

10-1-1957

Cooperative Apartments in Florida: A Legal Analysis

Seneca B. Anderson

Follow this and additional works at: <https://repository.law.miami.edu/umlr>

Recommended Citation

Seneca B. Anderson, *Cooperative Apartments in Florida: A Legal Analysis*, 12 U. Miami L. Rev. 13 (1957)
Available at: <https://repository.law.miami.edu/umlr/vol12/iss1/4>

This Leading Article is brought to you for free and open access by the Journals at University of Miami School of Law Institutional Repository. It has been accepted for inclusion in University of Miami Law Review by an authorized editor of University of Miami School of Law Institutional Repository. For more information, please contact library@law.miami.edu.

COOPERATIVE APARTMENTS IN FLORIDA: A LEGAL ANALYSIS

SENECA B. ANDERSON*

In recent months there has been a substantial rise in the number of cooperative apartments along the Gold Coast of South Florida.¹ As a result, Florida lawyers are being called upon to advise prospective purchasers and to protect their rights, as well as to organize these housing cooperatives.

The cooperative apartments springing up in this locality are not low cost housing developments sponsored by veterans' organizations, labor unions, or governmental agencies² but expensive dwellings offered at substantial prices to persons of means by developers not engaged in philanthropy but in the pursuit of profit.

The first aim of this article is to explain how these apartments are organized, taxed and financed, and to offer an exposition of the dangers and disadvantages frequently accompanying their acquisition and ownership, many of which may not be apparent to the uninitiated. The avenues of investigation which the attorney for the vendee can most profitably explore will be suggested and the aspects of cooperative ownership which it is most incumbent upon him to spell out to his client will be considered. He will also be reminded of remedies available to the purchaser whose vendor has failed to comply with the requirements of state and federal statutes regulating the sale of securities.

A second but equally important aim is to point out to counsel for the promoter those steps which must be taken if civil and criminal liability under these statutes is to be avoided, and to suggest others which he can and should take either to protect his client or to overcome the legitimate objections of alert regulatory bodies and discriminate buyers.

GENERAL COMMENTS ABOUT COOPERATIVE APARTMENTS

Many persons, especially older people who have owned their own homes, have a real need for the feeling of permanence and security associated with home ownership. This is perhaps doubly true in Florida where so many are new-comers to the state. Yet many such persons are reluctant to assume the annoyances necessarily incident to the maintenance of real

*A.B. 1930, Louisiana State University; LL.B. 1933 Harvard University; Member of Tennessee, Massachusetts, and Miami, Florida, Bars.

1. They are no innovation to the Florida scene, the first one in Miami having been erected in 1924. Ryan, *Co-operative Development in Florida*, 8 ANNALS OF REAL ESTATE PRACTICE 147, 153 (1925).

2. They have been so sponsored elsewhere. Note, *Co-operative Apartment Housing*, 61 HARV. L. REV. 1407 (1948).

property. To their problem the cooperative apartment may well provide the most satisfactory solution. By pointing out abuses sometimes associated with the promotion of these enterprises, it is not intended to condemn those which are properly organized and soundly financed. On the other hand, it cannot be denied that cooperative apartments, at their best, offer many disadvantages over home-ownership, the principal ones being that the so-called owner holds no legal title to his apartment, but is in reality a lessee³ whose possession under certain circumstances can be terminated against his will and through no fault of his own;⁴ that his investment is frozen since cooperative stock is not generally acceptable collateral;⁵ that he surrenders much of the sovereignty which the fee owner traditionally exercises over his home;⁶ and that the history of cooperative apartments, especially in time of recession, has been an unfortunate one.⁷ An added disadvantage to the Florida resident is loss of his homestead tax exemption.⁸ At their worst, they offer possibilities for fraud not to be found in the traditional forms of land tenure.⁹

Their most obvious disadvantage over an ordinary lease or tenancy from month to month lies in the fact that, except where the building is heavily mortgaged or the stock in the cooperative can be bought at a distress price, the cooperative plan requires a substantial cash outlay far in excess of the relatively small security deposit or prepayment of rent normally required of the apartment house tenant.¹⁰ This disadvantage

3. While the courts have recognized that the proprietary lessee has many of the attributes of an owner and is to be so treated for some purposes, as in *Hicks v. Bigelow*, 55 A.2d 924 (Mun. Ct. of App. D.C. 1947), he still lacks many of them. See notes 4 and 6 *infra*.

4. In *Penthouse Properties, Inc. v. 1158 Fifth Avenue, Inc.*, 256 App. Div. 685, 691, 11 N.Y.S. 2d 417, 432 (1st Dep't 1939) the court pointed out that one justification for denying a stockholder-lessee of an apartment the right to alienate it without the consent of fellow stockholders lay in the fact that "failure of any tenant to pay his proportion of operating expenses increases the liability of other tenant stockholders." Thus, if some tenants fail to meet their assessments, the corporation may not be able to meet its mortgage payments with resultant loss of the building through foreclosure in spite of the fact that other tenants are not in arrears. For other instances in which a tenant may be deprived of his apartment against his will see note 100, *infra*.

5. In 61 HARV. LAW. REV. 1407, 1412, *supra* note 2, reference is made to "the reluctance of mortgage lenders to take as security stock from which benefits can be obtained only within rules and subject to assessments imposed by the cooperative."

6. For example most proprietary leases make occupancy conditioned upon the observance of rules established by the directors or a majority of stockholders. These rules may prohibit alterations to the interior of the apartment, use of the front entrance by servants and tradesmen, overcrowding and other practices permissible to the ordinary home owner.

7. See Litchfield, *Cooperative Apartments*, 53 ARCH. FORUM 313, 315 (1930); *Postwar Co-ops*, 88 ARCH. FORUM 93 (1948).

8. Even if the fact is ignored that legal title is in the corporation and not the individual, it has already been decided that only one exemption per building is allowable. *Overstreet v. Tobin*, 53 So.2d 913 (Fla. 1951).

9. See *infra* p. 40. Offsetting these disadvantages are possible operating economies through group action. Furthermore an apartment in a large building should cost less than an individual home of the same size, since there are savings in land, foundations and roof to name a few of the more obvious ones.

10. Personal inquiry has disclosed that the cash payment required for a cooperative apartment in many South Florida projects exceeds \$25,000.

may be compensated for, in part at least, by reduced rentals in case the building is economically managed, but this potential saving may prove illusory since there is no guaranty that the assessments will not exceed current rentals charged by competing landlords.¹¹

Cooperative home ownership has a possible tax advantage over a tenancy since the shareholders of the cooperative, if it is properly organized, can claim a deduction for their proportionate share of certain interest and taxes.¹² While this is available only to those who elect to waive the standard deduction, it may be assumed to have some appeal to most occupants of the expensive cooperative buildings now dotting the Florida landscape.

An effective selling point employed by salesmen for many of these apartments is their supposed exclusiveness. The prospective purchaser is told that his co-tenants will be persons of his own economic, racial and social background and that no one can sub-lease, let alone purchase, an apartment without the consent of all or at least a majority of the stockholders or their chosen representatives. This may or may not prove true. The promoter selects the pre-incorporation subscribers. Those who subscribe initially generally have no legal right to pass upon the qualifications of other original subscribers subsequently brought into the venture, although the promoter may make it a practice to consult them. If the last few apartments cannot readily be sold to "desirable" persons, it is hardly likely that the promoter will voluntarily exercise a veto which will adversely affect his financial interests. Furthermore, even after the cooperative is in operation, and the promoter is no longer in the picture, racial and social bias may not withstand the pressure of cash in times of economic stress, and the required majority of the stockholders, if they are threatened with added assessments, may vote to accept a well heeled parvenu, regardless of the extent to which a minority may protest. Lastly, in the light of recent decisions of the United States Supreme Court holding unenforceable restrictive covenants imposing racial barriers¹³ as well as all types of segregation statutes and ordinances,¹⁴ no one can state with assurance that restrictive devices employed by cooperative apartments can long withstand determined assault.¹⁵

11. See Litchfield, *supra* note 7.

12. See *infra* pp. 30-32.

13. Shelley v. Kraemer, 334 U.S. 1 (1949).

14. Brown v. Board of Education, 347 U.S. 483 (1954); Gayle v. Browder, 352 U.S. 913 (1956).

15. The courts of Massachusetts and New York have upheld them. 68 Beacon Street v. Sohler, 289 Mass. 354, 194 N.E. 303 (1935); 1165 Fifth Ave. Corp. v. Alger, 288 N.Y. 67, 41 N.E.2d 461 (1942); Penthouse Properties, Inc. v. 1158 Fifth Avenue, Inc., 256 App. Div. 685, 11 N.Y.S.2d 417 (1st Dep't 1939). In the last case cited the court went out of its way to say ". . . we have not considered nor do we decide whether the consent of the directors or stockholders may be, or has been, arbitrarily withheld."

Notwithstanding these objections, apartments operated as cooperatives have met with widespread acceptance and the public will, in all probability, continue to invest in them. Though a buyer may be prepared to accept the disadvantages necessarily incident to cooperative home ownership, he needs to have them explained to him, since the salesman can only be counted upon to extoll the virtues of the plan. He also needs to be protected against unusual or unnecessary hazards arising through either the carelessness or the venality of those who organize the enterprise.

The lawyer's knowledge of property law, of the law of landlord and tenant, of federal taxation, of corporation law, and of the statutes regulating the sales of securities, as well as his imagination, common sense, business judgment and skill in handling a client is rarely put to greater test than when he organizes a cooperative apartment venture for its promoter or when he reviews it for a would-be purchaser whose wishes may run counter to his best interests. By the same token, nowhere is the average individual in greater need of skilled legal services than just before he affixes his signature to a stock subscription or stock purchase agreement for shares in a cooperative housing corporation. Regardless of the merits or demerits of title insurance as a substitute for legal services when acquiring a fee simple title, no title policy yet devised will protect the purchaser from all of the legal pitfalls incident to the purchase of a cooperative apartment. This is doubly true where the cooperative, as seems to be increasingly the case in Florida today, is not the fee owner of the land on which the apartment is erected, but is the lessee or even a sub-lessee under a ground lease.

