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In Support of *SEC v. W.J. Howey Co.*: A Critical Analysis of the Parameters of the Economic Relationship Between an Issuer of Securities and the Securities Purchaser

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IN SUPPORT OF SEC v. W.J. HOWEY CO.: A CRITICAL ANALYSIS OF THE PARAMETERS OF THE ECONOMIC RELATIONSHIP BETWEEN AN ISSUER OF SECURITIES AND THE SECURITIES PURCHASER

JEFFREY ALLEN TEW* & DAVID FREEDMAN**

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I. INTRODUCTION

There is currently raging, among the various jurisdictions, an intense dispute over the nature and definition of the term “security.” In some jurisdictions, judicial interpreters of local “Blue Sky” statutes have toed the line of traditional concepts. In others, the judiciary, spurred on by cries of public policy, has seized upon new concepts with the result that many of the local securities acts now are held to embrace transactions

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that were once thought clearly to be outside the scope of the statutes. But there are two groups in society whose needs also warrant the protection of "public policy" who are placed in grave jeopardy by the judicial abandonment of traditional concepts of the term "security": businessmen, who find that the road to jail is paved with wrong guesses by corporate counsel; and corporate counsel, who find that the road to malpractice is paved with definitions of the term "security" that defy any possibility of logical business planning.¹ In short, from the viewpoint of these two groups, new definitions have transformed the securities acts from firm but comprehensible policemen into ravenous monsters. The thrust of this article will be to critically dissect the traditional definition of the term "security" and to contrast the traditional concept with the "risk capital" concept now adopted in an expanding minority of jurisdictions.

II. **HOWEY—THE TRADITIONAL VIEW: ONE PARTY SUPPLIES THE WORK AND THE OTHER SUPPLIES THE FUNDS. A "SECURITY" HAS BEEN SOLD WHEN THE VALUE OF ONE'S PURCHASE DEPENDS ON THE ABILITIES OF SOMEONE ELSE**

The following analysis of the economic relationships inherent in the purchase and sale of securities is based upon two underlying assumptions:

1. While all securities may be investments, not all investments are securities.

As one federal court has put it: "To conclude that the natural desire of any purchaser that his purchase should appreciate in value make a 'security' of what has been purchased, is obviously to so muddle the term as to make it meaningless."² Thus, it is crucial to isolate the criteria that separate an investment from a "security." That task is one of the undertakings of this article.

2. All subclasses of instruments or arrangements within the generic term "security" are founded upon the same economic relationship between the issuer and the purchaser.

The typical securities act will contain, in addition to the more easily recognizable securities such as stock or debentures, a collection of seemingly innocuous terms such as "investment contract" or "certificate of interest or participation in a profit sharing scheme." The critical economic arrangements in all of these terms are basically identical. Certainly there are the fundamental differences between an equity interest³ and a debt

1. Additionally, corporate counsel may find the road to jail, pursuant to 18 U.S.C. § 2(a) (1970).

2. *Contract Buyers League v. F & F Inv.*, 300 F. Supp. 210, 224 (N.D. Ill. 1969).

3. "[A] corporate share is a very complicated chose in action. It is not a right to a definite sum of money, but rather to a proportionate share of the assets of the company,

interest.⁴ But "the term 'securities' is a more inclusive term than 'investment contracts.'"⁵ If an interest has "so many of the substantial attributes of 'stock,' 'share,' 'evidence of indebtedness,' and 'investment contract,'"⁶ it must fall within the statutory scheme even though it is not entirely "debt" or "equity."

As will be demonstrated, as diverse as the ordinary concepts of "debt" and "equity" might be, there are essential characteristics that remain the same. So even though a particular case might specify a test for an "investment contract," the principles can be readily applied to all types of "securities." "Security" is a generic term, and its essential characteristics are present in all of the various statutory subclasses. The fact that a particular case refers to a particular statutory term is not a crucial consideration.

With these basic premises in mind, the federal concept of the characteristics of a security will now be dissected.

A. *The Definition from SEC v. W. J. Howey Co.*

Generally, the starting point of any discussion of the term "security" is likely to involve the analysis of the United States Supreme Court decision in *SEC v. W.J. Howey Co.*⁷ In *Howey*, the defendants owned large tracts of citrus acreage in Lake County, Florida. Defendants offered to the public both a land sales contract and a service contract, informing potential buyers that an investment in a small citrus grove was not economically feasible unless service arrangements were also made. The average size of the tracts sold to the public was 1.33 acres, and parcels as small as 0.65 of an acre were conveyed. Although the purchaser, upon full payment, received a warranty deed to his small tract, the service contract conveyed a leasehold interest back to defendants. Defendants were given complete discretion and authority over cultivation, harvesting, and marketing. The landowner did not even have the right to enter upon his premises. There was no right to specific fruit. All of the produce was pooled and the defendants, who were well established in the citrus industry, disbursed a share of the net profits to the landowners in accordance with output from the individual parcels.

In analyzing the offering, the Supreme Court noted that the term "security" included not only the commonly known documents traded on exchanges, but also

whatever they may be, upon dissolution." *Hunt v. Eddy*, 150 Kan. 1, 12-13, 90 P.2d 747, 754 (1939).

4. The fundamentals of a debt instrument involve "a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest." INT. REV. CODE OF 1954, § 385.

5. *State v. Evans*, 154 Minn. 95, 101, 191 N.W. 425, 427 (1922).

6. *Donovan v. Dixon*, 261 Minn. 455, 467, 113 N.W.2d 432, 439 (1962).

7. 328 U.S. 293 (1946) [hereinafter referred to as *Howey*].

