Ohio Securities Bulletin

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COURT HOLDS "MEMBERSHIP" IN RECREATIONAL FACILITY IS A SECURITY

By Nancy Ivers Ferguson*

On December 23, 1980 in an unreported decision, the Franklin County Court of Appeals affirmed a lower court decision holding the sale of memberships in a recreational camping facility to be investment contracts and thus securities as defined in Revised Code section 1707.01. The case, entitled Peltier v. Condo-Mobile, Inc.,[1] substantially follows the tests for an investment contract set forth by the same court in an earlier decision, Peltier v. Koscot Interplanetary, Inc.[2]

Although earlier programs of Condo-Mobile Inc. encompassed the sale and lease of property in a recreational vehicle park, the transactions at issue involved the sale of "memberships", entitling persons to use facilities at a recreational vehicle park owned by Condo-Mobile, Inc. Under what the trial court labeled as a "rather intricate sales program", each membership purchaser was entitled to use the park, and to receive at least a six percent sales commission for all purchasers he recruited, as well as an override commission on the sales of his recruits.

The purchaser's participation in the sale of a membership to a recruit was limited to an invitation to attend a promotional sales meeting. Promotional sales meetings were conducted by a Condo-Mobile management group.

Prospective purchasers were told they could rise to management level and have a potential opportunity for profit-sharing, upon obtaining a certain number of sales. Other benefits to the more successful purchaser/salesman would include an annual salary for life, a choice of an automobile for life, and guaranteed life insurance.

Neither Condo-Mobile, nor its employees or agents were registered as broker-dealers or salesmen with the Ohio Division of Securities. The memberships offered for sale by Condo-Mobile were not registered with the Division.

Upon appeal, Condo-Mobile raised three assignments of error. The first challenged the trial court's findings that Condo-Mobile was in Contempt of Court as a result of its violation of a temporary restraining order. The second, challenged the trial court's holding that the sale of "memberships" by Condo-Mobile constituted a sale of investment contracts. The third, challenged the appointment of a receiver to manage the business of Condo-Mobile.

Interestingly, a significant part of the Court's opinion centered on a discussion of the investment contract issue. Citing State Commissioner of Securities v. Hawaii Market Center, Inc.[3] and Koscot,[4] the Court stated the four tests for investment contracts as follows:

"(1) an offeree furnishes initial value to an offeror, and
"(2) a portion of this initial value is subjected to the risks of the enterprise, and
"(3) the furnishing of the initial value is induced by the offeror's promises or representations which give rise to a reasonable understanding that a valuable benefit of some kind, over and above the initial value, will accrue to the offeree as a result of the operation of the enterprise, and
"(4) the offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise."

The Court quickly satisfied the first test, finding that the defendants had admitted that the offerees had furnished initial value to the offeror (Condo-Mobile).

Addressing the second test, the Court found that "at least a part of the membership fees were used as investment capital and found its way into the general operations of of the enterprise."[5] Following its decision in State v. George,[6] the Court found this to be sufficient "initial value . . . subjected to the risks of the enterprise," to

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satisfy the second test. Although Condo-Mobile had argued that the risks of the venture or enterprise were terminated since facilities had already been constructed, the Court found that representations concerning future swimming pools, roadways, hiking trails and clubhouses retained sufficient "risk" to the venture.

Applying the third test, the Court stated that "defendants were enticing persons to purchase memberships within Condo-Mobile through representations that said persons would thereby receive the opportunity to earn commissions, bonuses and other incentives . . . . Because the members of Condo-Mobile received a commission or bonus from memberships sold by members they had brought into Condo-Mobile, they received benefits that were not solely a result of their own effort." As in the Koscot[7] case, this fact was persuasive in convincing the Court that a member expected to receive valuable benefits over and above the initial value of his membership fee.

Although Condo-Mobile had a property owners association which handled many of the day-to-day activities of the campground, the Court found that "managerial decisions" were made by an executive board. Membership purchasers had no representation on this executive board. Since membership purchasers had no control over the costs of membership, any of the sales programs, the allocation of funds or any of the requirements for membership in Condo-Mobile, the fourth test for an investment contract was satisfied.

While initially, the incorporation of a "membership" into the definition of a security may have appeared overinclusive, a close examination of the Condo-Mobile case is more reassuring.

