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Cash Flow: Misleading Connotations of "Dividend" Distributions

Harold V. Lese and Barbara A. Lee***

IT IS NOT OFTEN that a new term of art comes into use in a particular field of law with the effect of simultaneously changing the face of a booming industry and testing the adequacy of an important field of federal regulatory activity. Yet the term "cash flow," of relatively recent importance in the real estate industry, has cast in a new light old questions about permissible sources of corporate distributions to shareholders, and given currency to new and revolutionary criteria of enterprise valuation.[1] More important, the practice of measuring distributions by cash flow rather than by net income can be both misleading and susceptible of fraudulent manipulation. These possibilities in turn suggest the desirability of re-examining the disclosure philosophy underlying federal securities regulation, particularly the Securities Act of 1933.[2]

The Report of the Special Study of the Securities Markets of the Securities and Exchange Commission[3] states that although it is impossible to determine with precision the dollar value of all the real estate equity securities offered in this country in the ten years immediately preceding the study, "Unofficial estimates . . . . run above $10 billion." [4] The first registration statement covering equity securities of a real estate syndicate was filed with the Commission in 1952, and registration statements filed with

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1 See Sheldon B. Guren, Address Before the New York Society of Security Analysts, August 3, 1961, Reprint through U. S. Realty Investments of Cleveland.

2 48 Stat. 74, 15 U.S.C. §§ 77a-77aa (1958).

3 H. R. Doc. No. 95, Part I, 88th Congress 1st Sess. (1963), hereafter referred to as Special Study Report.

4 *Id.* at 576.

the Commission in the following decade involved offers of well in excess of $800 million of such securities.[5] The balance of such offerings has been made in reliance on one or another of the exemptions from registration provided in Sections 3 and 4 of the Securities Act, particularly the exemption applicable to intrastate offerings.[6] "A very substantial number" of these, according to the Special Study Report,[7] has been made in the State of New York, which has always been the principal center of the real estate industry, and was for a time the only state in which real estate operations could be called a significant segment of the economy.[8]

In the boom which has characterized the real estate industry since 1952 and only recently shown signs of decline, three types of securities have made up the bulk of the market. Early emphasis was on the syndicate form of enterprise, which raised capital by the sale of limited partnership interests. The corporate form, no doubt for tax reasons, appeared more recently, and seems to be the principal source of the problems discussed herein. More recently still, the Real Estate Investment Trust Act of 1960[9] has given rise to still another form, the implications of which are as yet unpredictable.

The Special Study Report sees the appeal of real estate equity securities as deriving from "two interrelated promises: 'anticipated cash-flow distributions,' and 'tax shelter.'"[10] "Cash flow" has been variously defined[11] and is often used without benefit of definition,[12] but is in the opinion of some accountants

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[5] *Ibid.*

[6] Section 3(a)(11), added by 48 Stat. 906 (1934), as amended, 15 U. S. C. § 77(c)(a)(11) (1958), exempts "any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within, or, if a corporation, incorporated by and doing business within, such State or Territory." See note 24, *infra*. As to regulation and securities issues generally see 2 Oleck, Modern Corporation Law, c. 32-36 (1959), and Loss, Securities Regulation (stud. ed. 1961).

[7] *Op. cit. supra* note 3, at 582.

[8] See Seligman, The Real Estate Markets I: The Future of the Office Building Boom, Fortune, March, 1963, p. 67.

[9] Int. Rev. Code of 1954, §§ 856-858.

[10] *Op. cit. supra* note 3, at 581.

[11] See Mason, "Cash Flow" Analysis and the Funds Statement (American Institute of CPA's, Accounting Research Study No. 2) 4 (1961). See generally *id.* 4-15.