“securities” of a more variable character, designated by such descriptive terms as “certificate of interest or participation in any profit-sharing agreement,” “investment contract” and “in general, any interest or instrument commonly known as a ‘security.’”⁸

In characterizing the scheme offered by defendants as a type of security known as an “investment contract,” the Court specifically stated the test that is the classic definition of the economic relationship between purchaser and issuer:

[A]n investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party⁹

With this statement, the Court captured the essentials involved when one supplies capital in return for a “piece of the action.” “Thus all the elements of a profit-seeking business venture are present here. The investors provide the capital and share in the earnings and profits; the promoters manage, control and operate the enterprise.”¹⁰

Some three years prior to *Howey*, the Supreme Court had its first opportunity to define the essentials of a “security” relationship. In *SEC v. C. M. Joiner Leasing Corp.*,¹¹ the defendants acquired oil leases from the owners of certain acreage for “practically nothing except [promising] to drill a well.”¹² Defendants, in order to finance the promised well-drilling, proceeded to sell assignments of their leases, with the subdivided parcels going for as little as \$5 per acre and usually encompassing 2½ to 5 acres. Prospective purchasers were assured that defendants would drill the well in a location that would test the oil-producing possibilities of the offered assignments. As in *Howey*, the purchasers resided throughout the country, often at a considerable distance from the site. There was no indication that any of the purchasers were capable of realizing a profit on their purchase through their own skills. Without the drilling of the well, none of the leases had any value. When the Court stated that “the undertaking to drill a well runs through the whole transaction as the thread on which everybody’s beads were strung,”¹³ it was expressing the concept later articulated more concisely in *Howey*—that the expectation of profit was based upon the efforts of someone else. Indeed, in *Howey*, when the Court enunciated the test of “an investment in a common enterprise with the expectation of profit solely from the

8. *Id.* at 297.

9. *Id.* at 298-99.

10. *Id.* at 300.

11. 320 U.S. 344 (1943) [hereinafter referred to as *Joiner*].

12. *Id.* at 346.

13. *Id.* at 348.

efforts of others," it further stated that "such a definition necessarily underlies this Court's decision in *SEC v. Joiner Corp.* . . ."¹⁴

Such a definition, in fact, underlies all "securities" transactions. Thus, the statutory term "evidence of indebtedness" has been equated with the term "investment contract."¹⁵ "Investment contract" has been used interchangeably with "beneficial interest in or title to property or profits,"¹⁶ as well as with "interest in a profit-sharing . . . scheme."¹⁷ In short, a share of common stock is also an investment contract as well as a certificate of interest in a profit-sharing scheme. Indeed, the basics of the *Howey* test were first proposed by the SEC as the general test for a "security."

Plaintiff [the SEC] has suggested as a definition of the general term "security" the following: "The investment of money with the expectation of profit through the efforts of other persons." Such definition has support in state decisions and describes a relationship which is in substance that of a security investor.¹⁸

One circuit has stated that *Howey* adds the test of "common enterprise" to the *Joiner* test of "*results dependent on the efforts of one other than the purchaser.*"¹⁹ This analysis is not precisely appropriate. *Howey* and *Joiner* express the same definition; *Howey* merely articulates it more precisely.²⁰

Howey, of course, did not originate the definition of the "security" relationship stated therein. State courts had analyzed the economics of the relationship on previous occasions.²¹ But the *Howey* enunciation carries with it the prestige attached to a United States Supreme Court decision, and, for the purpose of this article, the "*Howey* test" will be used as a label for this definition of the parameters of the "security" relationship:

14. 328 U.S. 293, 299 (1946).

15. See, e.g., *State v. Hodge*, 204 Kan. 98, 460 P.2d 596 (1969).

16. See, e.g., *Freeze v. Smith*, 254 Mich. 386, 236 N.W. 810 (1931).

17. See, e.g., *Kerst v. Nelson*, 171 Minn. 191, 213 N.W. 904 (1927); *State v. Heath*, 199 N.C. 135, 153 S.E. 855 (1930). See also *People v. Syde*, 37 Cal. 2d 765, 767, 235 P.2d 601, 602 (1951), in which the *Howey* test was applied to the term "interest in a profit-sharing agreement." Perhaps the most comprehensive of all applications of the *Howey* formula appears in *Sperry & Hutchinson Co. v. Hudson*, 190 Ore. 458, 469, 226 P.2d 501, 505 (1951): "The terms 'evidence of indebtedness,' 'certificate of interest or participation in any profit-sharing agreement,' and 'investment contract' as used in the act . . . contemplate the presence of the investment process, that is, 'the investment of funds . . . with a view of receiving a profit through the efforts of others . . .'"

18. *SEC v. Universal Serv. Ass'n*, 106 F.2d 232, 237 (7th Cir. 1939).

19. *Los Angeles Trust Deed & Mtg. Exch. v. SEC*, 285 F.2d 162, 168 (9th Cir. 1960) (original emphasis).

20. The "common enterprise" in *Joiner* is delineated in section II, B, 2, b, 2, *infra*.

21. See, e.g., cases as early as *Lewis v. Creasey Corp.*, 198 Ky. 409, 413-14, 248 S.W. 1046, 1048 (1923): "the investor will earn his profit through the efforts of others . . ."; and *State v. Whiteaker*, 118 Ore. 656, 660, 247 P. 1077, 1079 (1926); "with a view of receiving a profit through the efforts of others than the investor . . ."

A "security" has been issued when the purchaser invests his money in a common enterprise and is led to expect profits solely from the efforts of other persons.

B. An Analysis of the Howey Test with Explanations, Caveats, and Examples

To evaluate both the correctness and the feasibility of the "Howey test," it must be subjected to stress and critical analysis at every point.²² Each element will be examined and probed to understand its necessity in the overall definition.

1. THERE MUST BE AN "INVESTMENT OF MONEY"

The absence of this element produces two immediate results. First, the test becomes meaningless, since all that is left is "in a common enterprise with the expectation of profits to come solely from the efforts of others"; and second, if nothing is invested, nothing can be lost, and so the protection of the securities laws is not necessary.

If, however, instead of deleting this element, substitutions for it are made, serious problems arise. A few examples will serve to bring these difficulties to light.

a. The purchaser desires to buy a tract from the Howey Co., but he has no money. To pay for his purchase, he deeds his home to the seller.

This example substitutes an "investment of a valuable consideration" for an "investment of money." Certainly, this minor variation does not alter the basic economic relationships within the plan. As one court has stated, the construction of an "investment of money" to mean "anything of value or any consideration, including any benefit to the promisor or detriment to the promisee" . . . does no more than effectuate the intent of the *Howey* Court by adapting its investment contract definition to a much more sophisticated scheme, without at all changing its meaning."²³

b. The purchaser desires to purchase a tract from the Howey Co. but he lacks sufficient funds; so, he pays half in cash and transfers title to his car for the other half of the purchase price.

