generally Miller, Cooperative Apartments: Real Estate or Securities?, 45 B. U. L. Rev. 465, 500 (1965).

[24] 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 in *Silver Hills Country Club* v. *Sobieski*, 55 Cal. 2d 811, 361 P. 2d 906 (1961). Cf. *El Khadem* v. *Equity Securities Corp.*, 494 F. 2d 1224 (CA9), cert. denied, 419 U. S. 900 (1974). See generally Coffey, The Economic Realities of a "Security": Is There a More Meaningful Formula?, 18 W. Res. L. Rev. 367 (1967); Long, An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation, 24 Okla. L. Rev. 135 (1971); Hannan & Thomas, The Importance of Economic Reality and Risk in Defining Federal Securities, 25 Hastings L. J. 219 (1974). 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. If dissatisfied with their apartments, they may recover their initial investment in full. See n. 5, *supra*.

Respondents assert that if Co-op City becomes bankrupt they stand to lose their whole investment. But, in view of the fact that the State has financed over 92% of the cost of construction and carefully regulates the development and operation of the project, bankruptcy in the normal sense is an unrealistic possibility. In any event, the risk of insolvency of an ongoing housing cooperative "differ[s] vastly" from the kind of risk of "fluctuating" value associated with securities investments. *SEC* v. *Variable Annuity Co.*, 359 U. S. 65, 90–91 (1959) (BRENNAN, J., concurring). See Hannan & Thomas, *supra*, at 242–249; Long, Introduction to Symposium: Interpreting the Statutory Definition of a Security: Some Pragmatic Considerations, 6 St. Mary's L. J. 96, 126–128 (1974).

There is no doubt that purchasers in this housing cooperative sought to obtain a decent home at an attractive price. But that type of economic interest characterizes every form of commercial dealing. What distinguishes a security transaction—and what is absent here—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.[25]

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[25] The SEC has filed an *amicus curiae* brief urging us to hold the federal securities laws applicable to this case. Traditionally the views of an agency charged with administering the governing statute would be entitled to considerable weight. See, *e. g., Saxbe* v. *Bustos*, 419 U. S. 65, 74 (1974); *Investment Company Institute* v. *Camp*, 401 U. S. 617, 626–627 (1971). But in this case the SEC's position flatly contradicts what appears to be a rather careful statement of the Commission's views in a recent release. In Release No. 33–5347, 38 Fed. Reg. 1735 (Jan. 18, 1973), applicable to the "sale of condominium units, or other units in a real estate development," the SEC stated its view that only those real estate investments that are "offered and sold with emphasis on the economic benefits to the purchaser to be derived from the managerial efforts of the promoter, or a third party designated or arranged for by the promoter," are to be considered securities. *Id.*, at 1736. In particular, the Commission explained that the Securities Acts do not apply when "commercial facilities are a part of the common elements of a residential project" if

"(a) the income from such facilities is used only to offset common area expenses and (b) the operation of such facilities is incidental to the project as a whole and are not established as a primary income source for the individual owners of a condominium or cooperative unit." *Ibid.*

See also SEC Real Estate Advisory Committee Report 74–91 (1972); Dickey & Thorpe, Federal Security Regulation of Condominium Offerings, 19 N. Y. L. F. 473 (1974).

Several commentators have noted the inconsistency between the SEC's position in the above release and the decision by the Court of Appeals in this case, which the SEC now supports. See Berman & Stone, Federal Securities Law and the Sale of Condominiums, III

In holding that there is no federal jurisdiction, we do not address the merits of respondents' allegations of fraud. Nor do we indicate any view as to whether the type of claims here involved should be protected by federal regulation.[26] We decide only that the type of

Homes, and Homesites, 30 Bus. Law. 411, 420–425 (1975); Comment, Condominium Regulation: Beyond Disclosure, 123 U. Pa. L. Rev. 639, 654–655 (1975); Note, *supra,* n. 20, at 628. In view of this unexplained contradiction in the Commission's position we accord no special weight to its views. See *Reliance Electric Co.* v. *Emerson Electric Co.,* 404 U. S. 418, 426 (1972); *Blue Chip Stamps* v. *Manor Drug Stores, ante,* at 746–747, n. 10.

[26] It has been suggested that the sale of housing developments such as condominiums and cooperatives is in need of federal regulation and therefore the securities laws should be construed or amended to reach these transactions. See, *e. g.,* Note, Federal Securities Regulation of Condominiums: A Purchaser's Perspective, 62 Geo. L. J. 1403 (1974); Note, Cooperative Housing Corporations and the Federal Securities Laws, 71 Col. L. Rev. 118 (1971). Others have disagreed, claiming that the extensive body of regulation developed over more than four decades under these Acts would be inappropriate and unduly costly to the sellers and buyers of residential housing. See Berman & Stone, *supra,* n. 24; Note, *supra,* n. 20. Moreover, extension of the securities laws to real estate transactions would involve important questions as to the appropriate balance between state and federal responsibility. The determination of whether and in what manner federal regulation may be required for housing transactions, where the characteristics of an investment in securities are not present, is better left to the Congress, which can assess both the costs and benefits of any such regulation. Indeed only recently Congress instructed the Secretary of Housing and Urban Development "to conduct a full and complete investigation and study . . . with respect to . . . the problems, difficulties, and abuses or potential abuses applicable to condominium and cooperative housing." § 821, 88 Stat. 740, 42 U. S. C. § 3532 (1970 ed., Supp. IV). See also Real Estate Settlement Procedures Act of 1974, 88 Stat. 1724, 12 U. S. C. § 2601 *et seq.* (1970 ed., Supp. IV); Interstate Land Sales Full Disclosure Act, 82 Stat. 590, 15 U. S. C. §§ 1701–1720.

transaction before us, in which the purchasers were interested in acquiring housing rather than making an investment for profit, is not within the scope of the federal securities laws.

Since respondents' claims are not cognizable in federal court, the District Court properly dismissed their complaint.[27] The judgment below is therefore

Reversed.

MR. JUSTICE BRENNAN, with whom MR. JUSTICE DOUGLAS and MR. JUSTICE WHITE join, dissenting.

I dissent. The property interests here are "securities," in my view, both because they are shares of "stock" and because they are "investment contracts."

I

Both the Securities Act of 1933, 15 U. S. C. § 77b (1), and the Securities Exchange Act of 1934, 15 U. S. C. § 78c (a)(10), define the term "security" as including, among other things, an "investment contract." The essential ingredients of an investment contract have been clear since *SEC* v. *W. J. Howey Co.*, 328 U. S. 293, 301 (1946), held that "[t]he test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others." See *Tcherepnin* v. *Knight*, 389 U. S. 332, 338 (1967). There is no doubt that Co-op City residents invested money in a common enterprise; the only questions in-

[27] Besides the Securities Acts claims, respondents also included a vague and conclusory allegation under 42 U. S. C. § 1983 against petitioner New York State Housing Finance Agency. We agree with the District Court that this count must also be dismissed. See n. 9, *supra*. The remaining counts in the complaint were all predicated on alleged violations of state law not independently cognizable in federal court.

volve whether the investment was to be productive of "profits to come solely from the efforts of others."

The record discloses little of the activities of Riverbay Corporation, the owner and operator of Co-op City, as a lessor of commercial and office space. It does appear, however, that revenues well in excess of $1 million per year flow into the corporation from such activities, Appendix in Court of Appeals 361a (hereafter App.), a fact noted by the Court of Appeals. 500 F. 2d 1246, 1254 (CA2 1974). Even after deduction of expenses—taxes alone take half of the gross—the residue could hardly be *de minimis,* even for an operation as large as Co-op City. Therein lies the patent fallacy of the Court's conclusion that this aspect of the corporation's activities is "speculative and insubstantial." *Ante,* at 856. The District Court rightly recognized that management by third parties is essential in a project so massive as Co-op City. 366 F. Supp. 1117, 1128 (SDNY 1973). Co-op City residents as stockholders were thus necessarily bound to rely on the management of Riverbay Corporation to produce income in the form of rents from the commercial and office space made an integral part of the project.

As stockholders, Co-op City residents also necessarily relied on corporate management to build and operate the facility efficiently to the end that monthly charges would be minimized. The Court of Appeals held that profits were involved partly because Co-op City offered housing at bargain prices. 500 F. 2d, at 1254. The Court substitutes its own judgment in holding that "[t]he low rent derives from the substantial financial subsidies provided by the State of New York." *Ante,* at 855. It is simple common sense that management efficiency necessarily enters into the equation in the determination of the charges assessed against residents. But even to the extent that the resident-stockholders do benefit in reduced charges from government subsidies, the benefit is not for this reason any the less a profit to them. The welfare benefits to which the Court refers, *ante,* at 855, may also be profits, but those profits lack the essential ingredient of profits present here that "come solely from the efforts of others." Here the resident investors utilize the efforts of others to obtain government subsidies. Investors in Wall Street who do this every day will be surprised to learn that the benefits so obtained are not considered profits.

The Court of Appeals also relied on the tax deductibility accorded to portions of the monthly carrying charges paid by Co-op City residents as a source of profit to them. 500 F. 2d, at 1254. The Court rejects this argument with the statement that "[t]hese tax benefits are nothing more than that which is available to any homeowner . . . ." *Ante,* at 855. This is true but irrelevant to the question whether they constitute profits that "come solely from the efforts of others." The special federal tax provision for cooperative owners, 26 U. S. C. § 216, was intended "to place the tenant stockholders of a cooperative apartment in the same position as the owner of a dwelling house so far as deductions for interest and taxes are concerned." S. Rep. No. 1631, 77th Cong., 2d Sess., 51 (1942). This tax benefit constitutes a profit both for the individual homeowners and for the "tenant stockholders of a cooperative apartment." The difference is that the profit of the individual homeowner does not "come solely from the efforts of others," whereas the profit from this source realized by a resident of Co-op City does. Setting up and operating a corporation so as to take advantage of special tax provisions is a project requiring specialized skills. If the arrangements go awry the residents can find themselves without the hoped-for tax advantages.

See, *e. g., Eckstein* v. *United States,* 196 Ct. Cl. 644, 452 F. 2d 1036 (1971). Thus, the investors must depend upon the "efforts of others," here Co-op City's management, properly to organize and operate the project to realize the tax advantage for them.

In *SEC* v. *C. M. Joiner Leasing Corp.,* 320 U. S. 344 (1943), the investment was in oil leases. In *Howey* it involved citrus groves. Though taxation was not a factor in the Court's disposition of those cases, each of those investments was of a type offering tax advantages as a principal attraction to the investor. Cunnane, Tax Shelter Investments After the 1969 Tax Reform Act, 49 Taxes 450 (1971). It is no answer that the individual investor could have obtained the same tax advantages by purchasing an entire citrus business or by becoming an independent oil operator. He could, but if he did his profits from tax advantages would not then "come solely from the efforts of others." It is only when he relies on third parties to produce the profits for him that, as here, the question of investment contract analysis arises.

Besides its express rejection of each of the forms of profit found by the Court of Appeals, the Court must surprise knowledgeable economists with its proposition, *ante,* at 852, that profits cannot assume forms other than appreciation of capital or participation in earnings.[1] All of the varieties of profit involved here accrue to the resident-stockholders in the form of money saved rather than money earned.[2] Not only would simple common sense teach that the two are the same, but a more sophisticated economic analysis also compels the conclusion that in a practical world there is no difference between

[1] See P. Samuelson, Economics 618–626 (9th ed. 1973).

[2] Apparently there is at least a possibility that dividends could be paid to shareholders, but these would really just be partial refunds of money already paid in which was not needed.

the two forms of income.[3] The investor finds no reason to distinguish, for example, between tax savings and after-tax income. Under a statute having as one of its "central purposes" "to protect investors," *Tcherepnin*, 389 U. S., at 336, it is obvious that the Court errs in distinguishing among types of economic inducements which have no bearing on the motives of investors. Construction of the statute in terms of economic reality is more faithful to its "central" purpose "to protect investors."

There can be no doubt that one of the inducements to the resident-stockholders to purchase a Co-op City apartment was the prospect of profits in one or more of the forms I have discussed. The fact that literature encouraging purchase mentioned some is important, although not conclusive, evidence. See *Joiner, supra*, at 353. The Information Bulletins, while not mentioning income from commercial and office space as an advantage of stock ownership, did emphasize the "reasonable price" of the housing, App. 166a, 187a, and they asserted that "every effort" would be made to keep monthly carrying charges low, *id.*, at 174a, 194a. Tax benefits were also discussed as an advantage of ownership, though of course no guarantee of favorable federal and state tax treatment was made. *Id.*, at 175a, 195a.

I do not deny that there are some limits to the broad statutory definition of a security, and the Court's distinction between securities and consumer goods is not frivolous. *Ante*, at 858. But the distinction is not useful in the resolution of the question before us. Of course, the purchase of the stock to get an apartment involves an element of consumption, but it also involves an element of investment. The variable annuity contract con-

[3] See, *e. g.*, P. Samuelson, *supra*, n. 1, at 435; Coase, The Problem of Social Cost, 3 J. Law & Econ. 1 (1960).

sidered in *SEC* v. *Variable Annuity Co.*, 359 U. S. 65 (1959), presented a not irrelevant analogous situation. What was purchased, after all, was expressly labeled "stock." In any event, what was purchased constituted an "investment contract," within *Howey*, for resident-stockholders of Co-op City invested "in a common enterprise with profits to come solely from the efforts of others." They therefore were purchasing securities within the purview of the Securities Act of 1933 and the Securities Exchange Act of 1934.

II

Moreover, both statutes define the term "security" to include "stock." Therefore, coverage under the statutes is clear under the Court's holding in *Joiner* that "[i]nstruments may be included within any of these definitions, as matter of law if on their face they answer to the name or description." 320 U. S., at 351; see *Tcherepnin,* 389 U. S., at 339. "Security" was broadly defined with the explicit object of including "the many types of instruments that in our commercial world fall within the ordinary concept of a security," H. R. Rep. No. 85, 73d Cong., 1st Sess., 11 (1933). Stock is therefore included because instruments "such as notes, bonds, and stocks, are pretty much standardized and the name alone carries well-settled meaning." *Joiner,* 320 U. S., at 351. Even if this principle nevertheless allows room for exception of some instruments labeled "stock," the Court's justification for excepting the stock involved in this case is singularly unpersuasive. The Court states that "[c]ommon sense suggests that people who intend to acquire only a residential apartment in a state-subsidized cooperative, for their personal use, are not likely to believe that in reality they are purchasing investment securities simply because the transaction is evidenced by something called a share of stock." *Ante,* at 851. But even informed commentators have expressed misgivings about this question.[4] Thus the Court's justification departs unacceptably from the principle of *Joiner* that "[i]n the enforcement of an act such as this it is not inappropriate that promoters' offerings be judged as being what they were represented to be." 320 U. S., at 353.

While the absence in the case of Co-op City stock of some features normally associated with stock is a relevant consideration, the presence of the attributes that led me to conclude that this stock constitutes an "investment contract," leads me also to conclude that it is a "stock" for purposes of the two statutes. Cf. *Affiliated Ute Citizens* v. *United States,* 406 U. S. 128 (1972).

In sum, I conclude that the interests purchased by the stockholders here were "securities" both because they were "stock" and because they were "investment contracts."[5] In my view therefore the Court of Appeals correctly held that the District Court erred in dismissing this suit.[6]

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[4] See, *e. g.,* 1 L. Loss, Securities Regulation 492–493 (2d ed. 1961).

[5] Accordingly, I have no occasion to examine the "risk capital" approach of *Silver Hills Country Club* v. *Sobieski,* 55 Cal. 2d 811, 361 P. 2d 906 (1961), to determine whether that would lead to the same result.

[6] Petitioners in No. 74-647, the State of New York and the New York State Housing Finance Agency, argue that respondents' suit against them is barred by the Eleventh Amendment. The Court finds it unnecessary to deal with this contention, but my conclusion requires that I answer the Eleventh Amendment defense. The Court of Appeals found no Eleventh Amendment bar here, and I am in agreement with this result.

The Housing Finance Agency is a "public benefit corporation" under New York law, N. Y. Priv. Hous. Fin. Law § 43 (1) (1962 and Supp. 1974–1975), empowered "[t]o sue and be sued," § 44 (1). The agency is authorized to accept funds from the State, the Fed-

III

At oral argument, petitioner United Housing Foundation contended strenuously that comprehensive state participation and regulation of the construction and operation of Co-op City constituted Riverbay Corporation not a capitalistic enterprise but a beneficial public housing enterprise, created by a partnership of public and private groups for the benefit of people of modest incomes. I need not disagree with this characterization to conclude that nevertheless there is a role for the fed-

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eral Government, or "any other source," § 44 (16), but it also is empowered to issue notes, bonds, or other obligations to obtain financing, §§ 44 (7) and 46. Significantly, the State is not liable on the agency's notes or bonds, and such obligations do not constitute debts of the State. § 46 (8). The agency is therefore not an "alter ego" of the State; rather it is an independent body not entitled to assert the Eleventh Amendment. See *Cowles* v. *Mercer County*, 7 Wall. 118 (1869); P. Bator, P. Mishkin, D. Shapiro & H. Wechsler, Hart & Wechsler's The Federal Courts and the Federal System 690 (2d ed. 1973). Compare *Matherson* v. *Long Island State Park Comm'n*, 442 F. 2d 566 (CA2 1971), and *Zeidner* v. *Wulforst*, 197 F. Supp. 23, 25 (EDNY 1961), with *Whitten* v. *State University Construction Fund*, 493 F. 2d 177 (CA1 1974), and *Charles Simkin & Sons, Inc.* v. *State University Construction Fund*, 352 F. Supp. 177 (SDNY), aff'd mem., 486 F. 2d 1393 (CA2 1973).

The State of New York, unlike the agency, may assert the Eleventh Amendment, but it has consented to suit. "With regard to duties and liabilities arising out of this article the state, the commissioner or the supervising agency may be sued *in the same manner as a private person*." N. Y. Priv. Hous. Fin. Law § 32 (5) (emphasis added). To be sure, state waiver statutes are to be strictly construed, and they do not necessarily indicate consent to suit in federal court. See *Kennecott Copper Corp.* v. *State Tax Comm'n*, 327 U. S. 573 (1946); *Ford Motor Co.* v. *Department of Treasury*, 323 U. S. 459 (1945); *Great Northern Life Ins. Co.* v. *Read*, 322 U. S. 47 (1944). Nevertheless, the language used in § 32 (5) is in my view sufficiently broad to permit suit in both state and federal courts.

eral statutes to play in avoiding the danger of fraud and other evils in the raising of the massive sums the project involved. See *SEC* v. *Capital Gains Research Bureau,* 375 U. S. 180, 195 (1963); H. R. Rep. No. 85, 73d Cong., 1st Sess., 2–3 (1933). No doubt New York's intensive regulation also helps avoid those evils. See N. Y. Priv. Hous. Fin. Law. But Congress contemplated concurrent state and federal regulation in enacting the securities laws. *SEC* v. *Variable Annuity Co.,* 359 U. S., at 75 (concurring opinion), and therefore the existence of state regulation does not and cannot be a reason for excluding appropriate application of the federal statutes. Indeed, the resident-stockholder investors of Co-op City are particularly entitled to the federal protection. The District Court properly observed:

> "[I]f ever there was a group of people who need and deserve full and careful disclosure in connection with proposals for the use of their funds, it is this type of group. . . . The housing selection decision is a critical one in their lives. The cost of housing demands a good percentage of their incomes. Their savings are most likely to be minimal, and they probably don't have lawyers or accountants to guide them. Further, they are people likely to put a great deal of credence in statements made with respect to an offering by reputable civic groups and labor unions, particularly when the proposal is stamped with the imprimatur of the state." 366 F. Supp., at 1125.

I part from the District Court in concluding however that investors not only *should be* protected but, under my reading of the statutes, *are* protected by the securities laws. A different, perhaps better, form of redress can and will be devised for this kind of investment, but until it is these investors are not to be denied what the federal statutes plainly allow them. See Note, Cooperative Housing Corporations and the Federal Securities Laws, 71 Col. L. Rev. 118 (1971). The SEC, though perhaps tardily, has come to the view that these housing corporations fall within its regulatory authority because the kind of investment involved is a "security" under the statutes. I wholly agree. I would affirm the judgment of the Court of Appeals.

POSNER, Chief Judge.

The district judge rebuffed the plaintiffs' effort to characterize a condominium time-sharing purchase and rental agreement as an investment contract subject to the Securities Act of 1933. 15 U.S.C. § 77b(1); 828 F.Supp. 623 (E.D.Wis.1993). We must decide whether he was right to do so. In 1990 the plaintiffs bought "week 5" of an apartment in the Fox Hills Golf Villas Condominium outside of Manitowoc, Wisconsin, from the developer (the principal defendant in this case) and at the same time entered into a "flexible time" agreement with the developer under which the plaintiffs could swap their week (which is in February) for a week in the summer. Under a supplement to the "flexible time" agreement called the "4-share" program, which the plaintiffs also signed and which like the "flexible time" agreement itself was renewable annually, the plaintiffs agreed not to occupy the unit during the week in the summer that they had obtained by the swap of their winter entitlement but instead to allow the developer to rent it. They would receive the rental, minus the developer's fee of 30 percent; the effect would be to reduce the cost to them of their investment in their own unit. They contend that this unusual feature of their relationship with the developer converted the sale of the condominium to them from a sale of real estate to a sale of an investment contract which the developer was required and failed to register under the Securities Act, thus entitling them to rescind the sale. 15 U.S.C. § 77*l*(1).

The Fox Hills Golf Villas Condominium is a recreational condominium project (Fox Hills Golf Course is, we were told at argument, the largest golf course in the midwest). Nothing is more common than for the developer of such a project to offer to rent out owned but temporarily unoccupied units as the agent of the owner. Because the resulting division of rental income makes the developer and the condominium owner coventurers in a profit-making activity, imparting to the condominium interest itself the character of an investment for profit as well as a home for occupancy, those circuits that believe that only "vertical commonality" is required to create an investment contract would deem the combination of sale and rental agreement in this case an investment contract. *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 479 (5th Cir.1974); *Cameron v. Outdoor Resorts of America, Inc.*, 608 F.2d 187, 193 (5th Cir.1979), modified, 611 F.2d 105 (5th Cir.1980) (per curiam); *Miller v. Central Chinchilla Group, Inc.*, 494 F.2d 414, 418 (8th Cir.1974); *SEC v. Eurobond Exchange, Ltd.*, 13 F.3d 1334, 1339 (9th Cir. 1994); *McGill v. American Land & Exploration Co.*, 776 F.2d 923, 925 (10th Cir.1985).

Other circuits, including our own, require more—require "horizontal commonality," that is, a pooling of interests not only between the developer or promoter and each individual "investor" but also among the "investors" (the owners of the condominiums, in this case)—require, in short, a wheel and not just a hub and a spoke. *Stenger v. R.H. Love Galleries, Inc.*, 741 F.2d 144 (7th Cir. 1984); *Milnarik v. M–S Commodities, Inc.*, 457 F.2d 274 (7th Cir.1972); *Deckebach v. La Vida Charters, Inc.*, 867 F.2d 278, 282 (6th Cir.1989); *Salcer v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 682 F.2d 459 (3d Cir. 1982). The Second Circuit seems to be leaning toward a requirement of horizontal commonality, see *Revak v. SEC Realty Corp.*, 18 F.3d 81 (2d Cir.1994); and in *Long v. Schultz Cattle Co.*, 896 F.2d 85, 88 (5th Cir.1990) (per curiam), the Fifth Circuit indicated that it would be willing to reconsider its contrary position announced in *Koscot* and *Cameron* in a suitable case. The Supreme Court has ducked the issue so far, *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 853 n. 17, 95 S.Ct. 2051, 2061 n. 17, 44 L.Ed.2d 621 (1975); *Mordaunt v. Incomco*, 469 U.S. 1115, 105 S.Ct. 801, 83 L.Ed.2d 793 (1985) (White, J., dissenting from denial of certiorari), and the SEC has hedged. "Guidelines as to the Applicability of the Federal Securities Laws to Offers and Sale of Condominiums or Units in a Real Estate Development," [1972–73 Transfer Binder] Fed.Sec.L.Rep. (CCH) & 79,163, at p. 82,540 (Securities Act Release No. 5347, Jan. 4, 1973); see *Bender v. Continental Towers Limited Partnership*, 632 F.Supp. 497, 501 (S.D.N.Y.1986).

Revak is the only appellate case that involves the sale of residential condominiums except for *Hocking v. Dubois*, 885 F.2d 1449 (9th Cir.1989) (en banc), where, however, horizontal commonality was present, making the choice between the two lines of case unimportant. *Id.* at 1453 n. 4. *Cameron*, which involved campsites, is quite close, however, and *Allison v. Ticor Title Ins. Co.*, 907 F.2d 645 (7th Cir.1990), involved an arrangement, which the jury found to be an investment contract, that is much like that in the present case—but whether the finding was correct was not an issue on appeal.

Our circuit's position comports better, we believe, with the purpose of the 1933 Act than that of the circuits which dispense with the requirement of establishing horizontal commonality. It is true that real estate is an "investment" in the fundamental sense of an outlay intended to yield benefits over a substantial period of time, conventionally at least a year. The benefits can be pecuniary or nonpecuniary but the combination of the "flexible time" agreement with the "4–share" program converts the condominium owner's investment, even if only temporarily, into a purely pecuniary investment, for the owner obtains no consumption value from his property when he is not occupying it. Even so, the optional character of the "flexible time" and "4–share" agreements makes it difficult to conceive of the sale of the condominium itself as the sale of a security, *Allison v. Ticor Title Ins. Co.*, *supra*, 907 F.2d at 649, and it is the sale of the condominium that the Walses want to rescind. The statutory language ("the term 'security' means any note, stock, treasury stock, bond, debenture, ... investment contract, ... or, in general, any interest or instrument commonly known as a 'security,' " 15 U.S.C. § 77b(1)) suggests that the term "investment contract" has the limited purpose of identifying unconventional instruments that have the essential properties of a debt or equity security. *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 690, 105 S.Ct. 2297, 2304, 85 L.Ed.2d 692 (1985); *Marine Bank v. Weaver*, 455 U.S. 551, 555–56, 102 S.Ct. 1220, 1223–24, 71 L.Ed.2d 409 (1982). A share of stock, for example, is an undivided interest in an enterprise, entitling the owner to a pro rata share in the enterprise's profits. *United Housing Foundation, Inc. v. Forman*, *supra*, 421 U.S. at 851, 95 S.Ct. at 2060. The owner of a condominium does not own an undivided share of the building complex in which his condominium is located. He owns his condominium, and if it is rented out for him by the developer he receives the particular rental on that unit rather than an undivided share of the total rentals of all the units that are rented out. The nature of his interest thus is different from that of a shareholder in a corporation that owns rental property. This is true whether he owns the condominium all year round or owns a temporal slice of it like the Walses, although we cannot find any case on the point.

It makes no difference that the rental received by the plaintiffs was not the rental of their own property, which was week 5 of "their" condominium unit. In effect they swapped week 5 for a subsequent week, then rented the subsequent week and received the rental (if there was any, for of course the developer might be unsuccessful in his effort to rent it). Still, they did not receive an undivided share of some pool of rentals or profits. They received the rental on a single apartment, albeit one not owned by them (for it was not their week).

There was a pooling of weeks, in a sense, because the plaintiffs selected their summer swap week from a "pool" of available weeks. But there was not a pooling of profits, which is essential to horizontal commonality. E.g., *Milnarik v. M–S Commodities, Inc., supra,* 457 F.2d at 276–77; *Hirk v. Agri-Research Council, Inc.,* 561 F.2d 96, 100–01 (7th Cir. 1977); *Union Planters National Bank v. Commercial Credit Business Loans, Inc.,* 651 F.2d 1174, 1183 (6th Cir.1981); *Curran v. Merrill Lynch, Pierce, Fenner and Smith, Inc.,* 622 F.2d 216, 222 (6th Cir.1980); *Revak v. SEC Realty Corp., supra,* 18 F.3d at 87–89. The requirement of horizontal commonality has been derided as being formalistic and unrelated to the purposes of the 1933 Act. James D. Gordon, III, "Common Enterprise and Multiple Investors," 3 *Colum.Bus.L.Rev.* 635, 660–62 (1988). We disagree. The Act is a disclosure statute. It requires promoters and issuers to make *uniform* disclosure to all investors, and this requirement makes sense only if the investors are obtaining the same thing, namely an undivided share in the same pool of assets and profits. That is not what the plaintiffs in this case received even after swapping. Their investment was in a specific time slice of a specific apartment the physical and temporal characteristics of which (including price) differed from those of other apartments. Their return was tied to another space-time slice with its own unique characteristics. Every week of every apartment was a different product. In fairness to Gordon, we note that he would not classify an arrangement lacking horizontal commonality as an investment contract unless the rental arrangements between the developer and each of the condominium owners were similar. But we think that such an approach would provide insufficient guidance to developers.

We can imagine a case—perhaps *Adams v. Cavanagh Communities Corp.,* 847 F.Supp. 1390 (N.D.Ill.1994), is the case, though we need not and do not so decide—in which undeveloped lots are marketed on a large scale to unsophisticated investors who neither inspect their lot before buying it nor ever build or occupy a home on it—it is for them purely a speculative investment—and while there is no pooling of profits the investors regard the lots as fungible. *Adams* was almost a case, at least as described in the district court's opinion—for we do not mean to be endorsing the description or otherwise prejudicing the decision of an appeal in that case should one be taken—in which the promoter was selling shares but calling them lots. The SEC in the release we cited earlier took the position that where the investment purpose is dominant (is everything, as we have described *Adams*), the sale is indeed of an investment contract. We need not decide whether interests so otherwise similar to shares in a real estate development company should be deemed to fall outside the protections of the 1933 Act merely because profits are not pooled, a conclusion that might be thought to create a loophole. Our case falls well short of that. The Walses bought and then rented a home. The unusual form of the rental arrangement did not convert the sale of the home into an investment contract.

AFFIRMED.

Marine Bank v. Weaver, 455 U.S. 551, 102 S.Ct. 1220, 71 L.E.2d 409 (1982).

CHIEF JUSTICE BURGER delivered the opinion of the Court.

We granted certiorari to decide whether two instruments, a conventional certificate of deposit and a business agreement between two families, could be considered securities under the antifraud provisions of the federal securities laws.

I

Respondents, Sam and Alice Weaver, purchased a $50,000 certificate of deposit from petitioner Marine Bank on February 28, 1978. The certificate of deposit has a 6-year maturity, and it is insured by the Federal Deposit Insurance Cor-

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*Briefs of *amici curiae* urging reversal were filed by *Acting Solicitor General Wallace, Stephen M. Shapiro, Ralph C. Ferrara, Frank L. Skillern, Jr.*, and *John E. Shockey* for the United States; and by *William H. Smith, Johanna M. Sabol*, and *Michael F. Crotty* for the American Bankers Association.

Leonard I. Schreiber filed a brief for Myrna Ayala as *amicus curiae* urging affirmance.

poration.[1] The Weavers subsequently pledged the certificate of deposit to Marine Bank on March 17, 1978, to guarantee a $65,000 loan made by the bank to Columbus Packing Co. Columbus was a wholesale slaughterhouse and retail meat market which owed the bank $33,000 at that time for prior loans and was also substantially overdrawn on its checking account with the bank.

In consideration for guaranteeing the bank's new loan, Columbus' owners, Raymond and Barbara Piccirillo, entered into an agreement with the Weavers. Under the terms of the agreement, the Weavers were to receive 50% of Columbus' net profits and $100 per month as long as they guaranteed the loan. It was also agreed that the Weavers could use Columbus' barn and pasture at the discretion of the Piccirillos, and that they had the right to veto future borrowing by Columbus.

The Weavers allege that bank officers told them Columbus would use the $65,000 loan as working capital but instead it was immediately applied to pay Columbus' overdue obligations. The bank kept approximately $42,800 to satisfy its prior loans and Columbus' overdrawn checking account. All but $3,800 of the remainder was disbursed to pay overdue taxes and to satisfy other creditors; the bank then refused to permit Columbus to overdraw its checking account. Columbus became bankrupt four months later. Although the bank had not yet resorted to the Weavers' certificate of deposit at the time this litigation commenced, it acknowledged that its

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[1] The certificate of deposit pays 7½% interest and provides that, if the bank permits early withdrawal, the depositor will earn interest at the bank's current savings passbook rate on the amount withdrawn, except that no interest will be paid for the three months prior to withdrawal. When the Weavers purchased the certificate of deposit, it could only be insured up to $40,000 by the FDIC. The ceiling on insured deposits is now $100,000. Act of Mar. 31, 1980, Pub. L. 96–221, 94 Stat. 147, § 308(b)(1), 12 U. S. C. § 1724(b) (1976 ed., Supp. IV).

other security was inadequate and that it intended to claim the pledged certificate of deposit.

These allegations were asserted in a complaint filed in the Federal District Court for the Western District of Pennsylvania in support of a claim that the bank violated § 10(b) of the Securities Exchange Act of 1934, 48 Stat. 891, 15 U. S. C. § 78j(b). The Weavers also pleaded pendent claims for violations of the Pennsylvania Securities Act and for common-law fraud by the bank. The Weavers alleged that bank officers actively solicited them to guarantee the $65,000 loan to Columbus while knowing, but not disclosing, Columbus' financial plight or the bank's plans to repay itself from the new loan guaranteed by the Weavers' pledged certificate of deposit. Had they known of Columbus' precarious financial condition and the bank's plans, the Weavers allege they would not have guaranteed the loan and pledged the certificate of deposit. The District Court granted summary judgment in favor of the bank. It concluded that if a wrong occurred it did not take place "in connection with the purchase or sale of any security," as required for liability under § 10(b). The District Court declined to exercise pendent jurisdiction over the state-law claims.

The Court of Appeals for the Third Circuit reversed. 637 F. 2d 157 (1980). A divided court held that a finder of fact could reasonably conclude that either the certificate of deposit or the agreement between the Weavers and the Piccirillos was a security.[2] It therefore remanded for further consideration of the claim based on the federal securities

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[2] The Court of Appeals also concluded that the pledge of a security is a sale, an issue on which the Federal Circuits were split. We held in *Rubin* v. *United States*, 449 U. S. 424 (1981), that a pledge of stock is equivalent to a sale for the purposes of the antifraud provisions of the federal securities laws. Accordingly, in determining whether fraud may have occurred here "in connection with the purchase or sale of any security," the only issue now before the Court is whether a *security* was involved.

laws. The Court of Appeals also reversed the District Court's dismissal of the pendent state-law claims.

We granted certiorari, 452 U. S. 904 (1981), and we reverse. We hold that neither the certificate of deposit nor the agreement between the Weavers and the Piccirillos is a security under the antifraud provisions of the federal securities laws. We remand the case to the Court of Appeals to determine whether the pendent state claims should now be entertained.

II

The definition of "security" in the Securities Exchange Act of 1934[3] is quite broad. The Act was adopted to restore investors' confidence in the financial markets,[4] and the term "security" was meant to include "the many types of instru-

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[3] Section 3(a)(10) of the 1934 Act, as set forth in 15 U. S. C. § 78c(a)(10), provides:

"(a) . . . When used in this chapter, unless the context otherwise requires—

. . . . .

"(10) The term 'security' means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, pre-organization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a 'security'; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity is likewise limited."

We have consistently held that the definition of "security" in the 1934 Act is essentially the same as the definition of "security" in § 2(1) of the Securities Act of 1933, 15 U. S. C. § 77(b)(1). *United Housing Foundation, Inc.* v. *Forman*, 421 U. S. 837, 847, n. 12 (1975).

[4] Fitzgibbon, What is a Security? A Redefinition Based on Eligibility to Participate in the Financial Markets, 64 Minn. L. Rev. 893, 912–918 (1980).

ments that in our commercial world fall within the ordinary concept of a security." H. R. Rep. No. 85, 73d Cong., 1st Sess., 11 (1933); quoted in *United Housing Foundation, Inc.* v. *Forman*, 421 U. S. 837, 847–848 (1975). The statutory definition excludes only currency and notes with a maturity of less than nine months. It includes ordinary stocks and bonds, along with the "countless and variable schemes devised by those who seek the use of the money of others on the promise of profits . . . ." *SEC* v. *W. J. Howey Co.*, 328 U. S. 293, 299 (1946). Thus, the coverage of the antifraud provisions of the securities laws is not limited to instruments traded at securities exchanges and over-the-counter markets, but extends to uncommon and irregular instruments. *Superintendent of Insurance of New York* v. *Bankers Life & Casualty Co.*, 404 U. S. 6, 10 (1971); *SEC* v. *C. M. Joiner Leasing Corp.*, 320 U. S. 344, 351 (1943). We have repeatedly held that the test "'is what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect.'" *SEC* v. *United Benefit Life Ins. Co.*, 387 U. S. 202, 211 (1967), quoting *SEC* v. *C. M. Joiner Leasing Corp.*, *supra*, at 352–353.

The broad statutory definition is preceded, however, by the statement that the terms mentioned are not to be considered securities if "the context otherwise requires . . . ." Moreover, we are satisfied that Congress, in enacting the securities laws, did not intend to provide a broad federal remedy for all fraud. *Great Western Bank & Trust* v. *Kotz*, 532 F. 2d 1252, 1253 (CA9 1976); *Bellah* v. *First National Bank*, 495 F. 2d 1109, 1114 (CA5 1974).

III

The Court of Appeals concluded that the certificate of deposit purchased by the Weavers might be a security. Examining the statutory definition, n. 3, *supra*, the court correctly noted that the certificate of deposit is not expressly excluded from the definition since it is not currency and it has a maturity exceeding nine months.[5] It concluded, however, that the certificate of deposit was the functional equivalent of the withdrawable capital shares of a savings and loan association held to be securities in *Tcherepnin* v. *Knight*, 389 U. S. 332 (1967). The court also reasoned that, from an investor's standpoint, a certificate of deposit is no different from any other long-term debt obligation.[6] Unless distinguishing features were found on remand, the court concluded that the certificate of deposit should be held to be a security.

Tcherepnin is not controlling. The withdrawable capital shares found there to be securities did not pay a fixed rate of interest; instead, purchasers received dividends based on the association's profits. Purchasers also received voting rights. In short, the withdrawable capital shares in *Tcherepnin* were much more like ordinary shares of stock and "the ordinary concept of a security," *supra*, at 556, than a certificate of deposit.

The Court of Appeals' also concluded that a certificate of deposit is similar to any other long-term debt obligation commonly found to be a security. In our view, however, there is an important difference between a bank certificate of deposit

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[5] The definition of a "security" in the 1934 Act, n. 3, *supra*, includes the term, "certificate of deposit, for a security." However, this term does not refer to certificates of deposit such as the Weavers purchased. Instead, "certificate of deposit, for a security" refers to instruments issued by protective committees in the course of corporate reorganizations. *Canadian Imperial Bank of Commerce* v. *Fingland*, 615 F. 2d 465, 468 (CA7 1980).

[6] In addition, the Court of Appeals noted that the Securities and Exchange Commission had taken the position that certificates of deposit are securities. However, the SEC has filed a brief as *amicus curiae* in this case, jointly with the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, and the Office of the Comptroller of the Currency, which argues that the Weavers' certificate of deposit is not a security.

and other long-term debt obligations. This certificate of deposit was issued by a federally regulated bank which is subject to the comprehensive set of regulations governing the banking industry.[7] Deposits in federally regulated banks are protected by the reserve, reporting, and inspection requirements of the federal banking laws; advertising relating to the interest paid on deposits is also regulated.[8] In addition, deposits are insured by the Federal Deposit Insurance Corporation. Since its formation in 1933, nearly all depositors in failing banks insured by the FDIC have received payment in full, even payment for the portions of their deposits above the amount insured. 1980 Annual Report of the Federal Deposit Insurance Corporation 18–21 (1981).

We see, therefore, important differences between a certificate of deposit purchased from a federally regulated bank and other long-term debt obligations. The Court of Appeals failed to give appropriate weight to the important fact that the purchaser of a certificate of deposit is virtually guaranteed payment in full, whereas the holder of an ordinary long-term debt obligation assumes the risk of the borrower's insolvency. The definition of "security" in the 1934 Act provides that an instrument which seems to fall within the broad sweep of the Act is not to be considered a security if the con-

[7] In *Teamsters* v. *Daniel*, 439 U. S. 551 (1979), we held that a noncontributory, compulsory pension plan was not a security. One of our reasons for our holding in *Daniel* was that the pension plan was regulated by the Employee Retirement Income Security Act of 1974 (ERISA): "The existence of this comprehensive legislation governing the use and terms of employee pension plans severely undercuts all arguments for extending the Securities Acts to noncontributory, compulsory pension plans." *Id.*, at 569–570. Since ERISA regulates the substantive terms of pension plans, and also requires certain disclosures, it was unnecessary to subject pension plans to the requirements of the federal securities laws as well.

[8] See, *e. g.*, 12 U. S. C. § 461(b) (1976 ed., Supp. IV) (reserve requirements); 12 U. S. C. §§ 161, 324, and 1817 (1976 ed. and Supp. IV) (reporting requirements); 12 U. S. C. §§ 481, 483, and 1820(b) (1976 ed. and Supp. IV) (inspection requirements); 12 CFR §§ 217.6 and 329.8 (1981) (advertising).

text otherwise requires. It is unnecessary to subject issuers of bank certificates of deposit to liability under the antifraud provisions of the federal securities laws since the holders of bank certificates of deposit are abundantly protected under the federal banking laws. We therefore hold that the certificate of deposit purchased by the Weavers is not a security.[9]

IV

The Court of Appeals also held that a finder of fact could conclude that the separate agreement between the Weavers and the Piccirillos is a security. Examining the statutory language, n. 3, *supra*, the court found that the agreement might be a "certificate of interest or participation in any profit-sharing agreement" or an "investment contract." It stressed that the agreement gave the Weavers a share in the profits of the slaughterhouse which would result from the efforts of the Piccirillos. Accordingly, in that court's view, the agreement fell within the definition of "investment contract" stated in *Howey*, because "the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others." 328 U. S., at 301.

Congress intended the securities laws to cover those instruments ordinarily and commonly considered to be securities in the commercial world, but the agreement between the Weavers and the Piccirillos is not the type of instrument that comes to mind when the term "security" is used and does not fall within "the ordinary concept of a security." *Supra*, at 556. The unusual instruments found to constitute securities in prior cases involved offers to a number of potential investors, not a private transaction as in this case. In *Howey*, for example, 42 persons purchased interests in a citrus grove during a 4-month period. 328 U. S., at 295. In

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[9] We reject respondents' argument that the certificate of deposit was somehow transformed into a security when it was pledged, even though it was not a security when purchased.

C. M. Joiner Leasing, offers to sell oil leases were sent to over 1,000 prospects. 320 U. S., at 346. In *C. M. Joiner Leasing*, we noted that a security is an instrument in which there is "common trading." *Id.*, at 351. The instruments involved in *C. M. Joiner Leasing* and *Howey* had equivalent values to most persons and could have been traded publicly.

Here, in contrast, the Piccirillos distributed no prospectus to the Weavers or to other potential investors, and the unique agreement they negotiated was not designed to be traded publicly. The provision that the Weavers could use the barn and pastures of the slaughterhouse at the discretion of the Piccirillos underscores the unique character of the transaction. Similarly, the provision that the Weavers could veto future loans gave them a measure of control over the operation of the slaughterhouse not characteristic of a security. Although the agreement gave the Weavers a share of the Piccirillos' profits, if any, that provision alone is not sufficient to make that agreement a security. Accordingly, we hold that this unique agreement, negotiated one-on-one by the parties, is not a security.[10]

V

Whatever may be the consequences of these transactions, they did not occur in connection with the purchase or sale of "securities."[11] The Weavers allege that the bank manipulated them so that they would suffer the loss the bank would

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[10] Cf. *Great Western Bank & Trust* v. *Kotz*, 532 F. 2d 1252, 1260–1262 (CA9 1976) (Wright, J., concurring) (unsecured note, the terms of which were negotiated face-to-face, given to a bank in return for a business loan, is not a security).

[11] It does not follow that a certificate of deposit or business agreement between transacting parties invariably falls outside the definition of a "security" as defined by the federal statutes. Each transaction must be analyzed and evaluated on the basis of the content of the instruments in question, the purposes intended to be served, and the factual setting as a whole.

have borne from the failure of the Columbus Packing Co. Their pendent state-law claims against the bank are not before the Court since the Court of Appeals did not treat the issue of those claims. Accordingly, the case is remanded for consideration of whether the District Court should now entertain the pendent claims.

Reversed and remanded.

Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc., 840 F.2d 236 (4th Cir. 1988):

Before POWELL, Associate Justice (Retired); United States Supreme Court, sitting by designation; ERVIN, Circuit Judge, and BUTZNER, Senior Circuit Judge.

POWELL, Associate Justice:

The dispositive issue presented in this case is whether the district court, 650 F.Supp. 1378 correctly concluded that appellants' general partnership interests in Rivanna Trawlers Unlimited are not securities within the meaning of the federal securities laws. We hold that these interests are not securities, and affirm.

The appellate record indicates that the Virginia general partnership, Rivanna Trawlers Unlimited ("RTU"), was formed in August 1982 when twenty-three parties executed an agreement for the purpose of forming a general partnership, "which will acquire, own, lease and operate multi-purpose fishing vessels and otherwise engage in the commercial fishing business...." (App. at 1535). At some point, not disclosed by the record, Joseph W. May, M.D. also joined the partnership.[1] On August 30, 1982 RTU purchased four fishing boats and entered into several agreements for their management and maintenance with Thompson Management, Inc. By the spring of 1983 the partners were expressing concern over the partnership's operations and they were considering management alternatives. Operation of the fishing boats had not been meeting the partners' financial expectations. The partners subsequently replaced RTU's external managers[2] twice and removed RTU's original managing partner Walter B. Salley, Sr., who was a general partner of GMS, and replaced him with a managing partnership committee.

1. Appellees' brief states that there were 25 partners in RTU. The Partnership Agreement exhibited at pages 1535–46 of the Joint Appendix contains the names of only 23 partners, including the GMS partnership. The Mutual Release Agreement signed by all the partners contains only 24 partners (Joseph May's name was added). It may be that appellees have included the individual partners of the GMS partnership in the total number of partners in the RTU partnership. This discrepancy is immaterial to the outcome of the case.

2. Use of the phrase "external managers" refers to the employment of individuals who were not necessarily members of the partnership to manage and maintain the partnership's fishing boats. "Internal manager" or "managing partner" refers to the partner or partners responsible for carrying out policy and management decisions made by the partners.

In August 1984 RTU and a number of its partners filed a complaint against Thompson Trawlers, Inc., Thompson Management, Inc. and various other companies and individuals, including Walter B. Salley, Sr. and Walter B. Salley, Jr., in the United States District Court for the Western District of Virginia. These plaintiffs alleged that their interests in the general partnership were "investment contracts" as defined in the federal securities laws, and that appellees had violated these laws. Appellants also alleged various violations of Virginia state law. An amended complaint was filed in November 1984 and a second amended complaint was filed in August 1985. Jurisdiction was asserted pursuant to § 22 of the Securities Act of 1933, § 27 of the Securities Act of 1934, and Rule 10b–5. There was no diversity of citizenship, and therefore pendent jurisdiction was asserted as a basis for the court's jurisdiction over the Virginia state law claims. In response to the second amended complaint, appellees filed motions to dismiss on the ground, among others, that the plaintiffs had failed to state a cause of action under the federal securities laws. Appellees argued that the plaintiffs' general partnership interests were not securities. Appellees also alleged that a "Mutual Release Agreement," signed by all the plaintiffs in October 1983, released the appellees from all claims asserted in the complaints.

The district court treated the motions to dismiss as motions for summary judgment. It found that the plaintiffs' general partnership interests were not securities and therefore it dismissed their federal claims.[3] Noting that its jurisdiction was premised on the federal securities law claims, the district court declined to consider the pendent claims. All but two of the plaintiffs appealed.

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3. In an alternative holding, the district court found that the "Mutual Release Agreement" signed by the plaintiffs was dispositive of all plaintiffs' asserted claims.

*   *   *   *

B

[4, 5] We address first appellants' claim that their interests in the RTU partnership were investment contracts, and therefore were securities within the meaning of the federal securities laws. The Supreme Court has defined an investment contract as "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...." *Securities & Exchange Commission v. W.J. Howey Co.*, 328 U.S. 293, 298–99, 66 S.Ct. 1100, 1102–03, 90 L.Ed. 1244 (1946). The critical issue on this appeal is whether appellants' general partnership interests in RTU meet the third prong of the *Howey* test—that is, the expectation of profits derived solely from the efforts of others.[4] General partnerships ordinarily are not considered investment contracts because they grant partners—the investors—control over significant decisions of the enterprise. *Deutsch Energy Co. v. Mazur*, 813 F.2d 1567, 1570 (9th Cir.1987); *Goodwin v. Elkins & Co.*, 730 F.2d 99, 102–03 (3d Cir.), *cert. denied*, 469 U.S. 831, 105 S.Ct. 118, 83 L.Ed.2d 61 (1984); *Odom v. Slavik*, 703 F.2d 212, 215 (6th Cir.1983); *Gordon v. Terry*, 684 F.2d 736, 741 (11th Cir.1982), *cert. denied*, 459 U.S. 1203, 103 S.Ct. 1188, 75 L.Ed.2d 434 (1983); *Williamson v. Tucker*, 645 F.2d 404, 422 (5th Cir.), *cert. denied*, 454 U.S. 897, 102 S.Ct. 396, 70 L.Ed.2d 212 (1981). In *Williamson*, a leading case, the Fifth Circuit identified a narrow exception to the strong presumption that a general partnership is not a security. The court stated that:

> ... a partnership can be an investment contract only when the partners are so dependent on a particular manager that they cannot replace him *or otherwise* exercise ultimate control.

Id. at 424 (emphasis added).[5] Only when this degree of dependence by the partners exists is there an investment contract. *Id.* at 423. Moreover, the court emphasized that "[t]he delegation of rights and duties—standing alone—does not give rise to the sort of dependence on others which underlies the third prong of the *Howey* test." *Id.* In other words, the mere choice by a

4. In *SEC v. Glenn W. Turner Enters.*, 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 821, 94 S.Ct. 117, 38 L.Ed.2d 53 (1973) the Ninth Circuit held that the term "solely" should not be given a literal construction. A more liberal interpretation of the term solely, as used in *Howey*, has been adopted by eight additional circuits. the Supreme Court's statements that economic reality is to govern over form in determining what is a "security," we agree that the term solely—used in *Howey*—must not be given a literal construction in all circumstances.

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In light of

5. Appellants argue that *Williamson* would characterize a general partnership interest as a security when the partners cannot replace a particular manager with *themselves.* This is incorrect. The court in *Williamson* was careful to qualify its language by stating that a manager is irreplaceable only when the partners are, "incapable, within reasonable limits, of finding a replacement manager." 645 F.2d at 425.

partner to remain passive is not sufficient to create a security interest. The critical inquiry is, "whether the powers possessed by the [general partners] in the [partnership agreement] were so significant that, regardless of the degree to which such powers were exercised, the investments could not have been premised on a reasonable expectation of profits to be derived from the management efforts of others." *Id.* at 419.

[6, 7] We agree with the Fifth Circuit, as well as the other circuits that appear to have embraced the *Williamson* reasoning,[6] that only under certain limited circumstances can an investor's general partnership interest be characterized as an investment contract. A court must examine the partnership agreement and circumstances of a particular partnership to determine the reality of the contractual rights of the general partners. When, however, a partnership agreement allocates powers to the general partners that are specific and unambiguous, and when those powers are sufficient to allow the general partners to exercise ultimate control, as a majority, over the partnership and its business, then the presumption that the general partnership is not a security can only be rebutted by evidence that it is not possible for the partners to exercise those powers.[7] As the district court stated, "[e]ven when general partners do not individually have decisive control over major decisions, they do have the sort of influence which generally provides them with access to important information and protection against a dependence on others." (App. at 318). In a case of this kind, it also is important to bear in mind that Congress, in enacting the securities laws, did not intend to provide a federal remedy for all common law fraud. *Marine Bank v. Weaver,* 455 U.S. 551, 556, 102 S.Ct. 1220, 1223, 71 L.Ed.2d 409 (1982).