Under most circumstances, purchasers of memberships expect to receive benefits approximately equal to the "initial value" paid. In Condo-Mobile, however, purchasers were promised that the value of the benefits received, would increase in the future. Condo-Mobile membership purchasers were also promised the increase would result from the operation of the enterprise, rather than inflation or other factors, and they were denied any managerial control which might have affected such an increase.

Upon close inspection, the circumstances surrounding the sale of "memberships" in Condo-Mobile, mirror those of the more traditional investment contract. Accordingly, the protective provisions of the Ohio Securities Act seem equally appropriate.

The Condo-Mobile decision speaks well for the ability of our courts to respond to innovative investment structuring. Defining "investment contract" and applying that definition to these innovative programs, are among the greatest challenges faced by the courts in the area of securities law.

These cases provide an equally great challenge to corporate counsel. To properly advise his clients, counsel must carefully scrutinize each creative business venture, applying the tests set forth in Koscot and Condo-Mobile.

[1]Peltier v. Condo-Mobile, Inc. No. 79AP-747, (Ct. App., Franklin County, December 23, 1980) [hereinafter Condo-Mobile].
[2]Peltier v. Koscot Interplanetary, Inc., (unreported) No. 72AP-220 (Ct. App., Franklin County, 1972) [hereinafter Koscot].
[3]State Commissioner of Securities v. Hawaii Market Center, Inc., 52 Hawaii 642, 485 P. 2d 105 (1971).
[4]Peltier v. Koscot, supra note 2.
[5]Peltier v. Condo-Mobile, Inc., supra note 1, at 3967.
[6]State v. George, 50 O App. 2d 297, 303 (1975).
[7]Peltier v. Koscot, supra note 2.

ANNOUNCEMENTS

Tender Offers

Ohio ex rel Krouse v. SEC

In February of 1980 the Ohio Commissioner of Securities brought suit against the Securities and Exchange Commission seeking a declaration that SEC Rule 14d-2 is invalid and does not affect the validity of The Ohio Take-over Act, Revised Code Section 1707.041.

The Ohio Act requires a take-over bid to be announced publicly at least twenty days before it is made, while Rule 14d-2 forbids public announcement of a bid more than five days before it is made. In promulgating the rule, which became effective January 7, 1980, the SEC declared that it preempted all state takeover laws in conflict with the rule.

Upon motion to dismiss by the SEC, Judge Kinneary for the District Court of the Southern District of Ohio held that Ohio lacked standing to bring this action either through its proprietary interest or its interest as parens patriae. Ohio ex rel Krouse v. SEC, No. C-2-80-111 (S. D. Ohio Oct. 18, 1980).

Pending appeal of this case, Judge Kinneary heard arguments in the case of Canadian Pacific Enterprises (U.S.) v. Krouse, (1981) Fed. Sec. L. Rep. (CCH) P. 97, 863, and concluded that Rule 14d-2 is a valid rule which preempts the Ohio twenty day waiting period. See, Ohio Securities Bulletin, 1981-1, at 3.

Because the Commissioner has subsequently appealed the decision of CPE v. Krouse, the Sixth Circuit has held that the underlying issue in Ohio v. SEC. was determined by collateral estoppel of Krouse v. CPE.

While the appeal of Ohio v. SEC. was accordingly dismissed, the appeal of Krouse v. CPE is still pending. See Ohio ex rel Krouse v. SEC, No. 80-3716 (6th Cir., April 14, 1981).

RELEASE

On January 16, 1981 Judge Joseph P. Kinneary of the United States District Court for the Southern District of Ohio, Eastern Division, issued his Opinion and Order in the case of Canadian Pacific Enterprises (U.S.) v. Krouse, (1981) Fed. Sec. L. Rep. (CCH) P. 97, 863. Judge Kinneary held that Rule 14d-2(b), 17 C.F.R. Section 240.14d-2(b), promulgated by the Securities and Exchange Commission effective January 7, 1980, is a valid rule that is in conflict with and preempts the provision of Ohio Revised Code Section 1707.04(B)(1) that requires an offeror to file with the Ohio Division of Securities ("Division") the information required by Ohio Revised Code Section 1707.041(B)(3) at least twenty days before commencing a take-over bid.