ORGANIZATION OF THE COOPERATIVE AND REGISTRATION OF ITS SECURITIES

Florida cooperative apartment buildings, with possible rare exceptions, are held by corporations. For that reason other schemes under which a housing cooperative may be organized will be ignored.¹⁶

Under a typical plan employed in this state, the apartment building is erected by a promoter on land which he either owns or on which he holds a long term lease. He organizes a corporation, all of the stock in which is sold to persons desiring apartments. The proceeds of the stock sales and of mortgages, if the property is to be encumbered, are used by the corporation to acquire the building from the promoter who may (1) sell it the fee either free and clear or subject to one or more mortgages, (2) assign his leasehold to the corporation or (3) lease or sub-lease the property to the corporation on a net long term lease.

The promoter puts a price tag on each apartment in the building. If some are more desirable than others, they naturally command the better

16. For a discussion of other methods, see Castle, *Legal Phases of Cooperative Housing*, 2 So. CALIF. L. REV. 1, 2 (1928).

prices. While the apartment is what the prospective purchaser seeks, what he actually receives is one or more shares of stock in the corporation, carrying the right to a proprietary lease in the apartment of his choice.¹⁷ This proprietary lease may be for a long term or for a short term with successive renewal privileges. The rent is determined by dividing among the various apartment holders, and according to pre-arranged formula, all costs of operation including ground and other rent if the property is not held in fee, debt service on mortgages, taxes, insurance, upkeep, cost of improvements and such reserves as may be agreed upon. Frequently the promoter has entered into a contract with the corporation whereby he is entitled to a management fee. As this fee may bear little or no relation to the value of services rendered, such contracts should be subjected to careful examination. Sometimes the proprietary lease calls for a high fixed rental and provides for rebates to the stockholders, if rent thus paid exceeds operating costs, or assessments if it proves inadequate; more frequently it calls either for no fixed rental or a nominal rent with assessments to be fixed periodically by the directors. In either event, the ultimate net rent is the operational cost divided among the apartments in accordance with the formula initially adopted.

It is unlawful for the promoter to offer stock in such a corporation¹⁸

17. Cf. *Hicks v. Bigelow*, 55 A.2d 924 (Mun. Ct. of App. D.C. 1947); *Penthouse Properties Inc. v. 1158 Fifth Avenue, Inc.*, *supra* note 15.

18. In spite of an argument contained in *Castle*, *supra* note 16, and the opinion of the Attorney General of Minnesota therein quoted, exempting stock in a housing cooperative from the Minnesota Blue Sky Law, there appears to be no reported decision sustaining this view.

The attitude of the Florida Securities Commission is reflected in the following release:

FLORIDA SECURITIES COMMISSION
STATE OF FLORIDA

Tallahassee

December 28, 1955

Re: Cooperative Housing Ventures

With reference to the subject matter the policy of this Commission is to consider each such venture on its own merit because of the variance of each cooperative housing venture. If securities are involved, they, in most cases, are subject to our Securities Law. Our Commission's counsel in the office of the Attorney General has many times verbally concurred with this policy of requiring the offering of such securities to meet the provisions of our Law.

We respectfully call your attention to page 621 of the Biennial Report of the Attorney General, 1935-1936, wherein an opinion was rendered this Commission on February 13, 1935, which gives an affirmative answer to the question of whether or not stock involved in a cooperative housing venture must be registered with this Commission, and further, that the salesmen therein must also be registered. You will note the concluding paragraph of this opinion reads:

"I can find no distinction between the sale of this stock and the sale of any other security, within the terms of the Act, which would in any manner take it out of the operation of the broad definitions of 'security' and 'sale' as given in this Act."

The following is an excerpt from a letter from a former Attorney General on the subject, dated July 25, 1931:

"The Florida Securities Commission Act does not affect the law pertaining to the organization of cooperative marketing corporations, except that if the

until he has complied with the Florida Blue Sky Law,¹⁹ and, where applicable, with the Federal Securities Act.²⁰ Failure to obey the requirements of either statute may invoke both civil and criminal penalties. These statutes are designed to, and do, provide the investor with some measure of protection against fraud and duplicity, and non-compliance affords him an opportunity to rescind as well as other remedies. Hence his attorney should have at least a general familiarity with both acts.²¹ For that reason the high spots of both acts, as pertinent to the solicitation of pre-incorporation subscriptions and the offering of shares in corporations operating cooperative apartments, will be briefly summarized.

A. *The Florida Blue Sky Law.*²² This statute regulates the sale of securities. The definition of securities contained in the statute is a very broad one. It includes, in addition to stocks, bonds and debentures, such divers intangibles as "evidence of indebtedness, certificate of interest or participation . . . certificates of interest in a profit sharing agreement or the right to participate therein . . . pre-organization certificate, pre-organization subscription, or any transferable share investment contract or beneficial interest in title to property, profits or earnings; interest in or under a profit sharing participation agreement or scheme or any other instrument commonly known as a security. . . ."²³

All securities offered for sale in Florida must be registered with the Florida Securities Commission except where they are declared to be exempt

cooperative marketing corporation wishes to sell stock, then it must qualify as required under the Florida Securities Commission Act with which you are familiar."

The following is taken from a letter from this Commission to a Florida resident dated September 30, 1938:

"It is the opinion of the Assistant Attorney General handling cases of this Commission that a cooperative association *selling stock* would have to comply with the provisions of the Florida Securities Act."

The following are two paragraphs taken from two different letters from this Commission in reply to inquiries from two separate law firms this month:

"While it may be said that the sale of stock is incidental to the forming of such an association, it still constitutes the sale of securities pursuant to Chapter 517, Florida Statutes."

"We wish to advise that in the past several parties have pointed out that similar associations failed to comply with our Act, but this merely served to cause such associations to meet with our requirements rather than excuse the new association from complying with same."

19. FLA. STAT. § 517 (1955).

20. Securities Act of 1933, 48 STAT. 74, 15 U.S.C. §§ 77a-77aa (1952). The applicability of the statute is dependent upon use of the mails or an instrumentality of interstate commerce.

21. The attorney for the promoter must have a detailed knowledge of these acts which can be acquired only by careful study of all their provisions. This article can only warn him of this necessity.

22. An excellent analysis of this act will be found in Robinton & Sowards, *Florida's Blue Sky Law: The Lawyer's Approach*, 6 MIAMI L.Q. 525 (1952), see also 12 U. MIAMI L. REV. 1 (1957). For a discussion of the applicability of the almost identical Illinois act to the sale of securities of cooperative apartments in that state, see Robert & Kenneth Marks, *Coercive Aspects of Housing Cooperatives*, 42 ILL. L. REV. 728, 731 (1948).

23. FLA. STAT. § 517.02 (1955).

by the statute or except where the transaction by which they are offered or sold is so exempted.²⁴ As none of the eleven classes of exempt securities²⁵ applies to stock in a cooperative housing corporation, their analysis would be superfluous. Suffice to say that there is nothing in the statute exempting securities of housing cooperatives per se although there is an exemption for securities of agricultural cooperative associations organized pursuant to Chapter 618, Florida Statutes.²⁶ The fact that the securities are issued by a foreign corporation does not exempt them nor does the fact that the corporation is organized as a non-profit corporation unless "organized exclusively for religious, educational, benevolent, fraternal, charitable or reformatory purposes and not for pecuniary profit and no part of the net earnings inure to the benefit of any private stockholder or individual."²⁷

The statute establishes fourteen different classes of exempt transactions, of which only four concern the prospective buyer of a cooperative apartment.²⁸ Sales under the following circumstances are exempt transactions:

- "(1) At any judicial, executor's, administrator's, guardian's, or conservator's sale, or at any sale by a receiver or trustee in insolvency or bankruptcy.
- (2) By or for the account of a pledge holder or mortgagee selling or offering for sale or delivery in the ordinary course of business and not for the purpose of avoiding the provisions of this chapter, to liquidate a bona fide debt, a security pledged in good faith as security for such debt.
- (3) The isolated sale of securities when made by or on behalf of a vendor not the issuer or underwriter thereof, who, being the bona fide owner of such securities disposes of his own property for his own account and such sale is not made directly or indirectly for the benefit of the issuer or an underwriter of such securities or for the direct or indirect promotion of any scheme or enterprise with the intent of violating or evading any provision of this chapter."

Solicitation of stock subscriptions is exempt when there are:

- "(10) Not exceeding twenty-five subscriptions for shares of the capital stock of a corporation prior to the incorporation thereof under the laws of this state when no expense is incurred, or no commission compensation or remuneration is paid or given for or in connection with the sale or disposition of such securities."

24. *Id.* § 517.07.

25. *Id.* § 517.05.

26. *Id.* § 517.05 (11). This exemption has been added since the publication of Robinton & Sowards' article, *supra* note 22, see 12 U. MIAMI L. REV. 5 (1957).

27. *Id.* § 517.05 (5). Compare the similar provision in the federal statute, 48 STAT. 906 (1934), 15 U.S.C. § 77c(4) (1952).

28. *Id.* § 517.06.

The first three classes are of importance to the buyer since they permit him and his executors or administrators to dispose of his stock or pledge it without complying with the Blue Sky Law, but they afford the promoter no relief.

The last, which is expressly limited to pre-incorporation subscriptions to stock in *Florida corporations only*, relieves the promoter from the requirement of registering the stock. However, he must affirmatively show to the Commission that the transaction is exempt, he must list all persons connected with the offering of such securities, and all funds collected from subscribers must be placed in escrow, if the Commission so requires,²⁹ as is its practice.³⁰

Thus, while promoters who qualify for this exemption are given the burden of proving that they are entitled to it,³¹ and while they are required to place pre-incorporation collections in escrow, the Securities Commission does not normally demand for securities sold in exempt transactions the detailed information necessary for registration. However, if it appears to the commissioners, through complaint or otherwise, that the exempt transaction smacks of fraud, the Commission is empowered to enjoin the sale.³²

The statute provides for registration in one of three different ways: by notification, qualification or announcement.³³ As stock in a cooperative housing corporation is not likely to meet the tests for registration by notification or announcement, it must be registered by qualification. The applicant must pay a registration fee and must supply the Commission with such complete detailed information on the finances, operational plan and structure of the enterprise as it may require, together with a copy of any prospectus, circular, or advertisement to be used. If, and only if, the Commission finds the sale of the security not to be fraudulent, that it will not tend to work a fraud, *and that the enterprise or business of the issuer is not based upon unsound business principles*, the security may be registered.³⁴ Then it may be sold only by the issuer or a registered dealer who has notified the Commission of his intention to offer it for sale.³⁵ Such a dealer must have posted a five thousand dollar bond with the Commission.³⁶ While only registered and bonded dealers may offer securities, including exempt ones, this is not true of transactions exempted by the statute.³⁷

The statute expressly provides that anyone who purchases a security sold in violation of any of its provisions may rescind and recover his

29. *Id.* § 517.06 (15).