C

[8] The RTU Partnership Agreement confers broad authority on the partners to manage and control the business. It provides that the partnership can be dissolved by a concurrence of 60% in interest of the partners. (App. at 1536). It also states that, "[c]oncurrence of sixty percent (60%) in interest of the partners should be required with respect to policy and management decisions on [sic] the partnership business...." (App. at 1538). Policy and management decisions include: (i) the power to sell and convey, lease, mortgage, or encumber partnership assets; (ii) the power to borrow or lend sums on behalf of the partnership when in excess of $5000; (iii) the power to hire agents to manage or operate the business of the partnership; (iv) and the power to appoint a successor to the managing partner named in the agreement. *Id.* Moreover, at all times, each partner has reasonable access to the partnership's books of account and has the right to demand an audit of the partnership. (App. at 1540). Unanimous consent of the partners is required to transfer legal ownership of partnership interests, *id.*, and additional partners can be added only with the unanimous consent of the partners.

6. *See, e.g., Deutsch Energy Co. v. Mazur,* 813 F.2d 1567 (9th Cir.1987); *Odom v. Slavik,* 703 F.2d 212 (6th Cir.1983); *Gordon v. Terry,* 684 F.2d 736 (11th Cir.1982), *cert. denied,* 459 U.S. 1203, 103 S.Ct. 1188, 75 L.Ed.2d 434 (1983). *But see, Goodwin v. Elkins & Co.,* 730 F.2d 99, 103–04 (3d Cir.) (Opinion of Garth, J.), *cert. denied,* 469 U.S. 831, 105 S.Ct. 118, 83 L.Ed.2d 61 (1984). Judge Garth, in an interesting opinion, concluded that in view of the powers expressly conferred on general partners by New Jersey law, he would hold that a partnership interest could not be considered a security as a matter of law. In view of the broad powers conferred by the RTU partnership agreement, we have no occasion to consider the effect of Virginia law. *See infra* note 8.

7. If and to the extent that *Williamson* and other cases may be read to require a court to look to the actual knowledge and business expertise of *each* partner in order to assess his or her individual ability intelligently to exercise the power of a general partner, we do not agree. Such an inquiry would undercut the strong presumption that an interest in a *general* partnership is not a security. It also would unduly broaden the scope of the Supreme Court's instruction that courts must examine the economic reality of partnership interests. *See infra* note 10. We note that no such specific argument is made in this case. Appellants' complaint and briefs properly speak only in terms of the rights and authority of the partners as a group.

(App. at 1543). Finally, unanimous consent of the partnership also is required to distribute profits other than in proportion to the partners' respective interests. (App. at 1539).[8]

[9] As the district court found, the express powers granted to the partners are sufficient, on their face, to give them the authority to manage their investments. Normally, such authority renders unnecessary the protection of the federal securities laws. The Eleventh Circuit has stated that, "[a]n investor who has the ability to control the profitability of his investment, either by his own efforts or by majority vote in group ventures, is not dependent upon the managerial skills of others." *Gordon v. Terry,* 684 F.2d 736, 741 (11th Cir.1982), *cert. denied,* 459 U.S. 1203, 103 S.Ct. 1188, 75 L.Ed.2d 434 (1983). In this case, the partners not only had the authority under the agreement to manage the business, they exercised this authority and demonstrated that they were not dependent on the irreplaceable skills of others.[9] Members of the partnership negotiated with external management groups, inspected the boats on behalf of the partnership, and reviewed partnership insurance material and financial information. Significantly, on two separate occasions the external managers were replaced. Moreover, as previously mentioned, by vote of the partners, one of the promoters, Walter Salley, Sr., was removed as managing partner of RTU and replaced with a management committee of partners. (App. at 1570). Partners also participated in settlement discussions.[10]

[10] The real gravamen of appellants' complaint lies in common law fraud. As previously mentioned, the securities laws were not intended to be a substitute for state fraud actions. We affirm the district court's finding that appellants' partnership interests are not securities within the meaning of the Securities Act of 1933 or the Securities and Exchange Act of 1934.[11]

8. In addition to the terms of the partnership agreement, Virginia law provides that, subject to any agreement between the parties, all partners have equal rights in the management and conduct of the partnership, Va.Code Ann. § 50–18(e) (1986); no persons can become a member of a partnership without the consent of all partners; *id.* at § 50–18(g); and that no act in contravention of any agreement between the partners may be done rightfully without consent of all the partners, *id.* at § 50–18(h). Moreover, section 50–19 of the Virginia Code provides that "every partner shall at all times have access to and may inspect and copy any of [the partnership's books]," and section 50–24 of the Virginia Code provides that included among the property rights of a partner are, "his right to participate in the management." *See supra* note 6.

9. This is not a case like *SEC v. W.J. Howey Co.* where the, "individual development of the plots of land that [were] offered and sold would seldom be economically feasible due to their small size," and therefore investors were, in reality, unable to exercise individual management and control over their plots of land. 328 U.S. at 300, 66 S.Ct. at 1103. The general partners of RTU all had a realistic opportunity to manage, control and supervise the operation of the partnership through the exercise of substantial partnership powers. In fact, the record indicates that many of the partners, to a varying extent, have done just that. *See, e.g.,* App. at 509–514, 1316–17, 1553–54, 1555, 1564–65, 1570 for examples of partner participation.

10. The fact that some of the general partners may have remained passive or lacked financial sophistication or business expertise does not affect the result. General partners who are capable of exercising significant managerial powers cannot convert their partnership interests into a security merely by remaining passive. *See supra* p. 240–41. Moreover, members of a general partnership who lack financial sophistication or business expertise nevertheless may exercise intelligently the powers conferred on them by the partnership agreement and state law. They are entitled to receive financial reports and have the right to inspect and obtain copies of partnership books and records. *See supra* note 8. To the extent a partner needs advice or assistance in the exercise of his powers, he is of course free to consult with more knowledgeable partners or third persons, or to employ accountants and lawyers. In a word, a general partner is not dependent only on the degree of his own business sophistication in order to exercise intelligently his partnership powers.

11. Appellants argue that because the court limited discovery on the issue of whether their interests were securities, they could not address such questions as to what representations were made to them with respect to their expected level of involvement, the character of their investment, and the expertise of the managers. Therefore, they argue it was improper to grant summary judgment based on the present record. This argument is not persuasive. The representations made to the appellants about their invest-

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IV

The decision of the district court granting summary judgment on the federal claims and dismissing the state law claims is—

AFFIRMED.

ment and the expertise of the managers were within the personal knowledge of those appellants. No discovery was necessary to enable them to submit such facts to the court in the form of affidavits or copies of any written material sent to the appellants. Indeed, in the affidavits submitted by each appellant, it was generally alleged that the Salleys represented that the success of the venture was dependent upon the unique and special skills possessed by others. It is clear, however, that this language merely meant that none of the appellants was expected personally to run a commercial fishing operation. It did not mean that the people hired by RTU were irreplaceable or uniquely capable of making the business succeed. Moreover, as stated in the text above, the partnership agreement signed by each partner explicitly vested full authority and control of the business in the partners. We find that appellants were not prejudiced in the presentation of their case by the district court's limitation of discovery.

12. Because our holding with respect to the proper characterization of appellants' general partnership interests is dispositive of the court's dismissal of the federal claims, it is unnecessary to consider the validity of the Mutual Release Agreement.

13. *See supra* p. 239.

Koch v. Hankins, 928 F.2d 1471 (9th Cir. 1991).

Before CHOY, TANG and FLETCHER, JJ.

OPINION

FLETCHER, Circuit Judge:

The plaintiff-investors ("investors") appeal from the district court's summary judgment that the investments did not constitute securities within the meaning of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b). The investors likewise seek to appeal the district court's denial of their motion for reconsideration of the summary judgment order in light of *Hocking v. Dubois*, 885 F.2d 1449, 1454 (9th Cir.1989) (en banc), *cert. denied*, — U.S. —, 110 S.Ct. 1805, 108 L.Ed.2d 936 (1990). The defendant-promoters ("promoters") have filed a motion to limit the scope of this appeal to review of the summary judgment order since the investors did not file a separate notice of appeal related to the later order denying reconsideration. The promoters also move for sanctions based on the investors' alleged violations of Circuit Rules 28–2.8 and 30–1.4.

BACKGROUND

The investors are primarily doctors, dentists and their relatives (and corporations formed by them for investment purposes) who invested between $23,000 and $500,000 each in general partnerships formed to purchase land for the production of jojoba. Several of the promoters had been the longtime accountants of a number of the investors. Promoter Beverly Chew, who drafted most of the relevant documents, had been the attorney for investors Koch, Wong and Lowe for a number of years prior to the time they made these investments.[1] Other defendants are corporations formed by the accountants and lawyer, relatives of the accountants and lawyer, and the accounting firm with which the accountants were affiliated at the time of the investments or with which they had previously been affiliated.[2] The investments were undertaken in part for tax purposes and allegedly were promoted to the accountants' clients on that basis.

The overall investment scheme involved thirty-five different general partnerships, each of which purchased eighty acres of land from "selling corporations" owned by the promoters, which in turn purchased land from a common seller.[3] In all, approximately 2700 acres and 160 investors were involved in the various general partnerships. Although the promoters present the general partnerships as independent entities, the investors assert that the promoters told them at the outset that it was not economically feasible to farm jojoba in eighty-acre parcels; that they never regarded their general partnerships as separate eighty-acre farms but rather as part of a 2700–acre plantation; and indeed that the promoters themselves did not view the general partnerships as separate farms with the capability of operating independently.[4] Prior to the solicitation of investor funds, the promoters arranged for the clearing and levelling of all 2700 acres of the land and the planting of jojoba seed for a predetermined price. Moreover, the Confidential Private Placement Memoranda for the thirty-five general partnerships all specified identically that the general partners would initially employ Franklin W. Rogers as foreman to carry out the onsite farming cultural practices; that two named experts would be consulted as to jojoba planting practices; that the partnership would execute an irrigation lease for a term of five years for an annual rental of $2,800; and that the partnership would purchase from the promoters by bill of sale a supply of jojoba seeds, fertilizer, weed control and other materials at a cost of $300 per acre. In addition, the thirty-five partnerships shared a common field office financed by an administrative fund to which all the partnerships contributed. At a minimum, therefore, whether the eighty-acre partnerships could or were intended to operate independently from the 2700–acre Great Western Jojoba plantation is a disputed question of fact.

Each general partnership was comprised of one operating general partner and a number of general partners. The thirty-five partnership agreements detail identically the rights and responsibilities of the partners. The operating general partners have responsibility for executing the general partners' decisions about the manage-

1. Doctors Koch, Lowe and Wong were approached by the promoters to be operating general partners and assist in raising funds for some of the general partnerships. They respectively were officers and directors of Flojanco, Inc., Abacus Investment Services, and CCW Financial Corporation, which acted as operating general partners in fourteen of the thirty-five general partnerships.

2. For the sake of simplicity we refer to the defendants collectively as "promoters" even though their roles may have differed.

3. The investors allege that the selling corporations paid from $1000 to $1600 per acre for the land, which they subdivided and resold to the general partnerships for between $2,000 and $3,500 per acre. They further allege that a double escrow was used so that the promoters expended no money of their own to acquire the land but, rather, used a portion of the money supplied by the investors to pay the promoters' obligation to the initial seller. The promoters contest these assertions regarding how the land purchase was structured and argue that they were not supported by any evidence in the trial court below. Since these allegations go to the merits of the investors' fraud claims, and are not relevant to the issue before this court, we need not and do not rely on them and therefore need not address whether they were adequately presented to the district court on summary judgment.

4. While the precise structure of the arrangement and the expectations of the parties are disputed, since we assume disputed facts in favor of the nonmoving party when reviewing a grant of summary judgment, we must accept as true the deposition testimony and declarations of the investors that they were told by the promoters that farming jojoba in eighty-acre parcels was economically infeasible and that their investment would be part of a 2700–acre plantation.

ment and control of partnership business.[5] Within each partnership, the general partners have full and exclusive control of the business of the partnership and can take action in that regard only upon a majority vote.[6] Within each partnership, the general partners have the ability to remove any person from a management position by majority vote and have access to the partnership's books and records.

The degree of actual participation by the general partners and operating general partners and its significance to the endeavor is a matter of considerable dispute. The promoters point out that some investors have voted on such partnership business decisions as whether to pay additional assessments to meet operating budgets, a proposed sale of partnership assets in response to an offer by a third party, whether to interplant alfalfa between rows of jojoba, whether to join a marketing cooperative, whether to amend the partnership agreement, water district elections, and whether to stop farming their parcel or section. In addition, some investors have visited the property their partnerships purchased and tested the soil. There are also letters and memoranda in the record from operating general partners and general partners which suggest that the operating general partners paid careful attention to the status of their particular farms and kept the general partners informed in some detail as to the status of particular plots.

The investors argue, on the other hand, that their role was essentially passive. It is undisputed that none of them had any experience in jojoba farming. It appears that even those investors who nominally held the role of operating general partner usually acted as conduits for materials created by the promoters. The investors assert that the operating general partners did not even generate the pro rata assessments for operating expenses for each general partner. Those figures were determined by the promoters. Finally, the investors assert that any voting they did was largely pro forma in light of their lack of expertise, their inability to devote time to direct participation in the project, and their ability at best to shape decisionmaking only for the eighty acres owned by their particular general partnership. It is even disputed in the record whether, had investors actively exercised decisionmaking regarding the farming of their particular parcels of land, their decisions would have been implemented.[7]

As one might guess from the fact that the parties are now in court, the investments proved less than successful. "The super bean of the future" did not achieve its full potential in this venture. Approximately ninety of the investors brought suit in the federal district court alleging violations of both federal and state law. The district court exercised its discretion to refuse jurisdiction of the pendent state law claims, leaving only the federal securities law claims. The promoters then brought motions for summary judgment on statute of limitations and jurisdictional grounds. The district court, relying heavily on the case of *Matek v. Murat*, 862 F.2d 720, 724–32 (9th Cir.1988), granted the promoters' motion for summary judgment on jurisdictional grounds, holding the invest-

5. In a number of the partnerships a promoter either acted as operating general partner directly or through a corporation formed for that purpose, or performed all of the work required of the operating general partner in exchange for some portion of the fees paid by the partnership for that function. It appears that such arrangements were contemplated from the outset.

6. The partnership agreement provides that

> The Partners shall be responsible for all decisions, ... including but not limited to hiring and firing of personnel, determination of the type of crops to be grown, ... the timing of and the manner of fertilization, pruning, thinning, pest and weed control, irrigation, repairs and maintenance on irrigation systems and other equipment, discing and general cultural practices, removal and replacement, capital expenditures, seed purchases, planting, harvesting, storage and sale.

7. Drs. Koch, Lowe and Wong assert in their declarations that the only specific instruction they ever gave the on-site managers in their roles as operating general partners for fourteen of the thirty-five partnerships was to "stop farming" in early 1988. They allege that by June, 1989, when they travelled to the site, there was no difference in growth of the jojoba plants or weed control that would indicate that farming had been ceased on any of the parcels.

ments were not securities within the meaning of the Securities Act of 1933 and the Securities Exchange Act of 1934. The investors filed a timely notice of appeal.

Subsequent to the granting of summary judgment, this court decided en banc the case of *Hocking v. Dubois*, 885 F.2d 1449 (9th Cir.1989). The appeal was therefore remanded on a limited basis to the district court for decision of the investors' Rule 60(b) motion for reconsideration in light of *Hocking*. The district court denied reconsideration. No notice of appeal was filed regarding that order.

DISCUSSION

[1] A district court's summary judgment that investments are not securities is reviewed de novo. *Deutsch Energy Co. v. Mazur*, 813 F.2d 1567, 1568–69 (9th Cir. 1987). We therefore, like the district court, consider the evidence in a light most favorable to the non-moving party (the investors) and determine whether there is any genuine issue of material fact and whether the promoters are entitled to judgment as a matter of law. *Lone Ranger Television, Inc. v. Program Radio Corp.*, 740 F.2d 718, 720 (9th Cir.1984). A district court's denial of a motion for reconsideration pursuant to Rule 60(b) is reviewed for abuse of discretion. *Fiester v. Turner*, 783 F.2d 1474, 1475–76 (9th Cir.1986); *Plotkin v. Pacific Tel. & Tel. Co.*, 688 F.2d 1291, 1293 (9th Cir.1982).

A. *Scope of the Appeal.*

Because the investors filed no notice of appeal related to the district court's denial of their motion for reconsideration, we do not review that order. As a practical matter, however, such limitation on the scope of the appeal makes no difference; since we review the grant of summary judgment de novo and would only review the denial of reconsideration for abuse of discretion, and since the two orders concern the same question of whether the investment constituted a "security," de novo review of the summary judgment obviates any practical need for review of the order denying reconsideration.

B. *Whether the Investment Constitutes a "Security".*

In order to make out a claim under the federal securities laws, the investors must demonstrate as a threshold matter that the promoters' alleged misrepresentations were made in connection with the purchase or sale of a security. Both section 2 of the Securities Act of 1933, 15 U.S.C. § 77b(1) (1982) and section 3 of the Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(10) (1982), define the term "security" to include, *inter alia*, any "investment contract." Since the investments involved in this case do not constitute any of the other types of securities protected by the Acts, the critical threshold inquiry is whether the general partnerships constitute "investment contracts" within the meaning of the Acts.

[2] The term "investment contract" has been interpreted by the Supreme Court broadly to reach "[n]ovel, uncommon, or irregular devices, whatever they appear to be ..." *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351, 64 S.Ct. 120, 124, 88 L.Ed. 88 (1943). "It embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." *SEC v. W.J. Howey Co.*, 328 U.S. 293, 299, 66 S.Ct. 1100, 1103, 90 L.Ed. 1244 (1946) (holding that a combined sale of units of a citrus grove development coupled with a contract for cultivating, marketing and remitting the net proceeds to the investor was an "investment contract"). The Court has consistently expressed the view that "[b]ecause securities transactions are economic in character Congress intended the application of these statutes to turn on the economic realities underlying a transaction, and not on the name appended thereto." *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 849, 95 S.Ct. 2051, 2059, 44 L.Ed.2d 621 (1975); *Howey*, 328 U.S. at 298, 66 S.Ct. at 1102. Thus, the fact that the investments here are structured as "general partnerships" is not determinative of their status

as securities; rather, we must examine the economic realities of the transactions to determine whether they are, in fact, investment contracts. *Matek v. Murat,* 862 F.2d at 724.

The Supreme Court in *Howey* set out the classic three-part definition of an investment contract: "[A]n investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person [1] invests his money in [2] a common enterprise and is led to [3] expect profits solely from the efforts of the promoter or a third party." 328 U.S. at 298–99, 66 S.Ct. at 1102–03. The Ninth Circuit has held that "the word 'solely' should not be read as a strict or literal limitation on the definition of an investment contract." *SEC v. Glenn W. Turner Enters., Inc.,* 474 F.2d 476, 482 (9th Cir.), *cert. denied,* 414 U.S. 821, 94 S.Ct. 117, 38 L.Ed.2d 53 (1973); *Hocking,* 885 F.2d at 1455. Instead, this circuit looks to whether "the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise." *Id.*[8] Here, as in most cases dealing with the *Howey* test, the inquiry revolves around the third, "control," element of the test—whether the investors had an expectation of profits which would be produced in essential part through the efforts of others.

1. Scope of Inquiry As to the Control Element of Howey.

[3] In deciding whether investors have raised a genuine issue of material fact as to the third element of *Howey,* we face a threshold question as to what evidence is relevant to that determination: whether the inquiry should focus solely on the formal partnership agreement and the powers it confers on the investors, or whether it should encompass other factors which implicate the investors' practical ability to control their investment. The district court relied on *Matek,* which mandates consideration only of the formal, legal powers of investors. 862 F.2d at 730. We conclude, however, that such reliance on *Matek* was erroneous in light of the subsequent en banc opinion in *Hocking v. Dubois,* 885 F.2d 1449 (9th Cir.1989).

In *Matek* a three-judge panel addressed for the first time in the Ninth Circuit "the issue of whether general partnership interests that are marketed are securities for the purposes of the securities laws." *Matek,* 862 F.2d at 725. The panel rejected the "bright-line" approach articulated in *Goodwin v. Elkins & Co.,* 730 F.2d 99 (3d Cir.), *cert. denied,* 469 U.S. 831, 105 S.Ct. 118, 83 L.Ed.2d 61 (1984), (holding that no general partnership formed pursuant to the UPA is a security), finding that such a label-oriented approach ignored the "economic reality test." *Matek,* 862 F.2d at 727. The panel likewise rejected the Fifth Circuit's three-prong test set out in *Williamson v. Tucker,* 645 F.2d 404 (5th Cir. 1981), as creating too much uncertainty. It adopted *Williamson's* first prong and expressly rejected the other two prongs, stating that *Williamson* went "too far." *Matek,* 862 F.2d at 728–29.

The Fifth Circuit held in *Williamson* that:

> A general partnership or joint venture interest can be designated a security if the investor can establish, for example, that (1) an agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership; or (2) the partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or (3) the partner or venturer is so dependent on some unique entrepreneurial or manage-

8. The Third, Fifth and Sixth Circuits have adopted this "*Glenn Turner* test." *Goodwin v. Elkins & Co.,* 730 F.2d 99, 103 (3d Cir.), *cert. denied,* 469 U.S. 831, 105 S.Ct. 118, 83 L.Ed.2d 61 (1984); *Williamson v. Tucker,* 645 F.2d 404, 418 (5th Cir.), *cert. denied,* 454 U.S. 897, 102 S.Ct. 396, 70 L.Ed.2d 212 (1981); *Odom v. Slavik,* 703 F.2d 212, 215 (6th Cir.1983) (per curiam). The Supreme Court has also noted the *Glenn Turner* test without expressing a view as to its applicability to the case before it. *Forman,* 421 U.S. 837, 852 n. 16, 95 S.Ct. 2051, 2060 n. 16.

> rial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers.

Williamson, 645 F.2d at 424. According to *Williamson* the critical determination is whether, although "[o]n the face of a partnership agreement, the investor retains substantial control over his investment and an ability to protect himself from the managing partner or hired manager ..., [the investor can demonstrate that] he was so dependent on the promoter or on a third party that he was in fact unable to exercise meaningful partnership powers." *Id.* The *Williamson* opinion made clear that the three factors are not exclusive and that "other factors could ... also give rise to such a dependence." *Id.* at 424, n. 15. *Williamson* likewise specified that the inquiry is not directed to what actually transpires after the investment is made, i.e., whether the investor later decides to be passive or to delegate all powers and duties to a promoter or managing partner; rather, "one would have to show that the reliance on the manager which forms the basis of the partner's expectations was an understanding *in the original transaction.*" *Id.* at 424, n. 14 (emphasis added).[9]

In rejecting the second and third prongs of *Williamson* as creating too much "uncertainty in the area of business investing," *Matek,* 862 F.2d at 729, the panel in *Matek* held that "[t]he proper focus must be the partnership agreement and not how in fact the entity functioned in carrying out its business affairs." 862 F.2d at 731. *Matek* likewise held that "access to information about the investment, and not managerial control, is the most significant factor." 862 F.2d at 728. The promoters urge this panel to follow *Matek* strictly and to look only to the partnership agreement in evaluating whether the investors expected profits through the efforts of others.[10] In the view of promoters (and *Matek*), if the "terms of the agreement provide [the investors] with all the access and ability to protect their investment that the securities laws would otherwise provide," then the investors' interests in the jojoba plantations are not securities. 862 F.2d at 731.

The promoters' reliance on *Matek* is misplaced, however, in light of the subsequent en banc decision in *Hocking,* which cites *Williamson* as "the leading case on the control issue" and expressly adopts and applies all three *Williamson* factors. 885 F.2d at 1460.[11] The *Hocking* opinion clouds the issue of *Matek*'s continuing viability because it cites *Matek* as a case in which the Ninth Circuit "previously adopted *Williamson*'s approach," apparently failing to note *Matek*'s rejection of the second and third *Williamson* factors. *Hocking,* 885 F.2d at 1460. The promoters latch onto this citation and contend that because *Hocking* cites *Matek* with approval and does not overrule or limit its holding, *Matek* remains viable. That position is directly contrary to *Hocking*'s express adoption of all three *Williamson* factors and its

9. The clear focus in *Williamson* on the investors' expectations at the time of the original transaction rather than on the de facto post-investment conduct of the parties obviates the concern expressed by the promoters that "[a]n interest marketed as a general partnership might be transformed into a security simply because its holder is not diligent or knowledgeable in exercising his rights under the agreement." *Matek,* 862 F.2d at 729. On the contrary, *Williamson*'s approach is entirely consistent with *Matek's* holding that "it is immaterial whether the partnership later fell into a pattern of circumscribed partnership participation ..." *Id.*

10. The promoters appear to argue that the panel should not even look to the Placement Memoranda in determining whether the investors expected profits through the efforts of others. Such a narrow approach is particularly inappropriate in this case where the partnership agreement makes no reference to any of the services being provided by the promoters, or to the sharing of services and equipment by the various partnerships. The economic reality of the investment simply would not be reflected in an evaluation of an 80-acre partnership without reference to the larger plantation.

11. *Hocking,* like *Williamson,* recognizes that "under different facts or legal arrangements other factors might [also] give rise to such a dependence on the promoter or manager that exercise of control would be effectively precluded." 885 F.2d at 1460, citing *Williamson,* 645 F.2d at 424 n. 15.

ultimate reliance on the third factor in reversing the district court's summary judgment that the investment was not a security as a matter of law.

The promoters also seek to distinguish *Hocking* on the basis that it did not address a general partnership but involved a condominium purchase and rental pooling agreement. This second point is a distinction without a difference, running directly counter to *Howey*'s mandate that courts address "economic reality" rather than focusing on the labels attached to schemes by promoters. It is clear that the en banc panel in *Hocking* was addressing the third element of *Howey* and adopted *Williamson*'s approach as the appropriate framework for analyzing investor control. It is likewise clear that the en banc panel in *Hocking* did not view its application of *Howey* as limited to the condominium context; on the contrary, it cited to a number of general partnership cases (including *Matek*) in its discussion of *Howey*'s third element. 885 F.2d at 1460–61.

The promoters' arguments that *Hocking* does not affect the viability of *Matek* are unpersuasive. We therefore look to the en banc opinion in *Hocking* as the controlling law of this circuit and apply all three *Williamson* factors in evaluating whether the investors expected profits produced by the efforts of others so as to satisfy the third element of *Howey*.

2. Application of the Williamson/Hocking factors.

[4] In determining whether the investors relied on the efforts of others, we look not only to the partnership agreement itself, but also to other documents structuring the investment, to promotional materials, to oral representations made by the promoters at the time of the investment, and to the practical possibility of the investors exercising the powers they possessed pursuant to the partnership agreements. *Hocking*, 885 F.2d at 1457. "[T]he question of an investor's control over his investment is decided in terms of practical as well as legal ability to control." *Id.* at 1460.

Assuming the disputed facts in favor of the nonmoving party (the investors), the investors were told from the outset that it was infeasible to farm jojoba in eighty-acre parcels and that the land owned by their partnership would be farmed as part of a 2700–acre plantation. They agreed from the outset to purchase irrigation, seeds, fertilizer and weedkiller from the promoters at specified prices. All 160 investors involved in the thirty-five partnerships agreed to hire the same on-site manager and were informed that the same two experts would be consulted regarding the planting. Most importantly, none of the investors knew anything about jojoba farming and, taking their allegations as true, none of them intended to engage actively in the business of jojoba farming. Rather, they relied substantially on the knowledge of the promoters and experts, and on the services to be provided by the on-site manager. Finally, it appears to be undisputed that jojoba farming was a relatively new undertaking in the United States, and that there were few individuals with expertise in the area.

The investors argue that all three *Williamson* factors tilt in favor of a finding that the investments here were securities. Because of the reliance of the individual partnerships on participation in the larger plantation, the investors contend that the power of the partnership is distributed as is the power in a limited partnership, thus implicating the first *Williamson* factor. The investors, however, are jumping ahead to the third factor and ignoring the crux of the first. It is clear from both *Williamson* itself and from *Hocking* that the first factor is addressed to the legal powers afforded the investor by the formal documents without regard to the practical impossibility of the investors invoking them. Here, the partnership agreement clearly affords the partners significant legal powers.

As a legal matter, the partners have the responsibility and authority to control every aspect of the jojoba cultivation process. Additional assessments of capital must be approved by 75 percent of the partnership units; a majority of the partnership units can remove any person from a management position; decisions regarding the management and control of the business must be made by a majority vote.[12] The partnership agreements contain many provisions parallel to those in *Matek,* where the court found the powers vested in the partners sufficient to enable them to protect their investment, thus signifying that the investment was not a security. Like the condominium purchaser in *Hocking,* who was free to terminate the rental pooling agreement, occupy the unit himself, rent the unit out on his own, or sell the unit, the investors here could—theoretically, at least—vote to cease farming, replace the operating general partner, terminate services by the on-site manager, vote to interplant rows of alfalfa, etc. *Compare Howey,* 328 U.S. 293, 66 S.Ct. 1100 (orange grove investment gave the management company a leasehold interest and full and complete possession of the acreage, along with full discretion and authority over the cultivation, harvest and marketing of the crops such that investors had no right of entry to market the crop without the consent of the company). Under these facts, as in *Hocking,* the investors have not demonstrated that their partnership agreements leave them "with so little power as to place [them] in a position analogous to a limited partner." 885 F.2d at 1461. It therefore appears that the first *Williamson* factor tilts in favor of the promoters.

Under the second *Williamson* factor we consider the investors' sophistication and expertise. There were approximately 160 investors in the overall scheme (90 of whom are plaintiffs in this case). While it is undisputed that none of the investors had prior experience in jojoba farming, that draws the question too narrowly. Under *Williamson,* the relevant inquiry is whether "the partner or venturer is so inexperienced and unknowledgeable *in business affairs* that he is incapable of intelligently exercising his partnership or venture powers." 645 F.2d at 424 (emphasis added). Here, while the investors were doctors and dentists as opposed to business-people, all of them had at least $23,000 to invest in the venture and some had considerably more. The record indicates that some of the investors had prior experience in pistachio ventures and other tax shelters at the time of their investment. However, since the district court focused exclusively on the investors' formal status, the record is not fully developed on this issue and we simply have no basis for evaluating the sophistication of many of the investors. The question of the investors' expertise or lack thereof and its effect on their ability to exercise their powers intelligently is a question of fact which should be resolved in the first instance by the trial court. Since the record is insufficiently developed on this issue, we remand to the district court to determine whether the investors have raised a genuine issue of fact as to whether their lack of expertise prevented them from exercising meaningful control over their investment.

We turn finally to the third *Williamson* factor, which involves whether "the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers." 645 F.2d at 424. In this case, the investors' reliance on participation in the larger, 2700-acre jojoba plantation is analogous to, and arguably more extreme than, Hocking's reliance on the rental pooling agreement. In *Hocking,* the en banc panel noted that while the investor enjoyed complete legal control over his particular condominium unit, he

12. Although an investor participating in a general partnership obviously relinquishes some control since decisions must be made by majority vote, this type of diminution in control by itself would not satisfy the third prong of *Howey* unless the numbers of partners became so large "that a partnership vote would be more like a corporate vote, each partner's role having been diluted to the level of a single shareholder." *Williamson,* 645 F.2d at 423. Such is not the case here. Even though each investor's absolute control is reduced by the voting structure, the general partners as a legal matter "do have the sort of influence [within the partnership] which generally provides them with access to important information and protection against a dependence on others." *Id.* at 422.

had made the investment in anticipation of receiving income from the rental pooling agreement, and in order for him to replace the management of that agreement he would have had to gain the votes of 75 percent of participating investors.[13] The court in *Hocking* held that "[those] facts alone create[d] a real question of whether Hocking was stuck with HCP as a rental manager." 885 F.2d at 1461. Because the rental pooling agreement resulted in the condominiums being managed as a resort hotel, and "[t]he commercial viability of a one-room hotel [did] not strongly argue for separate management," the court found that "[t]he individual investor may have [had] no choice but to place his condominium in the rental pool, if he [were] to receive significant rental income." *Id.* It thus reversed the district court's summary judgment that the investment was not a security.

Here, as in *Hocking,* there is a question of fact as to whether the investors could, as a practical matter, pull out of the larger enterprise and still receive the income they had contemplated when they made the investment. The promoters focus on the significant management powers and access to information afforded the general partners by the partnership agreements. The partnership agreement, however, only provides for the exercise of general partner control and decisionmaking *within* each partnership, and as to the land controlled by each partnership, not as to issues concerning the entire plantation. Likewise, the access to information provisions of the partnership agreement apply only to information related to the partnership and available to the partnership or the operating general partner. As discussed *supra,* however, actual farm management was not undertaken directly by the general partners on a partnership-by-partnership basis and the investors assert that they never intended to play an active role in managing the farming of jojoba. Rather, the thirty-five general partnerships shared a common foreman, originally selected by promoter Hankins and later replaced by him, who oversaw the planting and management of the entire 2700-acre plantation.

As in *Hocking,* while the investors here could readily order the on-site manager to cease cultivating their particular plot,[14] it would be difficult if not impossible for an investor to affect the management of the plantation as a whole. There is not even a formalized mechanism in the partnership agreements for attempting to effect change on behalf of all thirty-five partnerships. Therefore, to replace the on-site manager for the entire plantation, an investor would have to catalyze a vote in each of the thirty-five partnerships (an endeavor which would be rendered difficult if not impossible by the fact that many of the investors did not even know the names of their own partners, much less have such information regarding the other thirty-four partnerships) and obtain the approval of a significant enough bloc of the partnerships to make it impracticable for the on-site manager to continue farming the remaining sections. In addition, the ready availability of alternative jojoba farm managers is more questionable than the availability of alternative realtors to manage a rental pool agreement in Hawaii, the situation presented in *Hocking.*

The fact that some investors were provided with detailed information about the status of their eighty acres and that some investors visited the land and even offered evaluations and suggestions to the on-site managers is not dispositive. *See Howey,* 328 U.S. 293, 296 n. 2, 66 S.Ct. 1100, 1101 n. 2 ("Some investors visited their particular plots annually, making suggestions as to care and cultivation, but without any legal rights in the matters."); *see also, Reeves v. Teuscher,* 881 F.2d 1495, 1499 (9th Cir. 1989) (although limited partners in real es-

13. There were approximately fifty other condominium owners participating in the rental pool agreement in *Hocking,* 885 F.2d at 1453.

14. As noted *supra,* note 7, there is some question as to whether such an order could or would be implemented by the on-site manager. It may not even be possible to cease watering one-eighth of a section of land, or to apply herbicide to only three-eighths of a section.

tate development project "attended meetings and approved [the promoter's] plans," where "they testified that they relied on his expertise ... and only supplied the capital," the court found the investment to be a security within the meaning of *Howey*). Although the investors here possessed many of the same *legal* powers that the general partners did in *Matek* (where the panel applied only the first *Williamson* factor but stated in dicta that the investors did not implicate the other two factors in any event, 862 F.2d at 730–31, n. 15), the general partnerships' reliance on the larger plantation creates a practical situation clearly distinguishable from that in *Matek*—whch involved a single general partnership composed of twelve experienced businesspeople whose partnership decisions were able to affect the outcome of their investment. In this case, even if a general partner vigorously exercised his or her rights under the partnership agreement, he or she arguably could have no impact on the investment (other than to ensure its failure by withdrawing from the larger plantation).

Thus, the investors here have at least raised an issue of fact as to the necessity of participating in the 2700–acre plantation in order to produce income from the general partnership acreage, and as to their ability to affect decisionmaking regarding that larger plantation. They have not, as did the plaintiff-investors in *Williamson*, made only vague statements that they relied and were dependent upon the efforts of the promoters. 645 F.2d at 425. Having raised a genuine question as to the third *Williamson* factor, they likewise have created a genuine question for the trier of fact as to whether at the time of their investment they expected any profit to arise essentially through the efforts of others. *Howey*, 328 U.S. at 299, 66 S.Ct. at 1103. The district court's grant of summary judgment in favor of the promoters must therefore be reversed.

3. Investors' Additional Arguments.

We need not reach the investors' additional arguments that the investment constituted a security because the "general partnership agreement was purposefully drafted to escape the application of the securities laws," *see Matek*, 862 F.2d at 731, or that it constituted a security under the "risk capital" approach, *see Great W. Bank & Trust v. Kotz*, 532 F.2d 1252, 1257 (9th Cir.1976) (per curiam).

CONCLUSION

We reverse the grant of summary judgment to the defendant-promoters and remand to the district court for further proceedings consistent with this order. The promoters' motions for sanctions based on the investors' alleged violations of Circuit Rules 28–2.8 and 30–1.2 are denied.

Before: BECKER and MANSMANN, Circuit Judges, and HOEVELER, District Judge.**

MANSMANN, Circuit Judge.

In this appeal, we are asked to decide whether a highly structured securitization transaction negotiated between Citicorp and an investor in a limited partnership constitutes an "investment contract" as that term is defined by the Supreme Court in *SEC v. W.J. Howey Co.*, 328 U.S. 293, 66 S.Ct. 1100, 90 L.Ed. 1244 (1946). Examining the economic reality of the transaction as a whole, we conclude that the limited partner retained pervasive control over its investment in the limited partnership such that it cannot be deemed a passive investor under *Howey* and its progeny. Accordingly, we find the securitization transaction here does not constitute an investment contract. We will, therefore, affirm the judgment of the district court.

I.

[1, 2] This case comes before us on review of the district court's order granting the Citicorp Defendants' motion to dismiss for failure to state a claim under Fed.R.Civ.P. 12(b)(6). When reviewing such an order, we are required to accept as true the factual allegations in the complaint. *D.R. v. Middle Bucks Area Vocational Technical School*, 972 F.2d 1364, 1367 (3d Cir.1992) (citation omitted); *Ransom v. Marrazzo*, 848 F.2d 398, 401 (3d Cir.1988). In considering a rule 12(b)(6) motion, "a court may consider an undisputably authentic document that a defendant attaches as an exhibit to a motion to dismiss if the plaintiff's claims are based on the document." *Pension Benefit Guaranty Corp. v. White Consolidated Industries, Inc.*, 998 F.2d 1192, 1196 (3d Cir.1993) (citations omitted). Thus, the facts as set forth in the amended complaint and the relevant portions of the defendants' exhibits[1] are summarized below.

A.

The controversy here arises out of alleged violations of sections 10(b) and 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78j(b), 78t(a), and 78t(b), and Rule 10b5, 17 C.F.R. § 240.10b–5 involving the "securitization" of a pool of delinquent residential mortgage loans ("Mortgage Loans") and real estate owned by Citicorp as a result of foreclosed loans ("REO").[2] The plaintiffs are The Steinhardt Group Inc. ("Steinhardt Group") and C.B. Mtge., L.P. ("C.B.Mtge."). The Steinhardt Group is a Delaware investment firm with its main office in New York City. C.B. Mtge., an affiliate of the Steinhardt Group, is organized as a Delaware limited partnership and holds a 98.79% interest as a limited partner in the Bristol Oaks, L.P. ("Bristol" or "Partnership"). Together, the Steinhardt Group and C.B. Mtge. are collectively referred to as "Steinhardt."

** Honorable William M. Hoeveler of the United States District Court for the Southern District of Florida, sitting by designation.

1. In support of its Motion to Dismiss, the defendants attached copies of the May 26, 1994 Letter Agreement between Citicorp and Steinhardt; the June 30, 1994 Mortgage Loan and REO Property Sale Agreement between Bristol Oaks, L.P., BHT, and Citibank; the Bristol Oaks Limited Partnership Agreement dated June 30, 1994 between BGO, C.B. Mtge., and OLS; and the June 30, 1994 Service Agreement between Bristol Oaks, BHT, and Ontra, Inc.

2. In addition to violations of federal securities laws, the amended complaint alleges common law fraud and breach of express and implied contractual obligations. The plaintiffs also assert derivative claims under Delaware law against the Citicorp Defendants on behalf of Bristol Oaks, L.P. and BHT Limited, L.P., the limited partnerships in which Steinhardt had invested. The plaintiffs sought to invoke the district court's supplemental jurisdiction under 28 U.S.C. § 1367(a) over these state law claims. Inasmuch as the plaintiffs have failed to state a federal claim under rule 12(b)(6), we find that no basis exists for retaining supplemental jurisdiction over the state law claims. Accordingly, the district court properly declined to exercise supplemental jurisdiction over the state law claims.

Bristol Oaks is a limited partnership formed under the laws of the state of Delaware for the express purpose of creating an investment vehicle for issuing debt and equity securities to investors. Bristol is made up of one general partner, BGO, Inc. (1% ownership interest), and two limited partners, C.B. Mtge., L.P. (98.79% ownership interest), and OLS, Inc. (.21% ownership interest).

The Citicorp Defendants are comprised of Citibank, N.A., a national banking association, Citicorp North America, Inc. ("CNAI"), Citicorp Securities, Inc. ("CSI"), Citicorp Mortgage, Inc. ("CMI"), and Citicorp, which controls either directly or indirectly the other Citicorp Defendants. With the exception of Citibank, all of the Citicorp Defendants are organized under the laws of the state of Delaware.

Also named as a defendant in this action is BGO, Inc. ("BGO"), a Texas corporation and the general partner of Bristol. BGO is 100% owned by Ontra, Inc. ("Ontra"). Bristol contracted with Ontra to provide loan servicing, loan workouts, REO sales, and oversight of these asset types to the Partnership. The claims against BGO concern its refusal of Steinhardt's demand that BGO file suit on behalf of the Partnership against the Citicorp Defendants.

Named as nominal defendants are Bristol and BHT Limited, L.P. ("BHT"), a Delaware limited partnership, which is owned 99% by Bristol. Not parties to this lawsuit are OLS, Inc., an Ontra affiliate owning a .21% limited partner interest in Bristol and BHT, Inc., an Ontra affiliate and 1% general partner in BHT Limited, L.P.

The fraudulent conduct alleged in the amended complaint arises out of a severe financial crisis faced by Citicorp during the early 1990's. With bad loans and illiquid assets threatening the very existence of the nation's then-largest banking institution, Citicorp was looking for a way to extricate itself from its financial problems. The securitization transaction was thus conceived by Citicorp to remove the nonperforming assets from its financial books and replace them with cash.

In essence, the securitization required Citicorp to create an investment vehicle—a limited partnership ultimately named Bristol Oaks, L.P.—that would issue both debt securities, in the form of nonrecourse bonds, and equity securities, in the form of partnership interests, to investors. Bristol would acquire title to the nonperforming Mortgage Loans and REO properties and would retain Ontra, Inc. to manage and liquidate the assets. Then Bristol would obtain bridge financing from Citibank and CNAI; shortly thereafter, CSI would securitize and underwrite a public offering of bonds and other debt securities to pay off the bridge financing. All of the investors' money was to be paid to Bristol and become the capital of that investment vehicle. The return on these investments was to come from the same pool of assets.

During late 1993 and the first half of 1994, representatives of CSI made a series of written and oral presentations to the Steinhardt Group in which they described returns of 18% or more annually by investing in Bristol. Throughout these presentations and in other meetings and telephone discussions, Citicorp explained how it had created the proprietary "Citicorp Non-Performing Loan Model" (the "Pricing Model"), based on its own past experience, intimate knowledge of the assets at issue, and the valuation of such assets. Citicorp represented the Pricing Model to be an accurate means of pricing the Mortgage Loans and REO properties in the portfolio and of providing the Steinhardt Group with the promised 18% or greater returns. In particular, Citicorp represented to the Steinhardt Group that no institution in America had more experience in single-family residential mortgages, or more knowledge about the process of collecting on defaulted mortgage loans. Moreover, Citicorp touted not only its longstanding reputation in the banking industry, but also how the assumptions in the Pricing Model were firmly grounded upon Citicorp's own unparalleled experience and expertise.

A series of factual assumptions lies at the core of the Pricing Model. First, Citicorp assumed that the most accurate "proxy" for the values of the REO and the properties mortgaged for the Mortgage Loans would be

Broker's Price Opinions ("BPOs"). These BPOs would be obtained from independent real estate brokers reflecting collateral value as well as the proceeds that would be obtained within six months if the properties were listed for sale. In addition, these BPOs were to provide "as is" values indicating what the properties were worth in light of their overall exterior and interior physical condition. Finally, an integral component of Citicorp's valuation methodology was obtaining BPOs for all of the assets, rather than just a sampling, thereby resulting in a more accurate valuation of the portfolio and significantly reducing the investment risk.

Under the Pricing Model, Citicorp represented the BPOs would be used to calculate a current Loan-to-Value ("LTV") ratio for each of the properties. The LTV ratio was used to project the probability of possible outcomes with respect to each of the Mortgage Loans, as well as the ultimate cash proceeds that would flow from each of the possible resolutions.[3] The Pricing Model further assumed that each of the existing and to-be-foreclosed REO properties could be sold for 98% of the BPO, which Citicorp represented to be conservative and designed to assure realization of its promised 18% return on the portfolio.

The Pricing Model also assumed that Ontra, as service-provider, would be able to resell the reinstated Mortgage Loans through a pre-existing "conduit" for such loans developed by Citicorp. Citicorp expressly stated in its written presentations to Steinhardt that the Pricing Model's assumptions were predicated on Citicorp creating a market in these loans to facilitate the stated time frames. Without such a conduit, Bristol could be left without an existing method to dispose of reinstated loans, with little choice but to foreclose on these Mortgage Loans, and holding reinstated loans for up to 30 years, negating the possibility of receiving an attractive resale price within six months as the Pricing Model assumed.

Citicorp further represented that CMI, in the past, had made little or no attempt to collect a substantial number of the delinquent Mortgage Loans and, thus, estimated that 45% of the total portfolio collections could be quickly restructured or worked out through payoffs or settlements.

Finally, based on its own experience, Citicorp included several other assumptions in the Pricing Model: the average cost of repairs and maintenance for each of the properties in its portfolio would be $1,000; the foreclosures would take an average of less than nine months at an average cost of $2,500; the time required for collection on the Mortgage Loans or foreclosure would not be delayed by future bankruptcy filings.

According to the amended complaint, Citicorp knew at the time it made these representations that several of the assumptions underlying the Pricing Model were false. Steinhardt claims that Citicorp obtained inflated valuations by promising the brokers they would later be hired to list the properties for sale if the BPOs were satisfactory to Citicorp. The inflated valuations, in turn, caused the assets to be overpriced, which resulted in the overstatement of future cash flow. Steinhardt further contends that CMI failed to follow its own internal controls for insuring unbiased appraisals, that it employed brokers not on Citicorp's approved list, and that it required brokers to provide large numbers of valuations within grossly inadequate periods of time, which further undermined their accuracy. Although Citicorp was allegedly warned repeatedly by one of its own officers that the assets were overpriced, these warnings were never revealed to Steinhardt. Rather, Steinhardt contends these warnings were actively concealed in order to induce it to invest in Bristol.

According to the amended complaint, Citicorp concealed other information from Steinhardt, including the true cost of repairs and maintenance, low-end BPOs and other appraisals, recent appraisals which reflected the decline in the real estate market, the true cost and time for foreclosures, the true likelihood of delays caused by bankruptcy proceedings, and Citicorp's intention not to provide a conduit for the sale of reinstated loans.

3. Possible outcomes with respect to the Mortgage Loans include the probability that the loan would be reinstated, worked out with a discounted payment, or foreclosed.

Steinhardt claims that "[t]he cumulative effect of all these misrepresentations by Citicorp was to fraudulently inflate the purchase price for the entire portfolio."

Based on Citicorp's representations, Steinhardt entered into a letter agreement dated May 26, 1994, with CSI, Citibank, CNAI, and Citicorp (the "Letter Agreement"), in which it committed to make an equity contribution of between $40 and $45 million in Bristol. According to the Letter Agreement, a portfolio of approximately $540 million to $660 million in Mortgage Loans and REO properties was to be sold by Citibank and CNAI to a newly formed limited partnership, Bristol. To fund the acquisition of the properties, Citibank and CNAI agreed to lend the newly formed partnership no less than 90% of the total purchase price; the remaining 10% was to be provided by the Partnership in the form of a cash payment representing the Partnership's total equity. Subsequently, debt securities were to be issued by the Partnership and underwritten by CSI to repay the Citibank and CNAI loans.

The Letter Agreement further provided that "[t]he Partnership will contract with Ontra, Inc ...., an independent third party who is experienced in loan servicing, loan workouts, REO sales, and oversight of these asset types", to service the properties.[4] An affiliate of Ontra, BGO, was named the general partner of the new limited partnership in exchange for a 1% equity contribution.

In addition, the Letter Agreement stated that the total purchase price of the assets "will be established to provide the Partners with an internal rate of return ... of 18% based on the agreed-to assumptions ... and methodology, subject to the satisfaction of Steinhardt's conditions. ..." One of these conditions was the receipt by Steinhardt of an unqualified "comfort letter," issued by a nationally recognized, big six, accounting firm, and which verified, without qualification, the validity of Citicorp's assumptions and methodology.

With regard to the issuance of debt securities, the Letter Agreement provided that CSI shall either underwrite the securities on a firm commitment basis or place the securities on a best efforts basis. In either event, Citibank and CNAI were to bear all of the costs, expenses and fees incurred in connection with the issuance of the securities. Under the Letter Agreement, the debt securities were the general obligation of the Partnership with recourse solely to the assets. Initially, the proceeds of the securitization were to be used to repay outstanding principal and accrued interest on the notes. Although CSI determined the structure of the securitization, Steinhardt had approval rights, and the economic and other terms of the debt securities were not to be established in any manner which adversely affected Steinhardt's return on its investments.

The first step of the securitization transaction was completed in the early part of July, 1994, in accordance with two Sale Agreements dated June 30, 1994.[5] Pursuant to the Sale Agreements, Bristol and BHT purchased approximately 3,100 Mortgage Loans and 900 REO properties from Citibank and CNAI for close to $415 million.[6] Bristol

4. In the amended complaint, Steinhardt claims that at the time the Letter Agreement was executed, Citicorp was already negotiating a "lock up" agreement with Ontra, whereby Citicorp was to have a right of first refusal on all of Ontra's assets and stock as well as "the power to limit Ontra's servicing solely to Citicorp's portfolios and the portfolio at issue. ..." Thus, Steinhardt contends, Ontra was never the independent third party the Citicorp Defendants represented it to be.

5. The Limited Partnership Agreement was also executed on June 30, 1994.

6. In the Sale Agreement, Bristol and BHT, collectively the Purchaser, represented and warranted to the Seller that it:

is a sophisticated investor and its bid and decision to purchase the Mortgage Loans and REO properties is based upon its own independent expert evaluations of the Mortgage File, the REO File and other materials made available by the Seller and deemed relevant by the Purchaser ... The Purchaser has not relied in entering into this Agreement upon any oral or written information from the Seller, or any of its respective employees, affiliates, agents or representatives, other than the representations and warranties of the Seller contained herein.... [T]he Seller has made no representations or warranties as to the Mortgage Loans and REO Properties (including without limitation, the value, marketability, condition or future performance thereof, ...)

purchased all of the assets except the New York REOs, which were acquired by BHT. C.B. Mtge. invested $42 million in Bristol and acquired a 98.79% limited partner interest.

Also contained in the Sale Agreements were numerous express representations and warranties made by Citibank and CNAI relating to the Mortgage Loans and REO properties which Steinhardt claims were breached. In particular, sections 6(a)(1) and 6(b)(1) contained assurances that "[t]he information set forth in the Mortgage Loan and REO Property Schedule is true and correct in all material respects as of the date ... such information is furnished". The Schedule was required to contain the latest appraised values of each Mortgage Loan and REO property. Instead of providing the latest appraised values as required by the agreements, Citibank and CNAI utilized, on over 2,300 of the assets at issue, appraised values obtained years earlier, at the time of loan origination, which failed to take into consideration declines in the real estate market. Consequently, Steinhardt contends, Citibank's misrepresentation caused the assets to be overvalued by at least 25%.