The opinion and order proscribes enforcement of the Ohio statute only to the extent it requires a public announcement of a take-over bid more than five days prior to commencement. The court left untouched its conclusion in AMCA International Corporation v. Krouse, 482 F. Supp. 929, Fed. Sec. L. Rep. (CCH) P. 97, 249 (S.D. Ohio 1979), that states are not preempted from regulating tender offers and that there was no conflict between Ohio and federal law prior to the promulgation of Rule 14d-2(b).

Because Rule 14d-2(b) applies only to tender offers for equity securities registered pursuant to Section 12 of the Securities Exchange Act of 1934, 15 U.S.C. Section 78l, the Division of Securities will continue to enforce Revised Code Section 1707.041 in its entirety, including the twenty day public notice provision of Section 1707.041(B)(1), with respect to take-over bids not subject to Rule 14d-2(b).

With respect to take-over bids subject to Rule 14d-2 (b), the Division will continue to enforce all provisions of Revised Code Chapter 1707, including those of Section 1707.041(B)(1) not enjoined by the Opinion and Order in Canadian Pacific Enterprises (U.S) v. Krouse. Subject to resolution of any appeal of that order, reformulation of the federal tender offer rules, or further statement or order of the Division, the Division will reconcile with the Opinion and Order the application of Revised Code Section 1707.041. Precedent for reconciliation is found in the interim order of Canadian Pacific Enterprises (U.S.) v. Krouse, No. C-2-80-1056 (S.D. Ohio, Dec. 17, 1980) (order dissolving temporary restraining order). In that interim order, Judge Kinneary, sua sponte, set forth a framework by which take-over bids might comply with both the federal rules and the Ohio statute in the absence of the Ohio twenty day notice provision.

With reference to this precedent and pursuant to the aforementioned reconciliation of Ohio and federal law, the Division of Securities will not deem an offeror to be in violation of Revised Code Section 1707.041(B)(1) if upon making a take-over bid or upon the public announcement of the terms of a take-over bid, he files with the Division of Securities and the target company copies of all information required by Revised Code Section 1707.041(B)(3), keeps the offer open, maintains withdrawal rights in force, and accepts shares for payment subject to the requirements of Revised Code Section 1707.041 (B)(1).

STAFF CHANGES

Andrew Federico left the Division of Securities to enter private practice in December. Mr. Federico served over two years as an attorney examiner for the Division specializing in investment companies and mutual funds. Mr. Federico has joined the firm of Carlile Patchen Murphy and Allison in Columbus.

Patricia Dye has recently joined the Division's Administration section as Attorney Assigned to the Commissioner. Ms. Dye, who was formerly employed as a legal intern at the Division, is a graduate of Capital University law school and is a recent admittee of the Ohio Bar.

Clyde C. Kahrl joined the Division staff in November, and is serving as Attorney Examiner in the registration section. Mr. Kahrl has a B.A. in economics from Cornell University and an MBA and juris doctorate from Ohio State University. He was admitted to the Ohio Bar in November.

Don E. Meyer joined the Division as an attorney-examiner in January. Mr. Meyer graduated from Ohio State University with a degree in accouting in 1975. After becoming a certified public accountant, Mr. Meyer worked in the tax department of Touch Ross & Company. Prior to his graduation from Capital University Law School in December, Mr. Meyer clerked for several Columbus law firms.

In January, Barry Moses joined the enforcement section of the Division as staff attorney. Mr. Moses received a degree in political science from Ohio University and juris doctorate from the University of Toledo College of Law. Prior to joining the Division, Mr. Moses worked for the firm of Green, Lackey & Nusbaum in Toledo.

In February, Phillip Lehmkuhl returned to the Division as Assistant Financial Institutions Supervisor. Mr. Lehmkuhl originally joined the Division in 1977, serving as staff attorney for the enforcement section. Prior to his departure, he served as counsel to the Commissioner.

Cynthia Plummer left the Division after serving more than three years as an investigator in the enforcement section. Ms. Plummer will assist her husband in their wholesale furniture business.

In April, Dale Barrett joined the Division as an investigator for the enforcement section. Mr. Barrett is a graduate of Ohio State University School of Journalism where he majored in public relations. Mr. Barrett also has a masters degree from Ohio State in public administration and criminal justice, specializing in white collar crime.