30. Robinton & Sowards, *supra* note 22 at 532.

31. FLA. STAT. § 517.17 (1955).

32. *Id.* § 517.19.

33. *Id.* § 517.08, § 517.09, § 517.091.

34. *Id.* § 517.09 (7).

35. *Id.* § 517.09 (7).

36. *Id.* §§ 517.12 (4) and 517.13.

37. *Id.* § 517.12 (1).

purchase price, interest and attorney's fees from any seller or any director, officer or agent of the seller who personally participated in the sale.³⁸ However, suits for rescission must be brought within two years of the sale and will not lie if the buyer has refused for thirty days a tender of the full purchase price and interest.³⁹ The statute leaves unimpaired the buyer's other remedies. Violation of any section of the act, including that which prohibits sale by an unregistered dealer or salesman, except in exempt transactions, is a felony whose penalty is a fine of not over five thousand dollars or imprisonment for not over five years.⁴¹

The act does not apply to the situation where a group of individuals unite to form a corporation with the actual incorporators taking stock.⁴² This may afford a loop-hole through which some promoters may attempt to escape all notification to the Florida Securities Commission. However, if it can be shown that the group was not spontaneously formed but came into being only as a result of the active solicitation of the promoter or those employed by him, there would seem to be a sale of a security within the purview of the Florida act. Then, unless it could be shown that there were less than twenty-five pre-incorporation subscribers and that no remuneration was paid for selling the security, registration would be necessary; if both these conditions were met, a determination of exemption and placing of funds in escrow would be required.

B. *The Securities Act of 1933.*⁴³ The Federal Securities Act defines a security in much the same manner as the Florida Blue Sky Law.⁴⁴ It, too, provides for "exempt securities" and "exempt transactions."⁴⁵

The only two security exemptions relevant to cooperative housing corporations are contained in the following provisions of the statute:

- (a) Any security which is a part of an issue *offered and*⁴⁶ sold only to persons resident within a single State or Territory,

38. *Id.* § 517.21. *But see* Nichols v. Yandre, 151 Fla. 87, 9 So.2d 157 (1942) holding ratification by directors not to constitute participation.

39. *Id.* § 517.21.

40. *Id.* §§ 517.22 and 517.23.

41. *Id.* § 517.30. The penalty was increased after the initial adoption of the act § 1 ch. 26970, 1951. The original act was severely criticized because the maximum penalty for its violation was less than for stealing a hog. Miami Daily News, February 21, 1951, p. 1, col. 4.

42. Robinton & Sowards *supra* note 22 at 531.

43. For an explanation of the purpose and substance of the statute, see P-H SEC. REG. SERV. ¶ 1421-1476.

44. "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, 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." 48 STAT. 905 (1934), 15 U.S.C. § 77 h (1) (1952).

45. *Id.* §§ 77c and 77d.

46. The italicized words were added by amendment on August 10, 1951, 15 U. S. C. § 5 (1952).

where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such State or Territory.

- (b) The Commission may from time to time by its rules and regulations, and subject to such terms and conditions as may be prescribed therein, add any class of securities to the securities exempted as provided in this section, if it finds that the enforcement of this subchapter with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering; but no issue of securities shall be exempted under this subsection where the aggregate amount at which such issue is offered to the public exceeds \$300,000.

Inasmuch as many persons to whom Florida cooperative apartments are offered are non-resident visitors to the state, the first of the above exemptions is a slender reed upon which to lean. In a case decided before the italicized words were added to the statute, the Federal Securities Commission held that the exemption did not apply even though all sales but one were made to residents of the state of incorporation.⁴⁷ Now that the amendment is in effect, it would seem that a single offer to a non-resident would deprive the securities of their exempt status and require their registration. Thus a Florida resident may be able to rescind the purchase of a security registered under the Blue Sky Law, but not under the Federal act, on a showing that a single offering was made to a non-resident.⁴⁸

If the total sales price of all the apartments held by the corporation does not exceed three hundred thousand dollars the second exemption may afford relief from registration. The present regulations,⁴⁹ however, require that a notification be filed with the Regional Office of the Securities Commission at least ten days before the securities are offered. They also call for "an offering circular" and a report of sales within six months. Furthermore, the commission reserves the right to suspend the privilege at any time.

The two pertinent exempted transactions are: "Transactions by any person other than issuer, underwriter or dealer; transactions by an issuer not involving any public offering."⁵⁰

With certain exceptions irrelevant to stock in housing cooperatives an issuer means "every person who issues or proposes to issue any security,"

47. In the Matter of Peterson Engine Co., 2 SEC 893 (1937).

48. This statement is predicated upon the assumption that "offered and sold" will be construed to mean "offered or sold." Since a sale presupposes an offer, the amendment seems pointless unless so construed.

49. Rule 252. An analysis of this regulation is beyond the scope of this article. It is to be found in P-H Sec. Reg. Ser. ¶ 2031.2.

50. 48 STAT. 77 (1933), 15 U. S. C. § 77d (1952).

an underwriter means "any person who has purchased from an issuer with a view to, or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking . . .," and a dealer includes a full or part time agent, broker or principal trading or dealing in securities issued by another.⁵¹ The effect of this exemption is to relieve the individual who wishes to dispose of his own apartment from the operation of the act, as well as his executors, administrators and creditors.

The key words in the second exemption are "public offering," a term not defined by the act. An issuer who pleads exemption from registration on the ground that no public offering is involved has the burden of proving such to be the case.⁵²

The Supreme Court of the United States has held that whether transactions in securities involve a public offering is not dependent on the number of persons to whom the offer is made, and that a quantity limit cannot be imposed on private offerings as a matter of statutory interpretation.⁵³

In an interpretive opinion of the General Counsel of the Commission,⁵⁴ it is suggested that whether or not there is a public offering is "essentially a question of fact." While no hard and fast rule is laid down, the following matters are considered relevant: (1) the number of offerees and their relationship to each other and the issuer, (2) the number of units offered, (3) the size of the offering and (4) the manner of offering. It is implied that if more than twenty-five persons are offered securities of a single issue, it will be treated administratively as a public offering in the absence of some unusual compensating factor.

Unless the security or the transaction is exempt, it is unlawful to make use of either the mails or interstate commerce in connection with the sale or delivery of the security or any prospectus.⁵⁵ In case one or the other is used the fact that either the security or the transaction is exempt will not relieve the seller from liability for actual fraud.⁵⁶

That act provides for the filing with the Commission of a registration statement to be accompanied by such information and such documents as the Commission may require.⁵⁷ It also requires that any offer to sell the security be accompanied by a prospectus which must comply with

51. *Id.* § 77 b.

52. *SEC v. Sunbeam Gold Mines*, 95 F.2d 699 (9th Cir. 1938).

53. *SEC v. Ralston Purina Company*, 346 U.S. 119 (1953).

54. SEC Act. Rel. 1-24-35, P-H SEC. REG. SERV. ¶ 2170.1.

55. 48 STAT. 77 (1933), 15 U.S.C. § 77 e (1952). The federal statute does not come into play unless either interstate commerce or use of the mails can be shown.

56. *Id.* §§ 77 p and 77 q.

57. *Id.* §§ 77 f and g.

standards established by the Commission.⁵⁸ Unlike the Florida act, the Federal Securities Act does not require that the Commission be persuaded of the soundness of the enterprise so long as it is free from fraud and full disclosure of all relevant facts is made.

Civil liabilities⁵⁹ as well as criminal penalties⁶⁰ are imposed on the seller of a security in violation of the statute. Of importance to the attorney whose client is barred from suing under the Florida statute by reason of the expiration of two years from the date of sale is the limitation of acts section of the federal statute,⁶¹ which, under certain circumstances, permits suit within three years.

Any dissatisfied purchaser of a cooperative apartment, before he sells his stock at a loss, should first determine if the promoter has complied with all requirements of both acts. An exemption under one statute is not necessarily an exemption under the other. Violation of either, even though in good faith and without fraud or misrepresentation, will enable the buyer to rescind. Where the securities acts are involved the maxim "caveat emptor" has been changed to "caveat vendor!" The promoter who neglects to register under both takes a chance out of all proportion to the cost and inconvenience of full compliance.

The corporation which is formed for the purpose of acquiring or leasing the apartment building may be either a Florida or a foreign corporation. If a Florida corporation, it must be organized under Chapter 608, Florida Statutes, which deals with general business corporations. It cannot qualify as a non-profit corporation under Florida law.⁶² Whereas most corporations may be organized with only three incorporators, cooperative associations require ten.⁶³ The statute does not define what is meant by a cooperative association, and there appears no reason why an ordinary business corporation formed with three incorporators cannot operate an apartment house on the cooperative plan.⁶⁴

58. *Id.* §§ 77 e (b) (2) and 77 j. The Florida Blue Sky Law does not require a prospectus.

59. *Id.* §§ 77 k and 77 l.

60. "Any person who willfully violates any of the provisions of this subchapter, or the rules and regulations promulgated by the Commission under authority thereof, or any person who willfully, in a registration statement filed under this subchapter, makes any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading, shall upon conviction be fined not more than \$5,000 or imprisoned not more than five years, or both." 48 STAT. 87 (1933), 15 U.S.C. § 77x (1952).

61. *Id.* § 77 m.

62. FLA. STAT. § 617 (1955) provides for the incorporation of corporations not for profit. Chapters 618 and 619 permit the organization of certain types of cooperatives as corporations not for profit, but none of these statutes is broad enough to include a cooperative housing venture of the type under discussion. *Cf.* note 66, *infra*.

63. FLA. STAT. § 603.03 (1) (b) (1955).

64. A New York corporation may. *Cf.* *Penthouse Properties, Inc. v. 1158 Fifth Avenue Inc.*, 256 App. Div. 685, 11 N.Y.S.2d 417 (1st Dep't 1939).