[12] See, *e.g.*, Berger, Real Estate Syndication: Property, Promotion, and the Need for Protection, 69 Yale L. J. 725, 745 (1960).

neither cash nor flow, but an ambiguous catch phrase whose meaningfulness is open to question.[13] Whatever the descriptive words employed, cash flow as the term is employed in the real estate industry must ultimately be defined as the result of an arithmetical process in which (1) taxable income is computed by subtracting deductible expenses, including depreciation, from gross income; (2) nondeductible mortgage amortization payments[14] are subtracted from taxable income; and (3) an amount of cash equal to the depreciation deduction is added back. The amount of the excess is "cash flow." [15] The crucial factor is the amount of the depreciation deduction. The Internal Revenue Code does not require that depreciation be taken at a uniform rate over the life of an asset; only "a reasonably consistent plan" must be followed.[16] When the taxpayer employs the declining balance[17] or sum-of-the-years-digits[18] method, the bulk of the depreciation allowable over the entire life of the asset is thrust into the first few years. The result is to reduce the taxable income, even to zero, which is often the taxpayer's goal,[19] and to create what for want of a better term may be called a "fund." In the hands of a shareholder, a distribution from this "fund" is treated not as a dividend but as a tax-free return of capital under section 301 of the Code, and is thus "tax-sheltered."

In the later years of the asset's life, by way of contrast, the shrinking depreciation deduction will be inadequate to wipe out taxable income and the "tax shelter" situation may well be reversed to the point where the taxpayer has taxable income but no distributable cash flow.[20] In a diversified enterprise, the use

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[13] Mason, *op. cit. supra* note 11, at 5, "deplore[s] the employment of such inaccurate terminology and urge[s] the adoption of a more appropriate phrase." Paton, The "Cash Flow" Illusion, 38 Accounting Rev. 243, 246 (1963) takes the position that the cash flow concept serves no legitimate function either as a substitute for or a clarification of the traditional income statement, if indeed it has any usefulness at all.

[14] Capital improvements, if any, would also be subtracted here, since they represent a cash disbursement but not a deductible expense, Int. Rev. Code of 1954, § 263.

[15] Compare the Special Study Report, *op. cit. supra* note 3 at 581, which produces the same result by a slightly different arithmetical process.

[16] Treas. Reg. § 1.167(a)-1(a) (1960).

[17] Treas. Reg. § 1.167(b)-2 (1956).

[18] Treas. Reg. § 1.167(b)-3 (1956).

[19] See, *e.g.*, Guren, *op. cit. supra* note 1.

[20] See Mason, *op. cit. supra* note 11, at 32.

of different methods of depreciation on different properties to equalize the tax savings may alleviate the burden of the later years somewhat, but for the most part it has been the practice of real estate taxpayers to sell the property at a capital gain after taking the maximum advantage of the depreciation deduction, and then use all or part of the proceeds to purchase a new property with which to begin the cycle anew.[21] The fallacy of building a whole industry on the assumption that real property values will rise not only indefinitely but in an unbroken, continuous curve, should be readily apparent. The "cash-flow illusion"[22] generates several other problems as well.

In direct contrast with many state statutes which regulate the securities industry by passing upon the merits of the securities offered,[23] the Securities Act of 1933 emphasizes the prevention of fraud and the full disclosure of material information with respect to any security offered to the public by means of the mails

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[21] Discussion of the full impact of the Internal Revenue Code upon devices used in this area is well beyond the scope of this paper. Suffice it to say that the present interplay between § 167, whereby depreciation is a deduction from "ordinary" income, and §§ 1001, 1011, 1201, and 1231, whereby gain on the sale of property used in business yields "capital" gain, in effect allows one to convert ordinary income into capital gain over the term of the investment. Such conversion is no longer possible with respect to personalty because of § 1245 (added in 1962). The Revenue Act of 1964, H. R. 8363, 88th Cong., 2d Sess., in § 220, adds a new section, § 1250, to the Code and eliminates this "loophole" with respect to realty as well. The early distributions of real estate corporations may still be "returns of capital" and taxfree, § 301(c)(e), but such tax benefit will be later offset by an increased tax burden upon sale or by greatly reduced depreciation deductions in later years.

Similarly, passing these fruits from the corporation to the shareholders at least tax cost often involves complicated maneuvers attempting to minimize the so-called "double tax," *i.e.* the corporation is taxed upon income as earned, and the shareholder is also taxed upon the dividends declared out of these earnings. A common method is accumulation of earnings and liquidation of the corporation under § 337, always being mindful of the pitfalls of "collapsibility" under § 341. Since § 857(b)(2) in effect eliminates the corporate-level tax if the Real Estate Investment Trust form is used, if possible use of this form may be indicated.

[22] Paton, *op. cit. supra* note 13.