SENATE BILL 363 RULES

In response to recently enacted Senate Bill 363, the Division of Securities filed proposed rules 1301:6-3-14, 1301:6-3-15 and 1301:6-3-16 of the Ohio Administrative Code on March 13, 1981. Senate Bill 363 enables Ohio to participate in the acceptance of the Uniform State Law exam administered by N.A.S.D. and requires the Division to specify, by rule, the types of examinations to be given to applicants.

A public hearing on the rules was held on April 14, 1981 with no witnesses appearing.

At the request of the Chairman of the Joint-Committee on Agency Rule Review, the proposed recission of Rule 1301:6-3-14 was withdrawn. The two other proposed rules cleared the Joint Committee on May 19, 1981, and have been adopted substantially as first proposed.

Copies are available upon request.

CHURCH EXTENSION SERVICES

The Division has recently reviewed guidelines adopted by other states pertaining to issues by national and regional church extension services. These issues typically involve ongoing operations with long operating histories and significant net worth. They generally involve cash from loans and other investments, and do not rely on donations.

Previously, the Division has held such offerings to the same standards as individual church offerings. Generally, they have been required to comply with sinking fund and trust indenture standards, and were not permitted to use compound interest, accrual of interest, demand obligations, variable interest rates or renewal upon notice ("roll over") notes.

Significant dissimilarities exist between individual church offerings and those of some national and regional church extension services. Under some circumstances, it appears inappropriate to apply the standards of the former to the latter.

Accordingly, the Division considers the national and regional church offerings on the same basis as other financial and corporate offerings, when appropriate. As with other substantial offerings, significant attention is given to financial history and ability to service debt out of income and adequate reserve funds.

COMMITTEE MEETINGS HELD

On May 26, 1981, the Division of Securities Committees held meetings at the Hyatt Regency Columbus. The meetings were scheduled from 1:30 to 4:30 p.m. and agendas included a variety of topics of interest to the particular committees.

Two new committees have been created since the last meetings which were held in November, 1980. Although the membership on the Enforcement Committee is still being formulated, the Real Estate Syndication Committee met for the first time in May.

The Real Estate Syndication Committee was severed from the Foreign Real Estate Committee when divergent interests were identified at the November meeting.

ANNUAL SECURITIES CONFERENCE

On December 11, 1981 the Ohio Division of Securities will hold its second annual Securities Conference at the Hyatt Regency Hotel in Columbus, Ohio. The format will be similar to last year's conference. Advisory Committee Meetings will be held in the morning and a general session, open to all, will follow the luncheon. Further details will be published in the next edition of the Ohio Securities Bulletin.

CORRECTION

The last issue of the Ohio Securities Bulletin featured an article by staff member Mark Holderman, entitled, "Claiming the 3-Q Exemption." Response to Mr. Holderman's article was tremendous; many practitioners phoned or wrote the Division applauding the utility of the article and encouraging future articles on similar topics.

We regret that the third paragraph of Mr. Holderman's article contained a typographical error. It should have read, "If undeterminable compensation or remuneration is to be paid, the issuer has the burden of proving the 10% limitation has not been exceeded." The original printing of this sentence omitted the word "not."

BULLETIN ARTICLES SOLICITED

Attorneys specializing in securities law and practitioners in the securities area are invited to submit articles for publication in the Ohio Securities Bulletin.

A limited number of articles will be printed in upcoming issues on a "space-available" basis.

Articles should be submitted to:

Nancy Ivers Ferguson, Editor
Ohio Securities Bulletin
Ohio Division of Securities
180 East Broad Street
Columbus, Ohio 43215

DEALER RENEWAL FEE REDUCTION PROPOSED

In March of 1981, Heritage Securities Inc. filed suit against the Ohio Division of Securities. The complaint alleged, among other things, that the Division's dealer-salesman license renewal fee structure was unconstitutional.

This event caused the Division of Securities to examine the relationships between broker-dealer fees and the Division's broker-dealer regulatory costs. Although the Division believes that the fees and costs were appropriate when enacted in July of 1979, Senate Bill 363, technological improvements by the Division, and certain other operational efficiencies have caused an imbalance. The broker-dealer industry is now paying a disproportionate share of the Division's income.