There seems to be no discernible advantage to foreign incorporation, since the foreign corporation would be subject to qualification⁶⁵ and taxation in Florida. Nevertheless it is rumored that a number of Florida cooperative apartments have been organized as non-profit corporations under Delaware law⁶⁶ and "memberships" have been sold in Florida without compliance with either state or federal securities acts, presumably on the theory that their non-profit status confers immunity.⁶⁷ Such memberships are securities within the meaning of both statutes; neither the security itself nor the transaction in which it is sold is exempt, and, as a consequence, registration is mandatory.

STOCK SALES VS. PRE-INCORPORATION SUBSCRIPTIONS

The promoter may adopt either of two alternatives in disposing of the apartments. Under one plan he first forms a corporation, then contracts with it to purchase or lease the building. Only after these steps are taken does he solicit sales, and those who agree to take apartments are delivered stock in return for the agreed upon price. Under the second plan, the corporation is not formed until all the apartments are spoken for. Each prospect is tendered a pre-incorporation subscription and is required to place either all or part of the subscription price in escrow with a trustee or agent who is directed to turn over the escrow funds and the balance of the subscription price to the promoter upon organization of the corporation, conveyance to it of the property, and delivery of the stock to the subscriber. Each method has its disadvantages as well as its advantages, although the former should prove preferable to both parties.

As has already been pointed out, if the promoter sells stock he must register it with the Florida Securities Commission and in most cases with the Federal Securities Commission as well. If he merely procures pre-incorporation subscriptions, if there are not over twenty-five subscribers, and if no commission or remuneration is paid for their procurement the transaction is exempt from registration but not proof of exempt status under section 517.06(11), Florida Statutes. In such a case there is no need to satisfy the Commission that the enterprise is "not based on unsound business principles" which must be accomplished as a condition precedent to registration in Florida.

65. FLA. STAT. § 613.01 (1955).

66. Most courts confronted with the question have held that a non-profit corporation cannot operate a cooperative apartment. *Russell v. Sweeney*, 153 Ohio St. 66, 91 N. E.2d 13, (1950). Delaware is an exception: *Read v. Tidewater Coal Exchange*, 13 Del.Ch. 195, 116 Atl. 898 (1922). By special legislation Illinois permits housing cooperatives to be so organized. *McCullough*, *Cooperative Apartments in Illinois*, 26 CHI.-KENT L. REV. 393, 311 (1948).

67. Both statutes confer immunity for the sales of securities of non-profit corporations, but only if they are organized for benevolent, charitable, religious or like purposes and meet the other requirements imposed by the statutes. FLA. STAT. § 517.05 (5) (1955); 48 STAT. 75 (1933), 15 U.S.C. § 77c(4) (1952).

Because of this exemption many promoters and their attorneys prefer to proceed by pre-incorporation subscription, not realizing that this method is accompanied by consequences far more onerous than registration. In the first place, the promoter will undoubtedly find it necessary to dispose of at least some of the apartments through real estate brokers.⁶⁸ This will deprive the transaction of its exempt status and necessitate registration since a commission will have to be paid. The promoters proceed at their own risk if they attempt to justify failure to register on the ground that they pay commissions only for the proprietary lease and not for the stock subscription. Secondly, after the stock subscription is signed, even though a part of the purchase price is placed in escrow, they may find that some of the subscribers are incapable of carrying out the purchase agreement, especially if there is protracted delay in selling all the apartments and completing the organization of the corporation. Thirdly, such stock subscriptions are frequently contingent upon obtaining other subscriptions for all of the stock in the corporation within a limited time. Fourthly, the subscriber may withdraw and demand the return of his money at any time before incorporation is completed, unless the agreement is drawn so as to constitute a contract between the subscribers.⁶⁹ Lastly, when the corporation is created the subscribers may refuse to permit the corporation to purchase the building on the terms which the promoter had contemplated receiving.

The majority of courts have ruled that, since the corporation is not in existence, there can be no contract between it and the subscriber until after it is formed.⁷⁰ Until then the subscription is only an offer and the subscriber is free to withdraw it prior to acceptance.⁷¹

The cases are by no means clear as to whether the offer is for a unilateral or bilateral contract. Once the corporation is organized, there is no difficulty in holding the subscriber although some courts find that the corporation is not bound unless and until it takes some affirmative step to accept the offer.⁷² One writer has rationalized the willingness of most courts to permit the subscriber to withdraw before incorporation, not on traditional principles of contract law, but on the desire of courts

68. To offer securities real estate brokers must first register as securities brokers or salesmen. While this requires proof of good moral character, a surety bond and payment of a fee, no other qualifications are required. FLA. STAT. § 517.12 (1955). Registered dealers must notify the commission of their intention to offer any security in advance of offering it. FLA. STAT. § 517.12 (8) (1955).

69. "Of course the subscription may be so worded as to create a binding contract between the subscribers, even in those states where the ordinary contract of subscription does not have that effect." FLETCHER, *CYC. CORPORATIONS* § 1425 (perm. ed. 1931).

70. *Planters' and Merchants' Independent Packet Co. v. Webb*, 156 Ala. 551, 46 So. 977 (1908); *Wallace v. Duell*, 18 Penn. App. 483, 79 S.W.2d 595 (1934).

71. *Bryant's Pond Steam Mill Co. v. Felt*, 87 Me. 234, 32 Atl. 888 (1895); *Hudson Real Estate Co. v. Tower*, 156 Mass. 82, 30 N.E. 465 (1892).

72. See Lukens, *The Withdrawal and Acceptance of Pre-Incorporation Subscriptions to Stock*, 75 U. PA. L. REV. 423 (1928).

to protect the subscriber from overzealous salesmanship, a solicitude not afforded him in many comparable situations.⁷³

While the majority of courts permit withdrawal prior to incorporation, a few have rejected the rule.⁷⁴ The Florida court has twice ruled that a corporation may maintain an action on a pre-incorporation subscription even though it is not named as a promisee therein,⁷⁵ but in both cases there was no showing that the subscriber evinced his desire to rid himself of his bargain until after the corporation had come into being. In three other cases⁷⁶ it has said, without any effort to explain its inconsistency, that other types of pre-incorporation contract were not enforceable either *by or against* a corporation, although in the *Greenfield Village* case, there was at least a hint that the result would be different if the corporation ratified the agreement.

The courts which permit withdrawal require that the intention to do so be indicated affirmatively, generally by notifying either the promoter, the salesman who obtained the subscription, the person in charge of the subscription list, or other stockholders.⁷⁷ If the subscription is merely an offer it would follow that death of the subscriber before incorporation terminates the offer and entitles the estate to recover any deposit or down payment accompanying the subscription.⁷⁸

The promoter who refuses to refund a subscription deposit and release a subscriber invites trouble. The disgruntled subscriber can be expected to register a complaint with one or both securities commissions. This may delay soliciting other subscriptions or issuance of the stock. Even assuming the securities commissions give the promoter a clean bill of health, a belligerent subscriber may approach other subscribers and if he can persuade them that the promoter is taking advantage of them, is asking too

73. "Perhaps an explanation of the readiness of courts to uphold withdrawal of pre-incorporation subscriptions, at least until after the corporation is incorporated, is to be found in the judicial consciousness or belief that promoters of new enterprises are frequently glib and persuasive individuals, and investors gullible and credulous persons; hence the courts are ready to give the subscriber a chance to amend an ill considered decision, provided he manifests his change of intention before the process of forming the enterprise has gone too far, and the point of incorporation of the corporation has been adopted as a more or less arbitrary 'dead line'". Frey, *Modern Developments in the Law of Pre-Incorporation Subscriptions*, 79 U. PA. L. REV. 1005, 1012-1013 (1931).

74. 4 FLETCHER, *CYC. CORPORATIONS* § 1722 (1931 ed.).

75. *Perry Hotel Co. v. Courtney*, 102 Fla. 1041, 136 So. 691 (1931); *Ocala Community Hotel Co. v. Holloway*, 103 Fla. 521, 137 So. 882 (1931).

76. *Sumner-May Hardware Co. v. Scully*, 66 Fla. 93, 62 So. 900 (1913); *Nichols v. Bodenwein*, 107 Fla. 25, 146 So. 86 (1933); *Greenfield Village, Inc. v. Thompson*, 44 So.2d 679 (Fla. 1950).

77. Frey, *supra* note 73 at 1011, note 17.

78. ". . . the continuance of an offer is in the nature of its constant repetition, which necessarily requires some one capable of making a repetition. Obviously, this can no more be done by a dead man than a contract can, in the first instance be made by a dead man." *Pratt v. Baptist Soc. of Elgin*, 93 Ill. 475, 478, (1879). The same thing has been held to be true, when the offeror is adjudged insane. *Beach v. The First Methodist Episcopal Church*, 96 Ill. 177 (1880). See also *RESTATEMENT, CONTRACTS*; § 48 (1932).

high a price for the property, or if he can otherwise enlist their sympathy and support, they may appear at the first meeting of stockholders and cause the corporation to reject the promoter's offer to sell or lease the building. He, too, can make no contract with the corporation prior to its incorporation,⁷⁹ and if it refuses to purchase or lease his building, he has no cause of action against it.

The lawyer with any extensive real estate practice has, on numerous occasions, found himself employed after the purchase and sale agreement has been signed. Unless title is defective or unmarketable, his client is bound and he can usually offer only sympathy if an unfortunate bargain has been made. The pre-incorporation subscriber, on the other hand, is in a favored position to withdraw from his bargain, and neither his attorney nor counsel for the promoter should ever forget it.