[23] *E.g.*, Calif. Corp. Code § 25507 (1955) requires, among other things, an administrative determination that the issuer's "proposed plan of business ... and the proposed issuance of securities are fair, just and equitable," before securities may be offered in that state. By way of contrast, Colorado R. S. 1953 §§ 125-1-1—125-1-17 employs the disclosure philosophy underlying the Securities Act of 1933, requiring registration of securities to be offered in the state and prohibiting fraud. The California approach is by far the more typical. See Associated Gas & Elec. Co. v. Public Serv. Comm'n, 221 Wis. 519, 266 N. W. 205, 209 (1936) (fairness of a plan of exchange under what is now Wis. Stats. § 189.02 (1955)); Merkel, Blue Sky Law Developments, 166 Commercial and Financial Chron. 1320 (1947) (administration of Ohio Rev. Code § 1707.01 (1951)).

or the facilities of interstate commerce or communication.[24] The Securities and Exchange Commission, among whose principal functions are to protect investors from fraud and to assure that they receive adequate and accurate information concerning securities offered for sale to the public, makes no judgment on the merits of any security and has no power to prevent offer or sale of any security, no matter how speculative or even unsound, so long as the disclosure requirements of the statute[25] and the Commission's rules and regulations promulgated thereunder[26]

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[24] Section 5 prohibits the sale or delivery by such means of any security as to which a registration statement is not in effect, and the offer of any security as to which a registration statement has not been filed, unless an exemption under Section 3 or 4 is available. Section 17 prohibits fraud in the offer, sale or delivery of any security by such means, whether or not registered, and whether or not any exemption from registration is available. Section 12(1) creates civil liabilities for violation of the registration requirements of Section 5; the anti-fraud provisions of Section 17 and 12(2) respectively render unlawful and create civil remedies for fraud and misrepresentation in the sale of securities. Section 24 provides criminal penalties for willful violation. In addition to the fact that the use of some interstate instrumentality is an essential element of violation of both Sections 5 and 17, Section 3(a)(11) exempts from registration offers and sales made to bona fide residents of the state in which the issuer is incorporated and doing business, even though the relevant instrumentalities may be employed in such offer or sale. These restrictions were in 1933 almost universally believed necessary to constitutionality, within the limits of contemporary construction of the regulatory powers of Congress, expressed in such cases as Hammer v. Dagenhart, 247 U. S. 251 (1918). Since then, a number of bills have been introduced to repeal Section 3(a)(11), *e.g.*, H. R. 572, 88th Cong., 1st Sess. (1963). The Special Study Report, *op. cit. supra* note 3 at 570, views the exemption as reflecting "a Congressional policy not to preempt the field of securities regulation or to supersede state control except in areas where state regulation does not adequately meet national needs," and briefly notes the difficulties in enforcement the Commission would encounter if its duties extended to intrastate offerings. The Special Study proposes an amendment requiring issuers and controlling persons to file with the Commission advance notification of intent to rely on the exemption, but urges retention of the exemption on the ground that "the exemption serves its intended purpose well, when availed of, as it ordinarily is, for small offerings by small businessmen in their home communities." *Id.* at 575. But it seems doubtful whether any useful purpose would be served by the adoption of the notification requirement. Even if the Commission's staff were to be greatly enlarged, it could hardly be discovered, from the mere notification, whether any violation had occurred, and the desirability or even the utility of investigating every issuer who files such a notification is open to serious question.

[25] Securities Act of 1933, §§ 6, 7, 10, Schedules A and B, 48 Stat. 78, 81, 88, 15 U. S. C. §§ 77f, 77g, 77j, 77aa. The anti-fraud provision, § 17, 48 Stat. 84, 15 U. S. C. § 77q, is of course applicable to exempt offerings as well.

[26] Regulation C, 17 C. F. R. §§ 230.400-230.494 expresses the standards established by the Commission for the registration process. The issuer must use such form, in submitting its registration statement, as shall have been prescribed by the Commission, Rule 401, 17 C. F. R. § 230.401. The form presently in effect for the use of real estate issuers is Form S-11, Securities Act Release No. 4422, October 26, 1961.

are fully complied with. The principal instruments by which the necessary information is made available to the public are a registration statement filed with the Commission as a public document[27] and a prospectus,[28] which must be current and must ordinarily be given before or simultaneously with delivery of the security[29] to every person who purchases within 40 days of the effective date of the registration statement, with certain exceptions.[30]

Three disclosure problems arise in connection with cash flow. The first and most obvious one is that of disclosing to an investor who is neither an accountant nor a lawyer that a deduction taken for tax purposes has given rise to a distribution which amounts to a return of capital. Related problems are the resort to alternative sources of distributions when cash flow is generated in increasingly smaller amounts, and market manipulation by insiders.