According to the amended complaint, Citibank and CNAI breached other specific representations and warranties contained in the Sale Agreements, including "warranties as to their conveyance of good title, the nonexistence of liens, compliance with zoning regulations and other applicable laws, the absence of any environmental violations, and the absence of any valid offset or defense to foreclosure, ...", among others.

Section 8 of the Sale Agreement sets forth specific remedies for breach of the representations and warranties. Upon notice of any breach of a representation or warranty, the Seller has thirty days to "use its best efforts promptly to cure such breach in all material respects...." If the Seller fails to do so, then, at the Purchaser's option, the Seller shall repurchase such Mortgage Loan or REO Property at the repurchase price. In addition to the repurchase remedy, the Seller is also required to indemnify and hold harmless the Purchaser against any losses, damages, penalties, fines, forfeitures, legal fees, judgments, and other costs and expenses arising from any claims resulting from the Seller's breach. The parties agreed that the above remedies "constitute[d] the sole remedies of the Purchaser respecting a breach of the foregoing representations and warranties."[7]

On December 14, 1994, the second step of securitization transaction was completed with the issuance of the debt securities. According to Steinhardt, Citicorp controlled every aspect of the securitization by: structuring all aspects of the securitization; drafting the prospectus; leading all material discussions with the rating agencies; acting as the sole underwriter for the issuance of the debt securities; separately indemnifying Bristol and its affiliates; purchasing an interest rate cap to minimize the risk of any changes in the variable interest rates; arranging for credit enhancement; paying for all of the expenses of securitization; in lieu of customary underwriter's fees, applying the proceeds of the securitization to pay off the bridge loans; and reimbursing Bristol for additional operating expenses resulting from the securitization.

According to the amended complaint, Steinhardt first learned of Citicorp's allegedly fraudulent scheme in 1995 through conversations with a former officer of CMI, which ultimately led to an investigation and the discovery of the alleged fraud. On December 1, 1995,[8] Bristol and BHT (collectively the "Partnerships"), sent Citibank and CNAI a repurchase notice for more than 2,300 assets; however, Citibank and CNAI refused to honor their obligations to repurchase

7. The amended complaint references a letter agreement dated July 6, 1994 in which Citibank and CNAI agreed that Bristol could assign the representations and warranties made under the Sale Agreement to "investors who will invest in the Securities." This letter, however, was not part of the record below.

8. Although paragraph 57 of the amended complaint avers that the notice was sent on December 1, 1995, paragraph 69 alleges that the same notice was sent on November 30, 1995. Since a copy of the notice is not part of the record, we do not know on which date the notice was actually sent. It is of no moment, however, to the issue before us.

these assets. In addition to ignoring their repurchase obligations, Citibank and CNAI have also failed to reimburse the Partnerships for expenses owed for real estate taxes, legal expenses and vendor expenses; refused to prorate unapplied funds; and failed to produce BPOs for approximately 850 assets. Steinhardt contends that the entire course of conduct of Citibank and CNAI constitutes a total repudiation of the Sale Agreements.

Subsequently, on November 16, 1995, representatives of Steinhardt met with officials of BGO, the general partner of Bristol, to demand that the Partnership commence litigation against the Citicorp Defendants. Despite repeated requests from Steinhardt, BGO has declined to commence legal action on behalf of the Partnership, choosing instead to negotiate, albeit unsuccessfully, with the Citicorp Defendants for over a year and a half. Citicorp has refused to honor the repurchase notice.

B.

On January 17, 1996, Steinhardt instituted the present action on its own behalf.[9] In response, the Citicorp Defendants filed a Motion to Dismiss the amended complaint under Fed.R.Civ.P. 12(b)(6). The district court granted their motion, ruling that Steinhardt's investment in the limited partnership did not constitute an investment contract as that term is defined in *Howey, supra.* In reaching this conclusion, the district court determined that although Steinhardt was a passive investor, a common enterprise was not established under the facts pleaded. The district court also declined to exercise supplemental jurisdiction over Steinhardt's state law claims, having found that the Citicorp Defendants did not present a predicate for the court to conclude that it would be serving the interests of fairness and economy by considering the state law claims. BGO moved to dismiss on the basis that the complaint failed to demand any relief from them. The district court ruled that BGO's motion was now moot since the court dismissed Counts I and II of the amended complaint and declined supplemental jurisdiction over the state law claims.

On December 2, 1996, the district court entered afinal order granting the Citicorp Defendants' Motion to Dismiss. This timely appeal followed. Our jurisdiction over this appeal arises under 28 U.S.C. § 1291; our review is plenary.

II.

[3] The outcome of this dispute hinges upon whether, under the circumstances, the securitization transaction constitutes an investment contract within the meaning of section 2(1) of the Securities Act of 1933, 15 U.S.C. § 77b(a)(1). In order to invoke the protections of the federal securities laws, an investor must show, as a threshold matter, that the instrument in question is a security. Section 2(1) of the Act sets forth the definition of the term "security."[10] Included in this definition are several catch-all categories which were designed to cover other securities interests not specifically enumerated in the statute. *See* Maura K. Monaghan, *An Uncommon State of Confusion: The Common Enterprise Element of Investment Contract Analysis,* 63 Fordham L.Rev. 2135, 2136 (May, 1995). One such category is the "investment contract."

[4] The term investment contract has not been defined by Congress, nor does the legis-

9. The amended complaint upon which our decision rests was filed on January 30, 1996.

10. 15 U.S.C. § 77b(a)(1) states:
The term "security" means 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, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, 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.

lative history to the 1933 and 1934 Acts illuminate what Congress intended by the term investment contract. The interpretation of this term has thus been left to the judiciary. In 1946, the Supreme Court took up the task of defining the parameters of an investment contract in the seminal case of *SEC v. W.J. Howey*, 328 U.S. 293, 66 S.Ct. 1100, 90 L.Ed. 1244 (1946). The Court stated:

> an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party ...

Id. at 298–99, 66 S.Ct. at 1103.[11] Thus, the three requirements for establishing an investment contract are: (1) "an investment of money," (2) "in a common enterprise," (3) "with profits to come solely from the efforts of others." *Id.* at 301, 66 S.Ct. at 1104.

In enunciating this test, the Supreme Court noted that the statutory purpose of compelling full and fair disclosure was fulfilled. *Id.* at 299, 66 S.Ct. at 1103 (citing H. Rep. No. 85, 73d Cong., 1st Sess., p. 11). The Court further observed that this definition "embodie[d] a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." *Id.* The *Howey* test still predominates in investment contract analysis today.

The facts in *Howey* inform our application of the test here. In *Howey*, the SEC sought to restrain a Florida corporation from offering and selling small tracts of land in a large citrus grove it owned in violation of section 5(a) of the Securities Act of 1933, 15 U.S.C. § 77e(a). The purchasers were offered land sales contracts for small parcels of the grove, along with a service contract for harvesting and marketing the fruit. Although the purchasers were free to contract with other service companies, the superiority of the corporation's service company was stressed. For the most part, the purchasers lacked the knowledge, skill, and equipment necessary for the care and cultivation of citrus trees. The purchasers had no desire to occupy the land or develop it themselves; they were attracted solely by the prospects of a return on their investments. The purchasers received an allocable share of the profits based on the amount of shares owned. Forty-one persons bought shares in the Florida citrus grove. Based on these facts, the Supreme Court concluded that all of the elements of an investment contract had been met. *Id.* at 299, 66 S.Ct. at 1103.

Clearly Steinhardt has alleged sufficient facts to meet the first prong of *Howey*. The Steinhardt Group, through its affiliate, C.B. Mtge., has invested $42 million dollars in Bristol with the expectation of receiving a return on its investment of approximately 18%. Thus, the facts alleged show that Steinhardt has undertaken some degree of economic risk. Monaghan, *supra*, at 2147 (citing Reves v. *Ernst & Young*, 494 U.S. 56, 67, 110 S.Ct. 945, 952, 108 L.Ed.2d 47 (1990)).

Regarding the second prong, commonality, we have previously applied a horizontal commonality approach in determining whether a particular investment constitutes a security. *See, Salcer v. Merrill Lynch, Pierce, Fenner and Smith*, 682 F.2d 459, 460 (3d Cir.1982). "[H]orizontal commonality requires a pooling of investors' contributions and distribution of profits and losses on a pro-rata basis among investors." *Monaghan, supra*, at 2152–53 (footnotes omitted). In the case before us, Steinhardt maintains that the district court erred in concluding that horizontal commonality was not adequately pleaded. In the alternative, Steinhardt argues that vertical commonality exists here and urges us to find that vertical commonality can satisfy the *Howey* common enterprise prong. On the other hand, the Citicorp Defendants agree with the district court's finding as to the

11. In *Howey*, the Supreme Court interpreted "security" as defined in section 2(1) of the Securities Act of 1933, 15 U.S.C. § 77b(1). This definition is, in essence, the equivalent of that contained in the Securities Exchange Act of 1934, 15 U.S.C. § 78c, the statute which is at issue here. *Tcherepnin v. Knight*, 389 U.S. 332, 342, 88 S.Ct. 548, 556, 19 L.Ed.2d 564 (1967); *Goodwin v. Elkins & Co.*, 730 F.2d 99, 102 n. 5 (3d Cir.1984) (citing *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 95 S.Ct. 2051, 44 L.Ed.2d 621 (1975)).

common enterprise element but disagree with the court's ruling insofar as it found that the third element of the *Howey* test was adequately pleaded—the "solely from the efforts of others" element. The Citicorp Defendants entreat us to find that Steinhardt negotiated such pervasive control over its investment in Bristol Oaks that it cannot meet the third element of *Howey*.

The district court found that only vertical commonality, and not horizontal commonality, was successfully pleaded in this case. Stating that the court of appeals has not adopted vertical commonality, the district court held that the common enterprise prong of the *Howey* test had not been adequately pleaded in the complaint. We have addressed horizontal commonality only once previously in *Salcer, supra*, where we summarily held the investment was not part of a pooled group of funds. We do not need to consider whether vertical commonality should be adopted here, or whether horizontal community was adequately pleaded, because we believe the third element of *Howey* is dispositive.

The third prong of the Supreme Court's test in *Howey* test requires that the purchaser be attracted to the investment by the prospect of a profit on the investment rather than a desire to use or consume the item purchased. *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 853–54, 95 S.Ct. 2051, 2060–61, 44 L.Ed.2d 621 (1975) (court concluded that sale of shares in a housing cooperative did not give rise to a securities transaction where none of the promotional materials emphasized profit and there was a low probability the shares would actually produce a profit). In analyzing this element, the courts have also looked at whether the investor has meaningfully participated in the management of the partnership in which it has invested such that it has more than minimal control over the investment's performance. Monaghan, *supra*, at 2151.

In *SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476, 482 (9th Cir.1973), the court of appeals stated that the critical inquiry is "whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise." Our sister court in the fifth circuit, citing *Glenn W. Turner Enterprises, supra*, noted that this inquiry comported with the position adopted by the SEC:

> It must be emphasized that the assignment of nominal or limited responsibilities to the participant does not negative the existence of an investment contract; where the duties assigned are so narrowly circumscribed as to involve little real choice of action or where the duties assigned would in any event have little direct effect upon receipt by the participant of the benefits promised by the promoters, a security may be found to exist. As the Supreme Court has held, emphasis must be placed upon economic reality. *See* Securities and Exchange Commission v. W.J. Howey Co., 328 U.S. 293, 66 S.Ct. 1100, 90 L.Ed. 1244 (1946)....

SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 483 n. 14 (5th Cir.1974) (citing Securities Act Release No. 5211 (Nov. 30, 1971), reported in 1971–72 Transfer Binder CCH Fed.Sec. L.Rep. # 98446).

We cited with approval the test set forth in *Glenn W. Turner Enterprises, supra*, for determining whether the third prong of *Howey* had been met in *Lino v. City Investing Co.*, 487 F.2d 689, 692–93 (3d Cir.1973), where we concluded that franchise licensing agreements did not constitute investment contracts because of the significant efforts of the licensee in promoting the franchise. In so ruling, we were persuaded by the reasoning of the Supreme Court,[12] the Ninth Circuit,[13] the SEC,[14] and the Supreme Court of

12. *See Howey, supra*, at 299, 66 S.Ct. at 1103. *Accord, SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351, 64 S.Ct. 120, 123–24, 88 L.Ed. 88 (1943); *Tcherepnin v. Knight*, 389 U.S. 332, 338, 88 S.Ct. 548, 554, 19 L.Ed.2d 564 (1967).

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

14. *See* Securities Act Release No. 5211 (Nov. 30, 1971), reported in 1971–72 Transfer Binder CCH Fed.Sec.L.Rep. # 98446.

Hawaii.[15] *Id.* at 692. Specifically, we noted the Supreme Court's statement in *Howey* that the "definition of a security 'embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.'" *Id.* (quoting *Howey, supra,* at 299, 66 S.Ct. at 1103). We held that "an investment contract can exist where the investor is required to perform some duties, as long as they are nominal or limited and would have 'little direct effect upon receipt by the participant of the benefits promised by the promoters.'" *Id.* (quoting Securities Act Release No. 5211, *supra*). Thus, we refused to read literally the term "solely," as used in the *Howey* test, when evaluating the efforts of the investor. *Id.*

In *Goodwin v. Elkins & Co.,* 730 F.2d 99 (3d Cir.1984), we were asked to consider the "solely from the efforts" requirement in the context of a partnership interest. There we looked to the partnership agreement to determine the amount of control a partner had over the management of a brokerage firm. The plaintiff in *Goodwin* had been a general partner in the defendant brokerage firm for more than 20 years. Dissatisfied with the management policies of the firm, Goodwin resigned but initially agreed to stay until March 31, 1982. In February 1982, he negotiated an agreement with the firm in which he agreed to make his resignation effective January 1, 1982 and the firm represented that no sale or merger of the business was planned. On March 17, 1982, the Elkins firm was sold and merged into another brokerage house which resulted in financial advantages to the general partners. Goodwin sued his firm to recover the difference in the value of his partnership interest on January 1 and March 31, 1982.

Although the panel in *Goodwin* unanimously held that the plaintiff's partnership interest did not qualify as a security under federal securities laws, they disagreed as to whether their examination of the issue should be limited to the partnership agreement. 730 F.2d at 103. Judge Garth reached the result solely by reference to the Pennsylvania Partnership Act.[16] He opined that "Goodwin's interest [did] not qualify as a security primarily because the role of a general partner, *by law,* extends well beyond the permitted role of the passive investor." *Id.* (footnote omitted). In concurring opinions, then-Chief Judge Seitz and Judge Becker limited their examinations to the terms of the partnership agreement in concluding that the general partnership interest did not constitute a security. *Id.* at 112–13. After analyzing the residual powers vested in Goodwin, the panel concluded that he still necessarily enjoyed considerable authority in the operation of the firm such that his interest could not be deemed a security. *Id.* at 107, 113–14. The panel further noted that "whether a partnership interest constitutes a security depends on the *legal* rights and powers enjoyed by the investor." *Id.* at 107.

To resolve the issue of whether Steinhardt's involvement in the Bristol Oaks Limited Partnership was limited to that of a passive investor, we must look at the transaction as a whole, considering the arrangements the parties made for the operation of the investment vehicle[17] in order to determine who exercised control in generating profits for the vehicle. The Limited Partnership Agreement ("LPA"), which establishes the relative powers of the partners in running the enterprise, therefore governs our inquiry.

Section 3.1(f) of the LPA, as amended, requires that "the Managing Partner shall not have the right to take any of the following actions ("Material Actions") without the consent of . . . a Majority of the Partners (or pursuant to an approved Business Plan). . . ." The "Material Actions", set forth in section 3.1(f) of the LPA, include most tasks that are crucial to turning the mortgages and REO into profit, which is the basic purpose of Bristol Oaks, e.g., entering into any written

15. *See State v. Hawaii Market Center, Inc.,* 52 Haw. 642, 485 P.2d 105 (1971).

16. 59 Pa. Cons.Stat. Ann. §§ 301–365 (Purdon Supp.1983).

17. The term "investment vehicle" refers to the Bristol Oaks Limited Partnership.

or verbal material agreement or transaction with any borrower outside of the Loan Documents; giving any material consent required to be obtained by any borrower under the Loan Documents; modifying or amending any of the Loan Documents; exercising any rights under the Loan Documents; selling, exchanging, securitizing, conveying, or otherwise voluntarily disposing of, or placing any encumbrance on, the Properties. Under the LPA, a "Majority of the Partners" is defined as "those Partners holding greater than fifty percent (50%) of the Percentage Interests . . .", meaning that Steinhardt alone constitutes a "Majority of the Partners."

Steinhardt approved the interim business plan[18] and although Citicorp drafted that plan, Steinhardt retains the power to amend that plan as it wishes in one of two ways: (1) in its capacity as "Majority of the Partners," Steinhardt can propose and approve a new business plan; and (2) if the general partner proposes a new business plan, Steinhardt retains veto power, which it can exercise merely by declining to approve the proposed change within fifteen business days. Thus, we agree with the Citicorp Defendants that "Steinhardt's consent is required for the taking of any 'Material Action,' whether through its control over the business plan, or through its veto power over 'Material Actions' that fall outside the parameters of the business plan."

The LPA further provides that where a Majority of the Partners proposes a Material Action, the general partner "shall use best efforts to implement such Material Action at the Partnership's expense on the terms proposed by such Majority of the Partners," i.e., Steinhardt. If the general partner refuses to act with such best efforts in pursuit of Steinhardt's proposals, Steinhardt can remove and replace the general partner without notice.

As the above provisions demonstrate, the LPA gives Steinhardt pervasive control over the management of the Partnership. Indeed, these quite significant powers are far afield of the typical limited partnership agreement whereby a limited partner leaves the control of the business to the general partners. We find the agreement altogether consistent with the arrangement before us: Steinhardt, a sophisticated investor, made a $42 million capital contribution in Bristol Oaks, thereby becoming a 98.79% partner through a highly negotiated transaction.

Moreover, it appears the parties have carefully constructed the LPA to give Steinhardt significant control without possibly running afoul of the Delaware Revised Uniform Limited Partnership Act, 6 Del. C. § 17–101, *et seq.* Indeed, Steinhardt has proposal and approval rights rather than more affirmative responsibilities. We also find unpersuasive Steinhardt's contention that its powers were limited under the LPA. First, Steinhardt points out language in the LPA that:

> [e]xcept for specific rights to propose and approve or disapprove certain Partnership matters as set forth in the Agreement, the Limited Partners shall not take any part whatsoever in, or have any control over, the business or affairs of the Partnership, nor shall the Limited Partners have any right or authority to act for or bind the Partnership.

Section 3.1(g) of the LPA. Given the extensive proposal and approval rights retained by Steinhardt under the LPA, the "except" clause swallows the general rule of nonparticipation. Second, Steinhardt points out that if a business plan was in place, as it was as soon as Steinhardt approved the interim agreement, Steinhardt's approval was not required for the general partner to take Material Actions. Steinhardt's argument lacks substance, however, since Steinhardt could amend the business plan at any time, and the general partner needed Steinhardt's approval to take any Material Action not provided for under the business plan.

At oral argument, counsel for Steinhardt made a corollary argument that since the interim agreement was in place, the general partner could operate the partnership without Steinhardt exercising the authority given to it under the LPA. Accordingly, counsel argued, Steinhardt's amended complaint

18. The Partners, simultaneously with the execution of the LPA, approved an interim business plan which set forth the policies and parameters of the real estate servicing operation during the period of time between the closing date and the date of the Master Business Plan.

could survive a 12(b)(6) motion. However, as *Goodwin* teaches, the issue does not turn on whether the investor actually exercised its rights, but rather, on what "*legal* rights and powers [were] enjoyed by the investor." 730 F.2d at 107. Moreover, on a 12(b)(6) motion, we must consider the commercial realities of the transaction and, in doing so, we conclude that without Steinhardt's involvement, the Partnership could only operate in a static, inflexible way that is unrealistic and impractical in today's business climate.

[5] Steinhardt further argues that the Delaware Revised Uniform Limited Partnership Act supports its position that it was a passive investor. The Act enumerates those actions of the limited partners that do not equate to controlling the management of the partnership and includes many of the approval rights given to Steinhardt. Steinhardt submits that since under the Act it would not be deemed to have exercised control, it must be a passive investor for *Howey* purposes.

We find that the Act is not controlling here. The LPA states "[e]xcept as otherwise expressly provided in this Agreement, the rights and duties of the Partners and the administration and termination of the Partnership shall be governed by the Act." The Act defines control, however, solely for the purpose of limiting the liability of the limited partners to third parties—a situation not present here. 6 Del. C. § 17-303(b). This does not necessarily equate to the threshold for finding a passive investor under federal securities laws. The Delaware Act puts third parties on notice that just because limited partners undertake certain responsibilities with regard to the management of the partnership, that does not make them liable for the obligations of the partnership. Here, Steinhardt is not trying to shield itself from liability, but rather, is seeking relief for alleged violations of federal securities laws. Federal law therefore determines whether the investor's involvement is significant enough to place it outside the role of a passive investor.

Thus, accepting, as we must, the facts as alleged in the amended complaint, we do not find Steinhardt is entitled to relief under *Howey* and its progeny.

III.

We find that the rights and powers assigned to Steinhardt under the LPA were not nominal, but rather, were significant and, thus, directly affected the profits it received from the Partnership. Accordingly, we hold Steinhardt's investment in the Bristol Oaks Limited Partnership does not constitute an investment contract.

Because we find that Steinhardt was not a passive investor, we need not consider whether the securitization here constituted a common enterprise. We will, therefore, affirm the judgment of the district court.

2001 SD 11

Kim TSCHETTER, Marvis Tschetter, a/k/a Marvie Tschetter, Clarence Tschetter and Goldie Tschetter, Plaintiffs and Appellants,

v.

James L. BERVEN, William J. Folkerts, and Venerts Investment, Inc., a South Dakota Corporation, Defendants and Appellees.

Nos. 21474, 21500.

Supreme Court of South Dakota.

Argued Nov. 29, 2000.

Decided Jan. 17, 2001.

After restaurant closed and bank commenced action against investors in limited liability company to recover monies loaned, investors brought cross-claim against restaurant developer for negligence and for breach of Uniform Securities Act. The Circuit Court, Third Judicial Circuit, Beadle County, Jon R. Erickson, J., granted summary judgment to developer. Investors appealed. The Supreme Court, Sabers, J., held that: (1) investment units in company were not "securities," and (2) developer did not assume a duty to advise investors of risks of their investment.

Affirmed.

Gilbertson, J., dissented in part and concurred in part and filed opinion in which Miller, C.J., joined.

SABERS, Justice

[¶ 1.] Marvie and Kim Tschetter, Clarence and Goldie Tschetter (Tschetters) purchased units from Venerts Investment, Inc., James Berven, and William Folkerts (Venerts) in Huron Kitchen LLC, a limited liability company, (Huron LLC) the entity which would construct and own a Country Kitchen restaurant. Tschetters claimed that: 1.) these units constitute securities under South Dakota law, and that: 2.) Venerts breached their duty in failing to assess the suitability of Tschetters for investment in Huron LLC. The trial court denied Tschetters' motions for summary judgment and granted judgment to Venerts by dismissing Tschetters' claims as a matter of law. We affirm.

FACTS

[¶ 2.] In 1994, Venerts entered into an agreement with Country Hospitality Corporation (CHC) to develop several Country Kitchen restaurants over a period of years. Venerts contacted Marvie and Kim Tschetter after learning from the architect retained by Country Kitchen that Tschetters were interested in the investment. Venerts contacted Clarence and Goldie, Marvie's parents, after learning from Marvie that they were also interested. Venerts met with Tschetters and provided them a business plan which described the project.

[¶ 3.] After additional meetings with Venerts, Tschetters eventually invested in Huron LLC. Marvie and Kim purchased 6.750 units for $33,750.00, representing one ownership share of a total of eleven in Huron LLC. Clarence and Goldie purchased 13.5 units for $67,500, making them owners of two shares in Huron LLC. An operating agreement was entered into on April 4, 1995 and the Country Kitchen in Huron was opened in the fall of 1995.

[¶ 4.] Several months later, financing difficulties caused Tschetters and others to personally guarantee loans from First Madison Bank to Huron LLC. Nevertheless, the Country Kitchen continued to experience financial difficulties and closed November 1996. After the restaurant closed, First Madison Bank commenced an action against the personal guarantors, including Tschetters, to recover the monies loaned. Tschetters responded with cross-claims against Venerts for negligence and breach of South Dakota's Uniform Securities Act.

[¶ 5.] Tschetters moved for summary judgment asserting that: 1.) the units in the Huron LLC are "securities" under SDCL 47-31A-401(m); and 2.) Venerts owed a duty to determine the suitability of Tschetters to invest in Huron LLC.

The trial court denied both motions. Tschetters appeal. Venerts filed a notice of review of: 3.) the trial court's decision denying the admissibility of evidence concerning settlement negotiations to prove Tschetters' role in Huron LLC.

STANDARD OF REVIEW

[1–5] [¶ 6.] Our standard of review for summary judgment is well-established:

> In reviewing a grant or denial of a summary judgment under SDCL 15–6–56, we must determine whether the moving party demonstrated the absence of any genuine issue of material fact and showed entitlement to judgment on the merits as a matter of law.

Kern v. City of Sioux Falls, 1997 SD 19, ¶ 4, 560 N.W.2d 236, 237. "The determination of whether a duty exists is a question of law for the court." *Gilbert v. United Nat. Bank,* 436 N.W.2d 23, 27 (S.D.1989). Similarly, "the construction of a statute and its application to the case at hand presents a question of law." *Shevling v. Butte County Bd. of Comm'rs,* 1999 SD 88, ¶ 12, 596 N.W.2d 728, 730. "Whether an instrument is a security is a question of law." *Nutek Information Systems, Inc., v. Arizona Corporation Commission,* 194 Ariz. 104, 977 P.2d 826, 829 (Ct.App.1998); *see also Securities Exchange Commission v. W.J. Howey, Co.,* 328 U.S. 293, 297, 66 S.Ct. 1100, 90 L.Ed. 1244, 1249 (1946). "We review questions of law de novo." *Hamerly v. City of Lennox Bd. of Adj.,* 1998 SD 43, ¶ 10, 578 N.W.2d 566, 568.

[¶ 7.] 1. WHETHER THESE UNITS IN HURON LLC ARE SECURITIES UNDER SOUTH DAKOTA'S UNIFORM SECURITIES ACT.

[6] [¶ 8.] This case presents a question of first impression in South Dakota. "We start with the proposition that statutes governing the registration and sale of securities are remedial in nature and are designed to protect the unwary buyer and thus should be liberally construed." *Hofer v. General Discount Corp.,* 86 S.D. 133, 192 N.W.2d 718, 722 (1971). However, to receive this liberal construction Tschetters must establish that the units they purchased are securities.

[¶ 9.] In South Dakota, "security" is defined as:

> any note; stock; treasury stock; bonds; debentures; evidence of indebtedness; certificate of interest or participation in any profit-sharing agreement; collateral-trust certificates; preorganization certificate or subscription; transferable shares; investment contracts; voting-trust certificates; 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; viatical settlement; or, in general, any interests 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. Security does not include any insurance or endowment policy or annuity contract under which an insurance company promises to pay a fixed sum of money either in a lump sum or periodically for life or some other specified period.

SDCL 47–31A–401. Tschetters contend that the units they purchased in Huron LLC are "investment contracts" and therefore "securities" under SDCL 47–31A 401.[1] South Dakota's definition of "securi-

1. In addition to asserting that the "units" constitute an "investment contract" Tschetters also argue that the "units are commonly known as securities" and, therefore, meet the definition of 47–31A–401. However, as recognized by the United States Supreme Court:

> We perceive no distinction for present purposes, between an 'investment contract' and an 'instrument commonly known as a security.' In either case, the basic test for distinguishing the transaction from other commercial dealings is 'whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others.'

ty" is substantially similar to the definition of "security" in the Securities Act of 1933 and the Securities Exchange Act of 1934. *See* Securities Act of 1933, 15 USCA 77(b)(1) (1997); Securities Exchange Act of 1934, 15 USCA 78(c)(a)(10) 1997. Therefore, we look to courts interpreting similar provisions for guidance.

[7] [¶ 10.] "We must therefore begin where all analyses of investment contracts start, with *Securities & Exchange Commission v. W.J. Howey Co.*, 328 U.S. 293, 66 S.Ct. 1100, 90 L.Ed. 1244 (1946)." [2] *Williamson v. Tucker*, 645 F.2d 404, 417 (5th Cir.1981) *cert denied* 454 U.S. 897, 102 S.Ct. 396, 70 L.Ed.2d 212 (1981). LLC membership interests constitute "securities" if they fulfill the criteria established by the United States Supreme Court in *Howey*. *Keith v. Black Diamond Advisors, Inc.*, 48 FSupp 2d 326 (S.D.N.Y.1999); *KFC Ventures, LLC v. Metaire Medical Equipment Leasing Corp.*, 2000 WL 726877, *2 (E.D.La.2000). The United States Supreme Court has stated that an "investment contract" is a " 'security' when a person 1.) invests money 2.) in a 'common enterprise' and 3.) is led to expect profits solely from the efforts of the promotor or a third party." *Nutek*, 977 P.2d at 830 (citing *Howey*, 328 U.S. at 301, 66 S.Ct. at 1100, 90 L.Ed. at 1244.)

[¶ 11.] The critical inquiry is the third prong of the *Howey* test-whether Tschetters were led to expect profits solely from the efforts of the promotor or a third party. We acknowledge, as other courts have done, that the use of the term "solely" is "not to be taken literally." *Id.* "Rather, the third prong is satisfied if 'the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which effect the failure or success of the enterprise.' " *Nutek*, 977 P.2d at 830; *citing* *SEC v. Glenn W. Turner Enters. Inc.*, 474 F.2d 476, 482 (9thCir.1973). The United States Supreme Court has also noted the definition of a security "embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others in the promise of profits." *Howey*, 328 U.S. at 299, 66 S.Ct. at 1103, 90 L.Ed. at 1250.

[¶ 12.] The leading case interpreting the third prong of the *Howey* test is *Williamson v. Tucker*, 645 F.2d at 404. *Williamson* approaches this inquiry by recognizing that substance should take precedence over form. *Id.* at 422–23. The *Williamson* court set forth three factors to aid in this determination:

1. an agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership; or
2. the partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or
3. the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager or the enterprise or otherwise exercise meaningful partnership or venture powers.

Id. at 424. These factors are not all-inclusive, and other considerations may come into play in each case. *Id.* at n. 5. In addition, we do not isolate these factors but consider them as a whole. *Koch v. Hankins*, 928 F.2d 1471, 1476–78 (9thCir.1991); *Nutek*, 977 P.2d at 831.

[8] [¶ 13.] Based on the evidence in the record and South Dakota law, Tschet-

United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 852, 95 S.Ct. 2051, 2060, 44 L.Ed.2d 621, 632 (1975).

2. Tschetters suggest the use of three other tests to make this determination, however, *Howey's* common enterprise test is the majority rule and we find it persuasive, especially as interpreted in Williamson. *See infra* for discussion.

ters had substantial rights and powers. South Dakota law vests the members of an LLC with management powers in proportion to their contribution of capital. SDCL 47–34–16. The members have the power to elect the managers of the LLC and set their responsibilities.

[¶ 14.] In addition, the Operating Agreement vested management powers of the Huron LLC in its members, which included Tschetters. These members were given notice of meetings and any member could call a meeting. The day-to-day decisions were made by two managers who were required to be members of the Huron LLC, and selected by the other members. The Huron LLC maintained and provided access to all records of actions taken by its members. Members could authorize loans on behalf of the company by agreement. The members had the authority to select an attorney to review the legal affairs of the Huron LLC. The members had the right to receive profits and distributions when warranted. The members could authorize incidental expenses within an aggregate of $12,500. The members were empowered to make any other routine actions incidental to the day-to-day activity of Huron LLC. The members were allowed to select officers for the Huron LLC and could remove the accountant with or without cause.

[¶ 15.] The Huron LLC's operating agreement establishes that substantial power and responsibility was vested in its members. The record also establishes that Marvie, acting for all the Tschetters, exercised substantial control over the affairs of Huron LLC. Apparently, Clarence and Goldie acquiesced in relying on Marvie and Kim for information and action. The minutes kept by the Huron LLC show that Tschetters were informed and active in this entity. Tschetters actions on behalf of Huron LLC after the restaurant began to fail shows they were aware of and capable of exercising the powers which they held as members.

[¶ 16.] Tschetters stress the fact that Huron LLC entered into a management agreement with CHC to establish their dependence on the efforts of others. However, our inquiry is the Tschetters role in the Huron LLC. The fact that Huron LLC acquiesced in management powers to CHC is not determinative. The Huron LLC retained the ability to terminate the management contract if the manager failed to perform "any material covenant, agreement, term or provision . . . for a period of thirty days." Apparently, here, the failure to perform exceeded a period of thirty days several times over. The management agreement required CHC to "direct, supervise, manage, and operate the [r]estaurant in an efficient and economical manner," "execute a marketing plan to attract guests," "determine and arrange to contract for all advertising and promotion [ ] deem[ed] necessary and appropriate for the operation of the [r]estaurant." Apparently, the failure to perform as required caused CHC's termination. The management agreement does not divest all power from Huron LLC but, instead, provides Tschetters and other members of Huron LLC substantial power and ability to conduct the necessary oversight of the restaurant's operation.

[9–11] [¶ 17.] The record fails to establish that this was a situation where the managers were so dominant that the members would be lost without them. *See Nutek,* 977 P.2d at 833. "The mere choice by a partner to remain passive is not sufficient to create a security interest." *Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.,* 840 F.2d 236, 240–41 (4thCir.1988). This determination "does not and should not hinge on the particular degree of responsibility assume[d] within the firm, nor does the delegation of membership responsibilities, or the failure to exercise membership powers, 'diminish the investor's legal right to a voice in partnership or company matters.'" *Keith,* 48 FSupp.2d at 334 (quoting *Hirsch v. duPont,* 396 F.Supp. 1214 (S.D.N.Y.1975)).

We acknowledge that the investor asserting that an "investment contract" constitutes a "security" has a "difficult burden to overcome." *Nutek,* 977 P.2d at 831.

[¶ 18.] Tschetters have the burden of establishing that their expectation of profits was based on the entrepreneurial efforts of others to establish an "investment contract." As indicated in one treatise, only in unusual circumstances would a member-managed LLC "be able to argue that they must rely on the entrepreneurial efforts of others rather than on their own management skills." Carol Goforth, *Why Limited Liability Company Membership Interests Should Not Be Treated As Securities and Possible Steps to Encourage This Result,* 45 Hasting L.J. 1223, 1275 (1994). This may be especially true when, as here, the investment related to a restaurant, rather than complicated communications systems, as in *Nutek.* In such an entity, the members retain substantial power over the LLC. *Id.* "The general framework is essentially antithetical to the notion of member passivity."

[¶ 19.] We hold that the third prong of the *Howey* test, as interpreted by *Williamson,* has not been met. In other words:

1. This agreement did not leave so little power in the hands of the partner as a limited partnership would;

2. The partner or venturer was not so inexperienced and unknowledgeable in the business affairs as to be incapable of intelligently exercising his partnership or venture powers; or

3. The partner was not so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace [him] or otherwise exercise meaningful partnership or venture powers.

[¶ 20.] If an interest in a limited liability company constitutes a "security," then that entity must comply with our securities law or exempt themselves from the application of those laws. This question can only be addressed on a case-by-case basis. Here, Tschetters did not sustain their burden. These "units" were not "securities" under this law and we affirm issue 1.

[¶ 21.] 2. WHETHER VENERTS HAD A DUTY TO ASSESS THE SUITABILITY OF TSCHETTERS FOR INVESTMENT IN HURON LLC.

[12] [¶ 22.] "[I]t is generally recognized that one who undertakes to provide professional services has a duty to the person for whom the services are performed to use such skill and care ordinarily exercised by others in the same profession." *Limpert v. Bail,* 447 N.W.2d 48, 51 (S.D.1989). Tschetters assert that such a duty was created when they filled out a "suitability agreement" which was reviewed by Venerts. If this is the law in this case, the Venerts would be required to "exercise due care in the performance of [their] assumed obligation." *Id.*

[13–15] [¶ 23.] Whether Venerts assumed a duty of care is a question of law. *See Tipton v. Town of Tabor,* 538 N.W.2d 783, 785 (S.D.1995). This duty "may be defined as an obligation [ ] which the law will give recognition and effect." *Hoekman, v. Nelson,* 2000 SD 99, ¶ 8, 614 N.W.2d 821, 823. Tschetters have the burden to prove that such a duty existed. *Id.* at ¶ 12.

[16] [¶ 24.] The only evidence Tschetters offer to support their contention that a duty existed is the "suitability agreement" itself. Examining this document, we find that it did not create a legal duty. This is not a situation where Venerts undertook to perform a contractual duty. *See Mark, Inc. v. Maguire Ins. Agency, Inc.,* 518 N.W.2d 227, 231 (S.D.1994) (Sabers, J., dissenting). It is apparent from examining the "suitability agreement" that it was not a task assigned to Venerts, but, instead, a device to benefit Tschetters by forcing them to think about their investment and at the same time providing assurance to Venerts of their investors' financial position. This benefit does not alone create a legal duty.

[¶ 25.] The form was completed by Tschetters and individually signed by each. It provided a brief statement of the financial security of Tschetters, and indicated that Tschetters "to the extent [deemed] necessary, [obtained] personal and professional advice from a financial advisor with respect to the risks inherent in this investment."

[¶ 26.] This "suitability agreement" does not create a legal duty for Venerts. Instead, it focuses responsibility on Tschetters. The best description for this instrument would be a "wake up call" for Tschetters to further consider their investment decision. This instrument did not create a legal duty for Venerts to advise Tschetters about potential risk.

[¶ 27.] We affirm issue 2.[3]

[¶ 28.] We conclude that the trial court correctly granted summary judgment in favor of Venerts. Therefore, it is not necessary to address issue 3.

[¶ 29.] KONENKAMP and AMUNDSON, Justices, concur.

[¶ 30.] MILLER, Chief Justice, and GILBERTSON, Justice, concur in part and dissent in part.

GILBERTSON, Justice (dissenting in part and concurring in part).

[¶ 31.] I respectfully dissent as to Issue One. I would hold there is a question of fact as to whether the investment made by the Tschetters constituted a security under SDCL 47-31A-401. I would reverse and remand for trial on this cause of action.

[¶ 32.] I initially part company with the Court on its treatment of the standard of review. Although the trial court granted summary judgment in favor of Venerts, this Court would treat the issue as a question of law. Its authority for that position, *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293, 66 S.Ct. 1100, 90 L.Ed. 1244 (1946) and *Nutek Info. Sys., Inc. v. Arizona Corp. Comm'n*, 194 Ariz. 104, 977 P.2d 826, 829 (Ct.App. 1998) were appellate reviews of a completed bench trial. The parties already had their day in court and the appeal was based on the full record of the trial court's decision on the merits.

[¶ 33.] Federal and state appellate courts that have addressed the issue of the appropriate standard of review of a grant or denial of summary judgment in securities cases have applied the normal summary judgment standard of review. *Smith v. Gross*, 604 F.2d 639, 641 (9th Cir.1979); *Great Western Bank v. Kotz*, 532 F.2d 1252, 1254 (9th Cir.1976); *Marx v. Computer Sciences Corp.*, 507 F.2d 485, 487 (9th Cir.1974); *South Western Oklahoma Develop. Auth. v. Sullivan Engine Works, Inc.*, 910 P.2d 1052, 1059 (Okla. 1996); *Feninger v. Capital Accumulations Services, Inc.*, 439 Pa.Super. 366, 654 A.2d 560, 561-62 (1994). There is no basis to depart from our settled standard of review of the granting of a motion for summary judgment. When reviewing a trial court's decision to grant summary judgment, we will affirm only if all legal questions have been decided correctly and there are no genuine issues of material fact. *Holzer v. Dakota Speedway*, 2000 SD 65 ¶ 8, 610 N.W.2d 787, 791 (citations omitted). The nonmoving party will receive the benefit of all reasonable inferences that can be drawn from the facts. *Id.* The Court puts the burden on the wrong party when it concludes, "[h]ere, Tschetters did not sustain their burden."[4] Because the trial

3. South Dakota's Uniform Securities Act does not apply as we hold the "units" did not constitute "securities" as defined therein.

4. Further examples of the misapplication of the standard of review and how it affected the Court's erroneous outcome are: "However, to receive this liberal construction Tschetters must establish that the units they purchased are securities." "Tschetters have the burden of establishing that their expectation of profits was based on the entrepreneurial efforts of others to establish an 'investment contract.'" Under the proper standard of review, the bur-

court granted summary judgment in favor of Venerts, the burden should have been placed on Venerts as the moving party, not the Tschetters.

[¶ 34.] I agree with the Court that the criteria set forth in *Howey* provides the applicable standard to address the issue. However, the form of the investment (an LLC) is not the exclusive factor. *Williamson v. Tucker*, 645 F.2d 404, 423 (5th Cir.1981). Each case is to be judged on its own facts and not upon the designated label attached to the investment. *Howey*, 328 U.S. at 298, 66 S.Ct. at 1102, 90 L.Ed. at 1249; *Nutek*, 977 P.2d at 836. The determinative issue is whether there is a question of fact that Tschetters would obtain profits from the entrepreneurial and managerial efforts of others.

[¶ 35.] The timeline of the events involved in this case is critical when examining the rights held by Tschetters in Huron LLC. Articles of Organization of Huron Kitchen, LLC, as a limited liability company, were signed by Folkerts and Berven on March 29, 1995. While the Tschetters were considering this investment, they were provided with a Business Plan for Huron LLC dated March 16, 1995 in which Berven and Folkerts as owners of Venerts, set forth their expertise at "areas of business development." [5] In the Business

den is on the defendants to show that the units in Huron LLC were *not* securities and that the Tschetter's expectation of profits were *not* based on the efforts of others.

5. The complete text of Folkerts' and Bervin's self-stated qualifications in the Business Plan is as follows:

> [William (Bill) J. Folkerts] graduated from Mitchell High School and went on to South Dakota State University where he received both B.S. and M.S. degrees in Agriculture and Economics. After more then [sic] 25 years working in the areas of business development, loan packaging, business counseling, loan servicing and technical assistance to local unit(s) units [sic] of government. His specialty was community economic development projects in the east-central part of the State. He provided direct management assistance for more than 9 years to many business and industrial clients.
>
> Folkerts and his wife have been active in the residential rental business for over 18 years. Their holdings include single family houses up to multi-family units. *In addition to these projects, Folkerts was instrumental in forming limited partnerships and "S" Corporations that own real estate.*
>
> He serves on numerous Corporate Boards of Directors and he along with his partner has developed c-store [sic], apartments, motels and restaurants. Some of these projects include: Governor's Inn Pierre; Comfort Inns [sic] in Vermillion; Comfort Inn Watertown; Sleep Inn Sioux Falls, Country Inn and Suites Sioux Falls; Country Kitchen Sioux Falls; Country Kitchen–Watertown; Country Inn and Suites Dakota Dunes; Country Kitchen–Dakota Dunes and Pump N' Pak–Watertown.
>
> *Venerts owned by Folkerts and Jim Berven is a[sic] investment development and management company that has management contract [sic] with the motels.*
>
> * * *
>
> [James (Jim) L. Berven] graduated from Augustana College in 1961 with a Bachelor of Science in Business Administration.
>
> * * *
>
> Berven received the designation of Certified Residential Specialist (CRS) and the coveted Certified Real Estate Brokerage Manager (CRB). He was selected as REALTOR of the year by the Watertown Board of Realtors in 1977 and 1981 and was also REALTOR of the Year for the South Dakota Association of REALTORS in 1981.
>
> * * *
>
> Presently, Berven is President of Berven Realty, Inc. a real estate brokerage and investment company, and serves as Chief Operating Officer of BFR Properties, Inc. a general construction company specializing in custom quality residential and commercial building projects.
>
> * * *
>
> He serves on numerous Corporate Boards of Directors and he along with his partner has developed c-store, [sic] apartments, motels and restaurants. Some of these projects include: Governor's Inn–Pierre; Comfort Inns [sic] in Vermillion; Comfort Inn–Watertown; Sleep Inn Sioux Falls, Country Inn and Suites Sioux Falls; Country Kitchen–Sioux Falls; Country Kitchen–Watertown; Country Inn and Suites–Dakota Dunes; Country Kitchen Dakota Dunes and Pump N' Pak Watertown. (emphasis added).

Plan, Berven and Folkerts designated themselves as the "Project Development Team," and informed the Tschetters that the "Management Team" of the Huron Country Kitchen would be as follows:

> Country Kitchen International by Carlson Hospitality *will be the managers of the Country Kitchen.* The management contract with Huron Kitchen, L.L.C. will be for 15 years and it has renewable options. (emphasis added).

That management agreement was reached in July of 1995 between Venerts and Country Kitchen binding Huron LLC to a 15 year management contract. The agreement was formally executed on August 28, 1995. Tschetters did not receive their shares, which entitled them to the rights and privileges of investors, until September 6, 1995, when the LLC conducted its organizational meeting. By the time the Tschetters received their interests in Huron LLC, their hands had effectively been tied by Venerts through the management agreement with CKI. The situation Tschetters were placed in is similar to the investors in *Nutek,* where "the members had little or no input in deciding to enter into these agreements because the agreements were already in place before [the] members were recruited to invest...." *Nutek,* 977 P.2d at 832.

[¶ 36.] While Huron LLC was a separate legal entity, the sole asset of the LLC was the restaurant, which was subject to the management agreement negotiated by Venerts. The United States Supreme Court has repeatedly noted that when examining securities law issues, the economic reality of a situation, rather than the form, will control. *Reves v. Ernst & Young,* 494 U.S. 56, 61, 110 S.Ct. 945, 949, 108 L.Ed.2d 47 (1990); *Int'l. Bhd. of Teamsters, Chauffeurs, Warehousemen & Helpers of America v. Daniel,* 439 U.S. 551, 558, 99 S.Ct. 790, 796, 58 L.Ed.2d 808 (1979); *United Hous. Found., Inc. v. Forman,* 421 U.S. 837, 848, 95 S.Ct. 2051, 2058, 44 L.Ed.2d 621 (1975). The economic realities of this situation suggest that the restaurant and Huron LLC were one investment. Without the restaurant, Tschetters would not have invested in Huron LLC. Therefore, I disagree with the Court's assertion that our inquiry is limited to Tschetters' role in Huron LLC. While the terms of the LLC agreement on paper would indicate that Tschetters, as members, were given an opportunity to participate in management decisions, in reality, they were already locked out by the previously signed 15–year management agreement with CKI at the time of their investment.[6] The terms of the agreement gave "exclusive supervision and control" of the restaurant to CKI as manager. The agreement further stated that the "[m]anager shall have discretion and control, free from interference, interruption, or disturbance, in all matters relating to the management and operation of the Restaurant subject only to those specific approvals of Owner as set forth herein."[7] Thus, Tschetters were denied

6. The Court emphasizes that the Operating Agreement of Huron LLC signed by Berven and Folkerts on April 4, 1995, declared that the business and direction of the LLC were to be under the authority of two managers who shall be elected annually and must be investor members of the LLC, thereby giving the Tschetters "substantial control over the affairs of Huron LLC." However, prior to the time the Tschetters made their investment, the exclusive management of the sole asset of the LLC, the restaurant, had been handed over to CKI per the 15 year management agreement.

7. The following text from the Management Agreement are examples of the total authority contracted away by Venerts, on behalf of the LLC, to CKI:

> 2.2 *Delegation of Authority. Operation of the Restaurant shall be under the exclusive supervision and control of the Manager which shall be responsible for the proper and efficient operation of the Restaurant. Manager shall have discretion and control, free from interference, interruption, or disturbance, in all matters relating to management and operation of the Restaurant subject only to those specific approvals of Owner as set forth herein.* Such authority of Manager shall include, but is not limited to, promotion and publicity programs, credit policies, employment and hiring pol-

control from the outset by the CKI management contract.

[¶ 37.] Furthermore, the applicable test is "whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise." *Williamson*, 645 F.2d at 418 (quoting *S.E.C. v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476, 482 (9th Cir.1973)). Under the terms of the management contract, Tschetters were precluded from exercising any managerial efforts over the enterprise, namely the restaurant.

> When the owners of a limited liability company are not expected to exercise control over the day-to-day business operations ... interests in limited liability companies should be classified as investment contracts, except in those instances in which the investor will be playing a substantial role in the management of the business.

Thomas Lee Hazen, *The Law of Securities Regulation* § 1.5, at 60 (3d ed. 1995). *See Lino v. City Investing Co.*, 487 F.2d 689, 692 (3rd Cir.1973) (stating that "an investment contract can exist where the investor is required to perform some duties, as long as they are nominal or limited and would have 'little direct effect upon receipt by the participant of the benefits promised by the promoters.' "). In addition, when determining the degree of control an investor holds, we should look to the "practical as well as legal ability to control" the enterprise. *Hocking v. Dubois*, 885 F.2d 1449, 1460 (9th Cir.1989); *Nutek*, 977 P.2d at 831. Clearly, any rights exercisable by Tschetters would have had little effect on the management of the restaurant. At the very least, there is a question of fact as to their authority exercisable over the enterprise.

[¶ 38.] The Court also misconstrues the authority of the LLC to terminate the management contract with CKI. Neither the LLC nor Tschetters could do so at their option or at their discretion as owners. The contract could only be terminated by the LLC upon the following applicable grounds:

> If Manager fails to keep, observe or perform any material convenant, agreement, term or provision of this Agreement and such default shall continue for a period of thirty (30) days after written notice thereof by Owner to Manager.

Thus, if the LLC terminated the management agreement for what it perceived to be "for cause," it faced a potential suit by CKI for breach of contract if the LLC could not prove a violation of the above provision. Given the fact there were fourteen years left to run on the management contact and the already precarious financial state of the LLC, damages for wrongful breach by the LLC would have been

icies, personal wage and compensation policies, receipt, holding and disbursement of funds, maintenance of bank accounts, procurement of inventories, supplies and services, and generally, all activities necessary for and incidental to the operation of the Restaurant.

* * *

6.1 *Standards of Operation. On and after the Opening Date, the Manager shall have the exclusive right and duty to direct, supervise, manage, and operate the Restaurant* in an efficient and economical manner in accordance with the standards and procedures as is customary and usual in the operation of a Country Kitchen® Restaurant and in accordance with the standard Country Kitchen® License Agreement, and determine the programs and policies to be followed in connection therewith, all in accordance with the provisions of this Agreement. However, Manager agrees to consult with and obtain the approval of the Owner on all major programs and policy matters which could substantially affect the type and character of the Restaurant. *In order for the Manager to comply with the standards and procedures, the Owner hereby agrees that Manager shall have uninterrupted control and operation of the Restaurant during the term of this Agreement. The owner will not interfere or involve itself with the day-to-day operations of the Restaurant, and Manager may operate the Restaurant free from interference by the Owner or representative of the Owner.* (emphasis added).

catastrophic.[8] The LLC could not simply cancel this agreement with impunity as the Court suggests.

[¶ 39.] Beyond that, the LLC entered into the franchise investment because of its reliance upon CKI to provide franchise management. The Country Kitchen franchise agreement was still in effect even if the CKI management contract had been cancelled. Examination of the management agreement shows the LLC to be a substantially different business venture for an investor as opposed to the outright purchase of a local "mom and pop" restaurant. Where in the Huron, South Dakota area was the LLC to obtain a qualified replacement manager with the necessary franchise expertise if it dismissed CKI's management?[9] As was observed in *Williamson:*

> A genuine dependence on others might also exist where the partners are forced to rely on some particular non-replaceable expertise on the part of a promoter or manager. Even the most knowledgeable partner may be left with no meaningful option when there is no reasonable replacement for the investment's manger.... [T]he partners may have the legal right to replace the manager, but they could do so only by forfeiting the management ability on which the success of the venture is dependent. Or investors may purchase joint venture interests in an operating business in reliance on the managing partner's unusual experience and ability in running that particular business; again, a legal right of control would have little value if the partners were forced to rely on the manager's unique abilities.