Organization of the corporation does not automatically force the subscriber to abandon hope of extricating himself from a too hasty stock subscription. He still has available the defense that the corporation was not organized in accordance with the undertaking,⁸⁰ the defenses afforded by the securities acts, if either has been violated, and the usual assertions of fraud, misrepresentation and the like. The Florida court has held that the promoter occupies a fiduciary relationship with the corporation, and while he is presumably entitled to make a profit on a sale of property to it, a hidden and secret profit will permit it to rescind even after the conveyance has taken place.⁸¹ A practical consideration not to be overlooked is that if the subscriber refuses to fulfill his subscription agreement, the burden is on the corporation to collect from him.⁸²

The promoter is not the only one who may suffer by adoption of the pre-incorporation subscription plan. The subscriber, though he may have an option to withdraw, cannot really tell what he is getting until the corporation is formed, the by-laws adopted, and the contract with the promoter executed. This is especially true where it is contemplated that a leasehold is to be acquired and not a fee simple title. While a warranty deed is standardized, this is not true of a lease, and the latter cannot be construed until it is drawn. Furthermore, the promoter, too, is free to back out since there is no contract with the corporation; and if someone else offers a higher price for the apartment of the subscriber's choice, the corporation may reject his subscription offer.

For the above reasons, it is believed that all parties are in a more favored position if the promoter first organizes the corporation, enters

79. See note 70 *supra*.

80. Frey, *supra* note 73, at 1013 et. seq.; Cataldo, *Conditions in Subscriptions for Shares*, 43 VA. L. REV. 353, 354, (1957).

81. Fort Myers Development Corp. v. J. W. Williams Co., 97 Fla. 788, 122 So. 264 (1929).

82. The Florida court has recognized for a hundred years that an action to recover the subscription price will lie. Kirksey v. Florida & G. Plank Road Co., 7 Fla. 23 (1857).

into his contract with it, and then sells the stock itself. In order to protect against the contingency that all the stock may not be sold, it is undesirable that he convey the property to the corporation until all the purchase price is raised, but it is a relatively simple matter to hold the purchase price in escrow and deliver each apartment to the purchaser under an agreement providing for a fixed rent until all apartments are taken and for a repurchase of the stock and cancellation of the lease if all stock is not paid for by a predetermined date.

In spite of the inconvenience attendant thereon, registration should afford no real objection if the enterprise is sound. Purchase of stock registered with the securities commissions deprives the buyer of many of the exits afforded the pre-incorporation subscriber, but prior formation of the corporation and execution and recording of contracts of sale or conditional leases gives his attorney the material on which to base an intelligent opinion as to the soundness of the legal foundation upon which the cooperative is to rest. Furthermore, if the Florida Securities Commission is made aware of the unsoundness of some of the business practices employed in the financing of many cooperative apartments, it can be expected to promulgate regulations which will prohibit these practices, or at least to refuse to register the securities of those corporations which follow them.

PROBLEMS OF TAXATION

While a cooperative housing corporation may receive preferred tax treatment under the laws of some states, such is not the case in Florida, where its corporate excise taxes, like those on its real and personal property, are computed on the same basis as the taxes of commercially operated corporations owning apartments rented to non-stockholders.

The cooperative is required to file the same federal income tax return as other business corporations but it is in a peculiarly favorable position to escape the payment of a tax by showing no net taxable income. Except where the corporation rents a portion of the building to outsiders, all payments received by it, in theory at least, should be offset by actual expenses which, if reasonable, are deductible from gross income. Refunds in case operating costs are less than assessments collected are not income to the stockholder⁸³ and may be deducted from the corporation's gross

83. In discussing refunds by purchasing cooperatives it has been said:

In the case of a cooperative which purchases supplies and equipment for its patrons, a distinction must be made initially between deductible items purchased for use in the patron's business on the one hand, and personal items on the other. If the patron purchases some seed from the cooperative for his farming operations, and he receives a patronage refund with respect to that purchase, the amount received is treated as income to the patron. It is perhaps more accurate to say that this amount is not income to the patron, but rather a reduction of the deduction which the patron took upon the original purchase of the seed. Whichever approach is adopted the effect is to

income.⁸⁴ The portion of assessments used for improvements and mortgage payments are treated as additions to capital and not income.⁸⁵ Thus, so long as the corporation's income is derived solely from proprietary leases, while it must file a federal income tax return, the return will normally show no tax due unless it uses part of its income to set up reserves.⁸⁶

At first, the stockholder of a cooperative apartment, like the tenant of its commercially operated competitor, received no income tax deduction for the share of his rent or assessments expended by the cooperative for taxes or interest.⁸⁷ Later Congress enacted section 23(z) of the Internal Revenue Code which created a deduction allowable in taxable years commencing after December 31, 1941. This section—renumbered 216 in the Internal Revenue Code of 1954—has since been expanded to include types of cooperative housing other than apartments.⁸⁸

increase taxable income. Although it would seem logical that such a downward adjustment in the deduction should affect taxable income in the year in which the deduction was originally claimed, that year may be considerably prior to the year in which the refund is made, and, therefore, for reasons of administrative convenience, the adjustment is made by increasing income in the year the patronage refund is received.

If the patron has purchased personal items such as food for household use, which does not entitle him to a deduction, the receipt of a patronage refund with respect to such items has no tax effect. It simply reduces the cost of the food to the patron. Asbill, *Taxation of Patronage Refunds*, 42 VA. L. REV. 1087, 1089 (1956).

A dividend to a stockholder-lessee, too, is a reduction in the rent he pays. Hence, if the apartment were used as his home, it would not be income, but if it were used for business, it would be a reduction of his rent deduction.

84. "Where a cooperative housing corporation collects predetermined carrying charges in excess of the actual charges paid or incurred by the corporation, any refund of such charges in the same year results in an adjustment so that only the net amount of the carrying charges would be taken into the corporation's account for tax purposes. Where excess predetermined charges at the end of a year are not used to reduce carrying charges until a year later, the excess is income to the corporation in the year received." Rev. Rul. 56-225, 1956-22 C.B. 56.

85. 874 Park Ave. Corp. 23 BTA 400 (1931).

86. Reserves for contingent liabilities are not deductible from income. Lucas v. American Code Co. 228 U.S. 445 (1930).

87. Wood v. Rasquin, 21 F.Supp. 211 (E.D. of N.Y. 1937) *aff'd per curiam* 97 F.2d 1023 (1938).

88. Amounts Representing Taxes and Interest Paid to Cooperative Housing Corporation.

(a) Allowance of deduction.—In the case of a tenant-stockholder [as defined in subsection (b) (2)], there shall be allowed as a deduction amounts (not otherwise deductible) paid or accrued to a cooperative housing corporation within the taxable year, but only to the extent that such amounts represent the tenant-stockholder's proportionate share of—

(1) the real estate taxes allowable as a deduction to the corporation under section 164 which are paid or incurred by the corporation on the houses or apartment building and on the land on which such houses (or building) are situated, or

(2) the interest allowable as a deduction to the corporation under section 163 which is paid or incurred by the corporation on its indebtedness contracted—

(A) in the acquisition, construction, alteration, rehabilitation, or maintenance of the houses or apartment building, or

(B) in the acquisition of the land on which the houses (or apartment building) are situated.

Study of this section shows that there are four separate tests which a cooperative must meet for its stockholder-tenants to qualify for the deduction: (1) There must be only one class of stock, (2) each stockholder, solely by virtue of ownership of his stock, must be entitled to occupy an apartment, (3) no stockholder may be entitled to receive a dividend or distribution except out of earnings and profits, save in the case of a partial or total liquidation of the corporation and (4) eighty percent or more of the corporation's gross income must be derived from stockholder-tenants.

Similarly, the tenant-stockholder cannot qualify for the deduction unless his stock is fully paid for in an amount at least equal to the fraction obtained by taking the value of the property as a denominator and the value of his apartment as numerator. This requirement of the statute clearly denies the deduction to a stockholder unless he pays for his stock in full and there is an outside chance that it may cause difficulty to stockholders of a cooperative which has apartments some of which are of greater value than others, but which issues the same number of shares to each apartment owner. If, for instance, the corporation owns a ten unit building with two apartments selling for ten thousand dollars each, four for nine thousand, and four for eleven thousand, it would seem to be the better part of wisdom to sell ten percent of the stock to each purchaser of the first two apartments, nine percent to each of the next four and eleven percent to each of the last four. If the stock is simply divided into ten no par shares and one such share is sold to each apartment owner at nine,

(b) Definitions.—For purposes of this section—

(1) Cooperative housing corporation.—The term “cooperative housing corporation” means a corporation—

(A) having one and only one class of stock outstanding.

(B) each of the stockholders of which is entitled, solely by reason of his ownership of stock in the corporation, to occupy for dwelling purposes a house, or an apartment in a building, owned or leased by such corporation,

(C) no stockholder of which is entitled (either conditionally or unconditionally) to receive any distribution not out of earnings and profits of the corporation except on a complete or partial liquidating of the corporation, and

(D) 80 per cent or more of the gross income of which for the taxable year in which the taxes and interest described in subsection (a) are paid or incurred is derived from tenant-stockholders.

(2) Tenant-stockholder.—The term “tenant-stockholder” means an individual who is a stockholder in a cooperative housing corporation, and whose stock is fully paid-up in an amount not less than an amount shown to the satisfaction of the Secretary or his delegate as bearing a reasonable relationship to the portion of the value of the corporation's equity in the houses or apartment building and the land on which situated which is attributable to the house or apartment which such individual is entitled to occupy.

(3) The term “tenant-stockholder's proportionate share” means that portion which the stock of the cooperative housing corporation owned by the tenant-stockholder is of the total outstanding stock of the corporation (including any stock held by the corporation.)” INT. REV. CODE OF 1954, § 216.

ten or eleven thousand dollars, depending upon the value of the apartment, the Commissioner might refuse the deduction to the owners of the eleven thousand dollar apartment. The question is whether the word "amount" as used in the statutory definition of "tenant stockholder" means "amount of stock" or "amount of money." Probably it means the latter, but why take a chance?

Much more dangerous is the possibility that contractual provisions denying proprietary leases to stockholders until they are approved by fellow-stockholders or their representatives will automatically disqualify the corporation and deprive the stockholder-tenants of their deductions on the theory that in such case the corporation fails to meet the second of the statutory tests.⁸⁹

For this reason, it is suggested that the only safe way to avoid endangering the deduction, while attempting to preserve the exclusive character of the building, is to place no restriction on occupancy by a stockholder but to prohibit transfer of the stock to persons not approved—which may be unenforceable, at least if approval is arbitrarily withheld—or prohibit its sale unless it is first offered to the corporation, a provision whose effectiveness is questionable since the corporation will not normally have the money to buy it without a capital assessment which many stockholders may find burdensome if not prohibitive. The by-laws and lease may contain such covenants against sub-leasing as the stockholders care to insert and may prohibit assignment to non-stockholders without jeopardizing the tax deduction.