This is essentially the same as Example *a*, *supra*, except that it consists of an "investment of money" in addition to an investment of "other consideration." The economic plan remains unchanged.

c. The purchaser, a carpenter, desires to purchase a tract from the Howey Co. but he has no or insufficient funds. He pays

22. Such an analysis is probably undertaken by every fast operator who seeks to avoid the scope of *Howey*.

23. *Murphy v. Dare to Be Great, Inc.*, 3 BLUE SKY L. REP. ¶ 71,053, at 67,282 (D.C. Super. Ct. 1972).

whatever cash he has, and, additionally, does repair work on the home of the seller.

This example reveals an investment of *labor*, either in place of, or in addition to, money. The work done is in no way related to the income-producing enterprise. Thus, this investment of labor serves merely as a medium of exchange. The scheme remains unchanged, as this labor can be merged with whatever money was paid, being merely another type of consideration.

d. The purchaser desires to purchase a tract from the Howey Co., but he has insufficient funds and is required to come down to the orange groves and work.²⁴

This example raises serious problems. It reveals a potential conflict between an "investment of money" (or some other medium of exchange) and the expectation that profits will come "solely from the efforts of others." This conflict arises because the consideration invested—the labor—may be directly related to the production of income. The question of whether this labor is merely a consideration that can be merged with money invested will be resolved by focusing on the *nature* of the labor to be done. If the purchaser is merely sweeping the office floors, then certainly that labor can be merged; the situation would then be identical to that of a restaurant patron who pays his tab by washing dishes. But if the activities place the purchaser at the heart of the income-generating activities, the "merger" question cannot be resolved so easily without endangering the entire concept of a "security." Consider, for example, the economic relationships in a true partnership. Such a relationship gives the participants full access to all relevant information, as well as the right to a voice in the operation of the venture, and the protection of full disclosures is not needed. Such an economic relationship is clearly not a "security."²⁵ But if the efforts of one partner are "merged" with any investment of funds he might have made, it could be concluded that he is expecting profits "solely" from the remaining effort-exerters, his partners. Such a merger obviously distorts the economic realities of a partnership and serves no valid purpose.

The analysis of the sort of labor that can properly be merged is more properly conducted by the inquiry into the "solely from the efforts of others" element. At this point, then, the *Howey* test can be stated as follows:

A "security" has been issued when the purchaser invests his money (or other consideration that is acting merely as a medium

24. See, e.g., the various problems and results in *SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476 (9th Cir. 1973), *cert. denied*, 94 S. Ct. 117 (1973); *People v. Jacques*, 137 Cal. App. 2d 823, 291 P.2d 124 (1st Dist. 1955); *People v. Syde*, 37 Cal. 2d 765, 235 P.2d 601 (1951); *Austin v. Hallmark Oil Co.*, 21 Cal. 2d 718, 134 P.2d 777 (1943).

25. See, e.g., *Vincent v. Moench*, 473 F.2d 430 (10th Cir. 1973); *Moulin v. Der Zakarian*, 191 Cal. App. 2d 184, 12 Cal. Rptr. 572 (4th Dist. 1961); *Hanneman v. Gratz*, 170 Minn. 38, 211 N.W. 961 (1927).

of exchange) in a common enterprise and is led to expect profits solely from the efforts of other persons.

2. THERE MUST BE A "COMMON ENTERPRISE"

- a. A "common enterprise" is a result and not a cause; it occurs whenever the investor's control over his chances for success are diluted

The lack of a "common enterprise," as well as the absence of expectation of profit "solely from the effort of others," is the key to distinguishing an "investment" from an investment in "securities." All securities might represent an investment, but all investments are not "securities." As the court in an early Kentucky decision put it,

In one sense of the word every contract is an investment by the parties thereto. If A. buys an automobile from B., the former invests his money and procures the automobile, while the latter invests his automobile and procures in lieu thereof the purchase price. The same is true with reference to a contract involving the exchange of commodities, and the same may be truthfully said with reference to all sorts and kinds of contracts. Surely . . . the Legislature [did not intend] to vest the Banking Commissioner with supervision of all sorts of contracts, though involving the idea of investment²⁶

The following example illustrates the point:

X purchases Blackacre from Y. Y makes no representations as to the chances that Blackacre will increase in value. X's purchase is motivated by his own analysis of economic conditions in the area; he thinks it is a "good buy."

This purchase is an investment, but it certainly is not a "security."²⁷ It is true that the activities of other persons will determine the value of the purchase; but these others are the amorphous group known as "the market." In reality, there are two avenues to approach the "securities" issue here: either there is no "common enterprise" in which X is participating, or the "others" who will affect X's success are so remote that X is really relying upon his own skill in forecasting what the "others" will eventually do.

The term "common enterprise" has been frequently used without

26. *Lewis v. Creasey Corp.*, 198 Ky. 409, 415, 248 S.W. 1046, 1049 (1923). See also *Sinva, Inc. v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 253 F. Supp. 359, 367 (S.D.N.Y. 1966): "In a sense anyone who buys or sells a horse or an automobile hopes to realize a profitable 'investment.'"

27. See, e.g., SEC Securities Act Release No. 5347 (Jan. 10, 1973) (BNA SEC. REG. & L. REP., No. 184, D-1 (1973)), to the effect that the offer of real estate as such, without any collateral arrangements, does not involve the offer of a security. Some unsuccessful plaintiffs have contended differently. See, e.g., *In re McCormick's Estate*, 284 Ill. App. 543, 1 N.E.2d 769 (1936).

any explanation of what the term entails. Perhaps the best attempt to date has been that of the Ninth Circuit in *Los Angeles Trust Deed & Mortgage Exchange v. SEC*,²⁸ to the effect that there must be present a party in addition to the purchaser; that the extra party must have some economic interest in the subject matter of the scheme; and that the economic welfare of the participants is inextricably woven together.²⁹

The presence of other interested parties in the scheme is essential, because, as contrasted with the situation in the Example, *supra*, such presence diminishes the control that any one investor might retain over his chances for success. The existence of a "common enterprise" varies directly with the number of participants in the scheme. If the investor remains in control, there is no "common enterprise."³⁰ If there is no "common enterprise," the purchaser acquires the "power to exercise absolute dominion and control" over the purchase.³¹

b. Pooling—Discretionary accounts and condominiums

A pooling feature within a scheme is a sure sign of a "common enterprise."³² Pooling serves to diminish whatever control an investor might have had, and, as will be demonstrated, serves to distinguish a "security" from "an investment operated through an agent."