Williamson, 645 F.2d at 423. "Thus, the investors, not only had 'no reasonable replacement' for their manager, they in effect had *no* replacement." *Nutek,* 977 P.2d at 834 (emphasis in original). *See, Koch v. Hankins,* 928 F.2d 1471, 1480 (9th Cir.1991) (stating that "the ready availability of alternative jojoba farm managers is [sufficiently] questionable" to create a question of fact.).

[¶ 40.] If Tschetters can show that CKI "was uniquely capable of such [managerial] tasks or that the [members] were incapable, within reasonable limits, of finding a replacement manager" they can satisfy the third prong of the *Howey* test. *Williamson,* 645 F.2d at 425. Here, unlike in *Williamson,* there is a question of fact as to whether the management contract "create[d] the sort of dependence implicit in an investment contract." *Id. See Koch,* 928 F.2d at 1481 (stating that "even if a general partner vigorously exercised his or her

8. The "basic management fee" to CKI was three percent of the gross sales for the full term of the fifteen-year agreement. Other financial obligations incurred by the LLC per the agreement which may or may not be claimed as damages by CKI in event of a breach of contract include a monthly advertising fee payable to Manger equal to two per cent of the gross sales. Manger also had authority to bind the LLC to a "national and regional advertising fund" not to exceed four per cent of the monthly gross sales. A reserve fund fee of two per cent of gross sales was also required. Although not applicable here because of chronic losses, the agreement also called upon the LLC to pay an "incentive fee" of ten percent of the net operating income minus debts.

Lest there be any doubts of CKI's position in event of a breach of contract by the LLC, the contract declared that CKI could "exercise any other remedy such party may have at law or in equity upon the default of the other party...."

The management agreement was finally cancelled by LLC in November of 1996, not coincidentally the same month the restaurant closed due to the financial losses.

9. The Management agreement drafted by CKI stated its requirements for management of this type of franchise enterprise of which it found itself capable:

> Manager has developed a business system for providing the public with food and restaurant services of a distinctive character under the name "Country Kitchen" ("the Business System") and has publicized the name "Country Kitchen" and other trademarks, trade names, service marks, logos, and commercial symbols to the public as an organization operating under the Country Kitchen Business System.

rights under the partnership agreement, he or she arguably could have no impact on the investment").

[¶ 41.] The Court views the conduct of Tschetters, particularly Marvie Tschetter, as exercising "substantial control" over the LLC. However, as is argued by Tschetters, their actions are in the nature of "somebody on the outside beating on the window trying to get in. Instead of making management decisions, they are left—as a result of the Restaurant Management Agreement—with only the ability to write letters complaining about how the investment is being managed." Further, a substantial portion of the actions by Tschetters were taken after the restaurant had undergone significant financial losses and its ability to survive under any circumstances was at best, very questionable.

[¶ 42.] Finally, I disagree with the Court's assertion that a member of an LLC has a "difficult burden to overcome" to show that his or her investment constitutes a security. The support for this assertion comes from *Williamson,* where that court noted that "an investor who claims his *general partnership or joint venture interest* is an investment contract has a difficult burden to overcome." *Williamson,* 645 F.2d at 424 (emphasis added). While there are similarities between an LLC and a general partnership, there are sufficient differences that justify different treatment. *See Nutek,* 977 P.2d at 833. The personal liability of a general partner provides an incentive to be highly involved in the enterprise, while at the same time discouraging unsophisticated investors. *Id.* at 833–34. Because a member in an LLC is shielded from personal liability, there is "less incentive to be informed about, or take an active role in, the business." *Id.* at 834. Therefore, we should not apply a strong presumption against an LLC interest being a security.

[¶ 43.] For all of the above reasons, I conclude a question of fact exists as to whether this investment by the Tschetters constituted a security under South Dakota law. As such, I would reverse and remand for trial on this issue.[10]

[¶ 44.] I agree with the Court on Issue Two.

[¶ 45.] I would not reach the notice of review issue raised by Venerts, as it was never certified by the trial court per SDCL 15–6–54(b) as part of this appeal.

[¶ 46.] MILLER, Chief Justice, joins this special writing.

10. The LLC had previously filed litigation against CKI. Apparently the parties settled this litigation.

The Florida State University
Tallahassee, Florida 32306-1034

College of Law

Memorandum

To: Real estate transactions
From: Don Weidner
Re: World Publishing, Geneva
Dated: February 22, 1988

Reg. § 1.61-8(c) provides, in part: "As a general rule, if a lessee pays any of the expenses of his lessor such payments are additional rental income of the lessor. If a lessee places improvements on real estate which constitute, in whole or in part, a substitute for rent, such improvements constitute rental income to the lessor. Whether or not improvements made by a lessee result in rental income to the lessor in a particular case depends upon the intention of the parties . . . ."

I.R.C. § 109 provides: "Gross income does not include income (other than rent) derived by a lessor of real property on the termination of a lease, representing the value of such property attributable to buildings erected or other improvements made by the lessee."

Reg. § 1.109-1(a) provides: "However, where the facts disclose that such buildings or improvements represent in whole or in part a liquidation in kind of lease rentals, the exclusion shall not apply to the extent that such buildings or improvements represent such liquidation."

I.R.C. § 1019 provides: "Neither the basis nor the adjusted basis of any portion of real property shall, in the case of the lessor of such property, be increased or diminished on account of income derived by the lessor in respect of such property and excludable from gross income under section 109 (relating to improvements by lessee on lessor's property)."

§ 178. Amortization of cost of acquiring a lease

(a) General rule.--In determining the amount of the deduction allowable to a lessee for exhaustion, wear and tear, obsolescence, or amortization in respect of any cost of acquiring the lease, the term of the lease shall be treated as including all renewal options (and any other period for which the parties reasonably expect the lease to be renewed) if less than 75 percent of such cost is attributable to the period of the term of the lease remaining on the date of its acquisition.

(b) Certain periods excluded.--For purposes of subsection (a), in determining the period of the term of the lease remaining on the date of acquisition, there shall not be taken into account any period for which the lease may subsequently be renewed, extended, or continued pursuant to an option exercisable by the lessee.

World Publishing Co. v. Commissioner, 299 F.2d 615 (8th Cir. 1962).

Before VOGEL, VAN OOSTERHOUT and BLACKMUN, Circuit Judges.

BLACKMUN, Circuit Judge.

This is a petition for review of a decision of the Tax Court approving the Commissioner's determination of deficiencies[1] in the taxpayer's income taxes for the respective calendar years 1952, 1953 and 1954.[2] 35 T.C. 7. The taxpayer, World Publishing Company, is a Nebraska corporation on the accrual basis. Its taxable year is the calendar year. It is engaged primarily in the newspaper business and it publishes the Omaha World Herald.

1. Although the deficiencies determined were attributable to several adjustments, only two of these items were contested in the Tax Court. One, concerning the deduction of fees accrued and paid in 1952 in connection with an application for a television license, is not raised in the petition for review and is not before us.

2. General code and regulations references herein will be to the Internal Revenue Code of 1954 and the Regulations issued thereunder. References to the 1939 Code and its Regulations 118 will be specifically designated.

The issue before us concerns the taxpayer's right to a deduction for depreciation of a portion of the price it paid when it purchased improved real estate subject to an outstanding lease to the tenant who had built the building on the property.

The facts are not in dispute: On June 29, 1928, George Warren Smith, Inc., was the owner of two mid-block lots in downtown Omaha. On that date Smith leased those lots to Farnam Realty Corporation. The lease was for a term of fifty years from July 1, 1928, and called for annual rentals averaging $28,500 but varying between $25,000 and $32,500 for specified decades. It required Farnam immediately to construct a "six (6) story, or more, and basement building" on the property at a cost of not less than $250,000. Farnam complied with this requirement.

On January 4, 1950, the taxpayer purchased as an investment Smith's entire interest in the property, including the lease, for $700,000. The deed recited that it was subject to the lease to Farnam. The parties have stipulated that "the remaining useful life of the building in January, 1950, was not greater than the unexpired term of the lease".

In its income tax return for each of the years in question the taxpayer asserted a deduction of $10,547.92 for "Depreciation and Amortization". This amount was determined by spreading $300,000 (constituting that part of its purchase price which the taxpayer claimed was allocable to the building) over the remaining years of the still outstanding lease. The Commissioner disallowed this deduction.[3]

Certain other provisions of the lease of June 29, 1928, from Smith, as lessor, to Farnam, as lessee, may be pertinent.

1. The parties agreed that "Any and all buildings erected on the said premises under covenants by, or permission granted, to the Lessee shall, at and upon the construction thereof, be and become a part of the realty and upon the termination of this lease, by the expiration of its term or by default or otherwise, any and all such buildings and improvements shall pass to and remain the property of the Lessor".

2. The lessee agreed to pay all taxes and assessments upon the land or the improvements or "which the Lessor shall be required to pay by reason of or on account of its interest in said land or improvements, or its interest in or under this lease, except estate, inheritance, and income taxes".

3. The lessee agreed, before beginning construction of the building, to submit all plans and specifications to the lessor for approval. The lessor could reject or amend these.

4. The lessee agreed to post security with a named Omaha bank for the construction of the building, and the lessor possessed rights, in the event of default in the construction, to call upon that security.

5. The lessee agreed at its expense to procure fire and tornado insurance for the full insurable value of the improvements, with the lessor having the right to attach any mortgage clause its mortgagee might require; to buy plate glass and explosion insurance "in such form as to furnish protection to the Lessor and Lessee"; to buy workmen's compensation insurance "for the protection of the Lessor"; and to buy upon demand "such other reasonable insurance protection as the Lessor may require". The lessee agreed to carry rental interruption insurance in its own favor.

6. The lessee agreed, in case of damage or destruction of the building or any part thereof during the lease, to repair and restore it; it was then entitled to the

3. In the 90-day letter the Commissioner said, "It is held that no part of the amount of $700,000 paid by you in 1950 to acquire real estate which was subject to a lease granted by the previous owner may be allocated to the building constructed by the lessee under the terms of the lease, and, further, that no part of said purchase price may be allocated as a basis for annual amortization deductions".

insurance collected. If, however, the damage or destruction occurred on or after noon of July 1, 1958, the lessee's obligation to restore, in the absence of default in its insurance covenants, was limited to the insurance received.

7. The lessee agreed that upon the completion of the building it "shall not be altered in any manner whatsoever" without the written consent of the lessor, except by governmental authority and except that the lessee could make at its own expense alterations and improvements "in a first-class manner" without such consent if the cost did not exceed $10,000. It was stated that it was "the intention that the building shall at all times be kept in such physical condition that excessive depreciation shall not occur".

8. The lessee agreed at its own cost to maintain the building, the premises and the fixtures in good condition and repair; to permit inspection by the lessor; and to permit the lessor to enter the premises and effect repairs when the lessee failed to keep its repair covenant.

9. The lessee agreed that the lessor could, up to a stated percentage of the ground value, borrow money on the security of the property and secure it by mortgages or deeds of trust "which shall constitute a lien on the grounds and buildings prior to the claim of the Lessee" or its assigns.

10. The lessee had the right to assign, if it was not in default, but was not thereby released from its obligations under the lease unless the lessor so consented in writing.

11. The lessee agreed that at the termination of the lease it would "surrender the possession of the demised premises to the Lessor with the buildings and improvements thereon without delay".

The taxpayer in fact has received and retained the insurance policies required by the lease. These are issued in the name of the taxpayer as the insured.

There is substantial, and uncontradicted, evidence in the record to support the $300,000 figure. A qualified appraiser testified that at the time of purchase the fair and reasonable value of the ground alone was $400,000 and the fair and reasonable value of the building alone was around $300,000. These valuation allocations correspond, too, with the full valuations thereof used for real estate assessment purposes at the time of the purchase. The witness also testified that in his opinion the probable value of the land alone at the expiration of the lease in 1978 would be approximately $400,000.

On these facts, uninfluenced by any decided lease cases, it would seem clearly to follow that the taxpayer is entitled to a deduction, under § 167(a) [4] and under the parallel § 23(*l*) of the 1939 Code, respectively applicable to the tax years in question, for depreciation of the $300,000 portion of its 1950 purchase price allocable to the improvements on the real estate in question. See Detroit Edison Co. v. Commissioner, 1943, 319 U.S. 98, 101, 63 S.Ct. 902, 87 L.Ed. 1286. The building, as well as the land, was acquired and held by the taxpayer "for the production of income". The taxpayer's interest was one acquired by purchase and was not in any sense a derivative right acquired without investment on its part. By the stipulation, the building is a wasting asset and its complete exhaustion will have been effected before the end of the lease term. The taxpayer's spreading of the wasting portion of its purchase price over the entire remaining lease term by the straight-line method [5] approximated the minimal deduction for the taxpayer.

[1] Furthermore, for what it may be worth, the lessor, and consequently the

4. "(a) General rule.—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

"(1) of property used in the trade or business, or

"(2) of property held for the production of income."

5. § 167(b) (1); Regs. § 1.167(b)-1; Regs. 118, § 39.23(1)-5.

taxpayer, in spite of a contrary suggestion at the trial by the Commissioner's counsel, clearly owned the building in more than a bare-legal-title sense. The lease recites that all buildings erected on the premises "shall, *at and upon the construction thereof, be and become* a part of the realty and upon the termination of this lease * * * shall pass to and *remain* the property of the Lessor". (Emphasis supplied.) Consistent with this are other provisions of the lease: the reference in the tax clause to the lessor's interest in the "land or improvements"; the lessor's right to amend and even reject plans and specifications for the building; the insurance protection afforded the lessor and its being named as insured; the lessor's right to subject the improvements as well as the ground to a mortgage lien; and the lessee's inability to alter the completed building beyond a $10,000 cost without the lessor's approval. Compare Bueltermann v. United States, 8 Cir., 1946, 155 F.2d 597, 598; First Nat. Bank of Kansas City v. Nee, 8 Cir., 1951, 190 F.2d 61, 68, 40 A.L.R.2d 423. This is consistent, too, with the general law, evidently recognized in Nebraska, to the effect that, unless provided otherwise by contract, a building permanently affixed to the land becomes a part of it. See Freeman v. Lynch, 8 Neb. 192; Frost v. Schinkel, 1931, 121 Neb. 784, 238 N.W. 659, 664–666, 77 A.L.R. 1381; Friedlander v. Rider, 1890, 30 Neb. 783, 47 N.W. 83, 84–85, 9 L.R.A. 700.

But the Commissioner—and the Tax Court has agreed with him—has taken the position that the taxpayer here acquired no depreciable interest in the property; that what it acquired was the land, not a wasting asset, for which it received ground rental income; that the taxpayer has not shown that it held any interest in the building for the production of income; that it acquired only such interest as its grantor Smith had; and that Smith had no depreciable interest in the lessee-constructed building. He strenuously urges, as supporting authority, a line of cases, including one of our own, concerning the situation where a taxpayer, through *inheritance* or *devise* from a deceased lessor, comes into the ownership of tenant-improved property subject to an outstanding lease:

* * * *

The theories which find expression in these cases are (a) that the decedent had—and his successor has—no invest-

6. Prior to Rowan, the Tax Court had held directly to the contrary in three inheritance-or-devise cases. Charles Bertram Currier, 1946, 7 T.C. 980 (reviewed by the Court, one judge dissenting); J. Charles Pearson, Jr., 1949, 13 T.C. 851 (reviewed by the Court, five judges dissenting); and Mary Young Moore, 1950, 15 T.C. 906. This was on the theory that the interposition of the estate tax and the acquisition by the heir or devisee of a basis in the improvement different from the cost to the decedent (which was usually zero where the tenant constructed the improvement) equates with an investment and the taxpayer has "the gradually disappearing value of a wasting asset" which "can not be replaced except by periodic depreciation adjustments". Currier, supra, p. 984 of 7 T.C.; Pearson, supra, p. 856 of 13 T.C. The Tax Court decisions in Currier, Pearson and Moore, however, were specifically overruled in Rowan, p. 874 of 22 T.C., where the

ment in the wasting asset and (b) that the heir or devisee could acquire no different interest than was possessed by the decedent. "The major thrust of the statute is toward an allowance for recovery of investment in a wasting asset". Goelet (District Court), p. 307 of 161 F.Supp. "Appellants fail to show how a depreciable interest in the building was supplied to them * * *". Goelet (2 Cir.), p. 882 of 266 F.2d. "All she [the taxpayer] could acquire by inheritance from her mother, the testatrix, was such interest as her mother had to devise".[7] Schubert, p. 579 of 286 F.2d.

Are these inheritance-or-devise cases cited by the Commissioner proper or helpful precedent for a situation involving acquisition by purchase? In determining this, some comments about the death cases are perhaps in order:

A. They have provoked substantial criticism. See Rabkin and Johnson, Federal Income, Gift and Estate Taxation, Vol. 2, § 45.09(2) and (3);[8] Lurie, Depreciating Structures Bought Under Long Leases: An Adventure in Blunderland, New York University 18th Annual Institute on Federal Taxation, 1960, pp. 43, 60–62; Rubin, Depreciation of Prop-

Fifth and Ninth Circuit decisions reversing Pearson and Moore were followed.

7. Seemingly contra to this last statement, however, is the statement of the Fifth Circuit in Pearson, supra, p. 74 of 188 F.2d:

"We agree with the general view of the Tax Court that there is no necessary inconsistency in the holding that, though an ancestor, lessor, having no cost basis, does not have a depreciable interest in a building erected by a lessee, an heir may, as an incidence of estate taxation, and, under Sec. 113(a) (5), I.R.C., have a basis for depreciation and an interest to depreciate".

8. "What is the position of a taxpayer who purchases the fee interest subject to an existing lease? * * * The decisions in this area are unrealistic, and the courts' opinions are hopelessly fuzzy and confusing.

"Let us take the simplest type of case. The taxpayer buys land and building for $150,000, with $100,000 allocable to the building. The property has an expected remaining useful life of 20 years. The entire property is subject to an outstanding lease for 5 years at a reasonable annual rent. The taxpayer would seem clearly entitled to an immediate depreciation of $5,000 per year upon his $100,000 building cost.

"Even this result, however, has been cast in doubt by two murky decisions, both of which involved an acquisition of the property by death, with the depreciable property constructed by the continuing lessee. Goelet v. United States, 266 F.2d 881, aff'g 161 F.Supp. 305; Rosalie M. Schubert, 33 T.C. 1048. Although it is hard to see why a basis-at-death is less depreciable than a basis-by-purchase, it is even harder to see why a purchaser is less entitled to depreciate property constructed by a lessee than to depreciate property constructed by his vendor. The decisions appear to leave both these cases open, but they do cast a pall of doubt. * * *

"The problem is somewhat more perplexing when the remaining lease term extends beyond the expected useful life of the property. Thus, suppose that in the above example the outstanding lease had 25 years to run at the time of the purchase. In the leading case in the area, which happened to involve an acquisition by death rather than by purchase, the Ninth Circuit questionably held that the owner could not take depreciation. The opinion states that the owner's interest is not affected by the wasting of the property, because the leasehold obligation will survive the property. Com'r v. Moore, * * * There are two obvious fallacies in this rationale: (1) It is unrealistic to ignore the possibility that the lease will be broken; surely, the purchaser has paid, at least in part, for the assurance that he will have a building to lease to someone else if the present lessee defaults. (2) Depreciation, or amortization, should be allowed on the portion of the purchase price which represents the future rent attributable to the building, because that amount is the present equivalent to the lessor of his purchase price for the building. Moreover, the absurdity of the rule is demonstrated if full depreciation is allowed when the life expectancy of the building is slightly greater than the term of the lease.

"* * * Somehow the prevailing notion seems to be that the lessee's right to his own depreciation precludes any deduction for the lessor's interest in his own wasting asset".

erty Purchased Subject to a Lease, 65 Harvard Law Review, 1952, pp. 1134, 1137, 1145–1146; dissenting opinion of Judge Opper, joined by Judge Drennen, in Schubert, supra, pp. 1055, et seq., of 33 T.C. See Mertens, The Law of Federal Income Taxation, Vol. 4, § 23.90, pp. 187–188.

B. The facts of certain of these cases possess some significance. In Goelet the district court emphasized that, although the taxpayer by the terms of the lease may have had "technical legal title to the building", this was not determinative but "beneficial ownership" was. In Schubert it appears from the majority opinion of the Tax Court, p. 1049 of 33 T.C., that under the lease the improvement was to become the property of the lessor only "upon the termination of the lease". In Friend, too, it is clear from the Board's opinion, p. 771 of 40 B.T.A., that the taxpayers "did not own the buildings" and did not "even claim that they are entitled to an allowance for depreciation in respect of the buildings." In Pearson, Moore, and Nee the appellate courts all concluded that no part of the estate tax valuation, which constituted basis, was attributable to the improvements and that the taxpayer's case, depending, as it did, on a basis to depreciate, consequently failed. And in our Nee case we concluded that the rentals were attributable solely to the land; that the building was not held by the testamentary trustee for the production of income; that the tenant had the right to remove the building and replace it; and that because of this right the title to the building may have been in the lessee (the trial court had held specifically that under the terms of the lease title to the building was in the lessee: D.C., 85 F. Supp. 840, 843; D.C., 92 F.Supp. 328, 329).

C. An alternative and forceful argument made by the taxpayer in some of these cases is that he is entitled to claim a deduction for amortization of the "premium value" of the lease. The argument was rejected in Schubert (4 Cir. and Tax Court), Friend (Tax Court) and Moore (Tax Court); see Martha R. Peters, 1945, 4 T.C. 1236, 1241–1242. It prevailed, however, in Moore (9 Cir.) and necessarily by the Tax Court on remand in that case. T.C.Memo. 1955–219.[9] It was avoided in Goelet, on the ground the point was not preserved below or in the administrative proceedings, and in Frieda Bernstein, 1954, 22 T.C. 1146, 1151–1152, affirmed, 2 Cir., 230 F.2d 603, on the ground of failure of proof. Moore demonstrates, however, that one circuit has afforded relief to a taxpayer who found himself with a newly acquired interest in property with a newly acquired basis which had no rational relationship to land value alone. This alternative argument was mentioned by the Tax Court in the present case and was again rejected; it is not particularly urged by the taxpayer on this appeal.

D. The cases themselves intimate, though perhaps by indirection, that the purchase situation is distinguishable. Thus, in Friend, the Seventh Circuit, at p. 960 of 119 F.2d, describes the testamentary trustees' position there as though "they have the same right to amortize such cost as if the purchase had been made for cash" and, on p. 961 of 119 F.2d, denies a construction of the statute that would "place the petitioners in the position of a purchaser of the leaseholds [together with the reversions] for a valuable consideration". This latter observation was also quoted with approval by the Fourth Circuit in Schubert, p. 580 of 286 F.2d. In Goelet the district court, at p. 310 of 161 F.Supp., refers to the devisees' attempt to draw an analogy to purchase cases and says "An extension of these decisions to the instant case is not warranted. The crucial distinguishing factor is the payment of a purchase price or the existence of an investment, not present here, to which type

9. It is of interest to note that, although Moore stands opposed to Friend and Schubert on this issue, the Supreme Court has denied certiorari in all three cases.

of transaction the statute was meant to apply". When the Friend case, supra, was in the Board of Tax Appeals, the Board said, p. 771 of 40 B.T.A.:

> "Clearly if a taxpayer had invested money in acquiring such right he would be entitled to deduct from the rents received each year an aliquot part of the cost of his investment; for he would be entitled under the same statute to recover back the cost of his investment, without being taxed thereon".

E. Finally, as a collateral comment on the cases, we cannot fail to observe that the depreciation provisions of the Internal Revenue Codes draw no distinction between death-acquired property and purchased property. The basis they establish for depreciation is the same as the basis for determining gain. § 167(f); §§ 23(n) and 114(a) of the 1939 Code. The only difference is as to what that basis is. §§ 1011, 1012 and 1014; §§ 113(b), 113(a) and 113(a) (5) of the 1939 Code. Once ascertained, its use, for depreciation purposes, is the same for both inherited and purchased property.

In summary, therefore, one may say of the inheritance-or-devise cases (a) that they are not without substantial criticism; (b) that many of them possess facts, particularly having to do with title and the allocation of basis to the improvement, which provide sources of difficulty and confusion; (c) that there is an alternative argument which has borne fruit in at least one circuit; (d) that the cases themselves intimate that a purchase situation may provide a different result; and (e) that the depreciation statute itself provides no basis for a distinction between the death situation and the purchase situation.

So much for these death cases. The situation before us, however, is that of a purchaser of the lessor's interest and is not that of the lessor's heir or devisee. No purchase case precisely in point has been found. We therefore start with three established propositions:

[2] 1. Where an owner of land erects a building on it and then leases it he is still entitled to recover the cost of the improvement by depreciation deductions. See Helvering v. Terminal R. Ass'n of St. Louis, 8 Cir., 1937, 89 F.2d 739, 742; Alaska Realty Co. v. Commissioner, 6 Cir., 1944, 141 F.2d 675, 153 A.L.R. 901; St. Paul Union Depot Co. v. Commissioner, 8 Cir., 1941, 123 F.2d 235, 238; Regs. 1.167(a)–4.

[3] 2. Where a lessee makes a capital improvement on leased property he is entitled to recover its cost by appropriate deductions for depreciation or for amortization. Regs. §§ 1.167(a)–4 and 1.162–11(b) (1); Regs. 118, § 39.23(a)–10(b); Duffy v. Central R. R. of New Jersey, 1925, 268 U.S. 55, 64, 45 S.Ct. 429, 69 L.Ed. 846; Nelson v. Commissioner, 8 Cir., 1950, 184 F.2d 649, 652.[10]

[4] 3. Conversely, in the situation just described, the lessor, having no investment in the lessee's improvements, is not entitled to a deduction with respect to them. 4 Mertens, § 23.90, where possible exceptions to this rule are noted.

[5] To these may be added the result reached by the death cases cited above. We think, however, that the death cases do not govern the purchase situation. We reach this result because:

A. The taxpayer-purchaser by his purchase of the property has made an investment. He is not concerned with the identity, as between his vendor-lessor and, the tenant, of the builder of the building. From this point of view, if he is entitled to the deduction where his vendor-lessor was the builder, he is entitled to a deduction where the tenant was the builder.

B. To allow the purchaser to depreciate in the one situation and to deny him depreciation in the other, especially where, as here, title to the building is in the lessor and then in the purchaser,

10. Compare § 178, as added to the 1954 Code by § 15 of the Technical Amendments Act of 1958.

seems to be illogical, to emphasize a historical fact not participated in or caused by the purchaser and not of any other considered economic consequence to him, and to exhalt form over substance. This would be illustrated by identical buildings, one constructed by the lessor and one by the lessee, on adjoining identical lots, subject to otherwise identical leases, when both improved properties are sold to the taxpayer-purchaser. There seems to be no merit in allowing the taxpayer, as distinguished from the lessor, depreciation on the one but not on the other.

C. It is no answer to say that the lease rentals, averaging $28,500, constitute only ground rent. We are concerned here not with depreciation of rentals, but with depreciation of a portion of this taxpayer's investment in the income producing property he purchased.

D. Whatever may be the proper result in the inheritance or devise situation, as exemplified by our 1951 holding in the Nee case, and by the other cases cited above, we are not now willing to extend the philosophy of those cases to the purchase situation of the present litigation.

We regard Millinery Center Building Corporation v. Commissioner, 2 Cir., 1955, 221 F.2d 322, as of particular and helpful significance here. That taxpayer had leased land with an option to renew and, in accordance with the lease, had erected a substantial building on it. Title to the building was in the taxpayer but under the lease it would vest in the lessor at the end of the lease term or the lessor could then compel the taxpayer to remove it. During the lease period the taxpayer fully depreciated the cost of the building. Then it exercised its option to renew. When this was done, it bought the fee. The taxpayer sought to deduct the difference between its purchase price and the then value of the land, as unimproved, as a business expense. The Tax Court disallowed this; it also refused to accept the taxpayer's alternative contentions (a) that the difference should be amortized over the lease term and (b) that it should be depreciated over the remaining useful life of the building. 21 T.C. 817. Six judges dissented on the ground that some part of the purchase price should be allocated to the additional rights the taxpayer acquired in the building and should be recovered through depreciation. On petition for review the Second Circuit reversed on the depreciation issue. It said, p. 324 of 221 F.2d, "A third-party purchaser of such a fee would be entitled to allocate part of its cost to the building and to depreciate it as such". On the taxpayer's petition for certiorari the Supreme Court affirmed. 350 U.S. 456, 76 S.Ct. 493, 100 L.Ed. 545. The Commissioner did not seek review of the allowance of depreciation.

The taxpayer there occupied a position similar to that of the taxpayer here. The only fact differences were the taxpayer's additional posture as lessee and the lease's consequent extinguishment upon the purchase. These differences seem to us, however, of minor import.

That Farnam may have been taking depreciation with respect to its cost in the building need not concern us. Its right so to do is not here at issue. Despite the Ninth Circuit's observation, by way of dictum in the Moore case, p. 272 of 207 F.2d, that "A construction of the law to permit not only the lessee (who has a real economic interest) but also the taxpayer here to take depreciation on the same building would be somewhat anomalous", we fail to see the anomaly. What is significant is that each taxpayer has a separate wasting investment which meets the statutory requirements for depreciation. To allow each to recover his own, and separate, investment is not, as is suggested, to permit duplication at the expense of the revenues and is not to permit one taxpayer to depreciate another's investment. That each is concerned with the same building is of no relevance. Farnam has its lessee's cost of the structure and the present taxpayer has the portion of its purchase price attributable to the building. If two taxpayers own undivided interests in improved real estate, each may be entitled to depreciation. The situation here is not dissimilar.

[6] This leaves only the question of proof. We could remand the case with instructions to the Tax Court to take further evidence as to that portion of the taxpayer's purchase price which was properly allocable to the building as distinguished from the land. We feel, however, that on this record the taxpayer has sufficiently established his $300,000 allocation. The Commissioner had his opportunity in the proceedings which have already taken place in the Tax Court to controvert the taxpayer's evidence. This he did not do but chose, instead, to rely on his basic thesis that the taxpayer had no investment which was entitled to depreciation.

The decision of the Tax Court is reversed with directions to recompute the taxpayer's deficiencies in accord with the views herein expressed.

ALDRICH, Chief Judge.

In 1926 the trustees under the will of one Eben Jordan, owning a parcel of land near Park Square, Boston, granted a ground lease on a net rental basis, the lease to expire, unless earlier for default or upon the payment of a substantial penalty by the lessee, 20 years after the death of certain lives in being, but in any event in 1990. The lessee thereafter erected a building known as the Motor Mart Garage. The taxpayer, M. DeMatteo Construction Co., purchased the property from the trustees in 1959. At this time the lease was in full force, and one of the named lives was still in being. The lease had, accordingly, not less than 20,[1] and not more than 31 years to run. In 1969, at the time of trial, the lease was still in effect, and the remaining named life still in being. Taxpayer's president, according to his testimony at the trial, initially allocated ten percent of its acquisition cost to the land, and ninety percent to the building. This latter percentage he intended to depreciate for tax purposes over the useful life of the building. To support the depreciation deduction taxpayer employed a qualified real estate expert, who advised it to apportion the cost at approximately two-thirds for the building and one-third for the land.

Taxpayer assumed a twenty-year life for the building from the date of purchase, and on this assumption took depreciation deductions on its income tax returns. Upon their disallowance taxpayer paid the additional tax and claimed refunds "for depreciation of the cost allocated to the building purchased by it or for amortization on [sic] the portion of its cost of the entire leasehold allocated to the building" for the years 1962–64. Thereafter, upon the Commissioner's presumed rejection of the claim by six months inaction, taxpayer sued in the district court for recovery of the payments.

The trial proceeded solely upon, and the evidence offered related solely to, taxpayer's first ground for relief, viz., its right to take depreciation in the building. In this court it seeks to argue, in addition, a premium lease amortization theory. We will not, however, consider this second alternative, which would require a different approach and different evidence.[2] This is an appeal asserting error at trial, not an opportunity to try some new theory.[3]

The district court dismissed the complaint on alternate grounds, that taxpayer had no cost basis in the building which would reach the end of its useful life prior to its reversion to taxpayer at the expected termination of the lease, and that the taxpayer had, in any case, failed to meet its burden of proving the fair and reasonable value of its interest in the building. D.Mass., 1970, 310 F. Supp. 1313.

The initial lessor was entitled to claim no depreciation with respect to the

1. No evidence was introduced as to the age or life expectancy of the named life in being.

2. Not the least of which would be the anticipated length of the lease. *See* n. 1, ante.

3. Although taxpayer points out that in the claims for refund, and in its complaint, it made reference to a premium lease amortization theory, it made no such claim at the trial. Three memoranda were filed in the trial court by the taxpayer. Only the second makes more than brief mention of lease amortization, and then solely for the purpose of deprecating it as a concept put forward by the government and rejected by the taxpayer.

building constructed by the lessee for the obvious reason that it had made no investment in the improvement and therefore had no cost basis in it. Buzzell v. United States, 1 Cir., 1964, 326 F.2d 825; Reisinger v. Commissioner of Internal Revenue, 2 Cir., 1944, 144 F.2d 475; Int.Rev.Code of 1954, §§ 167(g), 1011–1012; *cf.* Detroit Edison Co. v. Commissioner of Internal Revenue, 1943, 319 U.S. 98, 63 S.Ct. 902, 87 L.Ed. 1286; Treas.Reg. 1.167(a)-4 (1956). Taxpayer's assertion that the situation changed when it purchased the property, that because it acquired title to the building it obtained a cost basis in it, assumes the point in issue. It does not explain why the rationale underlying the denial of depreciation to the original lessor does not apply equally to the subsequent purchaser. It may be that taxpayer would present some sort of claim if, at the time of purchase, the anticipated life of the building had exceeded the term of the lease. *Cf.* Millinery Center Bldg. Corp. v. Commissioner of Internal Revenue, 1956, 350 U.S. 456, 76 S.Ct. 493, 100 L. Ed. 545. Where, however, as the trial court found to be the case here, the building's useful life will expire before the purchaser gains possession of it, and there is no indication the purchaser believes otherwise, the selling lessor has nothing to sell except the bare legal title, and the purchaser buys nothing more. We see no justification for allocating a portion of taxpayer's purchase price to, and thus establishing a cost basis in, the building when taxpayer purchased no interest of any substance in it.

Taxpayer places it reliance upon World Publishing Co. v. Commissioner of Internal Revenue, 8 Cir., 1962, 299 F.2d 614, which holds that depreciation is available because the purchasing lessor acquires the building as income producing property. That decision has received considerable criticism, and we decline to follow it.[4] It is the lease which produces the income, not a building which the lessee constructed and which is going to reach the end of its useful life before the taxpayer obtains possession. Taxpayer may have had a amortizable cost basis in the lease, but, as we have indicated, that question is not before us. Nor can we accept the distinction the Eighth Circuit draws in order to escape the force of the unanimous decisions reaching a contrary result where the lessor acquires the property by inheritance or devise. See the cases cited therein 299 F.2d at 618.[5]

Finally, taxpayer asserts that it had an interest in the building because the lessee, through default or otherwise, might prematurely terminate the lease before the expiration of the life of the building. The depreciable interest, if any, *cf.* Puerto Rico v. United States, 1 Cir., 1942, 132 F.2d 220, cert. denied 319 U.S. 752, 63 S.Ct. 1165, 87 L.Ed. 1706 is a highly speculative one, and the taxpayer had failed to prove its worth. It is obviously considerably less than the full value of the building. In this respect the Commissioner's finding of no depreciable interest must be presumed to be correct.

Affirmed.

4. *See, e. g.*, 76 Harv.L.Rev. 1303 (1963); 23 Md.L.Rev. 353 (1963); 1963 Wis.L. Rev. 484.

5. As the opinion in *World Publishing* recognizes, the depreciation provisions of the revenue laws make no distinction between purchased property and property acquired by inheritance or devise. Int.Rev.Code of 1954, § 167. The provisions for determining basis, on the other hand, are different. Purchased property has a basis of cost, while property taken by inheritance or devise has a basis of fair market value at the time of the transfer. Int. Rev.Code §§ 1012, 1014. However, an economically rational purchaser will pay the fair market value at the time of acquisition. If *World Publishing* is correct in distinguishing between persons acquiring by devise and by deed, both have acquired the same property, from the same type of predecessor, and have the same basis, but one can depreciate and the other cannot.

433 F.2d—80

Geneva Drive-In Theatre, Inc. v. Commissioner, 67 T.C. 764 (1977).

GENEVA DRIVE-IN THEATRE, INC., ET AL.,[1] PETITIONERS v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 8401–73, 8402–73, 8407–73. Filed January 31, 1977.

FEATHERSTON, *Judge:* Respondent determined the following deficiencies in petitioners' Federal income taxes:

Petitioner	*Tax year ended*	*Deficiency*
Geneva Drive-In Theatre, Inc	June 30, 1968	$4,190
	June 30, 1969	5,465
	June 30, 1970	5,458
	June 30, 1971	639
Las Vegas Theatrical Corp	Mar. 31, 1971	645
Concord Theatre Co	Mar. 31, 1968	5,244
	Mar. 31, 1969	3,072
	Mar. 31, 1970	2,530
	Mar. 31, 1971	3,712

The only issue for our decision is whether petitioners are entitled under section 167(a)[2] to depreciation deductions in respect of certain improvements erected or installed by the lessee of property acquired by petitioners subject to an outstanding lease.

FINDINGS OF FACT

Petitioners Geneva Drive-In Theatre, Inc. (hereinafter Geneva), Concord Theatre Co. (hereinafter Concord), and Las Vegas Theatrical Corp. (hereinafter Las Vegas) had their principal offices in San Francisco, Calif., on the date their petitions were filed. Geneva timely filed corporation income

No. 8402–73; Concord Theatre Co., docket No. 8407–73.

[2] All section references are to the Internal Revenue Code of 1954, as in effect during the tax years in issue, unless otherwise noted.

tax returns for the fiscal years ended June 30, 1968, June 30, 1969, June 30, 1970, and June 30, 1971, with the Internal Revenue Service Center at Ogden, Utah. Concord timely filed a corporation income tax return for the fiscal year ended March 31, 1968, with the District Director of Internal Revenue at San Francisco, Calif., and for the fiscal years ended March 31, 1969, March 31, 1970, and March 31, 1971, with the Internal Revenue Service Center at Ogden, Utah. Las Vegas timely filed a corporation income tax return for the fiscal year ended March 31, 1971, with the same Internal Revenue Service Center.

On March 3, 1950, John Huston (hereinafter Huston), owner of two parcels of unimproved real property in Alameda, Calif., leased those two parcels to Alameda Drive-In Theatre, a copartnership, composed of Phillip F. Hearty, Inc., a corporation, and Garmon Development Co., a corporation. Thereafter, Alameda Drive-In Theatre changed its name to Island Auto Movie, and for convenience the lessee in the lease agreement with Huston will be referred to as Island.

As a condition of the lease, Island was required to erect improvements so that the leased property could be operated as a drive-in theater. The lease provided that the "Lessee shall complete the erection and installation of such drive-in theatre by midnight on September 30, 1950." Island complied with the lease and erected theater improvements on the property. The lease expired on March 2, 1970.

Pursuant to the lease, the lessee was to insure the buildings and improvements against loss or damage. The proceeds from such insurance policies were to be available to the lessee to restore the insured property to its condition immediately preceding the loss. Should the insurance proceeds be insufficient to make needed repairs or construct new buildings or improvements, then the lessee was to provide the balance of the necessary funds. The lease provided that upon expiration or termination of the lease, for any reason, all buildings and improvements of any kind constructed by the lessee on the property would vest in the lessor as "absolute owner."

On April 9, 1965, Leslie M. Kessler and Albert H. Kessler, acting on behalf of Concord, and Raymond J. Syufy, acting on behalf of Geneva, purchased from Huston the two parcels of land leased to Island and two adjoining parcels for $400,000.

On June 17, 1965, an agreement was entered into between the owners of Concord and Raymond Syufy and Syufy Enterprises, acting for Geneva, to acquire the title to the four parcels of real estate and the improvements thereon. Concord and Syufy Enterprises, acting for Geneva, were each to acquire an undivided one-half interest in such parcels. A one-half undivided interest in the title to the four parcels and the improvements thereon, originally taken in the name of Concord, was thereafter transferred to Geneva by a corporation grant deed dated July 6, 1965.

Geneva and Concord incurred expenses in the amount of $4,907 in acquiring the property from Huston. Upon acquisition of the property, Concord and Geneva formed a California general partnership known as Alameda Properties Joint Venture (hereinafter Alameda) which had its principal office in San Francisco, Calif. Alameda later changed its name to Island Auto Movies Co. (Island Auto).

In 1970, Las Vegas became a general partner in Island Auto with Geneva and Concord by purchasing a fractional interest from Geneva. Island Auto timely filed a 1970 United States Partnership Return of Income with the Internal Revenue Service Center at Fresno, Calif.

Alameda originally allocated $165,000 of the $404,907 purchase price (including expenses) paid in 1965 to the land and the remaining $239,907 was allocated to the following assets:

	Percent of purchase price	*Basis*
Snack bar building	10.970	$26,000
Paving	27.004	64,000
Underground drain	5.063	12,000
Electrical wiring	13.713	32,500
Speaker poles	1.055	2,500
Fence	2.532	6,000
Marquee	2.110	5,000
Marquee letters	.633	1,500
Projection of sound equipment	10.127	24,000
Speakers and projection boxes	5.063	12,000
Miscellaneous equipment	10.549	25,000
Screen tower	5.063	12,000

Playground equipment	.422	1,000
Ticket and vending machines	1.266	3,000
Subrental building	3.164	7,500
Box office building	1.266	3,000
	100.000	237,000

The parties have agreed to adjust the allocation of the purchase price and expenses to attribute $204,847 to the land.

When petitioners purchased the property in 1965, the anticipated useful life of the improvements exceeded the term of the lease. Alameda claimed depreciation on the assets and improvements acquired from Huston commencing in 1965, using a 9-year composite useful life.

In his notice of deficiency, respondent disallowed petitioners' claimed deductions for depreciation on the leasehold improvements for the taxable years 1967 through 1969 as follows:

> On July 2, 1965, the partnership Island Auto Movies Co. (formerly Alemeda [sic] Properties Joint Venture) acquired land and a lease thereon at a cost of $404,907.00. This lump sum amount was allocated as follows: land $165,000.00 and 16 types of depreciable assets $239,907.00. Depreciation thereafter was claimed on the latter amount using a 9 year composite life. The 16 types of depreciable assets consisted of leasehold improvements and personal property previously erected or acquired by the lessee for use in his business. Under the terms of the lease the lessee was required on March 2, 1970, to surrender possession to those assets as well as the land.
>
> It is determined (1) that $204,847.00 represents the value of the land as previously agreed upon (2) that the remainder of $200,060.00 represents the value of the right under the lease to acquire the 16 types of depreciable assets on March 2, 1970, and no depreciation is allowable thereon until that event occurred. * * *

OPINION

Section 167(a)[3] permits the deduction of a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property which is (1) used in the taxpayer's trade or business or (2) held for the production of income. To qualify

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[3] SEC. 167. DEPRECIATION.

(a) GENERAL RULE.—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

for this deduction the taxpayer has the burden of proving that he has a depreciable interest in the property in the sense that he has made an investment in it and will suffer the economic loss resulting from its deterioration through obsolescence or use. See *Barnes v. United States*, 222 F.Supp. 960, 962 (D. Mass. 1963), affd. sub nom. *Buzzell v. United States*, 326 F.2d 825 (1st Cir. 1964), and cases cited therein. The allowance is intended "to approximate and reflect the financial consequences to the taxpayer of the subtle effects of time and use on the value of his capital assets." *Detroit Edison Co. v. United States*, 319 U.S. 98, 101 (1943).

Accordingly, in the instant case, when Huston on March 3, 1950, leased his unimproved real property to Island for 20 years and Island erected or installed the drive-in theater facilities at its cost, Island, as lessee, became entitled to deductions for depreciation of the property items comprising the installation. Sec. 1.167(a)–4,[4] Income Tax Regs. Island made the capital outlay for the construction and installation of such items, and they were used in its business. The depreciation deductions enabled Island to recover, tax wise, the economic loss it suffered as a result of the deterioration of the improvements through use or obsolescence. Huston was not entitled to depreciate the facilities because he made no investment and had no depreciable interest in them. They were not used in his trade or business or held for the production of income. The rent which he received compensated him only for the use of the land, a nondepreciable asset.

The crucial issue is whether, despite the fact that Huston was not entitled to depreciation deductions in respect of the theater installation, petitioners qualified for such deductions

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[4] The rule is succinctly stated in sec. 1.167(a)–4, Income Tax Regs., in part as follows:

Capital expenditures made by a lessee for the erection of buildings or the construction of other permanent improvements on leased property are recoverable through allowances for depreciation or amortization. If the useful life of such improvements in the hands of the taxpayer is equal to or shorter than the remaining period of the lease, the allowances shall take the form of depreciation under section 167. * * * If, on the other hand, the estimated useful life of such property in the hands of the taxpayer, determined without regard to the terms of the lease, would be longer than the remaining period of such lease, the allowances shall take the form of annual deductions from gross income in an amount equal to the unrecovered cost of such capital expenditures divided by the number of years remaining of the term of the lease. * * *

immediately upon their 1965 purchase of Huston's interest. We hold they did not. However, petitioners may recover through depreciation deductions beginning March 2, 1970, the date the lease terminated, their $200,000 investment in excess of the amount paid for the purchased land. The depreciation allowance in respect of this $200,000 investment will be spread over the useful life of the theater facilities remaining after that date.

When petitioners bought Huston's interest in the land and improvements in 1965, he conveyed to them the property subject to the lease. Petitioners acquired only such rights as Huston had: (1) Legal title to the land, subject to the lease; (2) the right to receive the rent prescribed by the lease for the use of the land; and (3) the right to have the land and theater improvements revert to them, as provided in the lease, upon its termination. Other than this reversionary interest, petitioners acquired no present interest in the theater improvements.

The land is not a depreciable asset, and petitioners have not shown that they paid any premium for the assignment of the lease which would entitle them to amortization deductions for the remainder of its term. Compare *Schubert v. Commissioner*, 286 F.2d 573, 580–583 (4th Cir. 1961), affg. 33 T.C. 1048 (1960), cert. denied 366 U.S. 960 (1961); *Commissioner v. Moore*, 207 F.2d 265, 277 (9th Cir. 1953), revg. and remanding 15 T.C. 906 (1950), cert. denied 347 U.S. 942 (1954). Indeed, the evidence is to the contrary.[5] Clearly, therefore, petitioners are not entitled to depreciation or amortization deductions in respect of either the land or the lease as such.

Nor are petitioners entitled to depreciation deductions in respect of the theater improvements until after the expiration of the lease term. Prior thereto, petitioners' interest in the improvements was not used by them in their business. The improvements could produce no income for petitioners until the lease terminated and their interest ripened into owner-

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[5] The parties have stipulated that, of the $404,907 purchase price, $204,847 was allocable to the land and the remainder to the improvements. The existence of the lease was regarded as unimportant. Raymond Syufy, who participated in the negotiation of petitioners' purchase, testified:

Q. Did you consider the lease that these properties were subject to?

A. No, the lease wasn't considered at all. I didn't care about the lease.

ship of the improvements. Their interest in the improvements did not diminish in value as a result of the passage of time but, instead, increased in value as the time for the actual enjoyment of the improvements approached. See *Goelet v. United States*, 161 F.Supp. 305, 310 (S.D. N.Y. 1958), affd. 266 F.2d 881 (2d Cir. 1959).

The improvements may have deteriorated in value as they were used in Island's business between the date of petitioners' 1965 acquisition and the lease termination on March 2, 1970, but petitioners did not suffer any economic loss as a result of that deterioration. The purchase price petitioners paid Huston no doubt took into account the facts that, under the lease, the theater improvements would not become petitioners' property until the lease terminated and that petitioners would receive them in their deteriorated condition as of the lease termination date.[6] Petitioners paid nothing for any substantial immediate interest in the improvements and acquired none other than the reversionary interest.[7]

We think it quite clear that petitioners' reversionary interest in the theater improvements was not a depreciable one. See *M. DeMatteo Construction Co. v. United States*, 433 F.2d 1263, 1265 (1st Cir. 1970); *Schubert v. Commissioner, supra* at 578–580; *Commissioner v. Moore, supra* at 269; *Goelet v. United States, supra* at 309–310. Upon the termination of the lease on March 2, 1970, when the theater improvements reverted to petitioners, their interest ripened into a depreciable one. They then became entitled to annual depreciation deductions in such amounts as to enable them to recover over

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[6] The Mar. 3, 1950, lease provided:

Lessee will * * * surrender, yield up and deliver to Lessor the possession of the said real property, together with the buildings, improvements and appurtenances thereunto belonging, and the items specified * * *, in as good condition as when the same were constructed by Lessee, ordinary wear and tear thereof excepted.

It is clear, therefore, that whatever depreciation occurred between 1965 and 1970 was suffered by the lessee.

[7] Petitioners' position is similar in many respects to that of a purchaser of depreciable property under an executory contract of sale. In such situations, even though the property may deteriorate during the period between the contract and delivery dates, the purchaser is entitled to no depreciation deductions until the contract is fully executed and the purchaser has taken possession and assumed the burdens of ownership. See *Charles C. Hanson*, 23 B.T.A. 590, 604 (1931); Rev. Rul. 69–89, 1969–1 C.B. 59; Rev. Rul. 68–431, 1968–2 C.B. 99.

the improvements' remaining useful lives the $200,000 of the purchase price allocable to them.

There may be situations where lessee-constructed improvements enhance the value of real property acquired subject to a lease. Such improvements, for example, may provide added assurance that the land rent to which the purchaser becomes entitled will be collectible. In that sense the deterioration or obsolescence of the improvements prior to the expiration of the lease may tend to cause the purchaser's investment to depreciate. In the final analysis, however, the existence of improvements in such circumstances adds value to the lease which produces income to the purchaser, and in appropriate cases the courts have indicated that the premium value of the lease is amortizable. See *Commissioner v. Moore, supra* at 277; *Schubert v. Commissioner, supra* at 580–583. On the other hand, in other cases, where the purchaser may be required to remove or rebuild deteriorated or obsolete structures, their existence may be a negative factor in the purchase. Careful attention, therefore, must be given to the facts of the individual case.

The evidence is explicit in the instant case that the improvements had value beyond the lease term. The purchasers were not interested in acquiring the lease as an investment. This is clear from the fact that none of the purchase price was allocated to the leasehold interest itself. In return for their disputed investment, petitioners acquired only a reversionary interest in the improvements which would ripen into ownership and the right to possession only upon the termination of the lease. Not until then would petitioners be able to use the improvements in their business or hold them for the production of income, and not until then would they suffer any loss as a result of the depreciation or obsolescence of these improvements.

Petitioners' reliance on *World Publishing Co. v. Commissioner*, 299 F.2d 614 (8th Cir. 1962), revg. 35 T.C. 7 (1960), is misplaced. In that case the taxpayer purchased for $700,000 an improved lot subject to a 50-year lease having 28 years to run. The unimproved land was appraised at $400,000 and a building erected by the tenant at the outset of the lease was appraised at $300,000. It was stipulated that the building would be without value by the time the lease expired. The court was faced with the issue as to how the taxpayer would be permitted to recover the $300,000 investment in excess of the land value. The court allowed the $300,000 to be deducted ratably over the remaining years of the lease.[8]

The *World Publishing* Co. opinion holds that the $300,000 was amortizable as a premium paid by the taxpayer for the favorable aspects of the lease and not as depreciation of the building. It is almost inconceivable that the taxpayer in that case would have paid $300,000 for a building which, as such, would provide it with no income and would have no value when the lease was terminated. In fact, the opinion enumerates 11 provisions of the lease which, in addition to rentals averaging $28,000 per year over the remaining 28 years of the lease term, conferred various benefits and rights upon the lessor and, as a result of the purchase, upon the taxpayer. While portions of the opinion could be interpreted to refer to the building as a wasting asset, the holding was (299 F.2d at 617) that: "The taxpayer's spreading of the wasting portion of its purchase price over the entire remaining lease term by the straight-line method approximated the minimal deduction for the taxpayer." Had the court intended to hold, as petitioners here maintain, that the taxpayer-purchaser was entitled to depreciate the building as such, the depreciable period would have been keyed to the remaining useful life of the building rather than the unexpired portion of the lease term.[9] In the instant case, petitioners make no claim to a right to amortize the lease over its remaining term and the opinion, therefore, is not apposite.

