SEC Argues That Sales Of Hotel Rooms Are Sales of A Security

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In June, I wrote this post about U.S. District Court Judge Dana Sabraw's opinion in *Salameh v. Tarsadia Hotels*, 2011 U.S. Dist. LEXIS 30375. The case involved the question of whether ownership interests in individual units of the Hard Rock Hotel San Diego constitute securities under either the investment contract test enunciated by the U.S. Supreme Court in *S.E.C. v. Howey*, 328 U.S. 293 (1946)) or the "risk capital" test described by the California Supreme Court in S*ilver Hills Country Club v. Sobieski*, 55 Cal.2d 811 (1961).

Time and this case have crept on and now Judge Sabraw's ruling is before the Ninth Circuit Court of Appeals. Recently, the Securities and Exchange Commission has weighed in with this amicus brief. Just like Captain Renault when he found gambling in Rick's Cafe Americain, readers will be shocked to learn that the SEC takes the position that the an investment contract is implicated in this case.

This case presents a challenge because plaintiffs first purchased hotel rooms and then a year later were offered a rental management agreement. Consequently, Judge Sabraw concluded that this significant gap meant that the rooms and rental agreement were not offered as part of a single package. The plaintiffs also specifically represented that they were not purchasing the rooms for investment. Further, there was no pooling of rental income. Judge Sabraw was therefore not persuaded that the plaintiffs had an expectation of profits.

In response, the SEC argues that Judge Sabraw's view of reality was too cabined, writing:

- *"The Commission believes that the district court, in determining that the hotel-room sales did not involve sales of investment contracts, failed to give effect to the economic and practical realities of the transactions as required by Supreme Court and Ninth Circuit precedent."*
- *"The district court failed to appreciate the broader realities underlying the arrangements between the parties."*
- *"The district court placed dispositive weight on these representations and, in doing so, failed to consider the broader realities of the overall transaction."*

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The SEC's repeated appeal to practical and economic realities is, of course, not a legal argument but an appeal to pragmatism. Such an appeal is appropriate when deciding questions of policy, but they are not legal arguments. In effect the SEC is arguing what it believes the law *should be* rather than what the law *is*, as defined by statute, rule and precedent. As Chief Justice John Roberts observed during his confirmation hearing:

> *"Judges are like umpires. Umpires don't make the rules, they apply them. The role of an umpire and a judge is critical. They make sure everybody plays by the rules . . . ."*

Confirmation Hearing on the Nomination of John G. Roberts, Jr. to be Chief Justice of the United States Before the Senate Committee on the Judiciary, 109th Cong. 55 (2005). Senior Judge Edward Becker of the Third Circuit Court of Appeals made a similar observation at the confirmation hearing of Samuel Alito, Jr.:

> *"When you take that judicial oath, you become a different person. You decide cases not to reach the result that you would like, but based on what the facts and the law command."*

Confirmation Hearing on the Nomination of Samuel A. Alito, Jr. to be an Associate Justice of the Supreme Court of the United States Before the Senate Committee on the Judiciary, 109th Cong. 655-56 (2006).

Readers interested in the SEC's position concerning the treatment of real estate interests under the securities laws may want to take a look at Securities Act Release No. 33-5347 (Jan. 4, 1973).

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