Distributions based on cash flow look—or can be made to look—very much like dividends,[31] especially when reputable businessmen take the position that "in real property *cash flow* is a more important yardstick than net profits."[32] One example from a recent registered offering will suffice to illustrate both the complexities of adequate and accurate disclosure and an approach which may be called typical. Under the heading of "Proposed Cash Distributions to Stockholders—Source and Tax Effects," the prospectus states that the issuer's policy will be "to

[27] Securities Act of 1933, § 6(d), 48 Stat. 78, 15 U. S. C. § 77f(d).

[28] *Id.*, §§ 2(10), 10, 48 Stat. 75, 81, 15 U. S. C. §§ 77b(10), 77j.

[29] *Id.*, § 5(b)(2).

[30] *Id.*, § 4(1), third clause. The use of a prospectus is also required, even after 40 days, "as to securities constituting the whole or part of an unsold allotment." *Ibid.*

[31] The term "dividends" is here employed in the sense of distributions out of earnings and profits on the assumption that this definition most nearly corresponds with the expectations (however inarticulate) of the average investor. Compare Special Study Report, *op. cit. supra* note 3 at 577n. State statutes governing the sources of distributions of course vary widely. Compare N. Y. Bus. Corp. Law § 510 (1961) ("a corporation may declare and pay dividends or make other distributions . . . except when currently the corporation is insolvent or would thereby be made insolvent") with Pa. Bus. Corp. Act § 702 (1957) ("dividends may be declared in cash or property only out of unreserved and unrestricted earned surplus"). For digests of statutes of all states see, 3 Oleck, Modern Corporation Law, c. 54 (1959).

[32] Guren, *op. cit. supra* note 1. *Contra:* Mason, *op. cit. supra* note 11, at 38-39.

make distributions . . . of substantially all the cash derived from the operations of the Company remaining after the payment of expenses . . ." but warns that this policy may be altered by "unforeseen or changed circumstances within or without the control of the Company," and that "no representation can be made that the results described actually will be obtained or that they are necessarily indicative of future results."[33] A "Summary of Pro Forma Operations and Cash Available for Distribution to Stockholders" has separate entries for "Depreciation: Regular" and "Depreciation: Additional—Accelerated rates for Federal income tax purposes," and shows a net loss "after depreciation."[34] It is not stated *in haec verba* that the loss would disappear and a net profit would result from the elimination of the additional depreciation deduction, but this would seem to be readily inferable from the financial data given. After discussion of some of registrant's properties, the section concludes with a summary of the tax effects of the issuer's distribution policies, the relevant portion of which is expressed as follows:

> If, as expected, after deduction of all expenses and depreciation, the Company will, for Federal income tax purposes, have neither accumulated earnings and profits nor earnings and profits for the year in which cash distributions are made to stockholders, such distributions will, in the opinion of . . . counsel to the Company, result in a reduction to stockholders of the tax basis of the shares owned and will not be subject to Federal income tax until such time as the stockholder's basis is recovered. Such basis, as reduced, will be used to determine gain or loss on the sale of shares. Distributions made after recovery of such basis will be taxable to stockholders in whose hands it [*sic*] is a capital asset as capital gain. When and if the Company has earnings and profits, distributions will first be attributable to such earnings and profits, and to such extent, will be taxable as dividends to the stockholders of the Company.[35]

But the difficulties attendant upon investor understanding of so complex—if not esoteric—an aspect of real estate securities derive principally from the fact that more than ninety per cent of real estate offerings since 1950 have taken place without registration, in reliance on the statutory exemption of intrastate

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[33] Prospectus of Primex Equities Corporation, June 27, 1962, pp. 5, 7.

[34] *Id.*, p. 8.