Even if petitioners are correct in their position that the *World Publishing* Co. opinion was intended to allow depreciation on the building as such, the case is nonetheless

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[8] The opinion is discussed in Note, 76 Harv. L. Rev. 1303 (1963); see also analyses of the opinion in Quilliam, "Depreciation of Property Acquired Subject to a Lease: Premium Lease Rentals as a Wasting Asset," 4 Valparaiso U. L. Rev. 261 (1969); Note, 23 Md. L. Rev. 353 (1963); *M. DeMatteo Construction Co. v. United States*, 433 F.2d 1263, 1265 (1st Cir. 1970). The opinion does not indicate that either party suggested that the $300,000 was allocable to the basis for the land on the theory the purchase was a bad bargain. Quite obviously, the reversionary interest in the building was without value.

[9] The court pointed out that under Nebraska law the taxpayer as purchaser of the land acquired legal title to the building. However, the location of the legal title does not govern the right to depreciation deductions. *Helvering v. Lazarus & Co.*, 308 U.S. 252 (1939); *First Nat. Bank of Kansas City v. Nee*, 190 F.2d 61, 68 (8th Cir. 1951).

distinguishable from the instant one. The *World Publishing Co.* lease permitted the lessor, up to a stated percentage of the ground value, to borrow money on the security of the property and the lien securing the loan would be prior to the claim of the lessee. Also, the lessor had the right to attach any mortgage clause the lessor's mortgagee might require in the insurance policies maintained by the lessee. These and other rights acquired by the taxpayer under the purchase agreement may be said to constitute a present interest in the building. Such rights far exceed the rights petitioners acquired in the theater improvements in the instant case, and the case is distinguishable from the instant one on that ground.

Nor does either *Millinery Corp. v. Commissioner,* 350 U.S. 456 (1956), or *Wilshire Medical Properties, Inc. v. United States,* 314 F.2d 333 (9th Cir. 1963),[10] aid petitioners. In those cases, the taxpayers had rented vacant land under long-term leases, constructed buildings on such land, and depreciated the buildings. They then acquired the fee interest before the useful lives of the buildings expired, and the courts held that the purchases gave the taxpayers new bases in the buildings to the extent that the amounts paid were allocable to the buildings. Such amounts were recoverable through depreciation deductions. The case *Wagner v. Commissioner,* 518 F.2d 655 (10th Cir. 1975), relied upon by petitioners, is likewise distinguishable on its facts.

One other argument is advanced, but not clearly articulated, by petitioners. The notice of deficiency determines that the portion of the purchase price not allocable to the value of the land acquired by petitioners on July 2, 1965, "represents the value of the right under the lease to acquire the 16 types of depreciable assets on March 2, 1970." Petitioners argue that, if they purchased a right to acquire assets, such right was an intangible asset which expired with the termination of the lease, and they are entitled to amortize its cost over the unexpired portion of the lease term as of the date of the purchase, citing section 1.167(a)–3, Income Tax Regs.

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[10] The facts stated in *Wilshire Medical Properties, Inc. v. United States,* 314 F.2d 333 (9th Cir. 1963), are abbreviated but are more fully stated in the District Court's unreported opinion (S.D. Cal. 1961, 7 AFTR 2d 1412, 61–1 USTC par. 9446).

We find no merit in this argument. We interpret the notice of deficiency to refer to the right which petitioners acquired to have the theater improvements revert to them as purchasers from the lessor upon the expiration of the lease. This right did not decrease in value as a result of the passage of time. Rather, as pointed out above, it increased in value as the time for the actual enjoyment of the improvements approached. Indeed, petitioners' own witness testified that the theater improvements were considerably more valuable in 1970 than the amount petitioners paid for them in 1965.[11]

To reflect the foregoing and the disposition of other issues,

Decisions will be entered under Rule 155.

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[11] Petitioners' witness testified as follows:

Q. Could you have purchased this property, this same property in 1970 for the same price that you paid in 1965?

A. No, sir. It would have been considerably more.

Q. In your opinion how much could the property have been sold for in 1970?

A. Probably 50 percent more.

Geneva Drive-In Theatre, Inc. v. Commissioner, 622 F.2d 995 (9th Cir. 1980).

Appeal from a Decision of the United States Tax Court.

Before ANDERSON and TANG, Circuit Judges, and WYATT,* District Judge.

PER CURIAM:

The issue in these consolidated cases is whether the taxpayers are entitled under Int.Rev.Code § 167(a) to depreciation deductions in respect of certain improvements erected by the lessee of property acquired by taxpayers subject to the outstanding lease. The Commissioner disallowed the claimed deductions for the years in question. The Tax Court, in an opinion reported at 67 T.C. 764 (1977), agreed with the Commissioner. We affirm the decision of the Tax Court for the reasons set forth in its opinion but with one modification.

I.

In 1950, lessor John Huston owned certain unimproved land. In that year he leased the land to lessee Island Auto Movie. The lease ran until March 2, 1970. Under the lease, the lessee was to build and maintain certain improvements and facilities on the land so that the property could be used as a drive-in movie theater. The lessee was required to keep the improvements in good condition. It was also required to insure the buildings and, if needed, use the proceeds to restore them. On expiration of the lease, all buildings and improvements would vest in the lessor as absolute owner. The facts are set out more fully in the Tax Court's opinion, 67 T.C. at 765–68.

In 1965, the taxpayers purchased from Huston the land and his interest under the lease. Of the total purchase price, it is agreed that approximately $200,060 is allocated and attributable to the improvements in question, while approximately $204,847 is allocated and attributable to purchasing the raw land. At the time of taxpayers' purchase in 1965, the anticipated remaining composite useful life of the improvements was nine years, which exceeded the remaining time on the lease. Taxpayers claimed depreciation deductions on the assets and improvements commencing in 1965, using the nine-year composite useful life basis.

In the notice of deficiency, the Commissioner disallowed the claimed depreciation deductions for the taxable years 1967 through 1969 and recomputed the tax owing. The Commissioner's view, with which the Tax Court agreed, is that in these circumstances the taxpayers are not entitled to the depreciation deductions until after the lease expires and the taxpayer-lessors come into possession. Thus, it is not disputed that these taxpayers may deduct the depreciation for their capital investment in these assets. The question is when. The Tax Court held the depreciation should be claimed in the period after the lease, *see* 67 T.C. at 770, whereas the taxpayers wish to take the depreciation over the entire nine-year life from 1965.

II.

[1] The Tax Court concluded that the taxpayers had purchased a reversionary interest, that the taxpayers' interest in the improvements was not a business or income-producing property of taxpayers until the lease terminated, that the taxpayers' investment suffered no economic loss prior to 1970, and that the taxpayers did not pay a premium for the lease. These determinations require interpretation of the particular facts of this case. The Tax Court's findings of fact and inferences from facts will be upset on appeal only if clearly erroneous. *See, e. g., Commissioner v. Duberstein,* 363 U.S. 278, 291, 80 S.Ct. 1190, 1199, 4 L.Ed.2d 1218 (1960); *Hunsaker v. Commissioner,* 615 F.2d 1253, 1256, 1258 (9th Cir. 1980); *First Security Bank v. Commissioner,* 592 F.2d 1050, 1053 (9th Cir. 1979); *Paxton v. Commissioner,* 520 F.2d 923, 925 (9th Cir.), *cert. denied,* 423 U.S. 1016, 96 S.Ct. 450, 46 L.Ed.2d 389 (1975). *See also Sibla v. Commissioner,* 611 F.2d 1260, 1262–

* Honorable Inzer B. Wyatt, Senior United States District Judge for the Southern District of New York, sitting by designation.

63 (9th Cir. 1980). The burden is on the one appealing to show such clear error on the tax court's part. *See Estate of Meyer v. Commissioner*, 503 F.2d 556, 557 (9th Cir. 1974).

[2] In the cases at bar, the taxpayers have not shown that the Tax Court's factual determinations are clearly erroneous. In view of those facts, the Tax Court's decision on the taxpayers' entitlement to depreciation was the correct application of law. Prior to termination of the lease, the taxpayers did not meet two of the prerequisites for a depreciation deduction. First, they did not hold the improvements for the production of income. *See M. DeMatteo Constr. Co. v. United States*, 433 F.2d 1263, 1265 (1st Cir. 1970); *Schubert v. Commissioner*, 286 F.2d 573, 580 (4th Cir.), *cert. denied*, 366 U.S. 960, 81 S.Ct. 1919, 6 L.Ed.2d 1253 (1961). Second, the taxpayers' investment in the improvements did not erode prior to 1970, see 67 T.C. at 771. They did not suffer economic loss from obsolescence or use, and so did not qualify for the deduction. *See Commissioner v. Moore*, 207 F.2d 265, 268–69 (9th Cir. 1953), *cert. denied*, 347 U.S. 942, 74 S.Ct. 637, 98 L.Ed. 1091 (1954). We believe the Tax Court's opinion correctly pointed out the distinctions between the cases at bar and *World Publishing Co. v. Commissioner*, 299 F.2d 614 (8th Cir. 1962). *See* 67 T.C. at 772–74.

We disagree with the analysis of the Tax Court in one respect. Among the reasons why the taxpayers did not suffer economic loss, the Tax Court said: "[The taxpayers'] interest in the improvements did not diminish in value as a result of the passage of time but, instead, increased in value as the time for the actual enjoyment of the improvements approached." 67 T.C. at 771.

Insofar as this makes entitlement to depreciation depend upon actual changes in market value, it is erroneous. "[T]ax law has long recognized the accounting concept that depreciation is a process of estimated allocation which does not take account of fluctuations in valuation through market appreciation." *Fribourg Navigation Co. v. Commissioner*, 383 U.S. 272, 277, 86 S.Ct. 862, 865, 15 L.Ed.2d 751 (1966). Indeed, if increase in market value affected depreciability, few investments in real property would be entitled to depreciation under recent market conditions. However, this error does not affect the result because there were ample other grounds to say the taxpayers between 1965 and 1970 did not have an economically wasting asset.

The decision of the Tax Court is AFFIRMED.

Section 1031 and History Highlights

Sec. 1031 [1986 Code]. (a) NONRECOGNITION OF GAIN OR LOSS FROM EXCHANGES SOLELY IN KIND.—

(1) IN GENERAL.—No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.

(2) EXCEPTION.—This subsection shall not apply to any exchange of—

(A) stock in trade or other property held primarily for sale,

(B) stocks, bonds, or notes,

(C) other securities or evidences of indebtedness or interest,

(D) interests in a partnership,

(E) certificates of trust or beneficial interests, or

(F) choses in action.

For purposes of this section, an interest in a partnership which has in effect a valid election under section 761(a) to be excluded from the application of all of subchapter K shall be treated as an interest in each of the assets of such partnership and not as an interest in a partnership.

(3) REQUIREMENT THAT PROPERTY BE IDENTIFIED AND THAT EXCHANGE BE COMPLETED NOT MORE THAN 180 DAYS AFTER TRANSFER OF EXCHANGED PROPERTY.—For purposes of this subsection, any property received by the taxpayer shall be treated as property which is not like-kind property if—

(A) such property is not identified as property to be received in the exchange on or before the day which is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange, or

(B) such property is received after the earlier of—

(i) the day which is 180 days after the date on which the taxpayer transfers the property relinquished in the exchange, or

(ii) the due date (determined with regard to extension) for the transferor's return of the tax imposed by this chapter for the taxable year in which the transfer of the relinquished property occurs.

(b) GAIN FROM EXCHANGES NOT SOLELY IN KIND.—If an exchange would be within the provisions of subsection (a), of section 1035(a), of section 1036(a), or of section 1037(a), if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(c) LOSS FROM EXCHANGES NOT SOLELY IN KIND.—If an exchange would be within the provisions of subsection (a), of section 1035(a), of section 1036(a), or of section 1037(a), if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without the recognition of gain or loss, but also of other property or money, then no loss from the exchange shall be recognized.

(d) BASIS.—If property was acquired on an exchange described in this section, section 1035(a), section 1036(a), or section 1037(a), then the basis shall be the same as that of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized on such exchange. If the property so acquired consisted in part of the type of property permitted by this section, section 1035(a), section 1036(a), or section 1037(a), to be received without the recognition of gain or loss, and in part of other property, the basis provided in this subsection shall be allocated between the properties (other than money) received, and for the purpose of the allocation there shall be assigned to such other property an amount equivalent to its fair market value at the date of the exchange. For purposes of this section, section 1035(a), and section 1036(a), where as part of the consideration to the taxpayer another party to the exchange assumed a liability of the taxpayer or acquired from the taxpayer property subject to a liability, such assumption or acquisition (in the amount of the liability) shall be considered as money received by the taxpayer on the exchange.

(e) EXCHANGES OF LIVESTOCK OF DIFFERENT SEXES.—For purposes of this section, livestock of different sexes are not property of a like kind.

(f) SPECIAL RULES FOR EXCHANGES BETWEEN RELATED PERSONS.—

(1) IN GENERAL.—If—

(A) a taxpayer exchanges property with a related person,

(B) there is nonrecognition of gain or loss to the taxpayer under this section with respect to the exchange of such property (determined without regard to this subsection), and

(C) before the date 2 years after the date of the last transfer which was part of such exchange—

(i) the related person disposes of such property, or

(ii) the taxpayer disposes of the property received in the exchange from the related person which was of like kind to the property transferred by the taxpayer,

there shall be no nonrecognition of gain or loss under this section to the taxpayer with respect to such exchange; except that any gain or loss recognized by the taxpayer by reason of this subsection shall be taken into account as of the date on which the disposition referred to in subparagraph (C) occurs.

(2) CERTAIN DISPOSITIONS NOT TAKEN INTO ACCOUNT.—For purposes of paragraph (1)(C), there shall not be taken into account any disposition—

(A) after the earlier of the death of the taxpayer or the death of the related person,

(B) in a compulsory or involuntary conversion (within the meaning of section 1033) if the exchange occurred before the threat or imminence of such conversion, or

(C) with respect to which it is established to the satisfaction of the Secretary that neither the exchange nor such disposition had as one of its principal purposes the avoidance of Federal income tax.

(3) RELATED PERSON.—For purposes of this subsection, the term "related person" means any person bearing a relationship to the taxpayer described in section 267(b) or 707(b)(1).

(4) TREATMENT OF CERTAIN TRANSACTIONS.—This section shall not apply to any exchange which is part of a transaction (or series of transactions) structured to avoid the purposes of this subsection.

(g) SPECIAL RULE WHERE SUBSTANTIAL DIMINUTION OF RISK.—

(1) IN GENERAL.—If paragraph (2) applies to any property for any period, the running of the period set forth in subsection (f)(1)(C) with respect to such property shall be suspended during such period.

(2) PROPERTY TO WHICH SUBSECTION APPLIES.—This paragraph shall apply to any property for any period during which the holder's risk of loss with respect to the property is substantially diminished by—

(A) the holding of a put with respect to such property,

(B) the holding by another person of a right to acquire such property, or

(C) a short sale or any other transaction.

(h) SPECIAL RULE FOR FOREIGN REAL PROPERTY.—For purposes of this section, real property located in the United States and real property located outside the United States are not property of a like kind.

Committee Reports for P.L. 99-514

.035 [Technical Corrections to the Tax Reform Act of 1984]

e. Like-kind exchanges * * *

Present Law.—Under the Code (section 1031), generally no gain or loss is recognized if property held for productive use in the taxpayer's trade or business, or property held for investment purposes, is exchanged solely for property of a like-kind that is also to be held for productive use in a trade or business or for investment.

The Act provides that, for purposes of the like-kind exchange provision, property which was not identified as the property to be received by the taxpayer on the date the taxpayer relinquishes property, or before the day which is 45 days after that date, does not qualify as like-kind property.

Explanation of Provision.—The bill specifies that like-kind property includes property identified as the property to be received by the taxpayer on or before (rather than only before) the date which is 45 days after the date on which the taxpayer relinquishes property.—House Committee Report.

Senate Committee Report.—[Same as House Committee Report.]

* * *

The Conference agreement follows the House and the Senate amendment.—Conference Committee Report.

Committee Reports on P.L. 98-369

Reasons for Change

Deferred like-kind exchanges

.037 The committee is concerned that like-kind treatment of nonsimultaneous exchanges has given rise to unintended results and administrative problems. These concerns extend to the underlying policy of the like-kind exchange rule.

The special treatment of like-kind exchanges has been justified on the grounds that a taxpayer making a like-kind exchange has received property similar to the property relinquished and therefore has not effectively "realized" a profit on the transaction. This rationale is less applicable in the case of deferred exchanges. To the extent that the taxpayer is able to defer completion of the transaction—often retaining the right to designate the property to be received at some future point—the transaction begins to resemble less a like-kind exchange and more a sale of one property followed, at some future point, by a purchase of a second property or properties. This is particularly true when (as was the case in the *Starker v. United States*) the taxpayer might have received like-kind or non-like-kind property in the future. The committee believes that like-kind exchange treatment is inappropriate in such situations and that the general rule requiring recognition of gain on sales or exchanges of property should apply to these cases.

The special treatment of like-kind exchanges has also been justified from an administrative standpoint because of the difficulty of valuing property which is exchanged solely or primarily for similar property. This rationale may also be less applicable to deferred like-kind exchanges, in particular exchanges which are "left open" until the taxpayer has selected a suitable exchange property. In such cases, the transferred property must be valued at a specific or near-specific dollar amount in order to determine the aggregate value of the properties that the taxpayer may receive in the future. Thus, the taxpayer's gain may be measured with reasonable accuracy in the year of the original transfer.

The committee is also concerned that the like-kind exchange rules significantly expand the ability of taxpayers to avoid recognition of gain on deferred payment sales. Unlike other nonrecognition rules (e.g., the rollover of gain on replacement of a principal residence), the like-kind exchange provisions have no express statutory time limit on the availability of nonrecognition treatment. Decisions such as that in *Starker v. United States* suggest that there may, in fact, be no limit on the time for which like-kind exchanges may be kept open. If this is the case, taxpayers, by combining the installment sale rules and the like-kind exchange provisions, may defer taxation on dispositions of property for an indefinite period of time, even if a right to receive cash instead of property is retained. If cash is ultimately received, the installment sale rules will achieve a deferral until the time of receipt, while if like-kind property is received, recognition will be even further delayed. By exercising the right to designate property shortly before death, a taxpayer may conceivably avoid any taxation on the sale. Interaction of the installment sale and like-kind exchange rules also raises serious administrative problems regarding the allocation of liabilities and basis among different properties, problems which may not be resolvable until all exchanges and payments required by the agreement have been completed. Thus the tax consequences of deferred exchanges may not be determined for many years after the transaction is initiated.

Exchanges of partnership interests

It is questionable whether the like-kind exchange provisions were originally intended to apply to exchanges of partnership interests. The statute by its own terms does not apply to exchanges of stock, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest (sec. 1031). These exclusions prevent taxpayers from trading investment interests so as to take advantage of like-kind treatment on dispositions of appreciated property. The committee believes that, at least under current conditions, partnership interests typically represent investment interests similar to those items already excluded from like-kind treatment and should therefore also be excluded from such treatment.

In reaching the decision above, the committee is particularly concerned by the use of the like-kind exchange rules to facilitate the exchange of interests in tax shelter investments for interests in other partnerships. Under this arrangement, taxation of the gain inherent in an interest in a "burned out" tax shelter partnership—i.e., a partnership which has taken substantial deductions for nonrecourse liabilities without actually paying off such liabilities, and hence without the partners suffering real economic loss—may be able to be avoided if the interest is exchanged, tax-free, for an interest in another partnership, provided the old partnership has a section 754 election in effect and the new partnership does not. While court decisions have limited like-kind exchange treatment to partnerships holding similar underlying assets, this rule may be inadequate to deal with the burned-out tax shelter abuses and the administrative hardships. The committee believes that such abuses and hardships are best prevented by specifically excluding partnership interests from the like-kind exchange rule.

Explanation of Provisions

Deferred like-kind exchanges

The bill provides that, for purposes of the like-kind exchange provision, any property received by the taxpayer more than 180 days (but not later than the due date of the taxpayer's return) after the date on which the taxpayer relinquishes property is not to be treated as like-kind property. Thus, tax-free treatment will be unavailable for exchanges not completed within this time period. In addition, property which was not identified as the property to be received by the taxpayer on the date the transferred property was relinquished will not qualify as like-kind property.

Exchanges of partnership interests

The bill specifies that the like-kind exchange rules do not apply to any exchange of interests in different partnerships. This rule is not intended to apply to an exchange of interests in the same partnership.

No inference should be drawn from the committee's action regarding the proper treatment of these transactions under present law. * * *

House bill

The House bill provides that, for purposes of the like-kind exchange provision, any property received by the taxpayer more than 180 days after the date on which the taxpayer relinquishes property (or after the due date of the taxpayer's tax return) is not to be treated as like-kind property.

Also, the like-kind exchange rules will not apply to any exchange of interests in different partnerships. * * *

Senate amendment

The Senate amendment generally is the same as the House bill, with two modifications. First, property which was not identified as the property to be received by the taxpayer on the date the transferred property was relinquished will not qualify as like-kind property. Second, the provisions apply to transfers after the date of enactment.

Conference agreement

The conference agreement follows the Senate amendment except that transferors are permitted 45 days after the transfer to designate the property to be received and that a modified form of the effective date provisions of the House bill are adopted. The conferees note that the designation requirement in the conference agreement may be met by designating the property to be received in the contract between the parties. It is anticipated that the designation requirement will be satisfied if the contract between the parties specifies a limited number of properties that may be transferred and the particular property to be transferred will be determined by contingencies beyond the control of both parties. For example, if A transferred real estate in exchange for a promise by B to transfer property 1 to A if zoning changes are approved and property 2 if they are not, the exchange would qualify for like-kind treatment. As under present law, these new rules would not permit a taxpayer who receives cash and later purchases the designated property to claim like-kind exchange treatment.

Effective dates

The provision relating to deferred like-kind exchanges is effective for transfers after the date of enactment. For transfers on or before date of enactment, any property received after December 31, 1986, will not be treated as like-kind property, except if the property to be received was designated in a written binding contract entered into before June 14, 1984, then the property must be received on or before December 31, 1988. The provision relating to partnership exchanges is effective for transfers of property after the date of enactment other than the exchanges made pursuant to binding contracts entered into on or before March 1, 1984. In the case of any transfer on or before the date of enactment which the taxpayer treated as part of a like-kind exchange and which is liable as a result of this provision, the period for assessing any deficiency of tax shall not expire prior to January 1, 1988.

The conference agreement also provides that the prohibition on like-kind exchange treatment for transfers of partnership interests is not to apply when general partnership interests are exchanged pursuant to a plan of reorganization of ownership interests which took effect on March 29, 1984, provided that all of the exchanges contemplated by the reorganization plan are completed on or before December 31, 1984.—Conference Committee Report.

Revenue Reconciliation Act of 1989

[Conference Committee Report]

The conference agreement includes the provision from the House bill.

Limitation on Nonrecognition of Gain

[Senate Committee Report]

[Like-kind exchanges]

If a taxpayer exchanges property with a related party (as defined for purposes of sec. 267) and the taxpayer would otherwise be eligible for nonrecognition treatment with respect to the exchange of such property under section 1031, and within two years of the date of the last transfer which was part of the exchange, either the related party disposes of such property or the taxpayer disposes of the like-kind property received in the exchange from the related party, then the original exchange will not qualify for nonrecognition under section 1031. Any gain or loss not recognized by the taxpayer as of the date of the original exchange will, subject to the loss limitation rules of section 267, be recognized as of the date of the subsequent disposition. Adjustments to the basis of the properties involved in the exchange also will be made as of the date of the subsequent disposition.

A disposition of the property will not invalidate the nonrecognition treatment of the original exchange if such disposition is due to the death of either party or the involuntary conversion of the property (within the meaning of section 1033), provided that the original exchange occurred before the threat or imminence of the conversion. A disposition also will not invalidate the nonrecognition treatment of the original exchange if it is established to the satisfaction of the Secretary of the Treasury that neither the exchange nor the disposition had as one of its principal purposes the avoidance of Federal income tax. It is intended that the non-tax avoidance exception generally will apply to: (i) a transaction involving an exchange of undivided interests in different properties that results in each taxpayer holding either the entire interest in a single property or a larger undivided interest in any of such properties; (ii) dispositions of property in nonrecognition transactions; and (iii) transactions that do not involve the shifting of basis between properties.

A disposition includes indirect dispositions of the property, such as by means of the disposition of the stock of a corporation or interests in a partnership that owns the property.

Nonrecognition will not be accorded to any exchange which is part of a transaction or series of transactions structured to avoid the purposes of the related party rules. For example, if a taxpayer, pursuant to a prearranged plan, transfers property to an unrelated party who then exchanges the property with a party related to the taxpayer within two years of the previous transfer in a transaction otherwise qualifying under section 1031, the related party will not be entitled to nonrecognition treatment under section 1031.

The running of the two-year holding period will be suspended during any period with respect to which a party's risk of loss with respect to the property is substantially diminished.

Effective Date.—The provision applies to transfers after July 10, 1989, other than transfers pursuant to a written binding contract in effect on July 10, 1989 and at all times thereafter before the transfer. For this purpose, a written contract which, on July 10, 1989, and at all times thereafter before the transfer, obligates the taxpayer to transfer the property to another party will not fail to qualify as a binding contract solely because it provides in the alternative for an exchange or a sale, or solely because the property to be received in the exchange was not identified on or before July 10, 1989.

[Conference Committee Report]

The conference agreement follows the Senate amendment, except that foreign real property and U.S. real property are not property of a like kind for purposes of section 1031. Although such properties are not of a like kind within the meaning of section 1031, this rule does not, however, apply for purposes of section 1033(g). No inference is intended to override or otherwise modify section 932 of the Code (involving the tax treatment of U.S. and Virgin Islands residents).

§7701(a)(42)-(45):

(42) **Substituted basis property.**—The term "substituted basis property" means property which is—

(A) transferred basis property, or

(B) exchanged basis property.

(43) **Transferred basis property.**—The term "transferred basis property" means property having a basis determined under any provision of subtitle A (or under any corresponding provision of prior income tax law) providing that the basis shall be determined in whole or in part by reference to the basis in the hands of the donor, grantor, or other transferor.

(44) **Exchanged basis property.**—The term "exchanged basis property" means property having a basis determined under any provision of subtitle A (or under any corresponding provision of prior income tax law) providing that the basis shall be determined in whole or in part by reference to other property held at any time by the person for whom the basis is to be determined.

(45) **Nonrecognition transaction.**—The term "nonrecognition transaction" means any disposition of property in a transaction in which gain or loss is not recognized in whole or in part for purposes of subtitle A.

Century Electric Co. v. Commissioner, 192 F.2d 155 (8th Cir. 1951)

RIDDICK, Circuit Judge.

The peitioner, Century Electric Company, is a corporation engaged principally in the manufacture and sale of electric motors and generators in St. Louis, Missouri. It is not a dealer in real estate. As of December 1, 1943, petitioner transferred a foundry building owned and used by it in its manufacturing business and the land on which the foundry is situated to William Jewell College and claimed a deductible loss on the transaction in its tax return for the calendar year 1943. The Commissioner of Internal Revenue denied the loss. The Commissioner was affirmed by the Tax Court and this petition for review followed.

The opinion of the Tax Court and its findings of fact, stated in great detail, are reported in 15 T.C. 581. Petitioner accepts the Tax Court's findings of fact as correct.

Since its organization in 1901 petitioner has been continuously successful in business. In its income tax return for the year

1943 it reported gross sales of $17,004,-839.73 and gross profits from sales of $5,-944,386.93. On December 31, 1942, petitioner owned land, buildings, and improvements of the total depreciated cost of $1,-902,552.16. On December 31, 1943, its actual cash on hand amounted to $203,123.70. During the year 1943 it distributed cash dividends of $226,705.69 and made a contribution to Washington University of $42,-500. It also held tax anticipation notes and Series G bonds totaling $2,000,000, readily convertible into cash and sufficient to liquidate its outstanding 1943 tax liability and its two outstanding 90-day bank notes due January 20, 1944.

Petitioner has always operated its business in large part on borrowed capital. In 1943 it had open lines of credit with the Chase National Bank of New York of $300,000, with the Boatmen's National Bank of St. Louis of the same amount, and with the Mercantile-Commerce Bank and Trust Company of $400,000. At the end of 1943 its outstanding loans from the Mercantile bank amounted to $600,000 approved by the authorized officers of the bank. Petitioner has always been able to liquidate its outstanding 90-day bank loans as they become due either by payment or renewal.

The assessed value of petitioner's foundry building and land upon which it is located for 1943 was $205,780. There was evidence that in St. Louis real property is assessed at its actual value. There was also evidence introduced by petitioner before the Tax Court that the market value for unconditional sale of the foundry building, land, and appurtenances was not in excess of $250,000.

As of December 1, 1943, the adjusted cost basis for the foundry building, land, and appurtenances transferred to William Jewell College was $531,710.97. The building was a specially designed foundry situated in a highly desirable industrial location. It is undisputed in the evidence that the foundry property is necessary to the operation of petitioner's profitable business and that petitioner never at any time considered a sale of the foundry property on terms which would deprive petitioner of its use in its business.

Petitioner's explanation of the transaction with the William Jewell College is that in the spring of 1943 a vice-president of the Mercantile bank where petitioner deposited its money and transacted the most of its banking business suggested to petitioner the advisability of selling some of its real estate holdings for the purpose of improving the ratio of its current assets to current liabilities by the receipt of cash on the sale and the possible realization of a loss deductible for tax purposes. Petitioner's operating business was to be protected by an immediate long-term lease of the real property sold.

Petitioner's board of directors rejected this proposition as unsound. But in July 1943, when a vice-president of the Mercantile bank suggested to petitioner's treasurer that it would be a good idea for petitioner to pay off all its bank loans merely to show that it was able to do so, petitioner interpreted this advice as a call of its bank loans. Acting on this interpretation, petitioner borrowed from the First National Bank in St. Louis on the security of tax anticipation notes held by it, funds with which it discharged all its bank loans. Immediately thereafter it re-established its lines of bank credit and began consideration of a sale of the foundry property and contemporaneous lease from the purchaser.

On September 2, 1943, petitioner's board of directors adopted a resolution that the executive committee of the board study the situation "and present, if possible, a plan covering the sale and rental back by Century Electric Company of the foundry property." The decision to enter into the transaction described was communicated to the Mercantile bank, but petitioner never publicly offered or advertised its foundry property for sale. The Tax Court found that petitioner "was concerned with getting a friendly landlord to lease the property back to it, as there was never any intention on the part of petitioner to discontinue its foundry operations." Several offers to purchase the foundry property at prices ranging from $110,000 to $150,000 were received and rejected by petitioner.

At a special meeting of the board of directors of petitioner on December 9, 1943, the president of petitioner reported that the officers of petitioner had entered into negotiations for the sale of the foundry property to William Jewell College for the price of $150,000 with the agreement of said college; "that in addition thereto said Trustees of William Jewell College further have agreed to execute a lease of the property so purchased to Century Electric Company for the same time and on substantially the same terms and conditions which were authorized to be accepted by the special meeting of shareholders of this corporation, held on the 24th day of November, 1943." The stockholders at the November meeting had authorized the sale of the foundry property at not less than $150,000 cash, conditioned upon the purchaser executing its lease of the property sold for a term of not less than 25 and not more than 95 years. The Board by resolution approved the proposed transaction with the William Jewell College, but on condition that "this corporation will acquire from Trustees of William Jewell College, a Missouri Corporation, an Indenture of Lease * * * for a term of not less than twenty-five years and for not more than ninety-five years." The resolution set out in detail the terms of the lease from the college to petitioner, approved the form of the deed from the petitioner to the college, authorized the president and secretary of petitioner to execute the lease after its execution by the trustees of the college, and directed "that the president and secretary of this corporation be authorized to deliver said Warranty Deed to said purchaser upon receiving from said purchaser $150,000 in cash, and upon receiving from said purchaser duplicate executed Indenture of Lease on the forms exhibited to this Board." The resolution provided that the deed and lease should be dated December 1, 1943, and effective as of that date.

The deed and the lease were executed and delivered as provided by the resolution of petitioner's board of directors. Neither instrument referred to the other. The deed was in form a general warranty deed, reciting only the consideration of $150,000 in cash. The lease recited among others the respective covenants of the parties as to its term, its termination by either the lessor or lessee, and as to the rents reserved.

As of December 31, 1942, the ratio of petitioner's current assets to its current liabilities was 1.74. The $150,000 in cash received by petitioner on the transaction increased the ratio of current assets to current liabilities from 1.74 to 1.80. The loss deduction which petitioner claims on the transaction and its consequent tax savings would if allowed have increased the ratio approximately twice as much as the receipt of the $150,000.

[1–3] The questions presented are:

1. Whether the transaction stated was for tax purposes a sale of the foundry property within the meaning of section 112 of the Internal Revenue Code, 26 U.S.C.A. § 112, on which petitioner realized in 1943 a deductible loss of $381,710.97 determined under section 111 of the code (the adjusted basis of the foundry property of $531,710.97 less $150,000) as petitioner contends; or, as the Tax Court held, an exchange of property held for productive use in a trade or business for property of a like kind to be held for productive use in trade or business in which no gain or loss is recognized under sections 112(b) (1) [1] and 112(e) [2], and

1. "Sec. 112. Recognition of Gain or Loss.
"(b) Exchanges solely in kind. (1) Property held for productive use or investment. No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment."

2. "(e) Loss from exchanges not solely in kind. If an exchange would be within the provisions of subsection (b) (1) to (5), inclusive, or (10), or within the provisions of subsection (*l*), of this sec-

Regulation 111, section 29.112(b) (1)-1.[3]

2. Whether if the claimed loss deduction is denied, its amount is deductible as depreciation over the 95-year term of the lease as the Tax Court held, or over the remaining life of the improvements on the foundry as the petitioner contends.

On the first question the Tax Court reached the right result. The answer to the question is not to be found by a resort to the dictionary for the meaning of the words "sales" and "exchanges" in other contexts, but in the purpose and policy of the revenue act as expressed in section 112. Compare Federal Deposit Insurance Corp. v. Tremaine, 2 Cir., 133 F.2d 827, 830; Cabell v. Markham, 2 Cir., 148 F.2d 737, 739; Markham v. Cabell, 326 U.S. 404, 409, 66 S.Ct. 193, 90 L.Ed. 165; Brooklyn National Corp. v. Commissioner, 2 Cir., 157 F.2d 450, 451; Emery v. Commissioner, 2 Cir., 166 F.2d 27, 30, 1 A.L.R.2d 409. In this section Congress was not defining the words "sales" and "exchanges". It was concerned with the administrative problem involved in the computation of gain or loss in transactions of the character with which the section deals. Subsections 112(b) (1) and 112(e) indicate the controlling policy and purpose of the section, that is, the nonrecognition of gain or loss in transactions where neither is readily measured in terms of money, where in theory the taxpayer may have realized gain or loss but where in fact his economic situation is the same after as it was before the transaction. See Fairfield S.S. Corp. v. Commissioner, 2 Cir., 157 F.2d 321, 323; Trenton Cotton Oil Co. v. Commissioner, 6 Cir., 147 F.2d 33, 36. For tax purposes the question is whether the transaction falls within the category just defined. If it does, it is for tax purposes an exchange and not a sale. So much is indicated by subsection 112(b) (1) with regard to the exchange of securities of readily ascertainable market value measured in terms of money. Gain or loss on exchanges of the excepted securities is recognized. Under subsection 112(e) no loss is recognized on an exchange of property held for productive use in trade or business for like property to be held for the same use, although other property or money is also received by the taxpayer. Compare this subsection with subsection 112(c) (1) where in the same circumstances gain is recognized but only to the extent of the other property or money received in the transaction. The comparison clearly indicates that in the computation of gain or loss on a transfer of property held for productive use in trade or business for property of a like kind to be held for the same use, the market value of the properties of like kind involved in the transfer does not enter into the equation.

[4] The transaction here involved may not be separated into its component parts for tax purposes. Tax consequences must depend on what actually was intended and accomplished rather than on the separate steps taken to reach the desired end. The end of the transaction between the petitioner and the college was that intended by the petitioner at its beginning, namely, the transfer of the fee in the foundry property for the 95-year lease on the same property and $150,000.

[5] It is undisputed that the foundry property before the transaction was held

tion if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain or loss, but also of other property or money, then no loss from the exchange shall be recognized."

3. "Sec. 29.112(b) (1)-1. Property Held for Productive Use in Trade or Business or for Investment.—As used in section 112(b) (1), the words 'like kind' have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under such section, be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for such fact relates only to the grade or quality of the property and not to its kind or class. * * *

"No gain or loss is recognized if * * * (2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or a leasehold of a fee with 30 years or more to run for real estate, or improved real estate for unimproved real estate * * *."

by petitioner for productive use in petitioner's business. After the transaction the same property was held by the petitioner for the same use in the same business. Both before and after the transaction the property was necessary to the continued operation of petitioner's business. The only change wrought by the transaction was in the estate or interest of petitioner in the foundry property. In Regulations 111, section 29.112(b) (1)-1, the Treasury has interpreted the words "like kind" as used in subsection 112(b) (1). Under the Treasury interpretation a lease with 30 years or more to run and real estate are properties of "like kind." With the controlling purpose of the applicable section of the revenue code in mind, we can not say that the words "like kind" are so definite and certain that interpretation is neither required nor permitted. The regulation, in force for many years, has survived successive reenactments of the internal revenue acts and has thus acquired the force of law. United States v. Dakota-Montana Oil Co., 288 U.S. 459, 466, 53 S. Ct. 435, 77 L.Ed. 893; Helvering v. R. J. Reynolds Tobacco Co., 306 U.S. 110, 116, 59 S.Ct. 423, 83 L.Ed. 536; and see Commissioner of Internal Revenue v. Crichton, 5 Cir., 122 F.2d 181.

[6] On the second question the Tax Court held that petitioner was not entitled to depreciation on the improvements on the foundry property over their useful life after December 1, 1943. The answer to this question depends upon whether as a result of the transaction under consideration the petitioner has an indentifiable capital investment in the improvements on the land covered by the lease. Petitioner contends that the amount of its claimed loss, $381,710.97, should be apportioned between the land and improvements in proportion to their respective cost bases as of November 30, 1943. This would result in an allocation of $277,076.68 of petitioner's investment in the leasehold to the improvements and $104,634.29 to the land. The difficulty with petitioner's position is that it involves assumptions and inferences which find no support in the record. What the petitioner has done is to exchange the foundry property having an adjusted basis of $531,710.97 on December 1, 1943, for a leasehold and $150,000 in cash. Its capital investment is in the leasehold and not its constituent properties. Accordingly, we agree with the Tax Court that petitioner is entitled to depreciation on the leasehold. The basis for depreciation of the leasehold on December 1, 1943, is, therefore, $381,-710.97 under section 113(a) (6) of the revenue code, deductible over the term of the lease.

The decision of the Tax Court is affirmed.

Jordan Marsh Co. v. Commissioner, 269 F.2d 453 (2d Cir. 1951), nonacq., Rev. Rul. 60-43, 1960-1, C.B. 687

Before HINCKS, LUMBARD and MOORE, Circuit Judges.

HINCKS, Circuit Judge.

This is a petition to review an order of the Tax Court, which upheld the Commissioner's deficiency assessment of $2,101,823.39 in income and excess profits tax against the petitioner, Jordan Marsh Company. There is no dispute as to the facts, which were stipulated before the Tax Court and which are set forth in substance below.

The transactions giving rise to the dispute were conveyances by the petitioner in 1944 of the fee of two parcels of property in the city of Boston where the petitioner, then as now, operated a department store. In return for its conveyances the petitioner received $2,300,000 in cash which, concededly, represented the fair market value of the properties. The conveyances were unconditional, without provision of any option to repurchase. At the same time, the petitioner received back from the vendees leases of the same properties for terms of 30 years and 3 days, with options to renew for another 30 years if the petitioner-lessee should erect new buildings thereon. The vendees were in no way connected with the petitioner. The rentals to be paid under the leases concededly were full and normal rentals so that the leasehold interests which devolved upon the petitioner were of no capital value.

In its return for 1944, the petitioner, claiming the transaction was a sale under § 112(a), Internal Revenue Code of 1939,[1] sought to deduct from income the difference between the adjusted basis of the property and the cash received. The Commissioner disallowed the deduction, taking the position that the transaction represented an exchange of property for other property of like kind. Under Section 112(b)(1) such exchanges are not occasions for the recognition of gain or loss; and even the receipt of cash or other property in the exchange of the properties of like kind is not enough to permit the taxpayer to recognize loss. Section 112(e).[2] Thus the Commissioner viewed the transaction, in substance, as an exchange of a fee interest for a long term lease, justifying his position by Treasury Regulation 111, § 29.112(b)(1)-1, which provides that a leasehold of more than 30 years is the equivalent of a fee interest.[3] Accordingly the Com-

1. "§ 112. *Recognition of gain or loss*—

"(a) *General rule*. Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section." 26 U.S.C.A. § 112.

2. "§ 112. *Recognition of gain or loss*—

* * * * *

"(b) *Exchanges solely in kind*—(1) *Property held for productive use or investment*. No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment.

* * * * *

"(e) *Loss from exchanges not solely in kind*. If an exchange would be within the provisions of subsection (b) (1) to (5), inclusive, or (10), or within the provisions of subsection (1), of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain or loss, but also of other property or money, then no loss from the exchange shall be recognized."

3. "Reg. 111, Sec. 29.112(b) (1)-1. *Property Held for Productive Use in Trade or Business or for Investment*.—As used in section 112(b) (1), the words 'like kind' have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under such section, be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for such fact relates only to the grade or quality of the property and not to its kind or class. Unproductive real estate held by one other than a dealer for future use or future realization of the increment in value is held for investment and not primarily for sale.

"No gain or loss is recognized if (1) a taxpayer exchanges property held for productive use in his trade or business, together with cash, for other property of like kind for the same use, such as a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose, or (2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or a leasehold of a fee with 30 years or more to run for real estate, or improved real estate, or (3) a taxpayer exchanges investment property and cash for investment property of a like kind."

missioner made the deficiency assessment stated above. The Tax Court upheld the Commissioner's determination. Since the return was filed in New York, the case comes here for review. 26 U.S.C.A. § 7482.

Upon this appeal, we must decide whether the transaction in question here was a sale or an exchange of property for other property of like kind within the meaning of §§ 112(b) and 112(e) of the Internal Revenue Code cited above. If we should find that it is an exchange, we would then have to decide whether the Commissioner's regulation, declaring that a leasehold of property of 30 years or more is property "of like kind" to the fee in the same property, is a reasonable gloss to put upon the words of the statute. The judge in the Tax Court felt that Century Electric Co. v. Commissioner of Internal Rev., 8 Cir., 192 F.2d 155, certiorari denied 342 U.S. 954, 72 S.Ct. 625, 96 L.Ed. 708, affirming 15 T.C. 581, was dispositive of both questions. In the view which we take of the first question, we do not have to pass upon the second question. For we hold that the transaction here was a sale and not an exchange.

The controversy centers around the purposes of Congress in enacting § 112 (b), dealing with non-taxable exchanges. The section represents an exception to the general rule, stated in § 112(e), that upon the sale or exchange of property the entire amount of gain or loss is to be recognized by the taxpayer. The first Congressional attempt to make certain exchanges of this kind non-taxable occurred in Section 202(c), Revenue Act of 1921, c. 135, 42 Stat. 227. Under this section, no gain or loss was recognized from an exchange of property unless the property received in exchange had a "readily realizable market value." In 1924, this section was amended to the form in which it is applicable here. Discussing the old section the House Committee observed:

> "The provision is so indefinite that it cannot be applied with accuracy or with consistency. It appears best to provide generally that gain or loss is recognized from all exchanges, and then except specifically and in definite terms those cases of exchanges in which it is not desired to tax the gain or allow the loss. This results in definiteness and accuracy and enables a taxpayer to determine prior to the consummation of a given transaction the tax liability that will result." (Committee Reports on Rev.Act of 1924, reprinted in Int.Rev.Cum.Bull. 1939–1 (Part 2), p. 250.)

Thus the "readily realizable market value" test disappeared from the statute. A later report, reviewing the section, expressed its purpose as follows:

> "The law has provided for 12 years that gain or loss is recognized on exchanges of property having a fair market value, such as stocks, bonds, and negotiable instruments; on exchanges of property held primarily for sale; or on exchanges of one kind of property for another kind of property; but not on other exchanges of property solely for property of like kind. In other words, profit or loss is recognized in the case of exchanges of notes or securities, which are essentially like money; or in the case of stock in trade; or in case the taxpayer exchanges the property comprising his original investment for a different kind of property; but *if the taxpayer's money is still tied up in the same kind of property* as that in which it was originally invested, he is not allowed to compute and deduct his theoretical loss on the exchange, nor is he charged with a tax upon his theoretical profit. The calculation of the profit or loss is deferred until it is realized in cash, marketable securities, or other property not of the same kind having a fair market value." (House Ways and Means Committee Report, reprinted in Int.Rev. Cum.Bull.1939–1 (Part 2), p. 564.)[4]

4. Emphasis supplied.

[1] These passages lead us to accept as correct the petitioner's position with respect to the purposes of the section. Congress was primarily concerned with the inequity, in the case of an exchange, of forcing a taxpayer to recognize a paper gain which was still tied up in a continuing investment of the same sort. If such gains were not to be recognized, however, upon the ground that they were theoretical, neither should equally theoretical losses. And as to both gains and losses the taxpayer should not have it within his power to avoid the operation of the section by stipulating for the addition of cash, or boot, to the property received in exchange. These considerations, rather than concern for the difficulty of the administrative task of making the valuations necessary to compute gains and losses,[5] were at the root of the Congressional purpose in enacting §§ 112(b) (1) and (e). Indeed, if these sections had been intended to obviate the necessity of making difficult valuations, one would have expected them to provide for nonrecognition of gains and losses in all exchanges, whether the property received in exchanges were "of a like kind" or *not* of a like kind. And if such had been the legislative objective, § 112(c),[6] providing for the recognition of gain from exchanges not wholly in kind, would never have been enacted.

That such indeed was the legislative objective is supported by Portland Oil Co. v. Commissioner of Internal Revenue, 1 Cir., 109 F.2d 479. There Judge Magruder, in speaking of a cognate provision contained in § 112(b), said at page 488:

"It is the purpose of Section 112 (b) (5) to save the taxpayer from an immediate recognition of a gain, or to intermit the claim of a loss, in certain transactions where gain or loss may have accrued in a constitutional sense, but where in a popular and economic sense there has been a mere change in the form of ownership and the taxpayer has not really 'cashed in' on the theoretical gain, or closed out a losing venture."

[2] In conformity with this reading of the statute, we think the petitioner here, by its unconditional conveyances to a stranger, had done more than make a change in the *form of ownership:* it was a change as to the *quantum* of ownership whereby, in the words just quoted, it had "closed out a losing venture." By the transaction its capital invested in the real estate involved had been completely liquidated for cash to an amount fully equal to the value of the fee. This, we hold, was a sale—not an exchange within the purview of § 112 (b).

The Tax Court apparently thought it of controlling importance that the transaction in question involved no change in the petitioner's possession of the premises: it felt that the decision in Century Electric Co. v. Commissioner of Internal Rev., supra, controlled the situation here. We think, however, that that case was distinguishable on the facts. For notwithstanding the lengthy findings made with meticulous care by the Tax Court in that case, 15 T.C. 581, there was no finding that the cash re-

5. In Century Electric Co. v. Commissioner of Internal Rev., supra, 192 F.2d at page 159, the court thought that in the enactment of § 112 Congress "was concerned with the administrative problem involved in the computation of gain or loss in transactions of the character with which the section deals." But so far as appears from the opinion the attention of the court had not been called to the legislative history of the section set forth earlier in this opinion.

6. "§ 112.
"(c) *Gain from exchanges not solely in kind.* (1) If an exchange would be within the provisions of subsection (b) (1), (2), (3), or (5), or within the provisions of subsection (1), of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph or by subsection (1) to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property."

ceived by the taxpayer was the full equivalent of the value of the fee which the taxpayer had conveyed to the vendee-lessor, and no finding that the lease back called for a rent which was fully equal to the rental value of the premises. Indeed, in its opinion the Court of Appeals pointed to evidence that the fee which the taxpayer had "exchanged" may have had a value substantially in excess of the cash received.[7] And in the Century Electric case, the findings showed, at page 585, that the taxpayer-lessee, unlike the taxpayer here, was not required to pay "general state, city and school taxes" because its lessor was an educational institution which under its charter was exempt from such taxes. Thus the leasehold interest in Century Electric on this account may well have had a premium value.[8] In the absence of findings as to the values of the properties allegedly "exchanged," necessarily there could be no finding of a loss. And without proof of a loss, of course, the taxpayer could not prevail. Indeed, in the Tax Court six of the judges expressly based their concurrences on that limited ground. 15 T.C. 596.

In the Century Electric opinion it was said, 192 F.2d at page 159:

> "* * * Subsections 112(b) (1) and 112(e) indicate the controlling policy and purpose of the section, that is, the nonrecognition of gain or loss in transactions where neither is readily measured in terms of money, where in theory the taxpayer may have realized gain or loss but where in fact his economic situation is the same after as it was before the transaction. See Fairfield S. S. Corp. v. Commissioner, 2 Cir., 157 F.2d 321, 323; Trenton Cotton Oil Co. v. Commissioner, 6 Cir., 147 F. 2d 33, 36."

But the Fairfield case referred to was one in which the only change in taxpayer's ownership was through the interposition of a corporate title accomplished by transfer to a corporation wholly owned by the taxpayer. And in the Trenton Cotton Oil case, the court expressly relied on Portland Oil Co. v. Commissioner of Internal Revenue, supra, as stating correctly the purpose of § 112(b), but quoted only the first of the two requisites stated in Portland. As we have already observed, in that case Judge Magruder said that it was the purpose of § 112(b) "to intermit the claim of a loss" not only where the economic situation of the taxpayer is unchanged but also "*where * * * the taxpayer has not * * * closed out a losing venture.*"[9] Here plainly the petitioner by the transfer finally closed out a losing venture. And it cannot justly be said that the economic situation of the petitioner was unchanged by a transaction which substituted $2,300,000 in cash for its investment in real estate and left it under a liability to make annual payments of rent for upwards of thirty years. Many *bona fide* business purposes may be served by such a transaction. Cary, Corporate Financing through the Sale and Lease-Back of Property: Business, Tax, and Policy Considerations, 62 Harv.L.Rev. 1.

In ordinary usage, an "exchange" means the giving of one piece of property in return for another[10]—not, as the Commissioner urges here, the return of a lesser interest in a property received from another. It seems unlikely that Congress intended that an "exchange" should have the strained mean-

7. It said, page 157: "The assessed value of petitioner's foundry building and land upon which it is located for 1943 was $205,000. There was evidence that in St. Louis real property is assessed at its actual value. There was also evidence introduced by petitioner before the Tax Court that the market value for unconditional sale of the foundry building, land and appurtenances was not in excess of $250,000."

8. Under the leases received back by Jordan Marsh Company, the lessee was required to pay all local taxes.

9. Emphasis supplied.

10. Trenton Cotton Oil Co. v. Commissioner, supra [109 F.2d 489].

ing for which the Commissioner contends. For the legislative history[11] states expressly an intent to correct the indefiniteness of prior versions of the Act by excepting from the general rule "specifically and in definite terms those cases of exchanges in which it is not desired to tax the gain or allow the loss."