Inasmuch as a deduction is an act of legislative grace to be strictly construed,⁹⁰ it cannot be extended beyond the terms of the statute. Thus a casualty loss which the ordinary home owner could deduct⁹¹ would probably afford no relief to the stockholder-tenant when he prepares his federal income tax return, since the statute makes no provision for treating the loss as his rather than the corporation's. On the other hand, the courts can be expected to pierce the corporate veil and refuse a deduction for any loss sustained by the stockholder in the sale of his stock⁹² unless, of course, he can show that he did not occupy the apartment but sub-leased it for profit.⁹³

In view of the holding that assessments for principal payments on mortgages are capital contributions and not income,⁹⁴ the cooperative,

89. 61 HARV. L. REV. 1407, 1418-9 (1948).

90. *Helvering v. Inter-Mountain Life Ins. Co.*, 294 U.S. 686 (1934); *New Colonial Ice Co. v. Helvering*, 292 U.S. 435 (1934).

91. INT. REV. CODE OF 1954, § 165 (c) (3).

92. The tax court has so ruled on several occasions. *Stewart*, 5 CCH Tax Ct. Mem. 229 (1946); *Chooluck*, 13 CCH Tax Ct. Mem. 864 (1954); *Barnum*, 19 TC 401 (1952).

93. *Cf. Calder* 16 TC 144 (1951).

94. See note 83 *supra*.

unlike the ordinary corporation, derives no tax benefit from paying rent to a lessor instead of principal and interest to a mortgagee.⁹⁵ Its stockholders, on the other hand, can deduct mortgage interest if they and the corporation meet the statutory requirements and the debt is for one of the purposes enumerated in the statute, but they can deduct no part of the rent paid by the corporation. For this reason alone, the tax conscious purchaser should think twice before acquiring an apartment in a cooperative which leases rather than buys the building.

Purchase of a cooperative apartment has one other potential tax advantage over a rental which may prove of importance to some individuals. The Internal Revenue Code permits one who has sold his residence at a profit to defer payment of a capital gains tax by reinvesting in a new residence.⁹⁶ The statutory definition of residence⁹⁷ includes stock held by a stockholder-tenant in a cooperative apartment or other cooperative housing corporation where both stockholder and corporation meet the tests imposed by section 216.⁹⁸

FINANCING THE BUILDING

In order to finance the purchase of the land and the construction of the improvements the promoter may resort to one or a combination of several devices. Sometimes he buys the land giving back a purchase money mortgage which he urges the seller to subordinate, first to a temporary construction mortgage, and then to a permanent first mortgage.⁹⁹ Or he may lease the land on a long term ground lease, depositing with the lessor only a comparatively small security deposit which is placed in the building fund when the building contract is let or returned to him upon completion of the improvements. Wherever possible, he gets the lessor to agree to subject his interest to the temporary construction mortgage and the initial permanent mortgage which will be used to pay off the construction loan. Either alternative may enable him to acquire the land and erect the improvements with little or no investment of his own funds.

The lessor who encumbers his interest with a first mortgage and the seller who subordinates his purchase money mortgage are taking a risk of loss by foreclosure not assumed by those who do not, and they therefore command a higher rent or higher price than the lessor or seller who "plays it safe." This increases the total cost of financing the development but many entrepreneurs either choose or are forced to operate almost entirely on other people's money. In many instances either of these arrangements may prove less expensive to the promoter than it would be for him to

95. Rent is deductible as a business expense whereas principal payments on a mortgage are not.

96. INT. REV. CODE OF 1954 § 1034.

97. INT. REV. CODE OF 1954 § 1034(f).

98. For text of statute see note 88 *supra*.

99. By permanent first mortgage is meant the one which refinances the construction loan. The term does not connote a perpetual mortgage.

obtain equivalent financing from other sources, although this was not true in the immediate post World War II days when one hundred percent FHA financing was obtainable.

The financing methods just described are not necessarily to be condemned by counsel for the purchaser, although the plan whereby the land is purchased is to be preferred to the lease arrangement both for the tax reasons heretofore mentioned and for other reasons presently to be discussed at length. While all financing devices are necessarily accompanied by risk of loss to the corporation's stockholders if it cannot meet its obligations, they enable the purchaser to acquire his apartment at a cash outlay which should decrease as the corporation's mortgage indebtedness and ground rent increase.

The ground lease without subordination does not appeal to many promoters. This, however, may be the only method whereby land in a particular locality, such as on a choice beach, may be acquired, and the desirability of the location may well offset the disadvantage of a leasehold estate over a mortgaged fee.

While many institutional mortgagees are empowered to and do make first mortgages on leasehold estates without joinder by the fee owner, loans of this character involve risks not incident to fee mortgages, and efforts to mortgage an unsubordinated leasehold, except where the property is subleased to business tenants of prime credit rating, will be less frequently successful than where the mortgagor offers a fee simple title. In practice it may be possible to obtain a fee mortgage on an apartment building for more than the sum of the capitalized value of the ground rent plus the amount that can be obtained on a leasehold loan, and at a lesser cost.

On the other hand, if the promoter has succeeded in signing up a full quota of subscribers to the stock of the cooperative, all of whom have placed substantial deposits in escrow, he may be able to find a construction lender who will advance the full cost of erecting the building, in spite of the fact that the security tendered is only a leasehold mortgage. If the promoter can accomplish this, his sole investment will be the security deposit and advance rental under the ground lease, but the task of obtaining one hundred percent subscription before the building is commenced is a feat of salesmanship sufficient to discourage all but the most optimistic, especially where the stockholders are required to pay a cash price large enough to discharge the construction loan, reimburse the promoter's expenses, and take care of his profit.

In the rare instances where the cooperative owns the land and improvements in fee simple and free of debt the apartment owner runs no practical risk of losing his apartment unless the majority of the stock-

holders specified in the by-laws elect to sell the building,¹⁰⁰ in which case he will receive his pro-rata share of the sales price. Where the property is free and clear, the only obligation of the corporation is to meet taxes, insurance and current expenses and, under such circumstances, unless the building is grossly mismanaged, the annual assessments to shareholder-tenants should be far less than rent in similar but commercially operated apartments.

However, the amount which each tenant must invest in an apartment subject to neither mortgage nor ground rent may be too much for all but a fortunate few. The tenant's risk of losing his apartment increases as the corporation's equity decreases; but he must never forget that his ability to pay his pro-rata share of operational and financing expense is no criterion for the safety of his investment. The inherent danger in the cooperative plan is that fellow shareholders cannot or will not carry their share of the burden. In that case, the solvent shareholder's only choice is to carry it for them or permit the building to be sold at foreclosure or forfeited for non-payment of rent, if it is on leased property. While it may be possible for some individuals to protect themselves where co-tenants of a two or three unit building fail to meet their assessments this possibility decreases with the size of the project. An apartment in a heavily mortgaged duplex may, therefore, present a far smaller hazard to the solvent stockholder-tenant in times of severe depression than an apartment in a huge building with a mortgage proportionately less burdensome although in the latter case the burden created by the insolvency of only one tenant will be lighter because it is spread among many.

Before purchasing a cooperative apartment in a mortgaged building, the buyer should inform himself not only as to the amount of the mortgage but as to the rate of interest, the manner in which principal is repayable, the grace provisions, and, where possible, the reputation of the mortgagee. If a mortgage falls due before it has been materially reduced, it may prove both difficult and expensive to refinance. Many a seller has reaped an exorbitant profit by repeated foreclosures on a single property. The cooperative apartment owner, since he is only one of many persons whose cooperation is required in event of financial difficulty, is peculiarly sus-

100. In the absence of special limitations in the articles of incorporation or by-laws, a majority of the stockholders of a Florida corporation can dispose of all of its assets and effect its dissolution. FLA. STAT. §§ 608.19, 608.27 (1955). Since the proprietary lease will normally stipulate that ownership of stock in the corporation is an essential condition of the lease, it follows that a majority of stockholders, by voting to sell the building and dissolve the corporation, can terminate all proprietary leases. The stockholder-tenant interested in a home rather than a real estate speculation should insist on either unanimous or nearly unanimous consent before this result can be achieved.

The proprietary lease should contain a self-subordinating clause whereby it is made junior to subsequent mortgages. Absent such an agreement a subsequent mortgage will be virtually impossible to obtain. It is probably good practice to couple with a subordination agreement a requirement in the articles of incorporation or by-laws that 75% or more of the stockholders must consent to any mortgage of the corporation's property.

ceptible to the unscrupulous mortgagee who is looking for an opportunity to foreclose.

His position, however, is far better in Florida than in a number of other jurisdictions. In the first place Florida subscribes to the lien theory of mortgages and only permits foreclosures of real estate mortgages by suits in equity.¹⁰¹ Secondly, under Florida law a foreclosure will not terminate a lease junior to the mortgage if it is recorded or the tenant is in possession, unless he is made a party defendant.¹⁰² This is not true in all jurisdictions,¹⁰³ and in states such as Maine and Massachusetts, which have adopted the title theory of mortgages, and where foreclosures by court action are the exception rather than the rule, a foreclosure by entry and sale will automatically destroy a junior lease.¹⁰⁴ In Michigan the tenant stockholder of a cooperative apartment was declared not to be an essential party to a suit to foreclose a mortgage given by the cooperative to a third party and, in spite of numerous allegations of fraud and conspiracy, was unable to set the foreclosure aside.¹⁰⁵ While a Florida foreclosure to which the tenant-stockholders are not parties would be valid against the mortgagor corporation, the mortgagee would gain a Pyrrhic victory indeed, since the foreclosure would neither cancel the proprietary leases nor disturb the possession of the tenants. Thus the stockholder-tenant of a Florida cooperative building can be sure that he will be notified of and made a party to a foreclosure, and, since such suits are usually not disposed of in too short a time, he will normally have a reasonable opportunity to join with his fellow tenants in an effort to reinstate or refinance the mortgage.