[35] *Id.*, p. 10.

offerings from the registration requirements.[36] Whereas the *raison d'etre* of the other exemptions from registration can safely be said to be the existence of other safeguards or regulation by another governmental body which can be viewed as eliminating the need for the protections of the Securities Act,[37] this rationale is of doubtful application to § 3(a)(11). Although a "very substantial number" of real estate offerings to the public in reliance on the intrastate exemption have been made in the state of New York,[38] the comparatively recent enactment in that state of a comprehensive program of real estate syndicate regulation[39] should not be viewed as a panacea in this troublesome area. For while New York continues to be the center of the real estate industry, intrastate offerings are by no means limited to that state,[40] and the variations in the extent and quality of the investor protection afforded by the blue sky laws of most states are as numerous as the states themselves.[41] Moreover, there appears to be considerable doubt as to the extent to which the rather stringent requirements of the exemption have actually been complied with in a large number of the New York offerings.[42] It has been suggested earlier that the abolition or amendment of the intrastate exemption might create more problems than it would solve,[43] and the observation is as pertinent here, but it can at least be hoped that other states, whatever their blue sky philosophy, will follow the lead of New York in recognizing the special regulatory problems presented by the real estate industry.

Once the "source"[44] of cash flow distributions is adequately

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[36] Special Study Report, *op. cit. supra* note 3, at 580.

[37] *E.g.*, H. R. Rep. No. 85, 73d Cong., 1st Sess. (1933) 14, notes that "adequate supervision of securities of a national bank is exercised by the Comptroller of the Currency." The Commission more recently has distinguished between a bank's own securities, expressly exempted under Section 3(a)(2), and "a variety of other securities," such as ADRs, as to which "the concept of supervision by banking officials," on which § 3(a)(2) is based, is inapplicable. 22 S.E.C. Ann. Rep. 43 (1956).

[38] Special Study Report, *op. cit. supra* note 3, at 580.

[39] N. Y. Gen. Bus. Law §§ 352-e—352-j (1961).

[40] See Special Study Report, *op. cit. supra* note 3, at 580.

[41] See note 23 *supra*.

[42] See Special Study Report, *op. cit. supra* note 3, at 580.

[43] See note 24, *supra*.

[44] Mason, *op. cit. supra* note 11, at 38, criticizes the usage describing depreciation as a "source" of cash and suggests instead that it is more appro-

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explained to the investor, if it is explained, a more serious disclosure problem may arise when the cash flow so explained becomes inadequate to support continued distributions at the original rate. One unanswered question on this point is whether the initial disclosure of the cash flow—accelerated depreciation concept should include a warning to the investor that this method may be supplemented by future dividends out of alternative sources. If the issuer's practice is to substitute fully depreciable assets for those on which accelerated depreciation has been used by the sale of the latter at a capital gain before the cash flow dwindles below the distribution level, reference in a prospectus to a wholly different source of future distributions may be not only pointless but itself misleading. When, on the other hand, a distribution is subsequently made in excess of cash flow, *e.g.*, from the proceeds of a new offering, it is not certain whether, under existing law, there is any obligation to disclose to shareholders the source of the distribution—if, indeed, any amount of disclosure may be adequate in a situation in which one shareholder's capital investment looks so much like return on the investment of another shareholder.[45] The only portion of the Securities Act of 1933 which might suggest such an obligation is Section 17(a) (3), which makes it unlawful "to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser." The difficulty with such a construction is that the statute as a whole deals with the offer and sale of securities, rather than with issuer-shareholder relations in general; the use of the word "purchaser" rather than "shareholder" or even "investor" in Sec-

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priate to speak of the deduction as a "measure" of cash. The term "source" of the distribution is here used in a non-technical sense to refer to the cash and cash equivalents, see text at note 13, *supra*, of which the depreciation deduction is a measure.

[45] The Preliminary Prospectus of Primex Equities Corporation, as amended, filed March 19, 1962, at 5, contains an interesting example of disclosure on this point:

> As shown in the Summary of Pro Forma Earnings and Cash Available for Distribution to Stockholders set forth below, the intended distributions to be made by the Company to holders of the Class A Common Stock may exceed cash available from the operations of the Company. In such an event, some portion of the excess of distributions over cash available may be paid out of the net proceeds of financing, including this offering. To the extent that such distributions are paid out of such net proceeds, they may be deemed a return of invested capital.