But even if under certain circumstances the return of a part of the property conveyed may constitute an exchange for purposes of § 112, we think that in this case, in which cash was received for the full value of the property conveyed, the transaction must be classified as a sale. Standard Envelope Manufacturing Co. v. C. I. R., 15 T.C. 41; May Department Stores Co. v. C. I. R., 16 T.C. 547.

Reversed.

NOTES

The IRS Response:

SECTION 112(b).—RECOGNITION OF GAIN OR LOSS: EXCHANGES SOLELY IN KIND

REGULATIONS 111, SECTION 29.112(b)(1)-1: Property held for productive use in trade or business or for investment.
(Also Part I, Section 1031; 26 CFR 1.1031(a)-1.)

Rev. Rul. 60-43[1]

The Internal Revenue Service will not follow the decision in *Jordan Marsh Company* v. *Commissioner*, 269 Fed. (2d) 453.

The United States Court of Appeals for the Second Circuit, in reversing the Tax Court, held that a transaction whereby the taxpayer in 1944 conveyed the fee of parcels of property used for its department store to a stranger for cash, equivalent to their fair market value, must be treated as a separate sale, even though, simultaneously, the property was leased back to the taxpayer for the same use at a fair and normal rental for a term of 30 years plus three days, with an option to renew for a similar term if the taxpayer as "lessee" should erect new buildings on the property.

[1] Based on Technical Information Release 194, dated December 18, 1959.

The Court of Appeals maintained that *Century Electric Co.* v. *Commissioner*, 192 Fed. (2d) 155, certiorari denied 342 U.S. 954, relied upon by the Government, was distinguishable on its facts.

It is the position of the Service that a sale and leaseback under the circumstances here present constitute, in substance, a single integrated transaction under which there is an "exchange" of property of like kind with cash as boot.

Leslie Co. v. Commissioner, 64 T.C. 247 (1975), nonacq., 1978-2 C.B. 3

IRWIN, *Judge:* Respondent determined deficiencies in petitioner's income tax as follows:

Year	*Deficiency*
1965	$176,551.77
1966	50,700.90
1968	155,770.75

The issues presented for our determination are (1) whether the sale and leaseback of property by petitioner in 1968 constituted an exchange of property of a like kind within the meaning of section 1031(a)[1] and, if so, (2) whether petitioner should be entitled to depreciate the property under any of the methods specified in section 167(b) and to avail itself of investment credits pursuant to section 38.

The deficiencies in 1965 and 1966 result from the disallowance of net operating loss carrybacks and investment credit carrybacks based on a claimed net operating loss in 1968 and are completely dependent upon our determination of whether the sale and leaseback comes within the purview of section 1031.

FINDINGS OF FACT

Some of the facts have been stipulated and the stipulation of facts, together with the exhibits attached thereto, are found accordingly.

Petitioner Leslie Co. (hereinafter referred to as Leslie or petitioner) is a New Jersey corporation primarily engaged in the

[1] All statutory references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated.

design, manufacture, and industrial distribution of pressure and temperature regulators and automatic instantaneous water heaters. At the time of the filing of its petition with this Court petitioner's principal place of business was located in Parsippany, N.J. For the taxable years 1965 and 1966 corporate income tax returns were filed with the District Director of Internal Revenue, Newark, N.J. The 1968 corporate income tax return was filed with the Internal Revenue Service Center, Philadelphia, Pa.

For many years prior to 1966 Leslie operated its entire business, plant, and office in Lyndhurst, N.J. In 1966 Leslie determined that the Lyndhurst plant would be inadequate for future use and decided to construct a new facility in Parsippany. Upon completion of the new plant the Lyndhurst property was to be sold. Pursuant to the decision to move, Leslie acquired land in Parsippany in March 1967.

On October 30, 1967, after having explored other financing possibilities without success, Leslie agreed to a sale and leaseback of the land with improvements to the Prudential Insurance Co. of America (hereinafter referred to as Prudential). The agreement provided that Prudential would enter into a contract for the purchase and leaseback of the Parsippany property, subject, inter alia, to the following requirements and conditions:

1. The sale price shall not exceed $2,400,000 or the actual cost of land, building and other improvements erected thereon, whichever is the lower. * * *

2. Leslie Co. shall have erected and completed on the above premises a one story, 100% sprinklered, masonry and steel industrial building containing approximately 185,000 square feet * * *. The building is to be constructed and improvements made according to detailed plans and specifications which have been approved by The Prudential. Any changes to the plans * * * must be approved by Prudential prior to commencement of construction.

* * *

4. Prudential will be furnished with the following prior to closing:

(a) A lease with Leslie Co. satisfactory in form and substance to Prudential and Leslie Co. for a term of 30 years at an absolute net rental of $190,560, or 7.94% of purchase price if less than $2,400,000, to be paid monthly, in advance, in equal monthly installments. The lease shall include two (2) renewal options of 10 years each with an absolute net annual rental of $72,000, or 3% of purchase price if less than $2,400,000. The lease shall further include a rejectable offer to purchase at the end of the fifteenth, twentieth, twenty-fifth or thirtieth year based on the following schedule:

at the end of the 15th year	$1,798,000.
at the end of the 20th year	$1,592,000.
at the end of the 25th year	$1,386,000.
at the end of the 30th year	$1,180,000.

On December 16, 1968, after completion of the plant as approved by Prudential,[2] Leslie delivered the deed to the Parsippany property to Prudential for $2.4 million. The fair market value of the property at the time of sale was in the neighborhood of $2.4 million. Contemporaneously with the transfer of title to Prudential, Leslie and Prudential entered into the lease as specified in the above agreement. The annual net rental[3] of $190,560 was comparable to the fair rental value of similar types of property in the northern New Jersey area. The lease also provided that all condemnation proceeds, net of any damages suffered by Leslie with respect to its trade fixtures and certain structural improvements, would become the property of Prudential without deduction for the leasehold interest of petitioner.

Leslie's total cost in purchasing the land and constructing the plant was $3.187 million, consisting of the following:

Land	$255,000
Building	2,410,000
Paving and landscaping	72,000
Boiler (including special features)	140,000
Special electrical wiring	138,000
Miscellaneous personal property (including certain special items)	140,000
Interim finance costs	20,000
Selling costs	12,000
Total cost	3,187,000

Leslie would not have entered into the sales part of the transaction without the guarantee of the leaseback.

The Parsippany plant was not in operation on December 16, 1968, the date of closing, and did not become fully operational until mid-January 1969. The useful life of the new plant was stipulated to be 30 years. Leslie sold the Lyndhurst plant for $600,000 when it moved into the Parsippany facilities.

Leslie is not a dealer in real estate.

On its 1968 corporate income tax return Leslie reported the disposition of the Parsippany property as a sale with a gross sale price of $2.4 million and a cost of $3,187,414 with a loss thereon

[2] We note that Prudential did not approve the original plans. There was also a misunderstanding on the part of Leslie with respect to the square footage requirements.

[3] The term "net rental," as employed by the parties, indicates that the lessee will pay all taxes, maintenance, and other charges on the property.

of $787,414. The claimed loss resulted in a net operating loss of $366,907, which was carried back to 1965. In addition, an investment credit of $436.41, not utilizable in 1968 on account of the claimed net operating loss, was carried back to 1965. An investment credit of $50,700, likewise not utilizable in 1968 on account of the claimed net operating loss, was carried back to 1966. Respondent, in disallowing the claimed loss, thereby disallowed all of the claimed carrybacks. Respondent would allow the loss as a cost of obtaining the 30-year lease and permit it to be amortized over the period of the lease.

Leslie treated the claimed loss as an unrecovered cost of plant construction on its books to be amortized over 30 years.

Prudential treated the rental receipts as rental income and depreciated the property on its corporate income tax returns.

OPINION

Respondent, relying upon section 1.1031(a)-1(c), Income Tax Regs.,[4] and *Century Electric Co.*, 15 T.C. 581 (1950), affd. 192 F. 2d 155 (8th Cir. 1951), cert. denied 342 U.S. 954 (1952), submits that the sale and leaseback between petitioner and Prudential falls within the nonrecognition provisions of section 1031,[5] and that, therefore, petitioner's claimed loss is not allow-

[4] (c) No gain or loss is recognized if (1) a taxpayer exchanges property held for productive use in his trade or business, together with cash, for other property of like kind for the same use, such as a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose; or (2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or exchanges a leasehold of a fee with 30 years or more to run for real estate, or exchanges improved real estate for unimproved real estate; or (3) a taxpayer exchanges investment property and cash for investment property of a like kind.

[5] SEC. 1031. EXCHANGE OF PROPERTY HELD FOR PRODUCTIVE USE OR INVESTMENT.

(a) NONRECOGNITION OF GAIN OR LOSS FROM EXCHANGES SOLELY IN KIND.—No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment.

(b) GAIN FROM EXCHANGES NOT SOLELY IN KIND.—If an exchange would be within the provisions of subsection (a), * * * if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(c) LOSS FROM EXCHANGES NOT SOLELY IN KIND.—If an exchange would be within the provisions of subsection (a), * * * if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without the recognition of gain or loss, but also of other property or money, then no loss from the able. In the same breath, respondent would allow the claimed loss as a "cost" of acquiring the leasehold and amortize it over the 30-year term. Petitioner, on the other hand, submits that there was no "exchange" within the meaning of section 1031, and that, therefore, the claimed loss must be recognized. We agree with petitioner that section 1031 is inapplicable and that the loss must be recognized. The amount is not in dispute.

As an exception to the general rule requiring the recognition of all gains and losses, section 1031 must be strictly construed. See sec. 1002 and the regulations thereunder, particularly sec. 1.1002-1(b), Income Tax Regs.[6] In order for this nonrecognition provision to come into play it must first be established that an exchange occurred. An exchange is defined in the regulations as a transaction involving the reciprocal transfer of property, as distinguished from a transfer of property for a money consideration. Sec. 1.1002-1(d), Income Tax Regs. See also *Vernon Molbreak*, 61 T.C. 382, 390-392 (1973), affd. per curiam 509 F. 2d 616 (7th Cir. 1975).

In the instant situation petitioner executed a sale and leaseback agreement with respect to the Parsippany property. It is clear that the sale and leaseback were merely successive steps of a single integrated transaction. It is also equally clear that petitioner, unable to obtain financing to construct a new plant, employed the sale and leaseback mechanism to obtain the needed new facilities. These factors, however, do not dispose of the issue.

While the leaseback arrangement was a necessary condition to the sale, we are of the opinion that, based on the record before us, the leasehold herein did not have any separate capital value which could be properly viewed as a portion of the consideration paid or exchanged. Petitioner received $2.4 million on the sale of the property. The sale and leaseback agreement, executed prior to

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(Continued)
exchange shall be recognized.

[6] (b) *Strict construction of exceptions from general rule.* The exceptions from the general rule requiring the recognition of all gains and losses, like other exceptions from a rule of taxation of general and uniform application, are strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception. Nonrecognition is accorded by the Code only if the exchange is one which satsifies both (1) the specific description in the Code of an excepted exchange, and (2) the underlying purpose for which such exchange is excepted from the general rule. The exchange must be germane to, and a necessary incident of, the investment or enterprise in hand. The relationship of the exchange to the venture or enterprise is always material, and the surrounding facts and circumstances must be shown. As elsewhere, the taxpayer claiming the benefit of the exception must show himself within the exception.

construction of the new facility, provided that the sale price was to be actual cost to petitioner or $2.4 million, whichever was less. This was based on Prudential's appraisal of the worth of the property after improvements. As it turned out, the actual cost to construct the new facilities (including purchase of the land) totaled $3.187 million. Although we are troubled by the disparity between $2.4 million and $3.187 million, the only evidence in the record (and this presented by respondent) indicated that the fair market value of the property as improved at the date of sale was in the neighborhood of $2.4 million, not $3.187 million. Respondent has also not objected to petitioner's proposed finding of fact that the property as improved had a fair market value of $2.4 million at the date of sale.[7] We also note that the evidence presented indicated that this valuation was comparable to the fair market value of similar types of property in the area. The annual net rental was also comparable to the fair rental value of similar types of property in the area. Based on the record before us, we have no choice but to find that the fair market value of the property was within the $2.4 million range. In our judgment, therefore, the sole consideration paid for the property was the $2.4 million in cash. The leasehold, while integral to the transaction, had no separate capital value and was not a part of the consideration. See *City Investing Co.*, 38 T.C. 1, 9 (1962). In support of our finding that the leasehold had no capital value in and of itself at the time of the sale, we also note that in addition to the fact of the sale price and net rentals being for fair value, the condemnation clause in the lease agreement provided (with certain exceptions not material herein) that in the event of condemnation all proceeds would be paid to Prudential without deduction for the leasehold interest. This clause, while clearly not conclusive on the issue, is further evidence of a lack of capital value.

Respondent, however, in the body of his reply brief, argues that since petitioner's cost exceeded the contract price, the difference must be equal to the capital value of the lease. We find this

[7] We hypothesize that respondent's willingness to accept petitioner's proposed finding of fair market value was due to his desire to ensure that the transaction would not be characterized as merely financial with title in substance remaining with petitioner. At the same time, relying upon *Century Electric Co.*, 15 T.C. 581 (1950), he must have assumed that this Court would disregard the fair market values in finding sec. 1031 applicable. What he has failed to take into account is that it must first be determined that an "exchange" occurred for sec. 1031 to apply.

unsupported by the evidence presented. In essence, it would appear that respondent is arguing that although the leasehold had no capital value, it had a premium value to petitioner. The excess expenditures over $2.4 million would not be a loss as such to petitioner since it would be able to utilize the improvements as lessee and thus would be willing to spend more than $2.4 million. Although this argument seems to comport to economic realities, it does not give the leasehold value. The difference between $2.4 million and $3.187 million is clearly attributable to the cost of building the plant (including the purchase of land); it is not attributable to the leasehold. While it may be true that it was only because of the leasehold that petitioner was willing to spend $3.187 million, it does not follow that the leasehold had a value equal to the difference between $2.4 million and $3.187 million. To reach such a result, it must be shown that the fair market value of the improved property was $3.187 million, not $2.4 million. This was not done.

From an accounting standpoint it is true that the loss, being an extraordinary item, may cause a distortion of income. That is probably why petitioner amortized the unrecovered costs over the 30-year term in its financial statements. Petitioner's treatment of the item on the books, however, is not dispositive of the issue for tax purposes. It is not at all uncommon to find that the book and tax treatment of a given transaction differ. Although losses may be amortized for book purposes, nothing in the Code permits such amortization for tax purposes.

When all the cards are on the table, the fact remains that petitioner had a cost basis of $3.187 million in the improved property and realized $2.4 million on the sale. The bonafideness of the sale was not questioned by respondent. As stated previously, since the evidence indicates that petitioner would be paying a net rent comparable to the fair rental value, the leasehold could have no value at the time of sale, and thus could not be a part of the consideration paid. It was merely a condition precedent to the sale; no more and no less. The fact that petitioner was willing to sell the property "only with some kind of leaseback arrangement included does not of itself detract from the reality of the sale." Cf. *City Investing Co., supra.*

We, therefore, conclude that there was a bona fide sale of the property and not an "exchange" within the meaning of section 1031. See *Jordan Marsh Co. v. Commissioner*, 269 F.2d 453 (2d

Cir. 1959), nonacq. Rev. Rul. 60-43, 1960-1 C.B. 687, revg. a Memorandum Opinion of this Court. We need not consider *Century Electric Co., supra,* and its possible conflict with *Jordan Marsh Co.* since we have found that there was no "exchange" within the meaning of section 1031. We do note, though, that if an "exchange" had been found, then, assuming "like kind" property, the fair market value of such property would appear not to be relevant.

Since the nonrecognition provisions of section 1031 are not applicable, the general rule of recognition under 1002 applies.

Because of our holding in the above issue we need not consider the other issue presented.

Reviewed by the Court.

Decision will be entered for the petitioner.

TANNENWALD, *J.,* dissenting: If I understand the majority opinion correctly, its rationale is (1) the sale and leaseback constituted "integral parts of a single transaction" but this factor is not dispositive of the issue of whether there was an exchange under section 1031, and (2) since the sales price and the lease rental were "for fair value," the lease lacked "capital value" and "the transaction must be classified as a bona fide sale and not as an exchange." I think this rationale is erroneous.

I start from the premise that the record supports a finding that the price Prudential paid for the property was equal to its fair market value and that the lease rental was "fair" (as to which the record, to put it mildly, is sparse). But the fact of the matter is that although the lease in the instant case may not have had a "capital value" in the normal sense of that term, it did have a value beyond the fair rental value to the petitioner herein.

Whatever the respective values of the lease and the fee, it is clear from the record herein that petitioner entered into the transaction with its eyes wide open. It knew at the outset that Prudential would acquire the full benefit (in the form of title to the fee) of all of its expenditures with regard to the property. It committed itself to expend whatever sums it took to construct the building with those improvements required by its own special needs and to pay the legal fees and other costs[1] required to con-

[1] The situation with respect to the cost of "miscellaneous personal property" is not clear,

summate the transaction with Prudential. The record herein contains insufficient evidence to support a finding that the petitioner did not contemplate or should not have reasonably contemplated the possibility of a cost overrun; indeed, the record tends to indicate that the opposite was the case.[2] The reason for petitioner's willingness to run the risk of this financial exposure is obvious; in order to operate its business, it needed and was entitled to obtain the lease from Prudential. Thus, the lease had a value *to this petitioner* beyond the rental value, namely, any excess cost that it might incur. In this respect, the situations of the taxpayers in both *Jordan Marsh Co. v. Commissioner*, 269 F. 2d 453 (2d Cir. 1959), revg. T. C. Memo. 1957-237, and *Century Electric Co. v. Commissioner*, 192 F. 2d 155 (8th Cir. 1951), affg. 15 T.C. 581 (1950), are clearly distinguishable. In both those cases, the costs in excess of the fair market value of the fee and/or the fair value of the lease were incurred long before the transaction under scrutiny (in one case, 12 years, and in the other, 13 years). It could not possibly be said that those costs were undertaken in order to consummate the transaction. Here, by way of contrast, petitioner incurred the excess costs for the express purpose of engaging in the transaction with Prudential. Under these circumstances, petitioner, unlike the taxpayer in *Jordan Marsh*, was not "clos[ing] out a losing venture" (see 269 F. 2d at 456), i.e., a venture that did not start out on a predetermined course.

Under my reasoning, it is unnecessary for me to decide the extent to which the decision or rationale of the Second Circuit Court of Appeals in *Jordan Marsh* is in conflict with *Century Electric*. See *City Investing Co.*, 38 T.C. 1, 7 (1962). I have no hesitancy, however, in holding that, even though there was a sale and not an exchange under section 1031,[3] the excess expended by petitioner over the cash received from Prudential, as far as the

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but it would appear that this included such property erected on or attached to the realty rather than movable property, since the former category was included in the lease while the latter was not.

[2] If the absence of such a contemplated cost overrun were shown to exist, it could be argued that the excess represented a loss rather than a payment for the lease, but I express no opinion as to what my conclusion would be under such circumstances.

[3] In view of the prior commitment by petitioner to sell the property to Prudential, it would seem that, in any event, the requirement of sec. 1031 that the property exchanged be "held for productive use in trade or business * * * (not including * * * property held primarily for sale * * *)" was not satisfied, at least as far as the building was concerned. Cf. *Brooks Griffin*, 49 T.C. 253 (1967).

petitioner is concerned, should be considered as akin to a bonus paid for the lease and amortized over its term. *University Properties, Inc.*, 45 T. C. 416 (1966), affd. 378 F. 2d 83 (9th Cir. 1967), and cases cited therein.[4]

RAUM, DRENNEN, QUEALY, and HALL, *JJ.*, agree with this dissent.

QUEALY, *J.*, dissenting: I must agree with Judge Tannenwald. In this case, the petitioner did not make an unrestricted sale of the property for $2.4 million. The sale was conditional on a leaseback of the property at a rental which was predicated on the sales price, irrespective of value. This was coupled with an option whereby the petitioner might buy back the property at a price which reflected the amortization of the sales price on account of the payment of the rentals. As a part of the consideration, petitioner thus reserved or received a leasehold interest and a favorable option to buy back the property. All things considered, it cannot be said that the petitioner sold the property at a loss.

WILBUR, *J.*, dissenting: The majority opinion founders on an artificial "either-or" dichotomy, and the decision reached suffers from hardening of the categories. The logic proceeds this way: either the transaction must be a sale or exchange; it can't be an exchange as the lease has no capital value; therefore it must be a sale.[1]

This conclusion enables petitioner to immediately write off 25 percent of the costs of acquiring the right to use a building for one-half a century that was constructed for its own special purposes.[2] This does not accord with my understanding of the

[4] Neither party addressed itself to the issue whether the transaction herein was a mere financing arrangement. Cf. *Helvering v. F. & R. Lazarus & Co.*, 308 U.S. 252 (1939). Similarly, neither party advanced the contention that petitioner simply acted as Prudential's agent in constructing the building and was simply a conduit for the formal transfer of the property because of its ownership of the land, although it appears that a plausible argument in this vein might have been made.

[1] This is known as the fallacy of the unextended middle. That there was a middle not considered in this case is clearly spelled out in n. 4 of Judge Tannenwald's dissenting opinion. But more importantly, the majority opinion begs the question, ignoring both the form and substance of the transaction, as indicated later in this opinion.

[2] The majority found that the initial agreement provided for the execution of a lease including a rejectable offer to purchase at specified prices after 15, 20, 25, and 30 years. The lease however, did not give Prudential the right to sell the property to Leslie for the specified prices at these intervals, but simply provides that Leslie, at its option, may offer

applicable law.

The expenditure at issue here was clearly incurred for the leasehold interest of 50 years. The majority concedes this by stating that Leslie "would not have entered into the sales part of the transaction without the guarantee of the leaseback;" that the leaseback "was a necessary condition of the sale;" and that "it was only because of the leasehold that petitioner was willing to spend $3.187 million," (thus incurring the loss). This is indeed an ineluctable conclusion, since petitioner constructed the building for Prudential at cost, could not hope to make a profit,[3] but could very well incur a loss in view of the upper limit of $2.4 million on Prudential's investment commitment.

Additionally, petitioner had for several years been planning a new facility, had purchased a site, had plans designed for the facility, and had sought financing from several sources. The arrangement with Prudential brought these goals to fruition; and petitioner's sole motivation for entering into this agreement was to acquire the right to use the building for 50 years. This was the only right Leslie acquired when the first contract with Prudential was signed. The "loss" was purely and simply incurred to acquire the leasehold interest.

The majority ignores the consequences of its own findings by concluding the lease had no capital value.[4] If the thinly supported

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to purchase the property for the specified prices at these intervals, and if Prudential rejects the offer, the lease will terminate. Thus, Leslie had the right under the lease to a 50-year term (at a predetermined fixed rent), a term equal to the useful life Prudential claimed for depreciation purposes, and nearly twice the useful life stipulated to by the parties. According to testimony offered by both parties, there was every expectation Leslie would use the building for this period.

[3] Par. 1 of the Oct. 30, 1967, letter agreement states that "the sales price shall not exceed $2,400,000 or the *actual cost* of the land, building, and other improvements erected thereon, *whichever is less*." (Emphasis added.)

[4] This is a questionable conclusion. The record makes it abundantly clear that Prudential viewed its role as financier rather than landlord, with the opportunity to invest a fixed amount ($2.4 million) recoverable over 30 years with minimal risk to principal. Net "rent" was a percentage of the amount Prudential invested—7.94 percent of $2.4 million for the first 30 years, providing both a fixed interest equivalent and principal amortization. After the first 30 years (when Prudential expected to recover its investment), the "rent" was reduced to 3 percent of the original amount Prudential invested, because in the words of the Prudential official responsible for the transaction, "it was adequate after our initial 30-year period. It covered depreciation and et cetera."

If the "rent" charged pursuant to Prudential's financing objectives bore any relation to the rent an owner of the premises not involved in this type of financing would charge, it was purely coincidental. I seriously doubt the coincidence occurred. Such expert testimony as there is appears directed to the rentals charged for similar space at the time of the lease. In this case the "rent" for valuable real estate in a major metropolitan area could not be increased for one-half a century, and the "rent" for the last 20 years actually decreased to a findings as to fair market value require the conclusion that a loss was incurred, in view of the above analysis, why must the loss be attributed to the construction of the building (for cost on which no gain was possible) rather than to the acquisition of the leasehold, which was petitioner's only objective? The answer of the majority is two-fold. Since Prudential didn't receive property whose value exceeded the $2.4 million it paid, the leasehold interest must therefore have been worth nothing. Additionally, since the leasehold contemplated fair "rental," it was in fact worth nothing. But this clearly begs the question, since, according to the majority it was petitioner who expended money in excess of the consideration received, and thus incurred the loss here in issue. The question is what was the "loss" attributable to? On this record, the "loss" is clearly attributable to the acquisition of the right to use the property at a fixed rental (diminishing substantially after 30 years) over one-half a century.[5]

The majority also fragments the transaction into component parts that are completely incompatible with its findings that "the sale and leaseback was merely successive steps of a single integrated transaction," and that the leaseback was "an integral part of the transaction." It is also incompatible with recognized principles of tax law. As we stated in *George A. Roesel*, 56 T.C. 14, 25-26 (1971):

> the economic substance of a transaction must govern for tax purposes rather than the time sequence or form in which such transaction is cast. *Gregory* v. *Helvering*, 293 U.S. 465. And it is well established that where a series of closely

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little more than one-third of the "rent" charged during the first 30 years. Granted it was a net lease, it is still hard to believe that, aside from this package transaction and Prudential's financing role, an owner of real estate in this area would agree to a fixed "rent" for years nearly a half century in the future equal to 3 percent of the property's current value. It may have been adequate to Prudential's financing objectives, but there are real doubts it represented fair rental value over the half-century term of the lease.

[5] For this reason I don't deal with the issue of whether or not the leasehold interest may have had some subjective value to petitioners different from its objective or fair market value. Since under the facts here present the expenditure or "loss" was incurred as an integral part of the agreement to acquire the leasehold, rather than to liquidate a prior investment of considerable duration, this case is clearly distinguishable from *Jordan Marsh Co. v. Commissioner*, 269 F.2d 453 (2d Cir. 1959), nonacq. Rev. Rul. 60-43, 1960-1 C.B. 687, revg. a Memorandum Opinion of this Court. It is also distinguishable because Leslie could not hope, under the terms of its agreement to realize any profit from construction of the building or its transitory ownership of the property. It is, however, puzzling that the majority, after making its findings of fair rental value, specifically rely on *Jordan Marsh Co.* for its conclusion that there was a sale rather than an exchange, yet it claims it is unnecessary to consider the possible conflict between *Jordan Marsh Co.* and *Century Electric Co.*, 15 T.C. 581 (1950), affd. 192 F.2d 155 (8th Cir. 1951), cert. denied 342 U.S. 954 (1952).

related steps are taken pursuant to a plan to achieve an intended result the transaction must be viewed as an integrated whole for tax purposes. *Redwing Carriers, Inc.* v. *Tomlinson,* (C.A. 5) 399 F. 2d 652, and cases cited therein.

This fragmentation is also wholly at odds with the underlying economic realities. In analyzing respondent's argument that the loss was incurred to acquire the leasehold interest, the majority notes that this "seems to comport with the economic realities." Indeed it does, and the general rule, as noted in the above quotation, is that taxation is predicated upon the economic realities.

Prudential clearly looked upon this venture as a financing transaction providing the opportunity to invest $2.4 million at a reasonable interest rate with minimal risks to principal during the period of principal amortization. Petitioner was willing to incur the risk that construction costs would exceed the *maximum* of $2.4 million Prudential agreed to invest, since the risk was more than offset by the right to use the property for 50 years into the future at a fixed annual rental that was not only precluded from increasing, but was reduced substantially at the end of 30 years.[6]

While I believe the economic realities the majority refers to should control, this case does not really require the application of metaphysical concepts like substance over form, or any similar esoteric principles. In both substance and form petitioner contracted at the outset with Prudential for a long-term lease. The contract between the parties contemplated from the beginning—before the first brick was laid—that Prudential would own the land and the building and gave petitioner the right to a half-century of occupancy in return for the agreed rental and the risk of construction cost overruns. Petitioner could not possibly realize a profit on construction and was required[7] to convey title to Prudential as soon as the building was completed. The fact that transitory title was lodged in petitioner briefly along the way does not obscure the inexorable destination of the trip.

In summary, the amount here in controversy was both in substance and in form clearly incurred to acquire the leasehold

[6] A substantial but unspecified portion of petitioner's "loss" was attributable to special features presumably for Leslie's particular needs that should have been amortized in any event. Leslie did, in fact, amortize the entire "loss" on its books.

[7] Failure to convey title would have imposed substantial liquidated damages and probably caused petitioner to either default on their construction period loan or pay substantially higher interest rates to obtain alternative financing, or both.

interest, not to make a profit on construction, which was impossible under the terms of the contract involved. The "sale" was merely a "step" in an "integrated transaction," in the majority's own words. We should not view events the parties have telescoped into one package from the reverse end of the telescope.

TANNENWALD and HALL, *JJ.*, agree with this dissent.

Before ALDISERT, GIBBONS, and GARTH, Circuit Judges.

OPINION OF THE COURT

GARTH, Circuit Judge.

This appeal involves the tax consequences of a sale and leaseback arrangement. The question presented is whether the sale and leaseback arrangement constitutes an exchange of like-kind properties, on which no loss is recognized, or whether that transaction is governed by the general recognition provision of Int.Rev.Code § 1002.[1] The Tax Court, on taxpayer's petition for a redetermination of deficiencies assessed against it by the Commissioner, held that the fee conveyance aspect of the transaction was a sale entitled to recognition, and that the leaseback was merely a condition precedent to that sale. The Tax Court thereby allowed the loss claimed by the taxpayer. For the reasons given below, we affirm.

I.

Leslie Company, the taxpayer, is a New Jersey corporation engaged in the manufacture and distribution of pressure and temperature regulators and instantaneous water heaters. Leslie, finding its Lyndhurst, New Jersey plant inadequate for its needs, decided to move to a new facility. To this end, in March 1967 Leslie purchased land in Parsippany, on which to construct a new manufacturing plant.

Leslie, however, was unable to acquire the necessary financing for the construction of its proposed $2,400,000 plant. Accordingly, on October 30, 1967, it entered into an agreement with the Prudential Life Insurance Company of America, whereby Leslie would erect a plant to specifications approved by Prudential and Prudential would then purchase the Parsippany property and building from Leslie. At the time of purchase Prudential would lease back the facility to Leslie. The property and improvements were to be conveyed to Prudential for $2,400,000 or the actual cost to Leslie, whichever amount was less.

The lease term was established at 30 years,[2] at an annual net rental of $190,560, which was 7.94% of the purchase price. The lease agreement gave Leslie two 10-year options to renew. The annual net rental during each option period was $72,000, or 3% of the purchase price. The lease also provided that Leslie could offer to repurchase the property[3] at five-year intervals, beginning with the 15th year of the lease, at specified prices as follows:

at the end of the	(15th year	$1,798,000
	(20th year	1,592,000
	(25th year	1,386,000
	(30th year	1,180,000

1. All references are to the Internal Revenue Code of 1954.

2. The parties stipulated, and the Tax Court found accordingly, that the useful life of the building Leslie constructed was 30 years.

3. *See* note 10 *infra*.

Under the lease Prudential was entitled to all condemnation proceeds, net of any damages suffered by Leslie with respect to its trade fixtures and certain structural improvements, without any deduction for Leslie's leasehold interest.

Construction was completed in December, 1968, at a total cost to Leslie (including the purchase price of the land) of $3,187,414. On December 16, 1968 Leslie unconditionally conveyed the property to Prudential, as its contract required, for $2,400,000. At the same time, Leslie and Prudential executed a 30-year lease.

Leslie, on its 1968 corporate income tax return, reported and deducted a loss of $787,414 from the sale of the property.[4] The Commissioner of Internal Revenue disallowed the claimed loss on the ground that the sale and leaseback transaction constituted an exchange of like-kind properties within the scope of Int.Rev.Code § 1031. That section of the Code, if applicable, provides for nonrecognition (and hence nondeductibility) of such losses.[5] Rather than permitting Leslie to take the entire deduction of $787,414 in 1968, the Commissioner treated the $787,414 as Leslie's cost in obtaining the lease, and amortized that sum over the lease's 30-year term. Accordingly, Leslie was assessed deficiencies of $383,-023.52 in its corporate income taxes for the years 1965, 1966 and 1968.

Leslie petitioned the Tax Court for a redetermination of the deficiencies assessed against it, contending that the conveyance of the Parsippany property constituted a sale, on which loss is recognized.[6] The Tax Court agreed.[7]

Although the Tax Court found as a fact that Leslie would not have entered into the sale transaction without a leaseback guarantee, 64 T.C. at 250, it concluded that this finding was not dispositive of the character of the transaction. Rather, it held that to constitute an exchange under Int.Rev.Code § 1031 there must be a reciprocal transfer of properties, as distinguished from a transfer of property for a money consideration only. 64 T.C. at 252, *citing* Treas.Reg. § 1.1002–1(d). Based on its findings that the fair market value of the Parsippany property at the time of sale was "in the neighborhood of" the $2,400,000 which Pru-

4. The $787,414 was the difference between Leslie's actual cost of $3,187,414 and the $2,400,-000 which Prudential paid Leslie for the property. This 1968 loss resulted in a net operating loss for that year of $366,907, which was carried back to 1965, and the carryback of an investment credit of $436.41 to 1965 and of $50,700 to 1966.

5. Int.Rev.Code § 1031 is an exception to the general rule of recognition of gains and losses on the sale or exchange of property. It provides:

> (a) Nonrecognition of gain or loss from exchanges solely in kind.
> —No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment.

Int.Rev.Code § 1031(a).

If an exchange would be within this provision but for the fact that money is received in addition to property, no loss is recognized. Int. Rev.Code § 1031(c). According to the regulations promulgated pursuant to this section, an exchange of a fee for a leasehold interest with 30 or more years to run is a like-kind exchange. Treas.Reg. § 1.1031(a)–1(c).

The Commissioner characterizes the instant transaction as an exchange of real property for a 30-year lease plus cash ($2,400,000.) (Appellant's Brief at 2). Thus, in the Commissioner's view, Int.Rev.Code § 1031(c) applies.

6. Leslie amended its petition before trial to argue, in the alternative, that the transaction, if not a sale, should be viewed as a mortgage financing arrangement, thereby entitling Leslie to capitalize the property and avail itself of depreciation deductions and the investment tax credit. The Tax Court did not reach this issue because of its holding that the transaction was a sale. Similarly, our disposition makes it unnecessary for us to consider this alternative argument.

7. 64 T.C. 247 (1975).

dential paid, and that the annual net rental of $190,560 to be paid by Leslie was comparable to the fair rental value of similar types of property in the Northern New Jersey area,[8] the Tax Court majority reasoned that Leslie's leasehold had no separate capital value which could be properly viewed as part of the consideration paid. Accordingly, Leslie having received $2,400,000 from Prudential as the sole consideration for the property conveyed, the Tax Court held that the transaction was not an exchange of like-kind properties within the purview of Int.Rev.Code § 1031, but was rather a sale, and so governed by the general recognition provision of Int.Rev.Code § 1002.[9]

Six judges of the Tax Court dissented from this holding. Judge Tannenwald, in an opinion in which Judges Raum, Drennen, Quealy and Hall joined, agreed with the Tax Court majority that the conveyance was a sale, but would have disallowed a loss deduction, reasoning that the leasehold had a premium value to Leslie equal to the $787,414 difference between cost and sales price.[10] This dissent reasoned that since Leslie would not have willingly incurred the loss but for the guaranteed lease, this amount should be treated as a bonus paid for the leasehold, and should be amortized over the leasehold's 30-year term.

Judge Wilbur, in a separate dissent with which Judges Tannenwald and Hall agreed, 64 T.C. at 257, declined to decide whether the conveyance was a sale or an exchange. His concern was that the Tax Court majority was permitting the taxpayer to "write off 25 per cent of the costs of acquiring the right to use a building for one-half a century that was constructed for its [Leslie's] own special purposes." He, like Judge Tannenwald, would hold that the loss incurred was attributable to the acquisition of the leasehold interest rather than to the construction of the building.

The Commissioner's appeal from the decision of the Tax Court followed.

II.

The threshold question in any dispute involving the applicability of Int.Rev.Code § 1031 is whether the transaction constitutes an exchange. This is so because § 1031 nonrecognition applies only to exchanges. Section 1031 does not apply where, for example, a taxpayer sells business property for cash and immediately reinvests that cash in other business property even if that property is "like-kind" property. *Bell Lines, Inc. v. United States,* 480 F.2d 710 (4th Cir. 1973). Hence, our inquiry must center on whether the Leslie-Prudential transaction was a sale, as Leslie contends, or an exchange, as the Commissioner argues. If a sale, then, as stated, § 1031 is inapplicable and we need not be concerned further with ascertaining whether the other requirements of that section have been met. *See Jordan Marsh Co. v. Commissioner,* 269 F.2d 453, 455 (2d Cir. 1959). If an ex-

8. These findings were based on the testimony of a witness presented by the Commissioner, who testified that the sale price of the property and the rental established by the lease were comparable to their respective fair market values. This testimony, as might be expected, was uncontroverted by the taxpayer.

9. Int.Rev.Code § 1002 provides, in pertinent part:

Except as otherwise provided . . ., on the sale or exchange of property the entire amount of the gain or loss . . . shall be recognized.

10. 64 T.C. at 255. Judge Quealy also filed a separate dissent, 64 T.C. at 257, in which he pointed to Leslie's reservation of a favorable option to repurchase the property as further support for the position that the petitioner incurred no loss upon sale.

We are hard pressed to agree with this characterization of Leslie's very limited rights of repurchase under the lease as "favorable." The repurchase right is set forth in Article XXIV of the lease, entitled "Option to Purchase." Leslie is given the right to terminate the lease after the 15th, 20th, 25th and 30th years. To do so, however, it must make an offer to repurchase the property back from Prudential, at specified prices. *See* page 3, *supra*. Prudential need not accept the offer, although nonacceptance does not prejudice Leslie's rights of termination. Thus Leslie's option to offer to repurchase may be exercised only at the risk of losing the right to use the property for the remainder of the lease term.

change, then of course we would be obliged to continue our inquiry to determine if the properties involved were "like-kind."

The Tax Court's conclusion that the Leslie conveyance resulted in a sale was predicated almost totally on an analysis of the applicable Treasury Regulations. Noting that Treas.Reg. § 1.1002–1(b) requires a strict construction of § 1031,[11] the Tax Court tested the instant transaction against the definition of "exchange" contained in Treas.Reg. § 1.1002(d):

> (d) Exchange. Ordinarily, to constitute an exchange, the transaction must be a reciprocal transfer of property as distinguished from a transfer of property for a money consideration only.

Based on its conclusion that the leasehold had no capital value, the Tax Court held that it was not a part of the consideration received but was merely a condition precedent to the sale. Thus, the conveyance to Prudential was "solely for a money consideration" and therefore was not an "exchange." The Tax Court cited *Jordan Marsh Co. v. Commissioner, supra,* in support of its result. In light of its holding, it specifically declined to consider or resolve any possible conflict between *Jordan Marsh,* a decision of the Second Circuit, and the Eighth Circuit decision in *Century Electric Co. v. Commissioner,* 192 F.2d 155 (8th Cir. 1951), *cert. denied,* 342 U.S. 954, 72 S.Ct. 625, 96 L.Ed. 708 (1952).

The Commissioner, relying on *Century Electric,* argues that the Tax Court erred in holding the Leslie-Prudential conveyance to be a sale. He could not, and does not, dispute the Tax Court's findings as to the fair market value and fair rental value of the property. Rather, he argues that value in this context is irrelevant and that the only appropriate consideration is whether the conveyance of the fee and the conveyance of the leasehold were reciprocal.[12] The Commissioner, without regard to his own regulations which define an "exchange," then seeks to support his position by reference to the legislative purpose giving rise to the enactment of the nonrecognition provision. He argues that this provision (§ 1031 and its predecessors) was adopted primarily to eliminate any requirement that the government value the property, involved in such exchanges.[13] Alternatively, the Commissioner argues that even if the conveyance is held to be a sale and thereby not within Int.Rev.Code § 1031, any expenditure incurred by Leslie over and above the selling price of $2,400,000 was not a loss as claimed, but rather a premium or bonus which Leslie paid to obtain the leasehold. Such an expenditure is a capital expenditure, the Commissioner argues, and

11. Treas.Reg. § 1.1002–1(b) provides in pertinent part:

> (b) Strict Construction of Exceptions From General Rule. The exceptions from the general rule requiring the recognition of all gains and losses, like other exceptions from a rule of taxation of general and uniform application, are strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception. Nonrecognition is accorded by the Code only if the exchange is one which satisfies both (1) the specific description in the Code of an excepted exchange, and (2) the underlying purpose for which such exchange is excepted from the general rule. . . .

12. As noted above, the Tax Court found that this element of reciprocity *was* present.

13. The Commissioner takes the position that:

> The statute was intended to be corrective legislation of three specific shortcomings of prior Revenue Acts, viz—(1) the administrative burden of valuing property received in a like-kind exchange; (2) the inequity, in the case of an exchange, of forcing a taxpayer to recognize a paper gain which was still tied up in a continuing investment; and (3) the prevention of taxpayer from taking colorable losses in wash sales and other fictitious exchanges. Preliminary Report of a Subcommittee of the House Committee on Ways and Means on Prevention of Tax Avoidance, 73d Cong., 2d Sess. (1933), pp. 37–42. See H.Rep.No.350, 67th Cong., 1st Sess. (1921), p. 10 (1939–1 Cum.Bull. (Part 2) 168, 175–176); H.Rep.No.704, 73d Cong., 2d Sess. (1934), pp. 12–13 (1939–1 Cum.Bull. (Part 2) 554, 563–564). The construction of Section 1031 in *Jordan Marsh* [*see* discussion *infra* p. 948] satisfies only one of these Congressional objectives. And, further, it has the effect of frustrating the Congressional objective of removing the administrative burden of valuating property in like-kind exchanges.

Appellant's Brief at 11.

therefore should be amortized over the 30-year lease term.

Leslie, on the other hand, urges affirmance of the Tax Court's holding, relying on *Jordan Marsh Co. v. Commissioner, supra,* and stresses, as does the Tax Court, that the initial issue to be resolved is the character of the transaction. Alternatively Leslie argues that, if the conveyance is held to be a like-kind exchange within Int.Rev.Code § 1031, Leslie, even though it is not the owner of the fee, should nonetheless be permitted to depreciate the property on an accelerated (double declining) basis and to avail itself of investment tax credits.[14]

In *Century Electric Co. v. Commissioner, supra,* the Eighth Circuit held a sale and leaseback arrangement to be a like-kind exchange governed by the nonrecognition provision of § 112 (the predecessor to § 1031). Its holding that no loss was to be recognized was based solely on its finding that the sale and leaseback transactions were reciprocal. The Eighth Circuit read the legislative history of § 112 as evidencing a Congressional purpose to relieve the government of the administrative burden of valuing properties received in like-kind exchanges. Thus the Court stated (192 F.2d at 159) that:

> the market value of the properties of like kind involved in the transfer does not enter into the equation.

By contrast, in *Jordan Marsh v. Commissioner, supra,* a case construing the same code provision as *Century Electric,* the Second Circuit held that a similar sale and leaseback transaction resulted in a *sale,* on which loss was recognized. The facts in *Jordan Marsh* were similar to the facts here. Jordan Marsh, the taxpayer, had sold two parcels of land for cash in the sum of $2.3 million, an amount which was stipulated to be equal to the fair market value of the property. Simultaneously, the premises were leased back to Jordan Marsh for a term of 30-plus years, with options to renew. The rentals to be paid by Jordan Marsh were "full and normal rentals", so that the Court found that the leasehold interest had no separate capital value.

The Court, in examining the legislative history of § 112, took issue with the Eighth Circuit's interpretation of the Congressional purpose behind the nonrecognition provision. The Second Circuit said that:

> Congress was primarily concerned with the inequity, in the case of an exchange, of forcing a taxpayer to recognize a paper gain which was still tied up in a continuing investment of the same sort.

269 F.2d at 456. It reasoned further that, if gains were not to be recognized on the ground that they were theoretical, then neither should losses, which were equally theoretical, be recognized. Analyzing the Jordan Marsh transaction in the light of this interpretation of Congressional purpose, the Second Circuit, finding Jordan Marsh had liquidated its investment in realty for cash in an amount fully equal to the value of the fee, concluded that the taxpayer was not "still tied up in a continuing investment of the same sort." Accordingly, the Court held that there was no exchange within the purview of § 112(b), but rather a sale.

Thus we may interpret the essential difference between *Jordan Marsh* and *Century Electric* as centering on their respective views of the need to value property involved in a sale and leaseback.[15] *Jordan*

14. As might be anticipated, the Commissioner would disallow both the depreciation and the investment tax credit on the ground that the leasehold, unlike a fee, is an intangible interest in property.

Leslie concedes in its brief that accelerated depreciation may be taken only with respect to tangible property, but argues that if the sale and leaseback transaction is held to be a like-kind exchange then the leasehold property received in exchange for the concededly "tangible" fee interest, must also be viewed as "tangible."

The Commissioner filed a reply brief in which he argued that Leslie's failure to file a cross-appeal precluded it from raising this issue. Because we do not reach Leslie's alternative argument, we need not decide whether it was properly raised.

15. The Court in *Jordan Marsh* also distinguished *Century Electric* on its facts, since in that case there had been no finding that the cash received by the taxpayer was the full

Marsh, viewing the Congressional purpose behind the non-recognition provision as one of avoiding taxation of paper gains and losses, would value the properties involved in order to determine whether the requirements of an "exchange" have been met. *Century Electric,* on the other hand, viewing the legislative enactment as one to relieve the administrative burden of valuation, would regard the value of the properties involved as irrelevant.

We are persuaded that the *Jordan Marsh* approach is a more satisfactory one. First, it is supported by the Commissioner's own definition of "exchange" which distinguishes an exchange from a transfer of property *solely* for a money consideration. Treas.Reg. § 1.1002–1(d) (emphasis added).[16] Second, if resort is to be had to legislative history, it appears to us that the view of Congressional purpose taken by the *Jordan Marsh* court is sounder than that of the Eighth Circuit in *Century.* As the Court in *Jordan Marsh* said in discounting the purpose attributed to Congress by the Commissioner and by *Century Electric*:

> Indeed, if these sections had been intended to obviate the necessity of making difficult valuations, one would have expected them to provide for nonrecognition of gains and losses in all exchanges, whether the property received in exchanges were 'of a like kind' or *not* of a like kind. And if such had been the legislative objective, § 112(c) providing for the recognition of gain from exchanges not wholly in kind, would never have been enacted. (Footnote omitted).

It seems to us, therefore, that in order to determine whether money was the sole consideration for a transfer the fair market value of the properties involved must be ascertained. Here, the Tax Court found that Leslie had sold its property unconditionally for cash equal to its fair market value, and had acquired a leasehold for which it was obligated to pay fair rental value. These findings, not clearly erroneous, are binding on this Court. *See* Int.Rev. Code § 7482; *Thornton v. United States,* 493 F.2d 164, 166 (3d Cir. 1974).

Nor do we think the Tax Court erred in concluding that the leasehold acquired by Leslie had no capital value. Among other considerations, the rental charged at fair market rates, the lack of compensation for the leasehold interest in the event of condemnation, and the absence of any substantial right of control over the property all support this conclusion. On this record, we agree with the Tax Court that the conveyance was not an exchange, "a reciprocal transfer of property," but was rather "a transfer of property for a money consideration only," and therefore a *sale, see* Treas. Reg. § 1.1002–1(d), governed by the general recognition provision of Int.Rev.Code § 1002.

The Commissioner's evidence that the rentals charged to Leslie under its lease were at fair market value, leading to our conclusion that the leasehold had no capital value, also disposes of the Commissioner's alternative argument on appeal that Leslie's excess cost of $787,414 was not a loss. *See* Int.Rev.Code §§ 1002, 1001.

The decision of the Tax Court will be affirmed.

equivalent of the value of the fee which had been conveyed. Nor had there been a finding that the leaseback was at a rental which was a fair rental for the premises.

Indeed, as noted in *Jordan Marsh,* the record in *Century Electric* indicated that the sales price was substantially less than the fair market value. There was also evidence from which the Court could have found that the leasehold had a separate capital value, since the conveyance to a nonprofit college avoided considerable tax liabilities on the property.

16. It was this definition on which the Tax Court relied in large part in holding the Leslie conveyance to be a sale for $2,400,000.

Rev. Rul. 90-34, 1990-16 I.R.B. 6 (April 16, 1990).

Rev. Rul. 90-34

ISSUE

If X transfers property to Y in exchange for property of a like kind, may the exchange as to X qualify for nonrecognition of gain or loss under section 1031 of the Internal Revenue Code even though legal title to the property received by X is never held by Y?

FACTS

X and Y are unrelated persons. X files its U.S. income tax return on a calendar year basis. On May 14, 1989, X and Y enter into a contract that requires X to transfer Blackacre to Y and Y to transfer to X property of a like kind with the same fair market value. Blackacre, unencumbered real property, has been held by X for productive use in its trade or business and has a fair market value of $1,000,000. Under the contract, X is required to locate and identify property with a fair market value of $1,000,000 that is of a like kind to Blackacre within 45 days of X's transfer of Blackacre to Y (the "identification period"), and Y is required to purchase and transfer the identified property to X before the earlier of 180 days from the transfer of Blackacre or the due date (including extensions) for X's U.S. income tax return for the taxable year in which X's transfer of Blackacre to Y occurs (the "exchange period"). If X fails to identify the property to be received in the transaction before the end of the identification period or Y fails to purchase and transfer such property to X before the end of the exchange period, Y is required to pay $1,000,000 to X. Neither X nor Y contracts to exchange Blackacre with any other party.

On May 23, 1989, X transfers Blackacre to Y. On June 1, 1989, X properly identifies Whiteacre as the property to be received. Whiteacre, owned by Z, a person unrelated to X, is unencumbered real property that has a fair market value of $1,000,000 and is of a like kind to Blackacre. On July 10, 1989, Y purchases Whiteacre from Z, and, at Y's direction, Z transfers legal title to Whiteacre directly to X before the end of the exchange period. X, thereafter, holds Whiteacre for productive use in its trade or business.

LAW AND ANALYSIS

Under section 1031(a)(1) of the Code, no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind that is to be held either for productive use in a trade or business or for investment.

Section 1031(a)(3) of the Code provides that any property received by a taxpayer will be treated as property which is not like-kind property if (A) such property is not identified as property to be received in the exchange on or before the day which is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange, or (B) such property is received after the earlier of (i) the day which is 180 days after the date on which the taxpayer transfers the property relinquished in the exchange, or (ii) the due date (including extensions) for the taxpayer's federal income tax return for the taxable year in which the transfer of the relinquished property occurs.

If Z had actually transferred legal title to Whiteacre to Y and Y had then transferred legal title to Whiteacre to X, the exchange of Whiteacre for Blackacre, as to X, would clearly qualify for nonrecognition of gain or loss under section 1031(a) of the Code. However, section 1031(a) does not require that Y hold legal title to Whiteacre, but merely that X receive solely property of a like kind to the property transferred in order for the exchange to qualify for nonrecognition of gain or loss. Therefore, the failure of Y to acquire legal title to Whiteacre does not disqualify X from nonrecognition of gain or loss under section 1031(a) on the transfer of Blackacre to Y in exchange for White acre.

HOLDING

X's transfer of property to Y, in exchange for property of a like kind, qualifies as to X for nonrecognition of gain or loss on the exchange under section 1031 of the Code even though legal title to the property received by X is never held by Y.

DRAFTING INFORMATION

The principal author of this revenue ruling is D. Lindsay Russell of the Office of Assistant Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Mr. Russell on (202) 343-2381 (not a toll-free call).

Hilton v. Commissioner, 74 T.C. 305 (1980).
Nims, J.