1. Discretionary accounts

Without doubt, a discretionary account with a broker involves an investment of money with an expectation that profits will come solely from the efforts of the broker. However, the courts that have dealt with these accounts have occasionally stumbled on the "common enterprise" element. The following examples will reveal the problems involved:

a. *X* places \$100 with *Y*, his broker. *Y* has the discretion to invest the money as he sees fit. *Y* is paid on a commission basis, *Y* provides similar services for other investors, but all such contracts are kept separate and distinct.

28. 285 F.2d 162 (9th Cir. 1960).

29. We find a "common enterprise" in which the appellants and the purchasers of second trust deed notes have an economic interest. We find that the economic welfare of the purchasers is inextricably woven with the ability of LATD to locate by the exercise of its independent judgment a sufficient number of discounted trust deeds, and the ability of LATD to subsequently meet its commitments

Id. at 172.

30. And, as will subsequently be shown, there is also no expectation that profits will result "solely from the efforts of others."

31. *Sinva, Inc. v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 253 F. Supp. 359, 366 (S.D.N.Y. 1966).

32. One of the indicia of a "security" has been stated to be the "commingling of payments made, where contributions of many persons are pooled in the operation of the enterprise and administered as a unit by the issuer." *SEC v. Timetrust, Inc.*, 28 F. Supp. 34, 39 (N.D. Cal. 1939).

b. *X* places \$50 with *Y*, his broker; *Y* adds \$50 of his own. *Y* has the discretion to invest the money as he sees fit. *X* and *Y* share in the profits.

c. *X* places \$100 with *Y*, his broker. *Y* has the discretion to invest the money as he sees fit. *Y* provides the same service for a number of other investors, combining the invested funds and investing for the benefit of all.

Example *a* causes the most problems, with the central dispute being over whether there exists a "common enterprise," or whether the scheme is merely an investment operated through an agent. *Maheu v. Reynolds & Co.*³³ involved a discretionary commodities account. Defendants argued that no "investment contract" existed, even though the account was managed and supervised by defendants in all respects, because defendant did not offer to large numbers of investors the "opportunity to invest in a pooled fund or common enterprise."³⁴ The court looked to *Howey* to see if pooling was essential and noted that in no instance had there been the sale of a right to share with others in the profits of land held in common with the *Howey* company or other purchasers. The *Maheu* court then concluded that the discretionary account, even without pooling, was a "security."³⁵

This analysis has a major flaw. It is true that in *Howey* the purchaser did not receive a share of the profits from the entire operation. But, while his income was determined by the output of his own tract, that produce was pooled for marketing by the *Howey* company. The profit to the investor was influenced to a large extent by the costs of the *Howey* operation, since "[s]uch tracts gain utility as citrus groves only when cultivated and developed as component parts of a larger area."³⁶ Certainly, if to the purchasers in *Howey* "individual development of the plots of land . . . would seldom be economically feasible due to their small size,"³⁷ the *Howey* company could not afford to care for each individual small parcel as a separate entity.

In effect, *Howey* represents a "securities" question in which the analysis turns to *agency* questions. A common enterprise exists when some other person has an interest in the operation, with a resulting diminution of the purchaser's control over his financial fortunes. But, if the other person in the scheme is merely the investor's agent, there is no such diminution since the agent is subject to the principal's control.³⁸

33. 282 F. Supp. 423 (S.D.N.Y. 1967).

34. *Id.* at 429.

35. For a similar analysis and result, see *Gould v. Barnes Brokerage Co.*, 345 F. Supp. 294 (N.D. Tex. 1972); *Berman v. Orimex Trading, Inc.*, 291 F. Supp. 701 (S.D.N.Y. 1968); *Oil Lease Serv., Inc. v. Stephenson*, 162 Cal. App. 2d 100, 327 P.2d 628 (1958). See also *Johns Hopkins Univ. v. Hutton*, 422 F.2d 1124 (4th Cir. 1970), in which apparently no "pooling" was involved.

36. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 300 (1946).

37. *Id.* at 300.

38. "Agency is the fiduciary relation which results from the manifestation of consent

If the Howey company were merely the agent of the investor, it could well be argued that no "security" existed,³⁹ but, in fact, whatever agency control might have existed in a purchaser of the tracts was diluted by the presence in the scheme of other "principals" to whom the "agent" was responsible. Thus, the "common enterprise" resulted from diminution of the principal-agent factor of control.

The Seventh Circuit picked up this line of analysis in *Milnarik v. M-S Commodities, Inc.*,⁴⁰ in which the plaintiff sought to rescind a discretionary trading account in commodities futures. The court found "the element of commonality"⁴¹ to be absent:

Although the complaint does allege that [defendant] entered into similar discretionary arrangements with other customers, the success or failure of those other contracts had no direct impact on the profitability of plaintiff's contract. [Defendant's] various customers were represented by a common agent, but they were not joint participants in the same investment enterprise.⁴²

....

"In essence this contract creates an agency-for-hire rather than constituting the sale of a unit of a larger enterprise. . . ."⁴³

The court concluded that "we do not believe an investor who grants discretionary authority to his broker thereby joins the broker's other customers in the kind of common enterprise that would convert the agency relationship into a statutory security."⁴⁴

While Example *a*, *supra*, raises serious problems, Examples *b* and *c* are much more easily resolved. Example *b* basically reflects the scheme

by one person to another that the other shall act on his behalf and subject to his control, and consent by the other to so act." RESTATEMENT (SECOND) OF AGENCY § 1(1), at 7 (1957).

Agents may be "servants"—whose physical activities are subject to control by the principal ("master")—or "non-servants"; some independent contractors are agents. Although their physical conduct is not subject to control by the principal, these agents owe duties to the principal even if he has contracted to permit the agent to exercise free discretion. *Id.* § 14(b) at 60. Typical of the "independent contractor" type of agent are the broker, the attorney-at-law, and the auctioneer. *Id.* § 1, comment *e* at 11.