The definitive prospectus, discussed in text at notes 33-35, *supra*, reflects no intent to adopt this policy, and the quoted paragraph is omitted.

tion 17 (a) (3) seems to express the Congressional intent unambiguously. Even so, it cannot be gainsaid that the availability to shareholders of information concerning the source of a distribution, *at the time of the distribution,* would be in harmony with the full disclosure aims of the Securities Act.

Whatever the subtleties of existing law, two affirmative steps have been taken in the direction of increased availability of such information. The first is the promulgation by the Commission of Form 7-K, which real estate issuers are required to file on a quarterly basis.[46] As presently in effect,[47] the form calls for detailed information on receipts and disbursements during the quarter, including the excess of cash generated over cash distributed, or the reverse. Like all other public documents of whatever kind, however, Form 7-K is available to those who wish to inspect it, but its dissemination to all shareholders is not required, and probably could not be required under existing law. Nor do the Commission's present powers to require the filing of reports, pursuant to Sections 13 and 15 of the Securities Exchange Act of 1934, extend to issuers who have no class of securities listed on an exchange or registered with the Commission under the Securities Act. If legislation pending at the time of this writing is passed by the 88th Congress, however, the filing of annual and quarterly reports in such form as the Commission may prescribe will be required of "every issuer which is engaged in interstate commerce, or in a business affecting interstate commerce, or whose securities are traded by use of the mails or any means or instrumentality of interstate commerce."[48]

The extent to which this bill, if enacted into law, will close existing gaps in presently available disclosure is typified by its effect on the intrastate exemption. Although an offering, to come

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[46] Rules 13a-15 and 15d-15 promulgated under the Securities Exchange Act of 1934, 17 C. F. R. §§ 240.13a-15, 240.15d-15, prescribe Form 7-K, with certain exemptions, respectively for real estate issuers of securities registered on a national securities exchange, and/or registered with the Commission under the Securities Act of 1933.

[47] Securities Act Release No. 7077, May 16, 1963, announced a proposed revision of Form 7-K and requested comments from the public. The proposed changes appear principally designed to present the same information in a manner more meaningful to the reader who lacks specialized training.

[48] If such issuer's total assets exceed $1,000,000 and a class of its equity securities is held of record by 750 or more persons "within one hundred and twenty days after the last day of its fiscal year ended after the effective date of this subsection." S. 1642, § 3(c); H. R. 6789, § 3(c), 88th Cong., 1st Sess. (1963).

within the terms of Section 3(a) (11) must be limited to bona fide residents of the state in which the issuer is organized and substantially doing business,[49] and indeed the offering issuer is all but an insurer of the offerees' residence, the use of the mails or the instrumentalities of interstate commerce does not defeat the exemption. Thus by relying or purporting to rely on the intrastate exemption, real estate issuers may continue to avoid the disclosure attendant upon registration under the Securities Act, but would nevertheless be required to make public the information called for in Form 7-K or whatever substitute the Commission might promulgate.

Upon enactment of this legislation, however, there would still remain the problem of assuring that the information thus made part of the Commission's public files would actually reach the hands of the issuer's shareholders—for with respect to complex and difficult concepts so readily susceptible of misrepresentation and distortion, "constructive knowledge" seems inadequate indeed. Section 19 of the Investment Company Act of 1940 provides a helpful analogy:

> It shall be unlawful for any registered investment company to pay any dividend, or to make any distribution in the nature of a dividend payment, wholly or partly from any source other than—
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> (1) such company's accumulated undistributed net income, determined in accordance with good accounting practice and not including profits or losses realized upon the sale of securities or other properties; or
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> (2) such company's net income so determined for the current or preceding fiscal year;
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> unless such payment is accompanied by a written statement which adequately discloses the source or sources of such payment. The Commission may prescribe the form of such statement by rules and regulations in the public interest and for the protection of investors.[50]

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49 See Securities Act Release No. 4434, December 6, 1961.

50 54 Stat. 821, 15 U. S. C. § 80a-19. The Commission's Rule 19-1, 17 C. F. R. § 270.19-1, specifies in some detail the form in which the disclosure required by § 19 shall be made. Of interest on this point, although § 19 was not directly at issue, is the recent decision in S. E. C. v. Keller Corp., 323 F. 2d 397 (7th Cir., 1963), an action to enjoin an unregistered investment company from violating § 7(a) of the Investment Company Act of 1940, 54 Stat. 802, 15 U. S. C. § 80a-7(a) and § 17(a) of the Securities Act, 48 Stat. 84, 15 U. S. C. § 77q(a). The district court found, however, that defendants were engaged in "employing a device, scheme, and artifice to defraud," in viola-

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This approach is still a long way from superseding state statutes regulating the source of dividends, but it represents a major step forward in corporate disclosure. An extension of the principle of Section 19 beyond the investment company field might well be an extremely practical means of solving the disclosure problems in the real estate field heretofore discussed.