*   *   *   *   *   *   *

This case involves (1) a sale-leaseback transaction between Broadway-Hale Stores, Inc. (Broadway), as seller-lessee, and Fourth Cavendish Properties, Inc. (Fourth Cavendish), as buyer-lessor; (2) the transfer by Fourth Cavendish of its interest, if any, in the property, located in Bakersfield, Calif., which is the subject of the sale-leaseback transaction (the property) to Medway Associates, a New York general partnership (Medway); (3) the acquisition of various interests in Medway by a series of "tier" partnerships: Grenada Associates (Grenada), Fourteenth Property Associates (14th P.A.), and Thirty-Seventh Property Associates (37th P.A.); and (4) the investment by petitioners as limited partners in two of the tier partnerships: 14th P.A. and 37th P.A.[3]

The principal issue presented for our consideration is whether petitioners are entitled to deduct their distributive shares of partnership losses. The issue arises in the context of the above-mentioned sale and leaseback transaction, and the claimed losses were attributable to the excess of interest expense and depreciation over rental income from the property and to compensation to partners.

Petitioners take the position that as members of one or the other of two partnerships, 14th P.A. or 37th P.A., they were entitled to deduct their distributive share of the alleged

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[3]Some of the petitioners invested in 14th P.A., while others invested in 37th P.A., but the legal issues herein are identical as to the investments in both partnerships.

partnership losses. In support of their position, petitioners contend that the sale and leaseback was a bona fide transaction, that the substance of the sale and leaseback comported with its form, that petitioners entered the transaction for reasons of economic substance apart from tax considerations, that indirectly through the various partnership tiers they acquired a depreciable interest in the property and sufficient obligations vis-a-vis the debt to entitle them to depreciation and interest deductions, and that the partners' compensation at issue was payment for future services.

Respondent makes three alternative arguments:

1. The transactions were contrived and "sham" transactions entered into by petitioners for the purpose of creating and obtaining deductions for artificial tax losses and nondeductible payments.
2. The sale and leaseback was a mere financing transaction and petitioners through their partnership interests did not acquire sufficient risks, benefits and burdens of ownership to constitute them as the owners of the Property for tax purposes.
3. The transactions involving petitioners were not transactions entered into for profit but were without any legal, economic or business purpose other than tax avoidance.

Consequently, respondent's view is that petitioners are not entitled to any partnership loss deductions during the years at issue.

Respondent has also raised various alternative issues in the event we uphold the validity of the sale-leaseback and find that Fourth Cavendish acquired an interest in the Bakersfield property which passed through to petitioners.

* * * *

OPINION

The principal issue presented for our consideration is whether petitioners are entitled to deduct their distributive shares of asserted partnership losses arising out of a sale and leaseback transaction.[14] The losses flowed through a series of tiered[15] partnerships and were attributable to payments to partners claimed as deductible expenses and to the excess of interest expense and depreciation over rental income from the property—the subject of the sale and leaseback. The availability of interest and depreciation deductions turns on whether the substance of the sale and leaseback comported with its form; the compensation question turns on whether the payments to promoters constituted deductible prepaid management fees or were payments for past services which must be capitalized.[16]

The terms of this sale and leaseback transaction are fairly traditional. In 1964, Broadway, a large department store chain, decided to build a retail department store in a proposed shopping center in Bakersfield, Calif. Although Broadway would provide immediate financing for construction through internal sources, its intention from the start was to obtain long-term financing for the building once it had been completed.

It had been decided that the store would be financed by making use of what has come to be known in the trade as a single-purpose financing corporation, formed and availed of for, and limited to, the sole purpose of facilitating this one transaction. Under this plan, the single-purpose corporation, Fourth Cavendish, would sell its corporate notes to certain insurance company lenders.[17] Broadway would then sell the property to Fourth Cavendish and funds derived from the sale of the notes would be paid to Broadway as the purchase price for the property. Simultaneously with the sale, Fourth Cavendish would

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[14]Some of the petitioners invested in 14th P.A. while others invested in 37th P.A., but the legal issues herein are identical.

[15]See discussion of the "Multi-Tiered Partnership" in A. Willis, Partnership Taxation, sec. 61–07, p. 181 (2d ed. 1976).

[16]The issues as framed by the parties are stated above in the preamble.

[17]As we have found in the findings of fact, Fourth Cavendish was used as the single vehicle for the sale and leaseback of three stores, including the one in Bakersfield with which we are concerned. However, since the transaction involving each of the three was, in a manner of speaking, hermetically sealed off from, and essentially unrelated to, the other two, we will, for simplicity of expression, deal with Fourth Cavendish in this opinion as though it were the single-purpose corporation for only the Bakersfield property (i.e., the property).

lease the property back to Broadway. In February 1965, commitments were obtained from the insurance companies to provide the financing once the building was completed.

Construction of the store by Broadway was completed in January 1967, and the store was occupied and opened for business in February 1967. Fourth Cavendish was formed on January 17, 1967. The stock of Fourth Cavendish was held in the name of Wood, Struthers, a New York investment firm that served as the intermediary in negotiating the transaction between Broadway and the insurance companies. On December 20, 1967, Fourth Cavendish sold its mortgage notes to the lenders and turned the proceeds over to Broadway as the purchase price for the property.

The entire cost of the purchase was raised by the sale of mortgage notes. Broadway paid the commitment fees and commissions for arranging the sale of the mortgage notes. Fourth Cavendish then transferred the property back to Broadway as lessee under a net lease (the lease) for a 30-year term with options for Broadway to extend for another 68 years.

The mortgage notes were secured by an indenture of mortgage and deed of trust which conveyed Fourth Cavendish's interest in the property to trustees (the trustee) for the insurance companies and by an assignment of the lease and the rentals to the trustee.

The transaction and the lease were structured so that Broadway's relationship vis-a-vis the property remained virtually unchanged. The lease is of the type known in the trade as a "triple net" lease; it absolved Fourth Cavendish and its assignees of any financial obligation relating to the property except the obligation to make monthly principal and interest payments. Even this obligation was structured so that it would place no burden on Fourth Cavendish. Rent payments were calculated to provide the lessor with just enough money to meet the periodic principal and interest payments and expenses incident thereto for the 30-year term that the third-party financing was outstanding. Fourth Cavendish was not required to take the formal step of making the payments. The rent flowed directly to the insurance companies from Broadway.

The transaction was further structured so that when Fourth Cavendish or its assignee completes paying off the financing, rental payments (assuming renewal options are exercised by

Broadway) will be reduced to $1\frac{1}{2}$ percent of the purchase price for the first renewal term of 23 years and to 1 percent of the purchase price for the second and third renewal terms.

At approximately the time that the sale and leaseback was effected in December 1967, Fourth Cavendish transferred its interest in the property to Medway, a general partnership that had just been formed to receive such interest. The partners in Medway were Cushman, holding a 50-percent partnership interest, MacGill, holding a 1-percent interest (both were partners in the Wood, Struthers investment firm), and a limited partnership that had just been formed, 14th P.A., which held a 49-percent interest.

It was to 14th P.A. that some of the petitioners in this case belonged as limited partners. The general partner in 14th P.A. was Jack R. Young & Associates (JRYA). The only contributions to 14th P.A. were made by the limited partners, who also held a 100-percent interest in the profits and losses of that partnership. Of the $180,000 contributed by the limited partners to the partnership, $70,000 was paid by the partnership to the general partner, JRYA, for "services," and the remainder $110,000 was paid to Medway as a capital contribution. Medway in turn paid the $110,000 to Cushman for services.

Fourteenth P.A. had only a 49-percent interest in Medway and thus a 49-percent interest in the property. A 51-percent interest in Medway (and thus the property) continued to be held by Cushman.

In 1969, Cushman and his colleagues decided to dispose of an additional 49-percent interest in Medway. To this end, two additional partnerships were formed. Grenada, a limited partnership, was formed by Cushman on some date after October 15, 1969. To this limited partnership, Cushman transferred all of his interest in Medway except for one-half of a 1-percent retained interest. Cushman was the general partner of Grenada and 37th P.A. was the limited partner. Thirty-seventh P.A. was formed by JRYA, which was the general partner, sometime in 1969. Thirty-seventh P.A. held 99 percent of the interest in Grenada. The limited partners in 37th P.A. contributed $155,000 to 37th P.A., of which $60,000 went to JRYA as a "payment for services" and $95,000 was paid to Grenada as a capital contribution and then paid to Cushman "for services." Most of the limited partners in 37th P.A. are also petitioners in this proceeding.

Interest and Depreciation Deductions

Notwithstanding the intricacies of the above-described tier partnership labyrinth, the central issue in this case is the bona fides of the sale-leaseback. This is essentially an exercise in substance versus form, and as earlier stated by the Supreme Court, "In the field of taxation, administrators of the law, and the courts, are concerned with substance and realities, and formal written documents are not rigidly binding." *Helvering v. Lazarus & Co.*, 308 U.S. 252, 255 (1939). Notwithstanding the approval of the sale-leaseback in the *Frank Lyon* case,[18] we do not understand the teaching of the Supreme Court's decision in that case to be that we are to accept *every* putative sale-leaseback transaction at face value, but rather that our precept is to determine whether there is, in the words of the Supreme Court, "a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached." *Frank Lyon Co. v. United States*, 435 U.S. 561, 583–584."[19]

We also recognize, as the Supreme Court made clear in *Frank Lyon*, that a sale-leaseback, in and of itself, does not necessarily operate to deny a taxpayer's claim for deductions. In this connection, implicit in the Supreme Court's opinion is the acceptance of the proposition (a position here argued in the brief amicus curiae) that the seller-lessee's financing requirements may be a valid business purpose to support a sale-leaseback transaction for tax purposes. See Note—"Problems of Judicial Interpretation of Real Estate Sale and Leaseback Taxation:

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[18] *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978).

[19] The tax consequences of real estate sale-leaseback transactions have been exhaustively analyzed by the courts and commentators, both before and after the *Frank Lyon Co.* decision. Some, but not all, of the cases are: *Estate of Franklin v. Commissioner*, 64 T.C. 752 (1975), affd. 544 F.2d 1045 (9th Cir. 1976); *Sun Oil Co. v. Commissioner*, 562 F.2d 258 (3d Cir. 1977); *American Realty Trust v. United States*, 498 F.2d 1194 (4th Cir. 1974); *Bolger v. Commissioner*, 59 T.C. 760 (1973); *Hill v. Commissioner*, 63 T.C. 225 (1974), affd sub nom. *Tenner v. Commissioner*, 551 F.2d 313 (9th Cir. 1977); *Miller v. Commissioner*, 68 T.C. 767 (1977); *Davis v. Commissioner*, 66 T.C. 260 (1976), affd 585 F.2d 807 (6th Cir. 1978), cert. denied 440 U.S. 981 (1979). See also L. Kaster, "Sale-Leasebacks Economics, Tax Aspects and Lease Terms," Practising Law Institute (1979).

Description, Analysis, and Proposed Revision," 33 Tax Law. 237, 250 (1979).

To recapitulate the foregoing, the transaction before us will not stand or fall merely because it involved a sale-leaseback mandated by Broadway's financing requirements, but rather must be tested to determine whether it (the transaction) (1) is genuinely multiple-party, (2) with economic substance, (3) compelled or encouraged by business realities (no "regulatory" realities are claimed), and (4) is imbued with tax-independent considerations which are not shaped solely by tax-avoidance features. *Frank Lyon Co. v. United States, supra.*

One key element of the above test is the phrase "genuinely multiple-party" for obviously, when looked at only from the viewpoint of Broadway, as seller-lessee, the transaction had economic substance and was encouraged by business realities. Petitioners have claimed in their brief and we have no reason to gainsay them that, had conventional mortgage financing been used, the insurance companies would have lent only 75 percent of the value of the property. The insurance companies, furthermore, had limitations on the total amounts and proportions of their funds that could be committed to direct real estate mortgages. Under the sale-leaseback approach Broadway was, in effect, able to finance 100 percent of the acquisition cost of the property. In addition, the purchase of corporate notes, which were secured by a lease between the corporation and a well-rated tenant, avoided certain other insurance company lending restrictions.

Similarly, Broadway had limitations in its loan and credit agreements with its banks which put a ceiling on the total amount of debt it could incur and also limited the total value of its property which could be mortgaged. At the same time, Broadway expected to be able to deduct as rent, during the initial 30-year term of the lease, an amount equal to 90 percent of the principal amortization and 100 percent of the interest costs of the underlying mortgage on the property. The mortgage contained a 10-percent balloon at the end of the 30-year term.

It is thus apparent that, viewed broadly from the vantage point of Broadway and the insurance companies, the sale-leaseback transaction followed what is essentially a widely used and acceptable business practice embracing substantial business as well as tax purposes and which had significant economic, nontaxable substance. In this context, we do not deem the existence of a net lease, a nonrecourse mortgage or rent during the initial lease term geared to the cost of interest and mortgage amortization to be, in and of themselves, much more than neutral commercial realities. Furthermore, the fact that the transaction was put together by an "orchestrator" (to use petitioner's term) would not alone prove fatal to the buyer-lessor's cause provided the result is economically meaningful on both sides of the equation. For even before the enactment of the at-risk rules of section 465, equipment-leveraged leases, often "packaged" by brokers, were acceptable to the Commissioner where substantial nontax economic interests were acquired by the buyer-lessor. Rev. Proc. 75–21, 1975–1 C.B. 715.

Overall, considering the involvement of Broadway and the insurance companies, there was at least a two-party aspect to the transaction. We explore subsequently herein, whether the facts, as they did in *Frank Lyon,* disclose a genuine *three*-party aspect.

But what Broadway sees is a reflection from only one polygon of the prism. In the *Frank Lyon* case, the Supreme Court appraised not only the substance of the seller-lessee's interest, but also that of the buyer-lessor and the legal and economic substance of the contractual relationship between the two.

We, therefore, turn now to a consideration of the substance of the buyer-lessor's (i.e., the petitioners') interest, and here the substantiality of that interest, aside from tax considerations, is far less apparent.[20] We must thus inquire: does the buyer-lessor's interest have substantial legal and economic significance aside from tax considerations, or is that interest simply the purchased tax byproduct of Broadway's economically impelled arrangement with the insurance companies?

It would, perhaps, at this point be appropriate to observe that the facts before us closely parallel the rather paradigmatic facts

[20]In their brief, petitioners draw attention to the fact that while title to the property is in the Medway partnership as transferee from Fourth Cavendish, there is a traceable claim of ownership to petitioners, and the losses claimed by petitioners are derived from the losses resulting from the ownership of the property by Medway. For convenience, therefore, we will from time to time refer to the petitioners by the generic description "buyer-lessor." We emphasize that, at this point, we are not considering the partnership and other tax questions inherent in the series of steps leading to the acquisition by petitioners of their respective limited partnership interests in 14th P.A. and 37th P.A.

(particularly where State law usury problems are encountered) of *Bolger v. Commissioner*, 59 T.C. 760 (1973). In *Bolger*, however, as we observed in note 5 of our opinion, "Respondent concedes that the leases involved should be recognized as such and makes no argument that the lessees are the ones to whom the benefit of a depreciation deduction should inure. Cf. *Helvering v. Lazarus & Co.* [,*supra*]" (59 T.C. at 767). Thus, we were there not called upon to scrutinize the leases qua leases.

We further observed in *Bolger* that the Commissioner might have pressed, but did not, the concept that, by virtue of the leases and financing transactions, the single-purpose finance corporations divested themselves (in favor of the lessee and the lenders) of all but bare legal title to the properties there in question. Following this concept to its logical conclusion would then have required a determination either that the single-purpose corporations thereby deprived themselves of any presently depreciable interest or that this right to deduct the cost of the buildings should be by way of amortization over the lease terms. Instead, the Commissioner merely argued that the buyer-lessor corporations retained, after the leaseback, such an interest in the properties as opposed to their transferees that they, and not the latter, should be held accountable for the income from the properties and be entitled to the depreciation deduction.

By contrast, in the case before us, respondent does not so blithely abandon ship and it is the efficaciousness of the lease, itself, which he now frontally attacks. Simply stated, respondent's position is that Fourth Cavendish and Medway, its transferee, are severally or collectively merely a pipeline through which Broadway transmits its mortgage payments to the insurance companies, lacking independent significance.[21]

Under the *Frank Lyon* test, petitioners must show not only that their participation in the sale-leaseback was not motivated or shaped solely by tax avoidance features that have meaning-

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[21]Respondent does not argue that *Bolger* should be distinguished because the partnerships here may not have assumed (at least at the inception of the sale-leaseback transaction) all of the obligations of the single-purpose financing corporation. Cf. *Davis v. Commissioner*, 66 T.C. 260 (1976), affd. 585 F.2d 807 (6th Cir. 1978), cert. denied 440 U.S. 981 (1979). For example, Fourth Cavendish transferred all its interest in the property to the trustee for the insurance companies under the mortgage indenture, and Fourth Cavendish also assigned all its interest in the lease to the trustee. In addition, we have found as a fact that Medway did not assume Fourth Cavendish's obligations under the lease until Jan. 12, 1970.

less labels attached, but also that there is economic substance to the transaction independent of the apparent tax shelter potential. Another way of stating the test is suggested by the Ninth Circuit's opinion in *Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9th Cir. 1976), affg. 64 T.C. 752 (1975), to wit: Could the buyer-lessor's method of payment for the property be expected at the outset to rather quickly yield an equity which buyer-lessor could not prudently abandon? An affirmative answer would produce, in the words of the Circuit Court, "the stuff of substance. It meshes with the form of the transaction and constitutes a sale." (544 F.2d at 1098.) Consequently, if the test is not met, the buyer-lessor will not have made an investment in the property, regardless of the form of ownership. And it is fundamental that depreciation is not predicated upon ownership of property but rather upon an investment in property. *Estate of Franklin v. Commissioner, supra* at 1049; *Mayerson v. Commissioner*, 47 T.C. 340, 350 (1966).

We recognize that the result in *Estate of Franklin* was predicated upon a finding that the purchase price of the property in question exceeded a demonstrably reasonable estimate of the fair market value. Nevertheless, we consider the imprudent abandonment test to be equally applicable to other fact patterns. For example, we find it appropriate to inquire, as we do in the instant case, whether the foreseeable value of the property *to the buyer-lessor* would ever make abandonment imprudent. This then requires an examination of the economics of the buyer-lessor's position to determine whether there has been, in fact, an investment in the property.

Petitioners and respondent each relied substantially upon the testimony of expert witnesses to show the presence or absence of economic motivation on the part of petitioners. In our findings of fact, we have recited in detail the qualifications of the respective experts and the conclusions they reached. We now explore the rationale behind their respective conclusions.

We begin by noting that Lichter, petitioners' expert, placed substantially his entire emphasis upon the making of assumptions about the value of the property, alternatively, 30, 53, or 76 years from 1967, determining the result of those assumptions in terms of the economic return to the petitioners, and then testing the reasonableness of the underlying assumptions. Lichter assumed that the property (land and building) would be worth its purchase price of $3,150,000 (rounded off from $3,144,337) on the date Broadway decided not to extend the lease, whether it be 30, 53, or 76 years from the commencement of the lease. He then calculated the discounted rate of return to be 7.08 percent, 4.81 percent, and 3.95 percent, depending upon whether Broadway terminated the lease after 30, 53, or 76 years.[22]

Lichter asserted that the 100-percent residual value theory is a reasonable and neutral assumption and one that is employed by a number of institutional lenders or purchasers in evaluating potential investments, although he did concede that the assumption might be considered "slightly positive" in this case. To illustrate the reasonableness of the assumption as applied in this case, Lichter employed several tests. Using the assessed value of $812,690 assigned to the land in 1967, Lichter concluded that the land value would have to appreciate only 4.7 percent per year for the land alone to be worth, in 1997, what the total land and improvements were worth in 1967.

Lichter then computed the value of the land, alone, in 1997, using a linear regression analysis. Linear regression analysis is simply a process of extrapolation. In this context, points on a graph represent the value of the Bakersfield land at particular times; the straight line on the graph connecting known values is extrapolated or extended so that the value at other times can be determined. Again, using *assessed* values, this time for the years 1967 through 1971, Lichter concluded that the value in 1997, as indicated by a linear regression analysis, would be $3,516,000.

Lichter employed similar calculations to determine the rate of return that would be earned by the petitioners at the end of each renewal term if Broadway chose not to extend the lease beyond each such term. Again, it was assumed that the property could be sold at such time as Broadway did not renew the lease for at least what the property was worth in 1967. Lichter also assumed that the balloon payment would be financed at 5⅛-percent interest and that a portion of the rent for the first renewal period would be used to satisfy the loan payments. He calculated the discounted rate of return on the original investment resulting from a sale of the property for its original value at the end of 53 years, plus the receipt of the rental income not needed

[22]Lichter made computational errors in his calculations which we see no need to discuss.

to finance the balloon payments, as 4.81 percent. Similar calculations assuming a sale after 76 years resulted in a discounted rate of return of 3.95 percent.

The weakness in Lichter's approach is that it assumes a priori one of the very points in issue, namely, the residual value of the property at such time when it is no longer subject to the lease. Lichter's attempt to establish this assumed value, the 100-percent residual value, fails because neither the 100-percent residual value theory nor the two tests employed to check the reasonableness of the theory are tied to the facts. Although the accuracy of the two tests is dependent upon the accurancy of the known values, Lichter did not attempt to ascertain the known values. Rather, he simply based his projections on the assessed land values without considering any evidence of valuation techniques employed by the assessor to ascertain whether such techniques were valid or the values reasonable.

Alternatively, Lichter might have been able to lay a foundation for this evidence by undertaking his own analysis of the property and economic trends to determine independently the known values or even to check the assessor's valuation. But he did not do that. Although Lichter did examine the Bakersfield store, he did not inspect the surrounding neighborhood or the city of Bakersfield, and there is no evidence that he examined the rest of the shopping center or that he looked at the 1965 agreement between Sears and Broadway restricting use of the property. In short, he did not consider many of the factors which would normally be considered by a qualified appraiser.

This does not mean that Lichter was careless in his work; he chose the assessed values with great care to justify the result he desired. For example, in determining that the land alone would have a value in 1997 equal to its full cost if it merely increased in value by 4.7 percent per year, Lichter projected from the 1967 assessed value of $812,690. The Bakersfield store had been completed by that time, and it is common knowledge that the assessed value for developed land is higher than the assessed value for undeveloped land, simply by virtue of the development. Thus, even if that value were accurate at the time, it was an inappropriate value from which to project the future value of the land. Had Lichter chosen the purchase price for the land of $198,135.66, his figures would be much different.

In short, Lichter did not establish the necessary factual link between the instant property and his assumptions. It might have been gratifying for petitioners to know that they could expect to realize a certain return on their investment if the property will be worth a certain amount when the lease expires, but that knowledge has little utility if it cannot reasonably be demonstrated that the property will actually have that value. Lichter's failure to lay the proper foundation for that conclusion means that his analysis is fatally defective for purposes of this case.[23]

The knowledge and experience of Steichen (respondent's expert witness) in real estate development and investment generally, and especially with regard to retail properties, were impressive. We find his analyses, opinions, and conclusions to be generally persuasive. His report and testimony, unlike that of petitioners' expert, were based upon a thorough investigation of the property and the details of the actual transaction before us, and we find the underlying premises of his analysis to be valid.

Steichen examined the 1965 agreement between Sears and Broadway and took it into account in his analysis. He made two trips to Bakersfield to familiarize himself with the physical aspects of the store and the shopping center, the general neighborhood surrounding the shopping center, and the city of Bakersfield as a whole. He examined the structure of the store and its merchandising layout. He examined the building permits for the store. He tried, but was unable, to examine or obtain

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[23]Even based upon petitioners' assumptions, the present value of the property determined on a conservative actuarial basis would not be indicative of economic substance. Such assumptions are:

(1) The pre-tax net income will be $23,000 per annum, commencing at the end of 30 years and ending 23 years thereafter.

(2) The property could always be sold for its original cost: $3,150,000 (rounded).

(3) The property will be free and clear at the end of 53 years.

Deriving factors from sec. 20.2031-10(f), table B, Estate Tax Regs., the computation is as follows:

(a) Determine present value of $23,000 per year for 53 years ($23,000 x 15.9070)	$365,861
(b) Subtract present value of $23,000 per year for 30 years ($23,000 x 13.7648)	316,590
Present value of net pre-tax rent	49,271
(c) Add present value of property to be received free and clear at end of 53 years ($3,150,000 x 0.0456)	143,640
Present value of the property	192,911
Cost of petitioners' interest	334,000
Deficit	(141,089)

copies of the tax assessor's records for the property. He did consider the impact of increasing interest rates.

Based upon the investigations he made in the field and personal observations he made by driving through the area surrounding the store, Steichen concluded that the property was located in the fastest growing suburban neighborhood in the city of Bakersfield, and that the shopping center was located there in order to serve the growing suburban market.

Although the shopping center appeared to be a well-constructed and well-maintained facility with a good representation of both local and national tenants, Steichen noted that the store showed signs of obsolescence both in terms of its merchandising layout and its structure. The store was not characteristic of the type of facility which was being developed by the department store industry in 1976. Steichen determined that the life expectancy of the housing stock being developed in the Bakersfield area in 1967 followed the "general rule"[24] and would have a life of at least 50 to 60 years with little change in the characteristics of the inhabitants of that housing stock.

In Steichen's opinion, it is highly unlikely that a department store would go into a location with the expectation of occupying a building at that location for only 30 years. Since Broadway found there was economic justification to enter this market area, Steichen expressed the belief that Broadway's expectation would run through the normal life expectancy of the viability of the market area the store was designed to serve. Consequently, Steichen believed that in 1967 and 1969, the petitioners had every reason to expect Broadway would exercise its right to extend the lease through the first-option period of 23 years.

Steichen expressed awareness of properties in the central cities of the United States having no fair market value, where the cost of demolition and improvement is in excess of the value of the underlying land. He stated that, by the year 2020, the property could very well be in the central city of the city of

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[24]Steichen stated that, as a general rule, there is a life span in residential properties which extends somewhere between 50 and 60 years of age, after which they tend to become, if not physically deteriorated, at least marked by obsolescence and, therefore, are no longer attractive to the persons who originally inhabited them. Therefore, a residential structure which in the economic sense is consumer durable, is owned by a number of successive persons during the course of its life, with each of these persons or types of persons having different characteristics.

Bakersfield. Steichen could not, therefore, projecting back to 1967 or even in 1976, anticipate that Broadway would extend the lease past the first-option period. If Broadway did not extend the lease past the first-option period, as in his view appears to be the more likely probability, Steichen felt it could only be because the location ceased to be a viable commercial location and consequently would have very little market value.

In Steichen's opinion, the cost of removing the store was a significant factor to be considered. He explained that the store was a single-purpose structure built to serve the needs of a specific type of tenant, and if it would not serve the needs of Broadway, the likelihood of attracting another tenant of that type was extremely remote. In any event, due to the highly speculative nature of any predictions concerning the future of the property, and the fact that the value of the economic returns produced by an extension of the lease past 2021 would be relatively small on a discounted basis, Steichen concluded that the value of those returns should not be considered in determining the fair market value of the property in 1980 or 1998.

Steichen analyzed the potential sources of economic gain for the petitioners under the following categories:

(1) Net income or losses;

(2) Net proceeds resulting from: (a) mortgage refinancing; (b) condemnation; or (c) sale.

Following Steichen's approach, of which we approve, we first address the following question: At what point, at what time, and under what conditions could it be presumed there would be net income to distribute, and in what amounts? Under the lease and deed of trust, all rent payments due under the lease for the first 30 years are to be used to service the mortgage notes, so no cash flow will be available to petitioners during the 30-year period. The lease rental is sufficient to amortize 90 percent of the principal amount of the mortgage notes, leaving $313,750 due in 1998.

At the end of the initial term of the lease, petitioners will have the option of either making capital contributions to cover the balloon payment or refinancing the balloon. Since there would be little incentive to do the former, in light of the rent provisions in the lease for subsequent option periods and the probability (as discussed *supra*) that Broadway would continue its occupancy for 23 years (at least beyond 1998), it must be assumed that, if possible, refinancing will be sought.

Assuming refinancing at 5⅛-percent interest (the rate in the original mortgage) over the 23-year period of the first lease extension, the annual financing cost would be approximately $23,000, to be paid out of the fixed rental of $47,062.50; thus leaving a total pre-tax cash flow for division among and distribution to all of the petitioners of approximately $23,000 per annum. It goes without saying that the opportunity to earn $23,000 annually, commencing 30 years from the inception of the transaction, would not in and of itself appear to justify the $334,000 original investment by the petitioners in the 14th P.A. and 37th P.A. partnerships.

The foregoing analysis assumes, of course, that Broadway would exercise its renewal option for the first 23-year period. Given the extremely favorable terms on which Broadway could renew, however, the only conceivable reason why it (or any corporate successor) would not renew would be that the property had lost its economic viability, in which event the property would also be worthless to the petitioners.

The record contains no direct explanation as to why the rent for the first renewal term was set at the exact figure of $47,062.50—1½ percent of the purchase price of the property. E. J. Caldecott, an attorney for and an officer of Broadway, testified that prior to 1965, Broadway's sale-leaseback transactions were entered into directly with the insurance companies, and the rent was structured on an agreed-upon construction percentage which normally was related to then-current interest rates. In Caldecott's words, the transaction was structured "to determine how much rent you would pay if the insurance companies were currently at a 5½ percent to 6 percent loan rate to others on a loan debt—we would get a constant of 30 years." It seems likely, therefore, that the first renewal term rent was related to the expected cost of refinancing the $315,000 balloon—an amount Broadway would have to pay or finance if the buyer-lessor defaulted.

In concluding the part of his report dealing with cash flow, Steichen stated that "an analysis of the cash flow from the rentals to be received when adjusted to reflect the financing costs indicates that there would be no cash available for distribution to the partners until the 31st year of the lease term and that where tax considerations are not taken into account the return at that time is too small to justify the wait." We agree.

The other possibilities for economic gain foreseeable at the inception of the transaction were sale, condemnation, or destruction or mortgage refinancing of the property. Section 21 of the lease deals with a sale or transfer of the property, and provides, in effect, that if the lessor receives a bona fide offer for the purchase of the property and decides to accept such offer, the lessee would have the right to purchase the interest of the lessor for $50,000. The property would still remain subject to the nonrecourse debt. Of this purchase price, the limited partners of both partnerships would be entitled to receive, as a group, 49 percent or $24,500. The limited partners of 14th Property Associates would thus suffer a loss of $155,500, and the limited partners of 37th Property Associates would lose $130,500. If the offering price were greater than $50,000, Broadway, as lessee, would merely exercise its option and pocket the gain.

At the trial of this case, petitioners attempted to establish that the language of section 21 of the lease, quoted in our findings, was a mistake, and that section 21 was, in fact, amended during the week before the trial. According to petitioners, the effect of the amendment was to remove the $50,000 purchase option and instead simply to vest in Broadway the right to veto any proposed purchaser which was a competitor of Broadway or did not have Broadway's credit standing, Broadway no longer having any right of first refusal. Petitioners sought to show that this was the intention of the various parties to the original financing all along, and that the inclusion of the language of section 21 quoted in our findings was an inadvertence.

The trier of the facts rejected the petitioners' version as above outlined and we have no reason to find otherwise. The trial judge had the opportunity to evaluate the credibility of the witnesses and due regard is to be afforded his judgment. Rule 182(d), Tax Court Rules of Practice and Procedure. Accordingly, we have found that the relevant language of section 21 of the lease was intended to read as we have quoted it in our findings of fact.

Regardless of section 21, however, petitioners' opportunity for gain on any sale will be limited to any then-present value of the rental income flow and the residual, the combined total of which, as we have shown, is minimal and in any event less than petitioners investment. The reason for this is that section 26(a) of the lease (also quoted in our findings) gives Broadway carte blanche to sublet the property or assign its leasehold interest after the original term of the lease. Since Broadway will thereby continue to have virtually total control of the property for an additional 68-plus years after the expiration of the original term, and since petitioners' interest will be strictly limited for all those years, Broadway, and not petitioners, will be in a position to realize the true economic value of the property by the simple expedient of using the property, itself, at nominal cost or subletting or assigning it to another for the then-going rate of property of this type in Bakersfield, Calif. In other words, Broadway's purchase option was essentially surplusage. This is, perhaps, one explanation for Broadway's magnanimous acquiescence, if it indeed did acquiesce, in the ante-trial "correction" of section 21.

Another possible source of economic gain would be through receipt of the proceeds of condemnation. However, since the act of condemnation lies wholly beyond the control of the owner or the lessee of property, and since the amounts of awards cannot even be speculated in advance, a prospective investor would not ordinarily look to condemnation as a likely source of economic gain.

Section 20.3 of the lease provides that should there be a total taking or a taking of such a substantial part of the property that in the judgment of Broadway's directors the property has been rendered unsuitable for use by Broadway in the operation of its business or it is not feasible to rebuild, the lease will terminate and the lessee must, under such circumstances, offer to purchase the property at a price equal to the unpaid principal of the notes outstanding together with unpaid interest thereon. If the lessor rejects the offer, award proceeds are to go to the lessor.

It is thus apparent that in this one situation—a substantial condemnation—there could be a potential for gain by the petitioners. It would appear questionable as to whether, in light of other lease provisions (relating to maintenance of the property, etc.), Broadway (the lessee) could simply keep the condemnation award and continue to pay rent on a nonoperative facility—a possibly attractive choice if the award were sufficiently large, particularly if at the time of the award the mortgage had been substantially reduced or paid off.

Nevertheless, the possibility of condemnation for a substantial amount of money, sometime in the future, of a major installation such as a department store building is not, in and of itself, the sort of speculative chance to which even incorrigible gamblers—which we assume these petitioners are not—would likely be attracted. The record contains no intimation that, at the time the instant transactions were entered into or at any other time, there was any prospect of condemnation. We therefore heavily discount condemnation as a consideration in evaluating a potential source of economic gain.

A final potential source of economic gain is through mortgage refinancing. Under the mortgage notes, a total prepayment is permitted in any calendar year beginning with 1978, subject to prepayment penalties beginning with 3 percent of the then-outstanding principal and reducing gradually to 0.15 percent in 1997. Taking into consideration the premium to be paid for prepayment and the fixed rental terms which generate no net cash flow during the initial lease term, the only opportunity for economic gain would occur in the event of a substantial decrease in interest rates below the 5⅛ percent provided for in the financing.

Respondent's expert, Steichen, testified at the trial that since the stated rate of interest of the mortgage notes was below the prevailing commercial lending rates at the time the financing was obtained, and since there was already in evidence continuing upward pressure on interest rates in general, the likelihood of a substantial reduction in interest payments which would lead to an economic gain through mortgage refinancing was quite remote. We find Steichen's testimony on this point convincing.

Finally, in considering whether petitioners made an investment in the property, we consider it to be significant that none of the petitioners' cash outlays went to Broadway. Petitioners' entire investment in 14th P.A. and 37th P.A. went to Cushman and others, but not to Broadway. Such payments constituted, in one sense, brokers' commissions which customarily (and absent a special agreement for shifting the burden of commissions) are paid by the seller. We do not intend to infer that the cost of brokers' commissions is not ordinarily taken into consideration by sellers of real estate in fixing the asking price for property, and, if the asking price is obtained, thereby passed on to the buyer. In such cases, the commissions become indirectly part of the cost of the property and one would normally expect that the purchasers of property would negotiate a return on this cash outlay in the form of increased rent. By contrast, Broadway's rent only covered that part of the investment represented by the mortgage.

Indeed, the petitioners do not pretend that the amounts paid to Cushman and others are part of the cost of the property. Rather, they seek to deduct the payments as the cost of services rendered to the partnerships. Thus, by petitioners' own admission, none of their payments went to the seller, directly or indirectly, so their investment in the property, absent the principal payments on the note, assuming arguendo they may be attributed to petitioners, was zero.

Furthermore, Broadway made substantial expenditures related to the property prior to its transfer to Medway which were not reimbursed. Using its own funds, Broadway incurred direct and indirect costs in the acquisition of the land and the construction of the store totaling $3,332,834, yet the selling price of the property under the sale-leaseback was only $3,137,700, a difference of $195,334. It might have been expected that Broadway would have undertaken to recover this outlay as a part of the sales price, but such was not the case. Thus, Broadway dealt with the transaction in this respect in the same manner as it would have done as the true owner of the property; it financed as much of the cost as possible and paid the balance from its own funds.

We are, in summary, persuaded that an objective economic analysis of this transaction from the point of view of the buyer-lessor, and therefore the petitioners, should focus on the value of the cash flow derived from the rental payments and that little or no weight should be placed on the speculative possibility that the property will have a substantial residual value at such time, if ever, that Broadway abandons the lease. The low rents and almost nominal cash flow leave little room for doubt that, apart from tax benefits, the value of the interest acquired by the petitioners is substantially less than the amount they paid for it. In terms discussed above, the buyer-lessor would not at any time find it imprudent from an economic point of view to abandon the property. *Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9th

Cir. 1976), affg. 64 T.C. 752 (1975). There is thus no justification for the petitioners' participation in this transaction apart from its tax consequences.

Having so analyzed petitioners' lack of potential for economic gain, we must nevertheless confront the question of how petitioners' position differs, if it does, from that of the buyer-lessor in the *Frank Lyon* case.[25] The facts of the *Frank Lyon* case are rather complicated but are pointedly significant. Initially, Worthen Bank & Trust Co. (Worthen) planned to construct a bank and office building. Its plans ran afoul of legal and regulatory restrictions and, as an alternative, Worthen proposed a sale and leaseback transaction. Bank regulatory authorities approved the plan as long as Worthen retained a repurchase option after the 15th year of the lease and obtained an independent third-party buyer-lessor. Frank Lyon Co. (Frank Lyon) became interested in the transaction and, after negotiating with several other equally interested entities, Worthen selected Frank Lyon to be the buyer-lessor. Meanwhile, Worthen had already arranged for the financing and the financiers approved Frank Lyon as the buyer-lessor.

Frank Lyon, the purchaser, was a substantial corporate entity which participated actively in negotiating the terms and conditions of the sale and leaseback, was personally liable for the payment of the principal and paid, in addition to the mortgage financing, $500,000 out of its own funds to Worthen.

The terms of the agreement called for Worthen to lease the land to Frank Lyon for 76 years and to sell the building and lease it back for a 25-year primary term and eight 5-year option terms. The sale and leaseback were effected simultaneously. The lease was a net lease, with Frank Lyon's only current financial obligation being the quarterly mortgage payments. Rent payments for the 25-year primary term were calculated to exactly equal the mortgage payments: $582,224 annually for the first 11 years and $613,156 annually for the succeeding 14 years. Thereafter, the amount of rent decreased to $300,000 per year during the option periods totaling 40 years. Worthen had options to repurchase the building at periodic intervals for the amount

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[25] *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978).

of the outstanding mortgage plus Frank Lyon's original $500,000 investment, with 6-percent interest compounded thereon.

The District Court held that Frank Lyon was entitled to the depreciation and mortgage interest deductions. The court based its finding that the substance comported with the form on the facts that the rent payments were reasonable, the option prices represented the fair market value of the properties, and the unlikelihood that Worthen would exercise the repurchase option. It refused to draw any negative inference from the fact that rentals combined with the options were sufficient to amortize the loan and pay Frank Lyon a fixed 6-percent return on its equity or that the lease was a net lease.

The Court of Appeals reversed. Analogizing property rights to "a bundle of sticks," the court concluded that Frank Lyon did not have sufficient sticks to allow it to be treated as the owner.

The Supreme Court reversed the Court of Appeals, sustaining the form of the transaction, and held that Frank Lyon was indeed the owner of the property for tax purposes, holding that "so-long as the lessor retains significant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes." The Court was very careful to circumscribe the scope of its imprimatur: "we emphasize that we are not condoning manipulation by a taxpayer through arbitrary labels and dealings that have no economic significance," *Frank Lyon Co. v. United States, supra* at 584.

Among the facts in the *Frank Lyon* case which distinguish it significantly from those in the case before us are the following:

(1) The rent during the initial lease term was sufficient to completely amortize the underlying mortgage principal, whereas in the case before us, the rent will amortize only 90 percent of the note principal, leaving a sizable balloon at the end.

(2) The rent in *Frank Lyon* was fair rental value for the property and after the initial lease term was substantial and free and clear to the buyer-lessor. In the case before us, the rent is not based on fair rental value. In the first renewal option period, the rent is relatively insignificant and, if applied to amortize the refinanced balloon, will provide an insignificant, if any, cash flow to petitioners.

(3) The buyer-lessor in *Frank Lyon* paid $500,000 of its own

funds to the seller-lessee; in the case before us none of petitioners' funds went to Broadway.

(4) In *Frank Lyon*, the buyer-lessor stood to realize a substantial gain in the event the seller-lessee exercised its repurchase option; in the case before us, the petitioners cannot dispose of the property at a profit.

(5) In *Frank Lyon*, the buyer-lessor was a substantial corporate entity which participated actively in negotiating the terms and conditions of the sale and leaseback, while in the instant case the entire "deal" was packaged as a financing transaction by the orchestrator, Cushman, and then marketed by him and his colleagues as a tax shelter. While, as we have indicated previously, this factor, alone, might not be fatal to petitioners' cause, considered in concert with the other negative factors outlined above, it lends no credence to any contention that there is here present any "genuine multi-party transaction with economic substance," as mandated by the Supreme Court in *Frank Lyon*. Furthermore, the extremely casual, not to say careless, way in which the various tier partnerships were fabricated, financed, and managed gives them an aura of mechanical contrivance which does not inspire confidence in the genuineness of the requisite multiparty transaction.

We recently applied the rule in *Frank Lyon* to uphold the validity of a sale-leaseback transaction in a case where the totality of facts and circumstances convinced us that the substance of the transaction was a bona fide sale-leaseback which should be given effect for tax purposes. *Belz Investment Co. v. Commissioner*, 72 T.C. 1209 (1979). In that case, the lessee and lessor were both substantial business entities and those two parties, as in *Frank Lyon*, negotiated the terms of the transaction at arm's length. Such cannot be said for the case before us. Fourth Cavendish, the putative buyer-lessor, was organized and put into place only after the financing was negotiated and finalized.

(6) The fact that the buyer-lessor in *Frank Lyon* was personally liable on the mortgage was, of course, a significant factor supporting the bona fides of the sale-leaseback transaction in that case. Nevertheless, we regard personal liability on the mortgage as atypical in modern real estate transactions and, consequently, we consider the absence of personal liability as a neutral factor in the case before us.

In summary, after considering all of the facts and circumstances in the case before us, we find that the petitioners have failed to show a genuine multiparty transaction with economic substance, compelled or encouraged by business realities and imbued with tax-independent considerations and not shaped solely by tax-avoidance features that have meaningless labels attached. *Frank Lyon Co. v. United States, supra* at 583–584. We further find that Medway, the limited partnership from which petitioners seek to derive their deductible losses, is a mere conduit through which Broadway's debt payments pass on their way to the insurance companies. It follows that petitioners have no "investment" in the property upon which depreciation can be predicated; it also follows that the debt in question has no economic significance to the petitioners and thus they have not, in this case, secured "the use or forbearance of money." *Estate of Franklin v. Commissioner*, 544 F.2d at 1049. We therefore conclude that petitioners, as members of 14th P.A. or 37th P.A., are not entitled to deduct partnership losses resulting from depreciation allowances and interest payments.[26]

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[26]Petitioner relies on *Hill v. Commissioner*, 63 T.C. 225 (1974), to sustain its position here. In *Hill*, the Court found that by virtue of a complicated sale and leaseback transaction, the titular owners were entitled to depreciation and interest deductions. The short answer to petitioner's argument that *Hill* should control is *Hill* antedated *Frank Lyon* which provides the basis for our decision in the instant case. More to the point, the Court found that the *Hill* transaction had economic substance. The owners had a reasonable hope of realizing economic gain; they also bore some of the risks, being required to contribute some $30,000 from their own resources during the 3-year period. Unlike the instant case, the Commissioner in *Hill* did not contest the form of the sale through an economic analysis because the facts would not support the contention that due to an excessive sale price a sale should not be deemed to have occurred. *Hill* was sanctioned because it had economic substance, something the transactions in the instant case are sorely missing.

Before ELY, HUG and ALARCON, Circuit Judges.

PER CURIAM:

[1] The carefully reasoned opinion of the Tax Court is reported at 74 T.C. 305 (1980). The facts are clearly set forth in that opinion. We affirm essentially for the reasons stated in the Tax Court's opinion. In short, we agree that *Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9th Cir. 1976), applies to this case and that the sale-leaseback transaction in *Frank Lyon Co. v. United States*, 435 U.S. 561, 98 S.Ct. 1291, 55 L.Ed.2d 550 (1978), is distinguishable.

Because of concerns raised by the Amicus, the National Realty Committee, Inc., however, we do place two specific caveats on the interpretation and application of the Tax Court's opinion.

[2] First, in its discussion of the economic value of the transaction, the court looked at the future income potential available to the taxpayers based on its *arguendo* assumption that the taxpayers' economic analysis, which it had found to be "fatally defective," 74 T.C. at 353, was nevertheless accurate. Using a six percent rate of return, the court calculated that the taxpayers were facing a net loss from the transaction. *Id.* at 353 n.23. We deem the six percent rate to be for illustrative purposes only. No suggestion of a minimum required rate of return is made. Taxpayers are allowed to make speculative investments without forfeiting the normal tax applications to their actions.

Second, in distinguishing *Frank Lyon Co.*, one of the factors noted by the Tax Court was that the present transaction involved a balloon payment, while in *Frank Lyon Co.* the entire purchase price was amortized during the primary lease period. 74 T.C. at 362–63. Although the inference could be drawn that the balloon payment *per se* weighed against the taxpayers, we do not so interpret the opinion. Balloon payments have a legitimate place in many kinds of financial arrangements. Simply because one was used in this sham transaction should not reflect negatively on the practice as a whole.

October 3, 2010

Flawed Paperwork Aggravates a Foreclosure Crisis

By GRETCHEN MORGENSON

As some of the nation's largest lenders have conceded that their foreclosure procedures might have been improperly handled, lawsuits have revealed myriad missteps in crucial documents.

The flawed practices that GMAC Mortgage, JPMorgan Chase and Bank of America have recently begun investigating are so prevalent, lawyers and legal experts say, that additional lenders and loan servicers are likely to halt foreclosure proceedings and may have to reconsider past evictions.

Problems emerging in courts across the nation are varied but all involve documents that must be submitted before foreclosures can proceed legally. Homeowners, lawyers and analysts have been citing such problems for the last few years, but it appears to have reached such intensity recently that banks are beginning to re-examine whether all of the foreclosure papers were prepared properly.

In some cases, documents have been signed by employees who say they have not verified crucial information like amounts owed by borrowers. Other problems involve questionable legal notarization of documents, in which, for example, the notarizations predate the actual preparation of documents — suggesting that signatures were never actually reviewed by a notary.

Other problems occurred when notarizations took place so far from where the documents were signed that it was highly unlikely that the notaries witnessed the signings, as the law requires.

On still other important documents, a single official's name is signed in such radically different ways that some appear to be forgeries. Additional problems have emerged when multiple banks have all argued that they have the right to foreclose on the same property, a result of a murky trail of documentation and ownership.

There is no doubt that the enormous increase in foreclosures in recent years has strained the resources of lenders and their legal representatives, creating challenges that any institution might find overwhelming. According to the Mortgage Bankers Association, the percentage of loans that were delinquent by 90 days or more stood at 9.5 percent in the first quarter of 2010, up from 4 percent in the same period of 2008.

But analysts say that the wave of defaults still does not excuse lenders' failures to meet their legal obligations before trying to remove defaulting borrowers from their homes.

"It reflects the hubris that as long as the money was going through the pipeline, these companies didn't really have to make sure the documents were in order," said Kathleen C. Engel, dean for intellectual life at Suffolk University Law School and an expert in mortgage law. "Suddenly they have a lot at stake, and playing fast and loose is going to be more costly than it was in the past."

Attorneys general in at least six states, including Massachusetts, Iowa, Florida and Illinois, are investigating improper foreclosure practices. Last week, Jennifer Brunner, the secretary of state of Ohio, referred examples of what her office considers possible notary abuse by Chase Home Mortgage to federal prosecutors for investigation.

The implications are not yet clear for borrowers who have been evicted from their homes as a result of improper filings. But legal experts say that courts may impose sanctions on lenders or their representatives or may force banks to pay borrowers' legal costs in these cases.

Judges may dismiss the foreclosures altogether, barring lenders from refiling and awarding the home to the borrower. That would create a loss for the lender or investor holding the note underlying the property. Almost certainly, lawyers say, lawsuits on behalf of borrowers will multiply.

In Florida, problems with foreclosure cases are especially acute. A recent sample of foreclosure cases in the 12th Judicial Circuit of Florida showed that 20 percent of those set for summary judgment involved deficient documents, according to chief judge Lee E. Haworth.

"We have sent repeated notices to law firms saying, 'You are not following the rules, and if you don't clean up your act, we are going to impose sanctions on you,' " Mr. Haworth said in an interview. "They say, 'We'll fix it, we'll fix it, we'll fix it.' But they don't."

As a result, Mr. Haworth said, on Sept. 17, Harry Rapkin, a judge overseeing foreclosures in the district, dismissed 61 foreclosure cases. The plaintiffs can refile but they need to pay new filing fees, Mr. Haworth said.

The byzantine mortgage securitization process that helped inflate the housing bubble allowed home loans to change hands so many times before they were eventually pooled and sold to investors that it is now extremely difficult to track exactly which lenders have claims to a home.

Many lenders or loan servicers that begin the foreclosure process after a borrower defaults do not produce documentation proving that they have the legal right to foreclosure, known as standing.

As a substitute, the banks usually present affidavits attesting to ownership of the note signed by an employee of a legal services firm acting as an agent for the lender or loan servicer. Such affidavits allow foreclosures to proceed, but because they are often dubiously prepared, many questions have arisen about their validity.

Although lawyers for troubled borrowers have contended for years that banks in many cases have not properly documented their rights to foreclose, the issue erupted in mid-September when GMAC said it was halting foreclosure proceedings in 23 states because of problems with its legal practices. The move by GMAC followed testimony by an employee who signed affidavits for the lender; he said that he executed 400 of them each day without reading them or verifying that the information in them was correct.

JPMorgan Chase and Bank of America followed with similar announcements.

But these three large lenders are not the only companies employing people who have failed to verify crucial aspects of a foreclosure case, court documents show.

Last May, Herman John Kennerty, a loan administration manager in the default document group of Wells Fargo Mortgage, testified to lawyers representing a troubled borrower that he typically signed 50 to 150 foreclosure documents a day. In that case, in King County Superior Court in Seattle, he also stated that he did not independently verify the information to which he was attesting.

A spokesman for Wells Fargo said the bank was confident in its foreclosure policies and practices; he also noted that the judge overseeing the case involving Mr. Kennerty had ruled in favor of the bank.

In other cases, judges are finding that banks' claims of standing in a foreclosure case can conflict with other evidence.

Last Thursday, Paul F. Isaacs, a judge in Bourbon County Circuit Court in Kentucky, reversed a ruling he had made in August giving Bank of New York Mellon the right to foreclose on a couple's home. According to court filings, Mr. Isaacs had relied on the bank's documentation that it said showed it held the note underlying the property in a trust. But after the borrowers supplied evidence indicating that the note may in fact reside in a different trust, the judge reversed himself. The court will revisit the matter soon.

Bank of New York said it was reviewing the ruling and could not comment.

Another problematic case involves a foreclosure action taken by Deutsche Bank against a borrower in the Bronx in New York. The bank says it has the right to foreclose because the mortgage was assigned to it on Oct. 15, 2009.

But according to court filings made by David B. Shaev, a lawyer at Shaev & Fleischman who represents the borrower, the assignment to Deutsche Bank is riddled with problems. First, the company that Deutsche said had assigned it the mortgage, the Sand Canyon Corporation, no longer had any rights to the underlying property when the transfer was supposed to have occurred.