39. There being no "common enterprise" or expectation of profits "solely from the efforts of others."

40. 457 F.2d 274 (7th Cir. 1972). For the same analysis (agency and not "security"), also see *Wasnowic v. Chicago Bd. of Trade*, 352 F. Supp. 1066 (M.D. Pa. 1972); *Dame v. Lee*, 180 Ga. 315, 178 S.E. 752 (1935).

41. *Milnarik v. M-S Commodities, Inc.*, 457 F.2d 274, 276 (7th Cir. 1972).

42. *Id.* at 276-77.

43. *Id.* at 277, quoting with approval *Milnarik v. M-S Commodities, Inc.*, 320 F. Supp. 1149, 1151 (N.D. Ill. 1970).

44. *Id.* at 279. See also *State v. Brill*, 3 BLUE SKY L. REP. ¶ 70,901 and ¶ 70,918 (Wis., Dane County Cir. Ct. 1971), in which defendant managed small parcels of land that had been sold to the public. As in *Howey*, the purchaser did not obtain a percentage of the entire operation; rather, defendant "managed the sum total of the properties for the benefit of all." *Id.* ¶ 70,918, at 67,115. And see an analogous scheme and result in *SEC v. Lake Havasu Estates*, 340 F. Supp. 1318 (D. Minn. 1972).

of *State v. Hofacre*.⁴⁵ In agency terms, this arrangement is classified as a "power coupled with an interest" or, as the *Restatement (Second) of Agency* puts it, a "power given as security."⁴⁶ In such a relationship, the principal's power to end the relationship is decreased.⁴⁷

Here the "common enterprise" is between the purchaser and the broker in his individual capacity. The broker, as agent, is responsible to more than one principal. Thus, the purchaser's control is diminished and his important power of termination is restricted: with the diminution of control comes the "common enterprise," and the "security" is much easier to find.

Example *c* reveals how, through a slight alteration of the economic relationships within a given scheme, a mere agency can be converted into something akin to an interest in a mutual fund.⁴⁸ In a similar situation, the court in *SEC v. Wickham*,⁴⁹ which involved a commingled fund arrangement, raised this example:

If we assume, for instance, that a race track habitue invites the public to pool its funds with him, and, in return for the various sums deposited, he issues a certificate entitling each holder to participate proportionately in the earnings that may result from his wagers with such money by reason of his knowledge, experience, and possible inside tips on horse races, it would not seem that one would have any difficulty in characterizing such transaction as the issuance of an investment contract, or as a participation in a profit-sharing agreement . . .⁵⁰

The presence in the scheme of other "principals" to whom the agent is accountable diminishes the control any one investor might have over his fortunes. A "security" results.

2. Condominiums

The presence of "security" problems involving condominium units was perhaps inadvertently predicted by the Supreme Court of Maine, when, in an early decision, it stated that the Blue Sky Law was designed to prevent swindles promising to "sell building lots in the blue sky in fee simple."⁵¹ The SEC has stated its views⁵² on the applicability of the federal acts to offers and sales of condominiums or units in real estate developments. Dealing mainly with condominium promotions, the Com-

45. 206 Minn. 167, 288 N.W. 13 (1939).

46. RESTATEMENT (SECOND) OF AGENCY § 138, at 339 (1957).

47. *Id.* § 139.

48. See generally *Investment Co. Inst. v. Camp*, 274 F. Supp. 624 (D.D.C. 1967), *rev'd*, 420 F.2d 83 (D.C. Cir. 1969), *rev'd*, 401 U.S. 617 (1970).

49. 12 F. Supp. 245 (D. Minn. 1935). See also *Anderson v. Francis I. duPont & Co.*, 291 F. Supp. 705 (D. Minn. 1968).

50. *SEC v. Wickham*, 12 F. Supp. 245, 248 (D. Minn. 1935).

51. *State v. Cushing*, 137 Me. 112, 115, 15 A.2d 740, 743 (1940).

52. SEC Securities Act Release No. 5347 (Jan. 10, 1973) (BNA SEC. REG. & L. REP., No. 184, D-1 (1973)).

mission raised three possible schemes, all of which must be analyzed in light of the "common enterprise" and "agency" problems raised in the "discretionary account" cases.

The first scheme involves the offer and sale of condominiums accompanied by a *rental arrangement*, where the emphasis is on the economic benefits that might accrue to the purchaser from the efforts of the promoter or a third party. In this type of promotion, the purchaser is told that he can arrange to have his unit managed and rented to others by some party, who is either the promoter or is "designated or arranged for by the promoter."

The Commission's contention is that by requiring the purchaser to utilize the efforts of a *particular* rental service, an investment contract results. This contention requires a greater depth of analysis. If there is no "common enterprise," then the situation resembles *Milnarik*, in which it was pointed out that even though several parties utilized the same agent, there was no relationship between the investments of the various participants. A "common enterprise" could well be developed along these lines: Proof should be adduced to the effect that the servicing of an individual unit is economically unfeasible; that it is essential to a successful venture to have a particular rental service so that access can be obtained not only to the common areas but also to the various units themselves, so that the entire operation can be run to the benefit of all. In short, the scheme must be revealed to be analogous to *Howey*, where the profits are directly related to operational costs and operational costs are minimized through efficient "cultivation" of the realty as a single unit. Such proof would serve to diffuse any "agency" control by the purchaser and would give life to a "common enterprise."

The Commission's second example involves the sale of a condominium coupled with participation in a pooling arrangement. Here, the purchaser actually occupies his unit; but on occasions when he will be away from the premises for an appreciable period of time, he contributes his unit to the pool of vacant units that are available to be leased to others. A management company operates the leasing operation and the unit owners share in the profits, usually apportioned by the number of hours that their particular unit was available in the pool, regardless of whether it was actually rented. The "common enterprise" is much clearer here and a "security" exists.