His rights where there has been a default under a ground lease are neither as well defined nor as protected as in the case of a mortgage default. Whether the tenancy is one created by a long term lease under which the tenant has erected a million dollar building, or merely a tenancy at will under a verbal agreement, the landlord may recover possession in case of a default in the payment of rent by a summary proceeding.¹⁰⁶

101. FLA. STAT. § 702.01 (1955); *Georgia Cas. Co. v. O'Donnell*, 109 Fla. 290, 147 So. 267 (1933).

102. *Dundee Naval Stores Co. v. McDowell*, 65 Fla. 15, 61 So. 108 (1913). This case involves a recorded lease but there seems no reason why it would not apply to an unrecorded lease of which the purchaser at foreclosure had notice.

103. *Western Union Tel. Co. v. Ann Arbor Ry.*, 90 Fed. 379 (6th Cir. 1898), later reversed on other grounds 178 U.S. 239 (1900); *Schaeffer v. 8100 Jefferson East Corp.*, 267 Mich. 437, 255 N.W. 324 (1934). See Annotation 14 ALR, 664, 668.

104. *Anderson v. Robbins*, 82 Maine 422, 19 Atl. 910 (1890); *Smith v. Shepard*, 15 Pick. (Mass) 147 (1833).

105. *Schaeffer v. 8100 Jefferson East Corp.*, *supra* note 103.

106. FLA. STAT. § 83.20 (1955), provides as follows:

Causes for removal of tenant. Any tenant or lessee at will or sufferance, or for part of the year, or for one or more years, of any houses, lands or tenements, and the assigns, under tenants or legal representatives of such tenant or lessee, may be removed from such premises in the manner hereinafter provided in the following cases:

Under the wording of the statute notice to sub-lessees is not required so long as a three day's notice demanding either possession or payment of rent in arrears is served upon the lessee. If payment is not made within this brief time, a court of law has no alternative but to order that the landlord be restored to possession.

If the sub-lessee is absent for even a few days he may return to find that the lease has already been declared forfeit and that the appeal time has expired. The question of whether such a judgment operates to cancel a sub-lease where the sub-lessee is not a party to the litigation is undecided in Florida.¹⁰⁷

Courts of equity have power to intervene to prevent a forfeiture and Florida chancellors have ordered a tenant restored to possession even after a county judge's judgment has become final and the landlord has ousted the tenant.¹⁰⁸

While the Florida Supreme Court has rather strongly implied that it will grant relief from forfeiture because of delay in payment of rent even when there is absent any element of fraud, mistake, estoppel, misleading of the tenant, or other similar conduct, it is to be noted that the court has emphasized these traditional grounds for equitable jurisdiction where it has granted relief.¹⁰⁹ Other courts have denied relief where these elements were absent and delay in paying rent was willful or aggravated, finding that the tenant did not come with clean hands.¹¹⁰ There is no reason to

(1) . . .

(2) Where such person shall hold over without permission as aforesaid, after any default in the payment of rent pursuant to the agreement under such premises are held, and three days' notice in writing, requiring the payment of such rent or the possession of the premises, shall have been served by the person entitled to such rent on the person owing the same. The service of such notice shall be by delivery of a true copy thereof, or if such tenant be absent from his last or usual place of residence, by leaving a copy thereof at such place.

107. *But see* 6701 Realty, Inc. v. Deauville Enterprises, Inc., 84 So.2d 325, 328 (Fla. 1955), in which the court points out that a lease may be terminated by a mere notice to the tenant without reentry where the lease so provides. ". . . the lessor gave to the lessee the required notice and thereby established a termination of the tenancy. While it is true that the lessor did not obtain physical possession until the entry of the final decree, nevertheless, the decree merely sustained and confirmed the ending of the tenancy brought about by the service of the notice." It has long been held that a sub-lessee acquires no greater rights against the lessor than the sub-lessor had to give. *Dunn v. Barton*, 16 Fla. 765 (1878).

108. *Rader v. Prather*, 100 Fla. 591, 130 So. 15 (1930); *Nevins Drug Co. v. Bunch*, 63 So.2d 329 (Fla. 1953).

109. Thus in *Rader v. Prather*, *supra* note 107, the court stressed a promise by the lessor not to press the lessee for rent if he would make certain repairs; in *Nevins Drug Co. v. Bunch*, *supra*, note 108, much evidence was adduced to show that a rent check was good for several days after it was delivered, although subsequently dishonored for lack of sufficient funds, and that the lessee had first offered to pay cash but that the lessor had told him to send a check. These facts, the court said, "were sufficient to give the appellant a standing in a court of equity to relieve him from a forfeiture . . . unless there are other facts and circumstances not disclosed by the record."

110. *Bonfils v. Ledoux*, 266 Fed. 507, (8th Cir. 1920); *Darvirris v. Boston Safe Deposit and Trust Co.*, 235 Mass. 76, 126 N. E. 382 (1920). See Annotation to these cases 16 ALR 437, 447.

suppose that the Florida courts, under like circumstances, would ignore these precedents.¹¹¹ Furthermore, all courts have required a tender of rent in arrears as a condition precedent to equitable intervention.¹¹² Equitable relief is far more difficult to obtain for the breach of some other covenants.¹¹³

The stockholder-tenant is not precluded from obtaining relief if he proceeds in his own name rather than in the name of the corporation, but he can not obtain it merely by tendering his proportionate share of delinquent rent.¹¹⁴

The really dangerous feature of the tenant-stockholder's position, where the building is on leased property, lies neither in any uncertainty as to the rights of a sub-lessee, nor in the necessity for affirmative action to obtain equitable relief. Except in aggravated cases, the tenant-stockholder can be sure that equity will protect him from forfeiture of the leasehold because of delay in paying rent or other money payments provided he tenders them later. The same is probably true of covenants to repair.¹¹⁵ The greater the extent of the improvements that have been added by the tenant, the greater should be the reluctance of the chancellor to sanction a forfeiture.

But ground leases frequently contain covenants besides those which call for money payments or repairs, as do mortgages. No matter what covenant of a mortgage is violated, the mortgagor can protect himself by paying the debt at any time before the foreclosure sale is confirmed.¹¹⁶

Such is not the case with a lessee. The theory under which equity will intervene where money payments are in arrears is that "the covenant for forfeiture on non-payment is intended as a mere security, and a forfeiture on that account will be relieved against on payment of the rent due and

111. There is a hint of this by the Florida Supreme Court in the language quoted in note 109 *supra*.

112. The Florida court has so held on many occasions. *Rader v. Prather*, *supra*, note 108; *Masser v. London Operating Co.* 106 Fla. 474, 145 So. 72, 79 (1932); *Mayflower Associates v. Elliott*, 81 So.2d 719 (Fla. 1955).

113. *Cesar v. Virgin*, 207 Ala. 148, 92 So. 406 (1921); *Mc Ginnis v. Knickerbocker Ice Co.* 112 Wis. 385, 88 N.W. 300, (1901); *Barrow v. Isaacs*, 1 Q.B. 417, 15 Eng. Rul. Cas. 769 (1891). The Florida court has said that a forfeiture for failure to pay taxes on time can be set aside by a court of equity. *Mayflower Associates v. Elliott*, *supra*, note 111. But this is not inconsistent with the above cases which deal with covenants not requiring money payments.

114. *Webber v. Smith*, 2 Vern. 103, 23 Eng. Reports 676 (1689).

115. In *Kaplan v. Flynn*, 255 Mass. 127, 150 N.E. 872 (1926) equity intervened to enjoin a forfeiture of a lease for failure to make repairs. The court said "Equity relieves against a forfeiture where no real fault is committed, or the breach is induced or waived by conduct, as well as when by action or mistake there has been a breach of some collateral covenant, such as to repair or insure, and where the lessor may be placed in the same position as if the breach did not occur by an award of damages or otherwise." The court distinguished the case of *Finkovitch v. Clime*, 236 Mass. 196, 128 N.E. 12 (1920) "where the acts of the lessee are willful, against the protest of the landlord and dictated by motives which are not commended by a court of equity." In the latter case the court refused to enjoin a forfeiture where the tenant persisted in hanging out her wash on the front porch in violation of a covenant against offensive use of the premises.

116. *Holloway v. Sewell*, 140 Fla. 464, 191 So. 825 (1939).

damages which the lessor may have sustained.¹¹⁷ On the other hand where the forfeiture is invoked because of the breach of a covenant not calling for a money payment, exact compensation cannot be made and equity is reluctant to rewrite the contract for the parties.¹¹⁸

The possibilities for fraud where the ground lease contains covenants of this latter type require no elaboration. Where the promoter is the ground lessor or has a financial interest in the fee such provisions are far more likely to be encountered than when the lease is negotiated at arm's length. Yet even in ground leases negotiated between parties with adverse interests such provisions as bankruptcy clauses, covenants calling for forfeiture if the premises are used for immoral purposes, and others whose violation is either difficult or impossible to rectify, are far too often encountered, presumably because of an indiscriminate use of short term lease forms by draftsmen who do not understand the fundamental differences between the two types of leases.¹¹⁹

The ground lease, therefore, should be subjected to careful scrutiny with several questions in mind. First and foremost the examiner must inquire if the lease provides for cancellation upon the breach of a covenant which is incurable. The bankruptcy clause usually found in short term leases is the classic example.¹²⁰ Counsel for the purchaser should, without exception, refuse to approve the purchase of a cooperative apartment where the ground lease contains an incurable default clause and the Florida Securities Commission should refuse to register any security of a cooperative apartment corporation which has a ground lease that violates this fundamental safety precaution.¹²¹

It is difficult to work up too much concern over a ground lease which omits a provision for notice and a grace period for redeeming curable defaults, since the Florida courts can be relied upon to read it into the contract. Nevertheless, it is desirable that the lessee corporation be able to float a leasehold mortgage in case of emergency and many lenders are reluctant to accept such a mortgage where there is not an express provision for notice to the mortgagee coupled with reasonable opportunity to cure any default.

117. *Cesar v. Virgin*, *supra* note 113. See also *Rader v. Prather and Nevins Drug Co. v. Bunch*, *supra* note 107.

118. See cases cited in note 113 *supra*.

119. For a discussion of these differences and of what provisions should be included in and excluded from a ground lease, see Anderson, *The Mortgagee Looks at the Ground Lease*, 10 FLA. LAW REV. 1 (1957).