Additional questions have arisen over the signature verifying an assignment of the mortgage. Court documents show that Tywanna Thomas, assistant vice president of American Home Mortgage Servicing, assigned the mortgage from Sand Canyon to Deutsche Bank in October 2009. On assignments of mortgages in other cases, Ms. Thomas's signatures differ so wildly that it appears that three people signed the documents using Ms. Thomas's name.

Given the differences in the signatures, Mr. Shaev filed court papers last July contending that the assignment is a sham, "prepared to create an appearance of a creditor as a real party in interest/standing, when in fact it is likely that the chain of title required in these matters was not performed, lost or both."

Mr. Shaev also asked the judge overseeing the case, Shelley C. Chapman, to order Ms. Thomas to appear to answer questions the lawyer has raised.

John Gallagher, a spokesman for Deutsche Bank, which is trustee for the securitization that holds the note in this case, said companies servicing mortgage loans engaged the law firms that oversee foreclosure proceedings. "Loan servicers are obligated to adhere to all legal requirements," he said, "and Deutsche Bank, as trustee, has consistently informed servicers that they are required to execute these actions in a proper and timely manner."

Reached by phone on Saturday, Ms. Thomas declined to comment.

The United States Trustee, a unit of the Justice Department, is also weighing in on dubious court documents filed by lenders. Last January, it supported a request by Silvia Nuer, a borrower in foreclosure in the Bronx, for sanctions against JPMorgan Chase.

In testimony, a lawyer for Chase conceded that a law firm that had previously represented the bank, the Steven J. Baum firm of Buffalo, had filed inaccurate documents as it sought to take over the property from Ms. Nuer.

The Chase lawyer told a judge last January that his predecessors had combed through the chain of title on the property and could not find a proper assignment. The firm found "something didn't happen that needed to be fixed," he explained, and then, according to court documents, it prepared inaccurate documents to fill in the gaps.

The Baum firm did not return calls to comment.

A lawyer for the United States Trustee said that the Nuer case "does not represent an isolated example of misconduct by Chase in the Southern District of New York."

Chase declined to comment.

"The servicers have it in their control to get the right documents and do this properly, but it is so much cheaper to run it through a foreclosure mill," said Linda M. Tirelli, a lawyer in White Plains who represents Ms. Nuer in the case against Chase. "This is not about getting a free house for my client. It's about a level playing field. If I submitted false documents like this to the court, I'd have my license handed to me."

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Niche Lawyers Spawned Housing Fracas

By ROBBIE WHELAN

The paperwork mess muddying home foreclosures erupted last month. But the legal strategy behind it traces to a lawyer's gambit in 2006 that has helped keep one couple in their home six years beyond their last mortgage payment.

Lillian and Robert Jackson stopped paying on their home in Jacksonville, Fla., in 2004 when business dropped off at their cleaning company. Eviction might have seemed inevitable when they faced a foreclosure hearing two years later.

Scott Lewis for The Wall Street Journal

Lawyer Michael Gaier switched his focus to foreclosure defense.

But their lawyer, James Kowalski, had the idea of taking a deposition from the signer of the mortgage papers. When a document processor for GMAC Mortgage admitted she routinely signed such papers without being familiar with details of the loans, she was tagged as one of a species now known as robo-signers.

It was a first step in the growth of a legal sub-specialty called foreclosure defense that has sown confusion and turmoil in the housing market. Lawyers in the field now commonly use a technique more identified with corporate litigation: probing depositions, designed to uncover any lapses in judgment, flaws in a process or wrongdoing. In the 23 states where foreclosures entail a court hearing, the bank may be ordered to pay the homeowner's legal bill if a lawyer can convince a judge that the bank has submitted false documents, such as affidavits saying employees personally reviewed the details of loans when they didn't.

The housing-market uncertainty stemming from the foreclosure fracas is unabated, despite moves by Bank of America Corp. and GMAC to resume some suspended foreclosure sales. In Florida, with over half a million foreclosure cases, banks that are reviewing their documentation have canceled hundreds of court hearings in recent weeks. Big banks that have said they are finding few or no flaws in the foreclosure process have encountered skepticism from some of the state attorneys general probing the mess, and those authorities are pushing ahead.

The great majority of delinquent borrowers don't hire lawyers but leave the home right before getting evicted. Some lawyers who represent financial institutions take a dim view of the growing ranks of lawyers pushing for a different outcome.

"There is a movement afoot by [state attorneys general] and private lawyers to use technical problems to avoid foreclosures where the borrower is in default and the foreclosure is in all

Jason Henry for The Wall Street Journal

Tom Ice has helped to develop legal tactics for foreclosure defense.

respects substantively appropriate. These are lawyers where the best job they can do for their clients is to keep them in their houses without paying the mortgage," said Andrew L. Sandler, a Washington securities lawyer who represents banks and firms that service mortgages.

Mr. Sandler added: "The class-action lawyers are swarming around this issue right now, because they perceive that it can result in significant fees for them. But they're not well-founded cases, and the banks will vigorously contest any class action around these issues."

The big risk to banks and the housing market, indeed, is that more homeowners and lawyers come to see such cases as attractive to fight.

Mr. Kowalski in Jacksonville has already filed a suit seeking class-action status, in circuit court in St. Johns County, Fla., naming Deutsche Bank AG and Citigroup Inc. mortgage unit Citi Residential Lending, accusing them of violating Florida laws and seeking nonmonetary relief. On Tuesday, a New Jersey law firm filed a damage suit in federal court in New Jersey accusing Bank of America of breaching contracts with borrowers at settlement.

A spokesman for Citi called the suit "without merit." B of A declined to comment. Deutsche Bank didn't have any immediate comment.

It isn't clear how significant the suits ultimately will be. Lenders say paperwork problems can easily be fixed, and foreclosures can proceed. "The homeowner might get to live in the house for a few more months free. But these people do not have a right to a free house," said Laurence E. Platt, an attorney who represents mortgage lenders.

The suits, probes and foreclosure freezes are the culmination of a legal drama that has been unfolding, largely unnoticed by the public, since the case against the Jacksons was thrown out in 2006 by Florida state-court Judge Bernard Nachman.

Related Article

Lenders Talking to States

He ordered GMAC Mortgage, a unit of Ally Financial Inc., to pay the $8,000 fee of the Jacksons' attorney after finding GMAC had filed false testimony, an affidavit in which a document signer, Margie Kwiatanowski, said she had personal knowledge of the details of loans such as the Jacksons'. GMAC declined to make Ms. Kwiatanowski available for an interview.

The judge also ordered GMAC to confirm that it had changed its policies to make sure anyone signing a document on its behalf read and fully understood the instrument. "Do not sign unless you have that comfort level," a GMAC memo then advised employees. "Do not sign verifications on court pleading documents unless you have independently checked the facts."

GMAC, which serviced the Jacksons' loan but didn't hold the mortgage, said: "As a servicer we try to avoid foreclosure whenever possible and work with the borrower on forbearance and home-preservation options before pursuing foreclosure." The firm wouldn't comment on cases still to be litigated.

GMAC also said it is reviewing all mortgages it services to make sure documents are properly prepared. It has never re-filed the case involving the Jacksons' house.

The Jacksons, still living there, are seeking a settlement. "What we want to do is to take the foreclosure off the credit report and dissolve it completely, so we can refinance the home and start over," said Ms. Jackson, 57.

In 2009, three years after the Jackson ruling, other Florida lawyers got into the act. Unaware of that case, a small law firm called Ice Legal took a deposition from another GMAC employee, who also testified to routinely signing foreclosure documents without reviewing the loans.

That testimony came about because the small law firm's founder, Thomas Ice, was searching for a way to help his bankruptcy clients.

Mr. Ice founded his firm in 2008 to focus on consumer bankruptcy, after a career at big law firms defending companies against plane-crash and SUV-rollover suits. With his wife, Ariane, a paralegal, he set up Ice Legal in a strip mall in Royal Palm Beach, Fla., next to a dentist.

As the economy frayed, bankruptcy clients appeared. Mr. Ice would help them with Chapter 13 filings that enable individuals, with a judge's blessing, to get rid of credit-card, car-payment and other debt. But the law doesn't let judges reduce someone's mortgage.

Searching for a way to defend clients facing foreclosure, Mr. Ice began researching English case law and the history of property rights. He ran across Sheldon v. Hently, a 1680 case that said an indebted merchant owed his debt to the person who had lent him the money, not to a debt collector who came around bearing a note.

While the English case didn't bear specifically on his work, it got Mr. Ice thinking about the concept of ownership of a debt, he says. A little more than a year after opening his firm, in the case of Boca Raton woman facing foreclosure, he decided to depose the GMAC employee who had actually signed documents concerning her indebtedness.

It was while grilling that employee, Jeffrey Stephan, that the firm discovered faulty documentation was more common than people had realized. Mr. Stephan testified he regularly signed more than 10,000 court affidavits a month without doing the required review of loan files.

Mr. Stephen also mentioned the name of his boss: Ms. Kwiatanowski, the woman whose failure to review loans before signing off had enabled the Jackson family in Florida to escape foreclosure for years.

Mr. Ice mentioned the deposition testimony to a fellow lawyer, Matthew Weidner. "Tom and I were talking, and it was, 'Jesus, they're like robots!'" Mr. Weidner says.

Mr. Weidner is also a blogger, and on Jan. 8 he wrote a blog post with an appellation for the routine signers. "We know from depositions taken of these 'robo signers,'" he wrote, "that they don't even read the documents placed in front of them and the notaries and witnesses that are supposed watch them as they sign are not present."

A GMAC spokeswoman, asked how Mr. Stephan could have submitted such affidavits years after a company memo had admonished employees to check the facts, said: "Obviously the policy wasn't being followed, and we discovered this procedural error. We became aware of the breakdown recently." Mr. Stephan couldn't be reached for comment. The woman in the Boca Raton case remains in her home.

Mr. Ice, recounting the suit and the legal steps he took, said it shows "the need for the complex litigation that is required to win these foreclosure cases."

Mr. Stephan re-emerged in June, in a case that helped spark the current foreclosure turmoil. A pro bono lawyer in Maine, Thomas Cox, took another deposition from Mr. Stephan, who again acknowledged routinely signing documents without reviewing the loans.

GMAC tried to sanction the lawyer on grounds he had embarrassed its employees, a maneuver that could have kept him from using the Stephan deposition as evidence. The motion was denied by Maine's Ninth District state court, which also ruled, late last month, that GMAC had submitted the Stephan affidavits "in bad faith." The court ordered GMAC to pay Mr. Cox $27,000, a sum it said he might have earned for his legal work if he hadn't been working pro bono.

GMAC suspended its foreclosure sales in 23 states in September and widened the freeze in October, before saying on Monday that it would again push forward with some of them. It has been replacing court affidavits that Mr. Stephan signed with documents signed by others.

At Ice Legal in Royal Palm Beach, attorneys are working through a load of several hundred foreclosure cases. Mr. Ice has hired three new lawyers and says he's so busy he has stopped playing golf and spends most of his time at the office. The firm has deposed alleged robo-signers at three other lenders or mortgage-serving companies besides GMAC.

Michael Gaier, an attorney in Philadelphia, switched to foreclosure defense last year after years of representing patients in malpractice suits and consumers who said they had purchased faulty products. His new legal practice "is academically challenging, and I'm hoping it'll be financially rewarding. I'm hoping the banks rewrite the mortgages, cover my fees. That's my end game," said Mr. Gaier.

Mr. Kowalski, the lawyer who in 2006 unearthed a robo-signer before that term was common, said, "I don't think the [mortgage] servicers ever thought that their process was going to see the light of day. It's just that so many of us have taken so many of these so far, that now, in 2010, we finally have some traction."

Corrections & Amplifications
The name of James Kowalski was spelled incorrectly in a previous version of this article.

SmartMoney Glossary: Wall Street, mortgage, bankruptcy, refinance, ruling,

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New York Sues Banks Over Mortgage Registry System

By CHAD BRAY

NEW YORK—New York Attorney General Eric T. Schneiderman sued three of the nation's largest banks over a private national mortgage registry system, contending it has resulted in a wide range of deceptive and fraudulent foreclosure filings.

The lawsuit, filed in New York State Supreme Court in Brooklyn, names units of Bank of America Corp., BAC -0.05%J.P. Morgan Chase & Co JPM +0.66%. and Wells Fargo WFC +0.49%& Co. as defendants, as well as MERSCorp., which owns and operates the Mortgage Electronic Registration Systems, known as MERS.

In his complaint, Mr. Schneiderman alleges that MERS has effectively eliminated the public's ability to track property transfers because those transfers are maintained in the private registry, rather than in the local county clerk's office. He contends the system is riddled with inaccuracies and, as a result, it is difficult to verify the chain of title for a loan or a current noteholder for many properties.


New York Attorney General Eric Schneiderman speaks at the Justice Department last month.

The attorney general says the system was designed to allow financial institutions to evade county recording fees, eliminate the need to publicly record mortgage transfers and to facilitate the rapid sale and securitization of mortgages.

"Once the mortgages went sour, these same banks brought foreclosure proceedings en masse based on deceptive and fraudulent court submissions, seeking to take homes away from people with little regard for basic legal requirements or the rule of law," Mr. Schneiderman said. "Our action demonstrates that there is one set of rules for all—no matter how big or powerful the institution may be—and that those rules will be enforced vigorously."

A Wells Fargo spokeswoman said the bank was reviewing the lawsuit and declined further comment. J.P. Morgan and Bank of America had no immediate comment.

"MERSCorp. Inc., and its subsidiary, Mortgage Electronic Registration Systems Inc., comply with laws as well as county and state recording statutes and mortgage regulations," said Janis Smith, a MERSCorp. spokeswoman. "Federal and state courts around the country have repeatedly upheld the MERS business model, and the validity of MERS as legal mortgagee and nominee for lenders. We refute the attorney general's claims and will defend the case vigorously in court."

The lawsuit is seeking that a declaration that the alleged practices by MERS violate the law as well as damages for harmed homeowners and civil penalties.

Mr. Schneiderman alleged that MERS was created in 1995 by the financial industry and operates as a membership organization with most of the large companies that participate in the mortgage industry as members.

More than 70 million loans nationally have been registered in MERS, including about 30 million currently active loans, he said.

MERS has granted more than 20,000 "certifying officers" the authority to act on its behalf, including the authority to assign mortgages, to execute paperwork necessary to foreclose, and to submit filings on behalf of MERS in bankruptcy proceedings, Mr. Schneiderman said.

Those certifying officers aren't MERS employees, but instead are employed by MERS members, including J.P. Morgan Chase, Bank of America and Wells Fargo, he said.

Write to Chad Bray at chad.bray@dowjones.com

Corrections & Amplifications
Wells Fargo & Co. is the formal name of the bank. An earlier version of this article incorrectly cited it as Wells Fargo Corp.

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Journal HOME

Negotiating the American Dream: A Critical Look at the Role of Negotiability in the Foreclosure Crisis

by Thomas Erskine Ice

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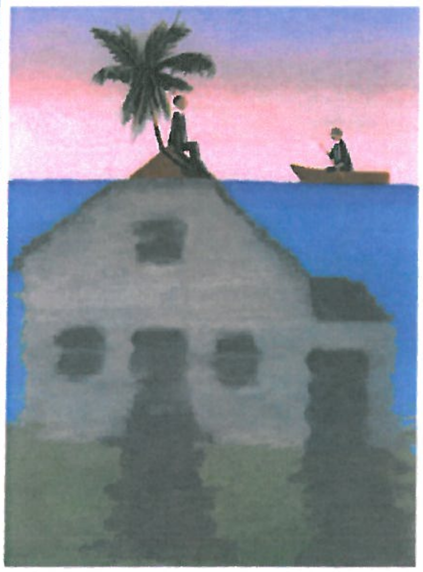

Contemporary negotiable instruments law developed hundreds of years ago, before every important institution of the modern financial world: incorporated banks, business corporations, developed capital markets, global monetary systems, electronic transfers, and even paper currency.[1] It is counterintuitive that this ancient law of negotiable instruments would have any relevance to one of the world's most sophisticated, cutting-edge tools of high finance — the pooling and securitization of mortgage loans. Yet, the courts routinely look to such law to resolve a foreclosure crisis spawned by the collapse of mortgage-backed securitization, a process which is as strained as trying to decide First Amendment issues using cases pre-dating the Constitution. It is all the more extraordinary that, just as the nation begins to awaken to "robo-signing" and other such pervasive and methodical abuses of the court systems, judges should find themselves slavishly compelled to apply a body of law shaped (and then abandoned) by the very authors of such scandals: the financial institutions.

This article explores the historical underpinnings of negotiability and whether the evidentiary shortcut that negotiability appears to offer as a means of proving a plaintiff's standing to sue can or should be applied in the context of the foreclosure cases facing the courts today. Examination of the original purposes of negotiability, as well as recent changes to the Uniform Commercial Code, leads to the conclusion that mere possession of a negotiable instrument (the promissory note) is insufficient to enforce a mortgage. The possessor or "holder" must prove ownership of the instrument — a complete chain of title from the original creditor — to invoke the equitable remedy of foreclosure.

The Private Currency of Merchants

The concept of negotiability is rooted in European mercantile customs, which, as of the 17th century, had developed a means of paying for goods, principally in international transactions, using documents called "bills of exchange."[2] Similar to a cashier's check today, the bill of exchange was an instrument representing an amount of money that the buyer had deposited with a third party. The bill instructed a fourth party, typically located near the foreign seller of the goods, to pay the seller upon presentment of the bill. Bills of exchange offered the advantage of being easier and safer to transport than precious metals or other valuables.[3]

As the use of these instruments became more common, merchants developed the practice of transferring the bills among themselves by endorsement.[4] Rather than presenting the bill to the local "fourth party" for payment, the payee would endorse the bill to another merchant as payment for goods or services.[5] Such instruments were often transferred dozens of times and served the function that currency serves today.[6]

This practice of transferring the bill to additional parties by way of "negotiation" and "endorsement" was later extended to promissory notes — two-party debt instruments.[7] As the courts came to recognize and enforce this endorsement-and-delivery method of transfer, documents that could be circulated in this manner came to be known as "negotiable" instruments. The "negotiability" of the instrument typically referred to its degree of "transferability."[8]

Holder in Due Course Doctrine

The "holder in due course" doctrine is said to be, not only the primary feature of negotiable instrument law, but "the most important principle in the whole law of bills and notes."[9] This doctrine grew out of an information vacuum typical in the age before computers and worldwide communications. In those days, the more times a particular instrument was transferred, the more attenuated the later recipients' knowledge about the original transaction became. Merchants, therefore, developed rules of negotiability to enhance the liquidity of the instruments by reducing the need for information about transactions earlier in the chain.[10] The most important of these was the "holder in due course" status, which simply disallowed most claims or defenses that might undermine the value of the instrument.[11] The holder in due course was a "good faith purchaser"—someone who paid value for the document without knowledge of any defect in either the seller's right to sell it or in the transaction that created it.[12] Because the holder in due course was a transferee that could receive greater rights than those of the transferor, the doctrine was a remarkable departure from basic common law principles that governed ordinary contracts,[13] but one necessary for the documents to function as a currency substitute.

Over time, governments began to issue paper currency,[14] supplanting the need for the unfettered transferability of bills and notes. New technology revolutionized payment systems by creating the means for instantaneous transfers of money and information about transactions. Negotiability had become anachronistic and unnecessary.[15] Nevertheless, in 1952, the already antiquated holder in due course rules were codified into Article 3 of the Uniform Commercial Code (UCC).[16] As a result, the "law for clipper ships and their exotic cargoes from the Indies"[17] became frozen in time and, rightly or wrongly, continues to influence court decisions today.[18]

Evolving from Article 3 Negotiability to Article 9 Sales as a Means to Transfer Mortgage Loans

Article 3 has been criticized as having been drafted by a process that was "captured by bank attorneys" such that the end result was "a pro-bank statute."[19] Yet, as the technology of payment systems continued to advance, the banking industry itself became dissatisfied with Article 3 as a means of transfer, particularly with respect to mortgage loans. The necessity of physical delivery of the documentation became a nuisance that hindered, rather than expedited transferability.[20]

In response, the industry orchestrated a change to Article 9 of the UCC in 1998 that brought mortgage loans within its purview.[21] Specifically designed to facilitate securitization,[22] not only did the new Article 9 provide for automatic perfection of the buyer's interest upon sale, even without the transfer of possession,[23] but it officially sanctioned the practice of using third-party agents as document custodians to "possess" the instruments.[24] When the transferor and transferee used the same document custodian, the transfers of possession could take place without physically moving the documents; the custodian could simply acknowledge the change.[25] Most importantly, revised Article 9 applied regardless of whether the promissory notes were actually negotiable.[26] Article 9, therefore, now provides all the benefits of negotiability, such as transferability and liquidity, without the outdated custom of transporting the note and mortgage.[27]

Infusion of the Concept of "Holder" into Foreclosure

In the early days of the foreclosure crisis, the allegations of standing in complaints filed in Florida merely tracked the language of the foreclosure form approved by the Florida Supreme Court — that the plaintiff bank "owns and holds the note and mortgage."[28] Over time, the complaints have evolved such that the word "holder" has been substituted for the "owns and holds" language approved by the Florida Supreme Court.[29] Replacing the traditional language with the unrelated Article 3 term "holder"[30] permits the bank to argue that mere possession of a document that its attorney asserts to be an original note endorsed in blank (or specially endorsed to the plaintiff bank) conclusively establishes its standing to foreclose.

Thus, despite the shift toward Article 9 as the real-world mechanism for transferring loans, Article 3 negotiability has become the dominant legal theory argued by plaintiffs in support of their standing to bring foreclosure actions. In the courtroom, Article 3 serves as the basis for arguing an evidentiary shortcut which not only discards ownership of the loan as an element of proof, but which circumvents basic foundational evidence for the authenticity of the note itself. By claiming that promissory notes are "self-authenticating" under the UCC,[31] standing is now routinely, albeit incorrectly,[32] established on a single unsworn representation by plaintiff's counsel that the document presented is the original note.

Can a Thief Really Enforce a Note?

The key to this evidentiary shortcut, this indifference to who actually owns the loan, is the idea that, under Article 3, mere possession, even wrongful possession, of a bearer instrument confers an unassailable right of enforcement. This argument holds that the court need not inquire into the true ownership of the note because, even if the bank's possession is shown to be illegitimate, the matter does not concern the borrower (or the court), but rather, concerns only the true owner.[33]

The notion that a borrower is precluded from challenging a holder's right of enforcement is often expressed apothegmatically as: "Even a thief is entitled to enforce a bearer instrument."[34] Needless to say, the assertion that a thief can obtain or pass title to stolen property flies in the face of common law.[35] It also offends the commonsense of the average citizen to say that a court of law has no choice but to employ its constitutionally granted powers on behalf of those with no legitimate right to the note so that they may profit from what must surely be a crime. Indeed, under negotiable instrument law prior to Article 3, only a holder in due course was immune to the defense of theft, not a mere holder.[36] Even the claimed status of holder in due course could be impeached with evidence that the note was not acquired in good faith, at which time the burden "shifted to the holder to prove that he took it free from defect or infirmity."[37]

Yet, §3.301 of the current version of the UCC states: "A person may be a person entitled to enforce the instrument even though the person is not the owner of the instrument *or is in wrongful possession of the instrument*."[38] The drafters' comments to Article 3 state without reservation that a "thief" or a "finder" may become a holder.[39] Still, after the adoption of the UCC, there was considerable debate as to whether its drafters meant to grant such rights to thieves.[40] At least one commentator has labeled this result an "authorization anomaly" and questioned whether any court will "accept such a daring theory" that a thief is *entitled* to enforce an instrument because it is an "obvious abuse of the term 'entitlement.'"[41]

Even the text of the UCC itself appears strangely ambivalent on the issue. It declares that one becomes a "holder" through "negotiation," which in turn is defined as a "transfer of possession [of an instrument] whether voluntary or involuntary."[42] Yet, a "transfer" of an instrument is described as a delivery — a "voluntary transfer of possession"[43] — of that instrument "for the purpose of giving the person receiving delivery the right to enforce the instrument."[44] Because no one intends to give a thief, or even a finder, the right to enforce an instrument, the two provisions appear irreconcilable.

Moreover, UCC §3.602[45] provides that payment made to a person entitled to enforce the instrument (which presumably includes a thief), discharges the borrower, unless the borrower knows "that the instrument is a stolen instrument and pays a person it knows is in wrongful possession of the instrument." Coupled with the thief's right of enforcement, this implies that the borrower can be compelled to pay an admitted thief, yet will still be liable to the rightful owner of the note.

Similarly, UCC §3-501(b)(2)[46] provides that, upon demand for payment, the borrower may ask that the person seeking payment give "reasonable identification" and if the demand is made on behalf of someone else, "reasonable evidence of authority to do so."[47] If even a thief is entitled to enforce the note, it seems inconsistent to require the thief to produce evidence of his or her authority to enforce the note.

This labyrinth of seeming self-contradictions in the UCC can be aligned by an interpretation of Article 3 that is consistent with prior negotiable instrument law. Specifically, the statutory declaration that a holder may enforce a stolen or found instrument should be construed as a description of what constitutes a prima facie case. Rather than a bar to evidence that the instrument is stolen, it merely creates a presumption that temporarily shifts the burden of introducing evidence of ownership to the defendant.

Protecting Consumers from Negotiability

Borrowers in foreclosure are, for the most part, consumers who had no bargaining power with which to influence a single term in the note and mortgage they signed. Most lacked even an understanding of the terms of those documents, much less, the destructive effect of negotiability on their defenses. In the context of credit transactions involving goods and services, the federal government took steps in 1971 to limit the negative effects of negotiability on consumers.[48] Specifically, the Federal Trade Commission promulgated a regulation entitled "Preservation of consumers' claims and defenses, unfair or deceptive acts or practices," also known as the "Holder Rule," which requires a notice on all consumer credit contracts that the holder would be subject to all claims and defenses that the consumer could assert against the seller of goods or services.[49]

In *Tinker v. De Maria Porsche Audi, Inc.*, 459 So. 2d 487 (Fla. 3d DCA 1984), the court held that "the effect of the federal [Holder Rule] is to defeat the holder in due course status of the assignee institutional lender, thus, removing the lender's insulation from claims and defenses which could be asserted against the seller by the consumer."[50] The FTC recently reaffirmed the rule, issuing an opinion letter that condemned court decisions, such as one in Florida,[51] which have barred consumers from affirmative recoveries under the Holder Rule unless rescission is warranted.[52]

It is against this backdrop that the courts are being asked to make decisions in foreclosure actions based on a presumed negotiability of mortgage notes, often with no analysis as to whether Article 3 is even applicable. Given the general obsolescence of negotiability and the banking industry's own rejection of Article 3 in favor of Article 9, the courts should not only analyze whether the notes are negotiable, but should employ a healthy skepticism when doing so.

Negotiability of Modern Mortgage Notes

It is perplexing that modern jurists often assume that all mortgage-backed promissory notes are negotiable, when the assumption runs counter to the historically essential requirement that a negotiable instrument be simple, unconditional, and without contingencies — a "courier without luggage."[53] In reality, a mortgage note is laden with the mortgage itself — a veritable steamer trunk full of additional rights and obligations that must accompany the note on all its travels. The Permanent Editorial Board for the Uniform Commercial Code has itself warned that "[i]t should not be assumed that all mortgage notes are negotiable instruments."[54]

The more intuitive stance is that today's complex mortgage loan transactions produce lengthy interrelated documents that do not qualify as negotiable instruments. Indeed, the banking industry's abandonment of Article 3 in favor of Article 9 transfers suggests there would be little reason for the industry to ensure that the notes it drafts for loans intended for securitization would comply with all the rules of negotiability.

Examination of the most commonly used form for the mortgage loan note, the "Fannie Mae/Freddie Mac Uniform Instrument Note" or "UI Note,"[55] supports the conclusion that negotiability is not at the forefront of the drafters' objectives. Fifteen years ago, one commentator argued that that the UI Note does not meet the requirements of negotiability because it contains an undertaking in addition to the payment of money, which is forbidden by UCC Article 3-104(a)(3).[56] Specifically, he argued that the requirement that the borrower notify the note holder in writing of any prepayment is just such an additional undertaking.[57] Courts, however, have recently begun to reject this argument, finding that the nonmonetary obligation is not a condition placed on the borrower's promise to pay. Rather, the notification requirement conditions the exercise of the right of prepayment, a benefit of which the borrower is not obliged to avail himself or herself.[58] Still, there are other more compelling reasons to conclude that modern mortgage notes are not negotiable.

Incorporation of Mortgage Terms: Opting for Security Over Transferability
One of the well-settled rules of negotiability is that the instrument cannot include obligations or conditions that cannot be determined from the four corners of the note itself.[59] Thus, incorporating the terms of another document, such as the mortgage, instantly destroys negotiability.[60] Mere reference to the mortgage without incorporating its terms, however, has no effect upon negotiability.[61]

This rule has led to bizarre tight-rope walking by the banking industry attempting to integrate terms from the mortgage into the note while still maintaining negotiability. In *Sims v. New Falls Corp.*, 37 So. 3d 358 (Fla. 3d DCA 2010), for example, Fannie Mae and Freddie Mac were permitted to explain their intent with respect to the drafting of a note (a UI Note for a second mortgage issued in Georgia) and security deed (equivalent to a mortgage). In that case, the term at issue was a choice of law provision that appeared in the mortgage, but not the note. Fannie and Freddie conceded that a conscious effort had been made not to incorporate the term by reference to the mortgage for fear it would "destroy the negotiability of promissory notes and open all foreclosure actions to otherwise barred collateral defenses."[62] Still, wanting to have their cake and eat it, too, Fannie and Freddie maintained that in a foreclosure action (as opposed to an action to enforce the note), the note and the mortgage should "be considered together as an integrated contract and that the choice of law provision in the [mortgage] would govern the enforcement of the [n] ote."[63] So, *Sims* reveals an important banking industry concession that, in a foreclosure context, its standard note has a decidedly non-negotiable characteristic — it can effectively adopt terms outside its own four corners.

This desire to incorporate terms from the mortgage, without appearing to, is most evident in §10 of the UI Note. Here, Freddie and Fannie begin by merely referencing the mortgage, which, by itself, would have no effect on the note's negotiability:

> In addition to the protections given to the Note Holder under this Note, a Mortgage, Deed of Trust, or Security Deed (the "Security Instrument"), dated the same date as this Note, protects the Note Holder from possible losses which might result if I do not keep the promises which I make in this Note.

The drafters go on, however, to state that the mortgage contains conditions under which the borrower may be required to make immediate payment — in other words, conditions that affect payment which are not contained in the note itself, "That Security Instrument describes how and under what conditions I may be required to make immediate payment in full of all amounts I owe under this Note."

Section 10 goes on to describe "*some* of those conditions" (emphasis added). The drafters' use of the word "some" unmistakably communicates that the mortgage contains additional promises of the borrower with respect to the loan that do not appear within the four corners of the note. Those additional promises include 1) payment of taxes; 2) payment of casualty insurance; 3) payment of mortgage insurance; 4) payment of community association fees and assessments; 5) furnishing the lender with notices of amounts due for taxes, assessments, and community association charges; and 6) furnishing the lender with receipts evidencing payments of taxes, assessments, and community association charges.[64] In addition, the borrower promises to occupy and use the residence as the borrower's primary residence for a period of at least one year.[65] The borrower also agrees to refrain from destroying, damaging, or impairing the property and repairing the property if so damaged.[66]

Moreover, §10 of the UI Note recites verbatim language from §18 of the UI Mortgage[67] that permits acceleration upon alienation of the collateral real estate. In doing so, it incorporates by reference the notice provisions of §15 of the mortgage, without ever describing the specifics of those provisions (emphasis added):

If Lender exercises this option [to accelerate upon sale or transfer of the property to a third party], Lender shall give Borrower notice of acceleration. The notice shall provide a period of not less than 30 days from the date the notice is given *in accordance with Section 15* within which Borrower must pay all sums secured by this Security Instrument. If Borrower fails to pay these sums prior to the expiration of this period, Lender may invoke any remedies permitted by this Security Instrument without further notice or demand on Borrower.

One example of an additional promise made by the borrower in §15 of the UI Mortgage is to "promptly notify Lender of Borrower's change of address." Under the UI Note, the borrower is not obligated to provide a change of address.[68]

Another complication is that the UI Mortgage defines the term "borrower" as the "mortgagor." To ensure that the lien applies equally to anyone on the deed, such as nonborrowing spouses or business partners, the practice is to include the names of property owners who borrowed no money as a borrower (and, thus, mortgagor) on the mortgage. The borrower on the UI Note, however, is merely the person obligated to repay the debt. As a result, the borrower on the note will often be one person, while the borrower on the mortgage will often be more than one. Not only does this raise the question of which borrower is being referred to in §10 of the UI Note (that quotes §18 of the UI Mortgage), but suggests that the note is incorporating promises by strangers to the note — parties whose identity cannot be ascertained without looking at the mortgage.

In the end, despite the drafters' studious avoidance of the word "incorporate," it cannot be disputed that the intended effect was to incorporate the terms of the mortgage, rather than merely reference them. While it might be said that the careful wording is a passing nod to negotiability, Freddie and Fannie have ultimately decided that negotiability must take a back seat to the preservation and enforcement of the mortgage terms intended to protect the collateral.

Does the Mortgage Follow the Holder of the Note or the Owner?

Even if the court decides that a note is negotiable (and that the plaintiff bank is its holder), the bank's work in a foreclosure case is only half done. Successfully claiming to be an Article 3 holder only entitles the bank to a money judgment on the note. It must now prove that it is entitled to enforce the mortgage.[69] For this, the foreclosing bank turns to the common law rule that the "mortgage follows the note."[70] Thus, so the syllogism goes, no document is needed to show that the plaintiff is entitled to enforce the mortgage because that right was transferred to it along with the note itself.[71]

Notably, the most often cited case for this proposition, *Johns v. Gillian*, 184 So. 140 (Fla. 1938), actually held that, when there is no written assignment of the mortgage, the plaintiff "would be entitled to foreclose in equity *upon proof of his purchase of the debt*."[72] But because even a thief can be a holder entitled to enforce a negotiable instrument, mere presentment of the original note is not evidence of an actual purchase of that note. The "mortgage follows the note" concept, therefore, is not the evidentiary shortcut it is professed to be, but just the opposite. It requires proof of purchase of the note, something that the Article 3 holder was able to skip on the way to enforcing just the note.

Accordingly, when the foreclosing bank is not the original lender, it must prove a purchase and an intent to transfer the mortgage with the note. Such proof of ownership of the loan brings the analysis into harmony with the fact that foreclosure is an equitable action.[73] As such, plaintiffs with "unclean hands," such as those in "wrongful possession" of the note, may not take a home as payment for the debt.[74] Requiring a greater showing of entitlement to foreclose than that to obtain a money judgment, *i.e.*, greater than mere possession of a note, is also entirely consistent with the public's interest in protecting homeownership as reflected in Florida's Constitution.[75]

Even if the additional proof requirement of *Johns* were to be ignored, since an Article 3 holder of the note need not be its owner, the abstract claim by a holder that the "mortgage follows the note" leads the court inexorably to the question of whether it follows the owner of the note or the holder of the note. If the transfer is one that occurs by operation of "equity," then it strains logic to suggest that equity would strip the true owner of the right to collect upon the collateral securing the note and give that right to a potential thief or finder.

Happily, the court need not ponder too long on the puzzle because the very architecture of the UCC answers the question. The common law concept that the lien faithfully tags along after the note is found in Article 9,[76] not Article 3. The UCC supplants common law[77] and the court must presume that the legislature, in adopting these provisions, intended that mortgages follow Article 9 owners, not Article 3 holders. Moreover, if there is any conflict between Article 9 and Article 3, the rules in Article 9 govern.[78] And finally, while possession is a means of perfection under Article 9, enforcement of the security interest requires proof that the buyer gave value to purchase the mortgage loan from a seller entitled to sell it.[79]

As a result, enforcement of a mortgage transferred under Article 9 (*i.e.* by following the note) requires proof of a sale, just as was required by common law under *Johns*. And because the foreclosing bank must show that it obtained the mortgage loan from a seller authorized to sell it, the bank must ultimately prove the sale at each link in the chain of ownership. The belief that an entity in wrongful possession of a note may foreclose on a home is firmly refuted by Article 9, and cases that hold that mere presentment of a note endorsed to the plaintiff is alone sufficient to prove standing to foreclose are misguided.

Care should be taken in the rush to extricate ourselves from the current mortgage foreclosure crisis not to elevate negotiability beyond the narrow mercantile milieu from which it developed, where merchants transacted business on an equal footing. In the foreclosure setting, both Article 9 and the common law require proof of the chain of title to the note, making Article 3 negotiability irrelevant to the determination of standing.

[1] James Steven Rogers, The End of Negotiable Instruments, Bringing Payment Systems Law Out of the Past 20 (Oxford University Press 2012) [hereinafter Rogers, The End of Negotiable Instruments]; Neil B. Cohen, *The Calamitous Law of Notes*, 68 Ohio St. L. J. 161, 161-62 (2007).

[2] Edward Jenks, *The Early History of Negotiable Instruments*, 9 L.Q.R. 70 (1893); Grant Gilmore, *The Good Faith Purchase Idea and the Uniform Commercial Code: Confessions of a Repentant Draftsman*, 15 Georgia L. Rev. 605, 607 (1981); James Steven Rogers, The Early History of the Law of Bills and Notes, A Study of the Origins of Anglo-American Commercial Law (Cambridge University Press 1995); Ali Khan, *A Theoretical Analysis of Payment Systems* 60 S.C.L. Rev. 426, 434, n. 45 (2008).

[3] Kurt Eggert, *Held Up in Due Course: Codification and the Victory of Form Over Intent in Negotiable Instrument Law*, 35 Creighton L. Rev. 363, 377-78 (2002).

[4] *Id*. at 390-91; Gilmore, *The Good Faith Purchase Idea* at 613.

[5] Ronald J. Mann, *Searching for Negotiability in Payment and Credit Systems*, 44 UCLA L. Rev. 951, 957 (1997).

[6] Rogers, The End of Negotiable Instruments at 71. ("What gave rise to the law of bills and notes in general, and negotiability in particular, was the circumstance that privately issued instruments circulated as a form of currency substitute."); *see also id*. at 93.

[7] Eggert, *Held Up in Due Course* at 388-389.

[8] Rogers, The End of Negotiable Instruments at 8.

[9] Rogers, The End of Negotiable Instruments at 22 (quoting William Everett Britton, Handbook of the Law of Law of Bills and Notes 25 (1943)).

[10] Mann, *Searching for Negotiability in Payment and Credit Systems* at 957-958.

[11] *Id.* at 958.

[12] Gilmore, *The Good Faith Purchase Idea* at 605, 607 (1981).

[13] Curtis Nyquist, *A Spectrum Theory of Negotiability*, 78 Marq. L. Rev. 897, 899-100 (1995).

[14] Rogers, The End of Negotiable Instruments at 32-35.

[15] *Id.* at 71, 93.

[16] Gregory Maggs, *Determining the Rights and Liabilities of the Remitter of a Negotiable Instrument: A Theory Applied to Some Unsettled Questions*, 36 B.C.L. Rev. 619, 626 (1995).

[17] Grant Gilmore, *Formalism and the Law of Negotiable Instruments*, 13 Creighton L. Rev. 441, 448 (1979).

[18] *Id.* at 461 (Article 3 is "a museum of antiquities — a treasure house crammed full of ancient artifacts whose use and function have long since been forgotten.").

[19] Allen R. Kamp, *Uptown Act: A History of the Uniform Commercial Code: 1940-49*, 51 SMU L. Rev. 275, 346 (1998); Frederick K. Beutel, *The Proposed Uniform [?] Commercial Code Should Not Be Adopted*, 61 Yale L. J. 334, 362-63 (1952) (calling the UCC a "Lawyers and Bankers Relief Act" and railing against what he called a "sellout" of the American Law Institute and the Commission of Uniform Laws to the banking lobby).

[20] Dale A. Whitman, *How Negotiability has Fouled Up the Secondary Mortgage Market, and What to Do About It*, 37 Pepp. L. Rev. 737, 740 (2010) ("[N]egotiability requires that, for every loan sold on the secondary market, the original promissory note must be delivered to the purchaser. In a national or global market, this requirement is extremely inefficient and inconvenient, and in recent years, has been widely ignored, much to the detriment of mortgage purchasers."); *see also* Mann, *Searching for Negotiability in Payment and Credit Systems* at 961.

[21] Dale Whitman, *Transfers of Mortgage Notes under New Article 9, available at* http://dirt.umkc.edu/files/newart9i.htm. These changes were enacted in Florida in 2001, effective 2002, Fla. Stat. §§679.1011-.709 (2012). The industry has also advocated a shift to paperless eNotes. *See* Electronic Signatures in Global and National Commerce Act, 15 U.S.C. §7001 *et seq.* (2012); Uniform Electronic Transaction Act adopted by the National Conference of Commissioners on Uniform State Laws in 1999 (adopted in Florida in 2000, Fla. Stat. §668.50 (2011)); *Case Closed, eNotes Are Legal, An Analysis of eNote Enforceability Nationwide*, a white paper jointly prepared by Mortgage Industry Standards Maintenance Organization (MISMO), the Electronic Signature and Records Association (ESRA), and the American Land Title Association (ALTA), *available at*

http://www.mortgagebankers.org/files/ResourceCenter/emortgage/eNote WhitePaper.pdf).

[22] Steven Schwarcz, *The Impact of Securitization of Revised UCC Article 9*, 74 Chicago-Kent L. Rev. 947 (1999); Whitman, *Transfers of Mortgage Notes under New Article 9* (apparent purpose of change was to insulate issuers of mortgage-backed securities from attacks by bankruptcy trustees "without the bother of taking physical possession of the notes in question, a process that they often consider irksome"); H. Bruce Bernstein, *Commercial Finance Association: Summary of the Uniform Commercial Code Revised Article 9, available at* https://www.cfa.com/eweb/DynamicPage.aspx?Site= cfa&WebKey=9d83ef78-8268-4aae-95e1 -7f4085764e46 (revised Article 9 facilitated mortgage-backed securitization); David Peterson, *Cracking the Mortgage Assignment Shell Game*, 85 Fla. B. J. 11, 12 (Nov. 2011) (revisions to Article 9 addressed the needs of banks in the securitization chain by treating mortgages as personal property that could be transferred without regard to the real estate records).

[23] Peterson, *Cracking the Mortgage Assignment Shell Game* at 12.

[24] *See* Fla. Stat. §679.3131(3) (2012).

[25] *Id.*

[26] Report of the Permanent Editorial Board for the Uniform Commercial Code, Application of the Uniform Commercial Code to Selected Issues Relating to Mortgage Notes 8 (American Law Institute and the National Conference of Commissioners on Uniform State Laws 2011)[hereinafter PEB Report].

[27] *See* Mann, *Searching for Negotiability in Payment and Credit Systems* at 969.

[28] Fla. R. Civ. P. Form 1.944.

[29] The typical standing allegation is now that the plaintiff bank is the "holder of the [n]ote and the [m] ortgage and/or is entitled to enforce them."

[30] The word "holds" in the phrase "owns and holds" appears to be unrelated to the Article 3 term "holder." A search of Florida law reveals that the phrase "owns and holds" is a ubiquitous legalism used in many contexts outside of negotiable instruments. Unlike the Article 3 "holder," the person who "owns and holds" an instrument is its owner. For example, when Fla. R. Civ. P. Form 1.934 (Promissory Note Complaint) was amended in 1980, the Florida Supreme Court added the same words found in the foreclosure form "the Plaintiff owns and holds the note" specifically "to show ownership of the note." Committee Note to Fla. R. Civ. P. Form 1.934 adopted by *The Florida Bar, In re Rules of Civil Procedure*, 391 So. 2d 165 (Fla. 1980).

[31] Fla. Evid. Code §90.902 (8) (Self-Authentication). *See Riggs v. Aurora Loan Services, LLC*, 36 So. 3d 932 (Fla. 4th DCA 2010).

[32] The Florida evidence rule on self-authentication of commercial papers is expressly limited to the "extent provided in the Uniform Commercial Code." Drafted in the days before high-resolution color copiers, scanners, and printers, however, the UCC speaks only to the authenticity of signatures on documents, not the authenticity of the documents themselves.

[33] *See Harvey v. Deutsche Bank Nat. Trust Co.*, 69 So. 3d 300, 304 (Fla. 4th DCA 2011) (even if the borrower could prove that an assignment was fraudulent, the dispute would be between the plaintiff and the actual owner of the note).

[34] *See In re Veal*, 450 B.R. 897, 912, n. 25 (B.A.P. 9th Cir. 2011) (noting that the ability of a thief to obtain payment on bearer instruments has factored in literature and film storylines).

[35] *Battles v. State*, 602 So. 2d 1287 (Fla. 1992) (a thief cannot convey good title to stolen property, even to a good faith purchaser); *Alamo Rent-a-Car, Inc. v. Williamson Cadillac Co.*, 613 So. 2d 517, 518 (Fla. 3d DCA 1993) (a thief cannot pass good title).

[36] *Antonacci v. Denner*, 149 So. 2d 52, 53 (Fla. 3d DCA 1963).

[37] *Id.* at 53-54. The Fifth District later noted that there was a split of authority under prior common law whether the burden would be on the holder to prove his BFP status once the claimant has introduced evidence of ownership. *Fid. & Cas. Co. of New York v. Key Biscayne Bank*, 501 F.2d 1322, 1325 n. 3 (5th Cir. 1974). While the court declined to decide which party bears the evidentiary burden, the fact that evidence of ownership of the instrument could be introduced against an alleged holder in due course was taken for granted.

[38] Fla. Stat. §673.3011 (2012) (emphasis added).

[39] Comments of the drafters of Article 3, Fla. Stat. §673.2031 (2012) ("A thief who steals a check payable to bearer becomes the holder of the check and a person entitled to enforce it...."); Fla. Stat. §673.2011 (2012) ("[I]f an instrument is payable to bearer and it is stolen by Thief or is found by Finder, Thief or Finder becomes the holder of the instrument when possession is obtained. In this case there is an involuntary transfer of possession that results in negotiation to Thief or Finder.").

[40] James J. White, *Some Petty Complaints About Article Three*, 65 Mich. L. Rev. 1315 (1967); Robert F. T. Dugan, *A New Approach to "Holder" Conundrums Under Articles 3 of the Uniform Commercial Code – A Reply to Professor White*, 13 B.C.L. Rev. 1 (1971). One of the drafters of the UCC publicly lamented its exaltation of transferability over property rights, as being out of step with modern economic realities. Grant Gilmore, *The Good Faith Purchase Idea and the Uniform Commercial Code: Confessions of a Repentant Draftsman*, 15 Georgia L. Rev. 605 (1981).

[41] Khan, *A Theoretical Analysis of Payment Systems* at 2 n. 9 and 22.

[42] U.C.C. §3.201; Fla. Stat. §673.2011 (2012).

[43] U.C.C. §1.201(b)(15); Fla. Stat. §671.201(15) (2012).

[44] U.C.C. §3.203; Fla. Stat. §673.2031 (2012). The requirement that there be an intent to give the recipient the right to enforce the note is necessary to prevent a mere handler with temporary consensual possession, such as a mailman, from becoming a "holder."

[45] Fla. Stat. §673.6021 (2012).

[46] Fla. Stat. §673.5011 (2)(b)2. (2012).

[47] Most modern promissory notes for the purchase of homes state that the borrower waives the right to require the holder to make a formal demand for payment. The language does not, however, expressly waive the borrower's right to require identification and evidence of authority to enforce the note once that demand for payment has been made.

[48] 16 C.F.R. §433.2.

[49] *Id.* The Holder Rule notice destroys the negotiability of any note upon which it appears because its very

presence makes the promise to pay conditional. A revision to Article 3 restored limited negotiability to notes containing the notice, but withheld a key attribute. It declared that no one may be a holder in due course of a note imprinted with the notice. U.C.C. §3-106(d); Fla. Stat. §673.1061(4) (2012); *see also*, Cohen, *The Calamitous Law of Notes* at 163-164.

[50] Tinker, 459 So. 2d at 492; *see also Florida Auto. Fin. Corp. v. Reyes*, 710 So. 2d 216, 218 (Fla. 3d DCA 1998).

[51] *Schauer v. Gen. Motors Acceptance Corp.*, 819 So. 2d 809, 813 (Fla. 4th DCA 2002).

[52] Opinion Letter of the Federal Trade Commission, May 3, 2012, *available at* http://www.ftc.gov/os/2012/05/120510advisoryopinionholderrule.pdf.

[53] *See, e.g., Gen. Motors Acceptance Corp. v. Honest Air Conditioning & Heating, Inc.*, 933 So. 2d 34, 37 (Fla. 2d DCA 2006).

[54] PEB Report at 4, n. 13.

[55] The version of the form discussed in this article is Form 3210, the Florida Fixed Rate Note — Single Family-Fannie Mae/Freddie Mac Uniform Instrument.

[56] Mann, *Searching for Negotiability in Payment and Credit Systems* at 969-73.

[57] *Id.*

[58] *In re Walker*, 466 B.R. 271, 283 (Bankr. E.D. Pa. 2012).

[59] U.C.C. §3-106(a); Fla. Stat. §673.1061(1)(b).

[60] *Holly Hill Acres, Ltd. v. Charter Bank of Gainesville*, 314 So. 2d 209, 211 (Fla. 2d DCA 1975).

[61] *Id.*

[62] *Sims,* 37 So. 3d at 364 (J. Cope's dissent).

[63] *Id*. at 362.

[64] UI Mortgage §3.

[65] UI Mortgage §6.

[66] UI Mortgage §7.

[67] Florida — Single Family — Fannie Mae/Freddie Mac Uniform Instrument, Form 3010.

[68] UI Note §7.

[69] PEB Report at 1 ("The UCC, of course, does not resolve all issues in this field [the transfer and enforcement of notes secured by a mortgage on real property]. Most particularly, as to both substance and

procedure, the enforcement of real estate mortgages by foreclosure is primarily the providence of a state's real property law....").

[70] *Johns v. Gillian*, 184 So. 140, 143 (Fla. 1938).

[71] *Harvey*, 69 So. 3d at 304.

[72] *Johns,* 184 So. at 143-414 (emphasis added).

[73] *See Smith v. Kleiser*, 107 So. 262, 263 (Fla. 1926) (foreclosure, as an action in equity, "should be in the name of the real owner of the debt secured").

[74] *Knight Energy Services, Inc. v. Amoco Oil Co.*, 660 So. 2d 786, 789 (Fla. 4th DCA 1995). Equity will intervene even when the wrongful conduct complained of harms someone other than the defendant. *Quality Roof Services, Inc. v. Intervest Nat. Bank*, 21 So. 3d 883, 885 (Fla. 4th DCA 2009) ("Unclean hands may be asserted by a defendant who claims that the plaintiff acted toward a third party with unclean hands with respect to the matter in litigation."); *see also Yost v. Rieve Enters., Inc.*, 461 So. 2d 178 (Fla. 1st DCA 1984) ("There is no bar to applying the doctrine of unclean hands to a case in which both the plaintiff and the defendant are parties to a fraudulent transaction perpetrated on a third party."); *Hauer v. Thum*, 67 So. 2d 643, 645 (Fla. 1953) ("It would matter not that the [defendants] were parties to the fraudulent transaction nor that the fraud was perpetrated upon a third party.").

[75] Fla. Const. art. X, §4.

[76] U.C.C. §§9-203(g) and 9-308(e); Fla. Stat. §§679.2031(7) and 679.3081(5) (2012).

[77] U.C.C. §1-103(b); Fla. Stat. §671.103 (2012).

[78] U.C.C. §3-102(b); Fla. Stat. §673.1021(2) (2012).

[79] U.C.C. §9-203(b); Fla. Stat. §679.2031(2) (2012).

***Thomas Erskine Ice** is the founder and principal legal strategist of Ice Legal, P.A., in West Palm Beach and Miami, and has practiced law in South Florida for more than 25 years. He is licensed to appear in the courts of Florida and the U.S. federal courts. He handles complex matters including bankruptcy, commercial litigation, personal injury, and wrongful death cases, and is a graduate of the University of Miami School of Law.*

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