Accordingly, the Division is supporting an amendment to Section 1707.17 O.R.C. The amendment, which has been incorporated into the state budget bill, would reduce by 40% the dealer license renewal fee; from $50.00 per salesman to $30.00 per salesman. If the amendment is adopted, the industry will save an estimated $200,000.

The Division intends to compare fees and costs in all areas of regulation as a part of its future budgeting process, proposing reductions or increases as appropriate.

INQUIRIES

Q. Should information about interest income be included in an oil and gas offering circular?

A. Definitely. "Interest income" is the interest earned on the deposit of subscription proceeds prior to the expenditure thereof. The offering circular should indicate that the interest income is being credited 100% to participants, or is being used to defray the costs of specific expenditures which should be listed in the circular.

Q. Are the time-sharing interests currently being offered by many real estate developers in the resort areas, securities requiring registration?

A. Many of the time-sharing or interval ownership interests being offered are securities and thus require registration unless exempt. The answer to your question will depend on an examination of the specific provisions of the time-sharing agreement involved. An attorney experienced in securities matters should be consulted to determine if registration is required.

Q. What form is used when registering under Section 1707.091 O.R.C.?

A. The Division does not have a form prepared specifically for filing under Section 1707.091. Persons relying on this section should use the Form 9 and indicate by cover letter that the filing is made pursuant to Section 1707.091 O.R.C.

Q. If a person issues a statement about the financial condition of an issuer which is false, and the person knows of its falsity, is this a violation of securities laws?

A. Section 1708.05 O.R.C. provides that no person, with the purpose to deceive, shall issue or cause to be issued, a statement as to the financial condition of an issuer, when he/she has reasonable cause to believe such statement is false in any material respect. Section 1708.99 provides that such a violation is a felony of the fourth degree.

DIVISION ORDERS

Donald R. Bendell, dba American Eagle Productions
On December 15, 1980, the Commissioner of Securities issued a Cease and Desist Order against Donald R. Bendell, dba American Eagle Productions. Mr. Bendell was found to have issued and sold securities in the state of Ohio which had not been registered or qualified in this state.

American Eagle was involved in the production of an independent martial arts motion picture in the Akron area. The securities sold in violation of the Act were percentages of the gross profits of the, as yet, uncompleted film.

The Division also found that Mr. Bendell is not, and had not been at any time, licensed by the Division.

Robert L. Thomas
On February 5, 1981, a Cease and Desist Order was issued against Robert L. Thomas. Mr. Thomas was found to have offered for sale to residents of Ohio, limited partnership units in Synfuels Development Program 1980. Said partnership units were not registered with the Division or subject to a claim of exemption. Also, Mr. Thomas was found not to be licensed during the year in which the securities were offered for sale.

MacKinnon Realty Company
On May 12, 1981, the Commissioner of Securities issued an order denying MacKinnon Realty Company's application for a broker dealer license. The license was denied on the grounds that MacKinnon Realty Company knowingly and intentionally made a false statement of a material fact in its application for a license in violation of Ohio Revised Code Section 1707.19(E).

Goldbanks Mining & Exploration Company, Inc.
On April 13, 1981, a Cease and Desist Order was issued by the Division of Securities against Goldbanks Mining and Exploration Company, Inc./Robert Heflin. Mr. Heflin and/or Goldbanks Mining and Exploration Company were found to have sold unregistered stock and were found not to have been licensed to sell securities at the time of said sale.

Tracker Security Systems, Inc.
On April 7, 1981, the Commissioner of Securities issued a Cease and Desist Order against Tracker Security Systems, Inc. and John A. Calandros. Mr. Calandros and other agents for Tracker Security Systems were found to have sold securities which were not registered with the Division of Securities or subject to a claim of exemption. The securities involved consisted of promissory notes.

Other Actions
Upon investigation and examination of records in each of the following cases, the Division found that the following parties did not file a valid report of sale for claiming exemption from registration under Section 1707.03(Q) O.R.C. In each case, the report of sale (Form 3-Q) was found to have been filed more than 60 days following the "sale" of securities, as that term is defined in Section 1707.01(C) O.R.C. Division Orders were issued in each case, and the records of the Division endorsed accordingly.

1. Briggs, Inc. by Division Order of January 15, 1981.
2. Co-Vest Oil and Gas Program-B by Division Order of January 8, 1981.
3. Co-Vest Oil and Gas Program-C by Division Order of January 8, 1981.

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