120. In spite of the fact that the inclusion of such a clause makes it impossible for the lessee to obtain an institutional leasehold mortgage, the writer has encountered this provision in ground leases not once, but many times.

121. The Florida Securities Commission is under a duty to refuse to register a security unless it finds that the enterprise or business of the issuer is not based upon unsound business principles, *supra* note 34. In response to an inquiry from the writer to the Commission, it was stated that the Commission would require a copy of any applicable ground lease, as a condition precedent to registration.

Counsel for the purchaser should be extremely suspicious of a sub-lease as distinguished from an assignment of the ground lease. In many instances promoters will obtain a ground lease on a tract of land large enough for several buildings. They will sublease parts of the tract to several corporations each of which operates a separate cooperative apartment. Or, while erecting only one building on a single leasehold, they will sublease to the corporation at a higher rental than they are paying. Any arrangement whereby there is a middleman between the ground lessor and the cooperative is highly dangerous unless there are the most stringent safeguards assuring the cooperative that the lessor will credit it with payments to the middleman and requiring the lessor to send it copies of all notices. Where the sub-lease covers only a part of the property embraced in the lease the sub-lessee of a part may have to pay the entire rent and taxes to prevent forfeiture. It would also be affected by a breach of a lease covenant by another sub-lessee corporation. While it is possible to insert enough safeguards to protect a sub-lessee from such hazards, institutional lenders as a rule will not lend on a sub-leasehold. Subleasing to the cooperative is indefensible and should be considered an unsound business practice by the Florida Securities Commission. If sufficient safeguards are not present, there is always the possibility of a collusive default by the middleman. Such collusion, while easy to allege, may prove impossible of proof.¹²²

RELATIONSHIP BETWEEN CORPORATION AND STOCKHOLDER LESSEE

The buyer of a cooperative apartment occupies a dual role in his dealings with the corporation—that of stockholder and that of tenant. Customarily, either the by-laws or the proprietary lease, and frequently both, expressly prohibit a severance of one role from the other and although a sub-lease may generally be made without a transfer of the stock, an assignment¹²³ of the proprietary lease must be accompanied by a conveyance of the stock.¹²⁴

It has been said that "the proprietary lease is the most important instrument in the cooperative apartment organizational set-up,"¹²⁵ a statement which is subject to challenge. The courts in adjudicating the rights of a stockholder-lessee, have looked to the proprietary lease, the subscription agreement and the corporate charter and by-laws, holding

122. Such collusion was charged between promoter and mortgagee but to no avail in *Schaeffer v. 8100 Jefferson Ave. East Corp.* *supra* note 103.

123. Both sublease and assignments normally require prior approval of other stockholders or of a body chosen for that purpose. *Castle, Legal Phases of Cooperative Housing*, 2 *So. CALIF. L. REV.* 1 (1928); *McChesney "Cooperative Apartments,"* 26 *CHI. KENT L. REV.* 303, 314 (1948). For a discussion of the difference between a sub-lease and an assignment, see: *C. N. H. F. Inc. v. Eagle Crest Development Co.* 99 *Fla.* 1239, 128 *So.* 844 (1930).

124. *Castle, supra* note 123 at 7; *McChesney, supra* note 123 at 313, 314.

125. *McChesney, supra* note 123 at 315.

that each complements the others.¹²⁶ Counsel for the prospective buyer, therefore, is under an obligation to familiarize himself with the provisions of all the documents if he is to render an intelligent opinion on the security of his client's investment. As a matter of precaution he should examine the minutes, contracts, and financial records of the corporation, as well, especially with regard to any management contracts which may have been theretofore executed.

The corporate structure is subject to so many ramifications, and the terms of proprietary leases may be so diverse, that no useful purpose would be served in exploring all the individual quirks and variations that may be encountered. It is better to consider those things which counsel for the buyer must search for and leave it to him to make his own decision where he encounters peculiar or unusual deviations in either the lease or the by-laws. He should bear in mind that the cooperative plan calls for a sharing of the expense of operation of the apartment building between the lessees of the various apartments. As some apartments may be larger than others in the same building or more expensive of operation, he must make sure that the plan whereby expenses are allocated is not loaded against his client.¹²⁷ He must determine whether by-laws which may be altered by a majority vote, a three-quarters vote, or only by unanimous consent will best fit his client's requirements. Can one obstinate tenant block the wishes of all or can a bare majority force out a tenant of moderate means by subjecting him to a series of heavy capital assessments for improvements which he feels he cannot afford? The answer to such questions will vary with the desires and circumstances of the individual. The point is that counsel must examine the documents with these questions in mind and discuss their provisions with his client if he is to do his job properly.

Of prime importance are those provisions of the by-laws and lease which impose restraints on alienation, both on the building as a whole and on the separate apartments. If they are too rigid, they may prohibit an advantageous sale; if they are too liberal, they may not meet the demands of many purchasers.¹²⁸ In South Florida, with its influx of winter visitors, many owners of cooperative apartments may find opportunities for lucrative short term sub-leases. Is the machinery by which approval of sub-tenants must be obtained so cumbersome that the applica-

126. "The original plan of organization, the subscription agreement and the proprietary leases constituted the contract and fixed the rights of the parties. They must be read together in order to determine the rights of the contracting parties." *Tompkins v. Hale*, 172 Misc. 1071, 15 N.Y.S.2d 854, 856 (Sup. Ct. 1939), *aff'd* 284 N.Y. 675, 30 N.E.2d 721 (1940).

127. In a multi-floor apartment building, is it equitable for the ground-floor tenants to be assessed with any part of the expense of maintenance and operation of the elevator?

128. In view of the fact that purchasers of cooperative apartments are more likely to be interested in a home than a real estate speculation, it will generally be desirable to require at least 75 or 80 percent consent before the building may be sold.

tion of a satisfactory sub-tenant will be unreasonably delayed, or is it so loose that the permanent occupant may be subjected to an influx of rowdy vacationers?

It is to be expected that the lessor-corporation will retain a lien on the stock in the corporation as security for the payment of assessments.¹²⁹ Attention should be paid to the conditions under which this lien may be enforced. Of special importance to the lessee where the proprietary lease is for a long term is a provision terminating the lessee's personal liability upon either an approved assignment of his lease or a surrender of his stock and abandonment of his lease.¹³⁰

This article has primarily been concerned with cooperative apartments which are leased entirely to stockholder tenants. In many instances, however, parts of an apartment building, especially the ground floor, may be rented by the corporation to one or more mercantile establishments such as a restaurant, barbershop, cleaning establishment or other enterprise, the owner of which is not a stockholder of the lessor. Counsel for the buyer should examine these leases both to determine that they call for a fair rent and to see that they impose no unusual burden on the corporation. Furthermore, he must bear in mind that if rentals from others besides stockholder-tenants amount to more than twenty percent of the corporation's gross income the proprietary-lessees will not be permitted to deduct their pro-rata shares of taxes and insurance on their individual federal income tax returns.¹³¹

CONCLUSION

Reliable statistics concerning cooperative apartments in South Florida are extremely hard to come by. Lawyers, mortgage lenders and real estate brokers all know of many such enterprises but nowhere are there accurate figures on just how many have been erected in recent years. The writer believes he is conservative in estimating that at least a hundred cooperative apartment buildings have been erected in Dade, Broward and Palm Beach counties alone during the years 1954, 1955 and 1956. It was, therefore, a complete surprise when, in response to an inquiry addressed to the Florida Securities Commission he was informed that no corporation operating a cooperative apartment had either registered its securities or notified the

129. Castle, *supra* note 123 at 4; McChesney, *supra* note 123 at 314.

130. Unless the lease contains an exoneration clause, an assignment does not release the initial lessee even though the lessor consents to the assignment and the assignee assumes the covenants, except where there is a novation. See Anderson, *supra* note 119 at 8.

131. See the statutory definition of a cooperative apartment corporation quoted in note 88 *supra*.

Commission of a sale in an exempt transaction during that three year period.¹³²

So incredible is this report that the writer is convinced that it must be erroneous and that the Commission's reply must be attributed to a failure to index the securities of these corporations under a separate heading. Surely during this period someone must have complied with the plain requirements of the law!¹³³ In any event the conclusion is irresistible that many have ignored it.¹³⁴

Conversations with mortgage brokers and brother lawyers have led the writer to two undocumented conclusions: (1) that some promoters are resorting to undesirable practices such as sub-leasing parts of a leasehold property to different cooperative housing corporations, and (2) that many are asking and getting grossly inflated prices for individual apartments.

Unless these conclusions are entirely without merit, it is reasonable to assume that there will be dissatisfied customers seeking a return of their money. The inevitable result will be that some promoters will find themselves sued for a return of the purchase price and indicted for violation of the Florida Blue Sky Law and the Federal Securities Act. Like troubles may beset the broker who negotiated the sale.

While it may be too late to rectify past errors, lawyers representing persons concerned with the promotion of these enterprises owe it to their clients to acquaint themselves with the laws applicable to the registration of securities and to insist that their clients observe them.

Furthermore, they owe at least a moral duty to the future stockholders of the cooperative to see that any underlying leases contain the minimum safeguards which professional developers of, and investors in, long term leaseholds have long required.

Cooperative apartments, in spite of the weaknesses inherent to any form of multiple ownership of residential property, serve a useful purpose. But unless some of the practices currently in vogue are abandoned, they are doomed to acquire an evil reputation in Florida.

132. The acting chief counsel for the Division of Corporation Finance of the Federal Securities Commission wrote the author on March 14, 1957 that the Commission's records are not broken down to show whether any corporations selling cooperative apartments in Florida have registered or claimed exemption from registration under the Securities Act of 1933.

133. The writer has seen prospectuses of Florida cooperatives in which the promoters claim that they are placing pre-incorporation subscriptions in escrow as required by the Florida Securities Commission.

134. In Robinton & Soward's *Florida's Blue Sky Law: The Lawyer's Approach*, 6 *MIAMI L. Q.* 525 (1952), the authors described the Florida Blue Sky Law as "currently unknown to the legal profession as a whole." In Marks, *Coercive Aspects of Housing Cooperatives*, 42 *ILL. L. REV.* 731 (1948), it was stated with respect to cooperative apartments in Illinois: "However, with rare exception, the sales of securities in cooperative ventures are not being registered or qualified by the promoters or issuers."