The third example offered by the Commission involves the sale of a condominium coupled with a condition that the purchaser must hold his unit available for rental for a designated period, or must use an exclusive rental agent. The mandatory requirements of such a plan tend to create a "common enterprise." The utilization of a rental agent could be viewed merely as a manifestation of individual control that accompanies ownership of a unit, but where the exercise of free choice is abolished and an exclusive agent is appointed by the vendor, it becomes more apparent

that the entire operation will be conducted for the benefit of all, and something other than a mere agency results.

The Commission concluded its analysis by stating that no "security" will be involved if, after purchasing his unit, the owner enters into a non-pooled rental arrangement with an agent neither designated nor required to be used as a condition to the purchase, whether or not such agent is affiliated with the seller. This conclusion recognizes that an investment operated through an agent, when the principal's control is not diluted in some manner, is not an investment in a "security."

Therefore, in discretionary account cases as well as in condominium cases, the problem that is troubling—or should be troubling—the courts is whether the investor has given up control over his chances for success. Findings of fact as to the terms of the "agency" should be crucial. A broker, for example, is recognized as the type of agent denominated as an "independent contractor."⁵³ While the principal-investor may not have control over the physical activities of the agent,⁵⁴ other circumstances could reveal ultimate agency control. Additionally, in a situation in which the investor turns over control to the broker, the act of turning over discretion can be viewed as an exercise of the control vested in the principal.⁵⁵

Of great aid to the courts has been the factor of the size of the interest conveyed. The fact that the interest conveyed is incapable of individual exploitation is an excellent clue that the purchaser is looking forward to participating in a common enterprise. The factor of impossibility of individual exploitation will defeat an "agency" argument; for if any effort to exploit the asset would be fruitless, it is difficult to see why an "agent" would assume the task. In *Howey*, because the transferred tracts were incapable of individual exploitation, the purchasers looked forward to sharing in the prosperity produced by the entire grove operation. The same aspect shows up in *Joiner*-type operations. A *Joiner* operation utilizes a step-transaction to disguise the "common enterprise." First, the purchasers buy small parcels near the drill site. These parcels—either the land itself, or mineral leases—are too small to be exploited individually. Step two reveals the obvious intent of the parties: When a well is drilled, the parcel owners exchange their holdings for a royalty interest in the well.⁵⁶ In *Moore v. Stella*,⁵⁷ for example, defendant sold the mineral rights to small parcels in a wilderness of undeveloped and unproven acreage. The court focused on the real issue quite accurately, noting that the question was

53. RESTATEMENT (SECOND) OF AGENCY § 1, comment *e* (1957).

54. *Id.* § 2.

55. See a similar successful argument in *Moulin v. Der Zakarian*, 191 Cal. App. 2d 184, 12 Cal. Rptr. 572 (4th Dist. 1961). See also RESTATEMENT (SECOND) OF AGENCY §§ 146, 425 (1957).

56. And hence the "common enterprise" comes into view. As one court has put it, "the deed is a mere disguise." *People v. Daniels*, 25 Cal. App. 2d 64, 69, 76 P.2d 556, 558 (2d Dist. 1938).

57. 52 Cal. App. 2d 766, 127 P.2d 300 (2d Dist. 1942).

whether, in practical effect, the scheme under which the deeds were given contemplated and involved investment by the purchasers in an enterprise or venture conducted by others for earnings and profits or, more specifically, whether investors were led to part with their money upon the promise and in the expectation that they would be able at some future time to lease their interests to some oil company upon a royalty basis⁵⁸

Promoters have tried to build a record through ploys such as giving the grantee rights of ingress and egress for drilling or mining.⁵⁹ This tactic is designed to create a facade that individual exploitation is possible, and that no participation in a "common enterprise" is anticipated. But if the units are too small, this extra gift will be disregarded and the obvious intent of the parties will prevail.⁶⁰

The "lack of expertise" on the part of the purchasers is another evidentiary feature that is probative of whether the parties intended to transfer an interest in a "common enterprise." If the purchaser knows nothing about raising oranges or drilling oil wells, a presumption that the parties were contemplating an interest in a "common enterprise" should arise. However, this factor should be subordinated in weight to the presumptions arising from the physical characteristics of the unit. A purchaser may be ignorant about drilling wells, but, if the parcel conveyed is capable of exploitation, the purchaser might well hire agents to exploit it for him. Since no other parcels would be necessary, no "common enterprise" would exist, and the purchaser would retain control over his chances through his "principal-agent" powers.

At this point it should be apparent that all of the characteristics of a "common enterprise" could easily be integrated into the element of expecting profits "solely from the efforts of others." If there is no "common enterprise," the purchaser must look to his own efforts, or the efforts of his agents, and, in actuality, he is relying on himself. If the parcel is incapable of individual exploitation, the purchaser envisions reliance on the efforts of others, as well as participation in a "common enterprise." One court has equated these two elements by stating that since the facts of the case showed that reliance upon the efforts of others was "unjustified and unreasonable," there were no elements of a "common enterprise" present.⁶¹

It seems to make no difference whether the "control" question is approached from the "common enterprise" path or through the avenue of "expecting profits solely from the efforts of others." In either approach, the emphasis must be on whether the investor loses control. The lower court in *Investment Co. Institute v. Camp*,⁶² explained the essence of

58. *Id.* at 771-72, 127 P.2d at 302.

59. *See, e.g.,* *People v. Jackson*, 24 Cal. App. 2d 182, 74 P.2d 1085 (1st Dist. 1938).

60. *Id.*; *People v. Leach*, 106 Cal. App. 442, 290 P. 131 (2d Dist. 1930).

61. *Darwin v. Jess Hickey Oil Corp.*, 153 F. Supp. 667, 672 (N.D. Tex. 1957).

62. 274 F. Supp. 624 (D.D.C. 1967), *rev'd*, 420 F.2d 83 (D.C. Cir. 1969), *rev'd*, 401 U.S. 617 (1970).

Howey: "[W]henever an investor relinquishes control over his funds and submits their control to another for the purpose and hopeful expectation of deriving profits therefrom he is in fact investing his funds in a security."⁶³

At this point, then, *Howey* can be restated as follows:

A "security" has been issued when the purchaser invests his money (or other consideration that is acting merely as a medium of exchange) in a common enterprise in which others have an interest in the subject matter so that the purchaser's principal-agent control is diluted, and is led to expect profits solely from the efforts of other persons.