One problem remains which does not lend itself to solution by means of such an approach—price manipulation. To the universal rule that the declaration of dividends is within the discretionary powers of corporate directors[51] "cash flow" has added a new leverage, in the form of substitution of depreciable assets. Since it has been the stated policy of a number of real estate syndicates to distribute all available cash,[52] knowledge of the imminent purchase or sale of the asset on which the generation of cash depends presents tempting opportunities to corporate insiders.[53] Although Section 16(b) of the Securities Exchange Act of 1934 limits short-swing profits by insiders of an issuer having any class of equity securities listed on a national securities exchange,[54] there is still room for improvement in extending such protection to investors of real estate securities, few of

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tion of § 17 of the Securities Act, and cited in support of this finding the distribution by the defendants of a brochure which contained various misrepresentations and omissions, including a statement "that Midco [Mid-Continent Securities Corp., parent of Keller Corp. and a defendant] paid a dividend in 1961, without mentioning that the dividend was at least in part a return of capital." On appeal, the defendants attacked only the adequacy of these findings to support the appointment of a receiver and the granting of a preliminary injunction. In affirming, the Court of Appeals noted, 323 F. 2d at 402: "The broad framework of the injunction in this case is particularly appropriate because of the public interest involved and the necessity of protecting the investing public from fraud and deceit."

51 *E.g.*, Gottfried v. Gottfried, 73 N. Y. S. 2d 692 (1947); see generally 11 Fletcher, Corporations §§ 5325-5327 (1958); 3 Oleck, Modern Corporation Law §§ 1364-1366 (1959).

52 See, *e.g.*, text at note 33, *supra*.

53 Derderian v. Futterman Corp., 63 Civil 1367 (S. D. N. Y.) is a suit pending at the time of this writing, brought by a shareholder, apparently in both his individual capacity and as the claimed representative of other shareholders against a real estate issuer, several officers and directors, and others. In an opinion denying one defendant's motion to dismiss as to it on grounds not here relevant, Judge Feinberg summarizes the principal allegations of the plaintiff's complaint, to the effect that "defendants made false and misleading statements or omitted to state material facts which caused the stock of the corporation to be sold at inflated prices to the public." (November 6, 1963.) Cf. S. E. C. v. Capital Gains Research Bureau, 84 Sup. Ct. 275 (1963); Cady, Roberts & Co., 40 S. E. C. 907 (1961).

54 48 Stat. 896, 15 U. S. C. § 78p.

which are listed on any exchange. The bills introduced in the 88th Congress to amend the 1933 and 1934 Acts in various respects would extend the scope of Section 16 in effect to any issuer whose business touches interstate commerce in any way.[55] It is difficult to see how any measure short of the pending proposal could meaningfully reach an industry relying on the intrastate exception from Securities Act registration to the extent that the real estate industry has relied on this exemption.

In summary, what the past decade of real estate syndicate operations has shown is a need, if not for federal regulation of corporate distributions, for improved disclosure in particular areas, notably disclosure of the source of distributions, to make meaningful the broad statements of distribution policy in prospectuses and other offering literature. The need is not for an abolition of existing exemptions from registration under the Securities Act of 1933, but for making disclosure more meaningful, especially continuing disclosure to investors of the extent to which attractive promises in a registration statement—or in a conversation attendant upon an exempt offering—have actually been put into practice. These problems will not suddenly disappear with the enactment of this or that piece of legislation, or with changing conditions in the real estate industry. The problem of adapting existing forms to new conditions is as inevitable in securing disclosure of material facts to prospective investors as it is in any other field. And no matter how the fabric of American business may be altered, it is hard to say that it will not be as necessary.

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[55] Specifically, the requirements of § 16 would be applicable to the same issuers to which the requirements of Sections 13 and 15 would be extended by the same bills, see note 48, *supra*.