3. THERE MUST BE AN "EXPECTATION OF PROFIT"

The importance of this element is that it serves to distinguish situations in which one purchases an interest in a profit-generating enterprise from situations in which one purchases *for his own consumption*. The key is that if one takes possession and exploits his purchase, then any profits that eventually accrue will be due to his own efforts. He will remain in control of his chances for success. "Expectation of profit" problems are found most often in cases involving real estate interests, usually in the nature of housing units or cemetery plots.

*Hacker v. Goldberg*⁶⁴ states the general rule. There, the purchaser bought a membership in a country club which entitled him only to the use of the facilities; he was in no way entitled to dividends or profits, or anything above the *quid pro quo* of his money for his enjoyment of the premises. No "security" was found:

We think the act intended to prohibit the sale unless its provisions were complied with, of securities from which income or profit was expected to be derived . . . and not for an interest in a club from which no financial profit or income could be derived⁶⁵

The New Jersey decision in *Maplewood Village Tenants Ass'n v. Maplewood Village*,⁶⁶ states the reason behind the general rule:

To place the purchaser of an apartment, made for the purpose of serving as a personal residence, within the coverage of the act would be illogical. The reasoning is that there is no entrusting of investment capital to a third party for the purpose of management or investment thereof, for the purpose of income generation or capital gain. When purchasing a condominium the buyer

63. *Investment Co. Inst. v. Camp*, 274 F. Supp. 624, 642 (D.D.C. 1967), *rev'd*, 420 F.2d 83 (D.C. Cir. 1969), *rev'd*, 401 U.S. 617 (1970).

64. 263 Ill. App. 73 (1931).

65. *Id.* at 76-77.

66. 116 N.J. Super. 358, 282 A.2d 428 (Ch. 1971).

is afforded personal control of his investment, as opposed to the securities investor whose investment may be controlled by third parties⁶⁷

Although some plaintiffs have vainly tried to have the ordinary installment land sales contract construed as a "security,"⁶⁸ "[t]he offer of real estate, as such, without any collateral arrangements with the Seller or others, does not involve the offer of a security."⁶⁹ It is the "collateral arrangement" which creates the "security." Thus, a unit in a cooperative apartment, when purchased for actual occupancy, does not involve the sale of a security.⁷⁰ In sharp contrast to the "actual occupancy" cases are schemes such as the one involved in *Sire Plan Portfolios v. Carpentier*.⁷¹ There, the seller purchased an apartment building in New York City and offered 280 "units of ownership." The seller would conduct the operations of the enterprise, with profits distributed pro rata to the owners. The "units" clearly were evidences of an interest in a "common enterprise" run by the seller, and were, therefore, "securities."⁷²

Cemetery plots present more difficult problems, since the dissatisfied plaintiff usually has not yet taken occupancy. In the housing unit cases, generally the presence or absence of a lease or actual occupancy is of evidentiary value. But with cemetery lots, the parties' intent must be determined from other indicia. The courts give special scrutiny to the presence of bulk purchases and representations that the purchase will appreciate in value. Thus, in *State v. Lorentz*,⁷³ where some purchasers bought over 100 lots, the court concluded that "[i]t is evident from the number of burial lots sold to different purchasers that they were not sold or purchased primarily for burial purposes of the buyer or his family. . . . They were purchased for resale."⁷⁴ But the absence of volume purchases can dictate an opposite result.⁷⁵

This sort of analysis—based on the intent of the purchaser—does not even come into play under the theory in *Holloway v. Thompson*.⁷⁶ The court there stated:

The owner of a cemetery lot is in a somewhat different position than the owner of an ordinary parcel of real estate. . . . [H]is

67. *Id.* at 379, 282 A.2d at 432.

68. *See, e.g., In re McCormick's Estate*, 284 Ill. App. 543, 1 N.E.2d 769 (1936).

69. SEC Securities Act Release No. 5347 (Jan. 10, 1973) (BNA SEC. REC. & L. REP. No. 184, D-1 (1973)); but see the discussion of cemetery plots *infra*, this section.

70. *See, e.g., State v. Hirsch*, 101 Ohio App. 425, 131 N.E.2d 419 (1956); *State v. Silverberg*, 166 Ohio St. 101, 139 N.E.2d 342 (1956); *Brothers v. McMahon*, 351 Ill. App. 321, 115 N.E.2d 116 (1953).

71. 8 Ill. App. 2d 354, 132 N.E.2d 78 (1956).

72. *See also Foreman v. Holsman*, 10 Ill. 2d 551, 141 N.E.2d 31 (1957).

73. 221 Minn. 366, 22 N.W.2d 313 (1946).

74. *Id.* at 368, 22 N.W.2d at 314.

75. *See, e.g., Memorial Gardens v. Love*, 5 Utah 2d 270, 300 P.2d 628 (1956).

76. 112 Ind. App. 229, 42 N.E.2d 421 (1942).

relation to the corporation having supervision over the cemetery is in many respects that of corporation and shareholder, the interest . . . being represented by lots instead of stock.⁷⁷

Under this theory, then, even the absence of bulk purchases would not be decisive; the single-lot purchasers would merely be minority shareholders. At a total variance with the theory is the dissent in *State v. Lorentz*,⁷⁸ which emphasized the lack of profit-sharing and in essence found *no* interest in an enterprise to exist.

The crucial factor appears to be a dispute over the services that will be rendered by the cemetery corporation. The care and maintenance can be viewed either as the normal duties necessary to create a proper atmosphere for the final resting place, or they can be viewed as the "collateral arrangement" that usually changes a purchase of realty into a security transaction. The problem is that *no one ever buys a cemetery plot without the arrangements that the cemetery will be kept in proper condition*. Thus, it must be determined whether something *beyond* the usual collateral arrangements has been sold. This, in turn, returns us to the representations that have been made. For example, the normal incidents, when coupled with a *promise to resell* the plot at a profit to the purchaser, tend to create a "security."⁷⁹ Similarly, inducements based on a resale market will cause the transaction to fall within the scope of the securities acts.⁸⁰

In short, then, the *normal incidents* to the purchase of a cemetery lot should not convert a purchase of realty into a "security," for even if the vendor's efforts in maintaining the cemetery do cause appreciation in value, the purchaser has not entrusted his funds in order to obtain such appreciation. He has entrusted his funds in order to procure the services, and not the profit that happens to accrue; he expects nothing beyond *quid pro quo*, his money for land and maintenance. Services or representation *beyond* the normal will indicate that the purchaser has entrusted his funds *not* for the services but for the profit that will accrue from the services.

Therefore, the prudent counselor involved in this area would do well to advise against a sales plan based on profit-expectation. Also, such an approach will most likely serve to discourage bulk purchases, as well as the chances of coming within the coverage of the securities acts.

4. THERE MUST BE AN EXPECTATION THAT PROFITS WILL RESULT "SOLELY FROM THE EFFORTS OF OTHERS"

a. Why "solely"? Partnerships and joint ventures

The "solely" requirement is the key to understanding exactly what type of animal is involved in a "security." A "security" is merely a varia-

77. *Id.* at 239, 42 N.E.2d at 425.

78. 221 Minn. 366, 374, 22 N.W.2d 313, 316 (1946) (dissenting opinion).

79. *See, e.g., State v. Cushing*, 137 Me. 112, 15 A.2d 740 (1940).

80. *See, e.g., In re Waldstein*, 160 Misc. 763, 291 N.Y.S. 697 (Sup. Ct. 1936).

tion of other possible types of business arrangements. It is an economic relationship between the parties, and, as such, has its own parameters and identifying characteristics, as do all of the other types of business relationships. As was demonstrated in the discussion involving the "common enterprise," an agency relationship can be transformed into a "security" relationship by adjusting the variables involved. The same process can occur with other business arrangements.

A true partnership interest can never be a "security."⁸¹ The reason is clear: a true partner retains some control over his chances for success. The same is true of a joint adventure:

In such situations, the member of the enterprise pools his money with that of others in the group; he has an equal right of control over the project and the opportunity and right to know what is going on. Because of this, the protection of the full disclosure offered by registration is not needed as it is in cases involving a non-participating investor.⁸²

The problems arise, of course, in piercing form to get to the substance. It is clear that a partnership interest that does not convey some control over the investor's chances for success will come within the coverage of the acts. One well reasoned test requires participation by all, sharing of profits and losses, and a community of interest in the control of partnership affairs.⁸³

Limited partnership interests have come under heavy attack.⁸⁴ A "true" limited partnership interest is not a "security."⁸⁵ The problem, once again, is to determine what characteristics of control the general partner must surrender. Some jurisdictions require, in addition to the right to participate in the conduct of the enterprise, that the element of mutual selection of partners (*delectus personarum*) exist, so that interests

81. See, e.g., *Vincent v. Moench*, 473 F.2d 430 (10th Cir. 1973); *Moulin v. Der Zakarian*, 191 Cal. App. 2d 184, 12 Cal. Rptr. 572 (4th Dist. 1961); *Hanneman v. Gratz*, 170 Minn. 38, 211 N.W. 961 (1927).

82. *Polikoff v. Levy*, 55 Ill. App. 2d 229, 234, 204 N.E.2d 807, 809 (1965). See also *People v. Jacques*, 137 Cal. App. 2d 823, 291 P.2d 124 (1st Dist. 1955); *Osuna v. Russell*, 176 Cal. App. 2d 92, 1 Cal. Rptr. 289 (4th Dist. 1959).

83. *Moulin v. Der Zakarian*, 191 Cal. App. 2d 184, 12 Cal. Rptr. 572 (4th Dist. 1961).

84. This is especially true in real estate syndications. See, e.g., *Rivlin v. Levine*, 195 Cal. App. 2d 13, 15 Cal. Rptr. 587 (2d Dist. 1961); *Curtis v. Johnson*, 92 Ill. App. 2d 141, 234 N.E.2d 566 (1968); *Polikoff v. Levy*, 55 Ill. App. 2d 229, 204 N.E.2d 807 (1965) (real estate joint venture); *Conroy v. Schultz*, 80 N.J. Super. 443, 194 A.2d 20 (Ch. 1963).

85. See, e.g., *Farnsworth v. Nevada-Cal Mgmt., Ltd.*, 188 Cal. App. 2d 382, 10 Cal. Rptr. 531 (2d Dist. 1961); *Garbo v. Hilleary Franchise Sys., Inc.*, 479 S.W.2d 491 (Mo. Ct. App. 1972). Even these results are cast in doubt by section 7 of the UNIFORM LIMITED PARTNERSHIP ACT, which provides that a limited partner who takes part in the control of the business will be liable as a general partner. While an interest represented by such a position might not be a "security," under the definition of this Act a true limited partnership must be "security" since, as such, the limited partner is excluded from participation. It could be contended, however, that the other sections of the Act that give the right of full access and disclosure to limited partners remove such an interest from the provisions of the securities acts. See, e.g., FLA. STAT. §§ 620.07, .10 (1971).

are not indiscriminately and widely offered.⁸⁶ Inactive limited partnership interests are almost certain to come within the purview of the acts.⁸⁷

Interests in a "joint venture" are argued along the same lines as partnership interests:

It is said . . . that such an enterprise differs from a partnership because it relates only to a single transaction. . . . There must be . . . a community of interest as well as some control over the subject matter⁸⁸

The key, then, is to keep some "measure of control in the hands of the members."⁸⁹ Of evidentiary value is the presence or absence of active participation and knowledge or lack of knowledge about the subject matter.⁹⁰ However, in the area of *delectus personarum*, one prominent case has applied a standard that is far less stringent than that applied to partnership interests: "[T]he fact that the plaintiff did not know the identity of or formally approve the admission of members to the venture after he joined it, does not preclude the existence of a joint venture."⁹¹

Therefore, the "solely" requirement serves the same purpose as the "common enterprise" element: When the investor retains some degree of control over his chances for success, the economic relationship is something other than a "security."

b. *Who* are the others from whom profits are to come?

As was discussed in the "common enterprise" section,⁹² if the "others" are mere agents there is no loss of control, and hence no "security." But what if the "others" are not the promoters of the scheme? The following examples will serve to illustrate this area:

86. See, e.g., *Rivlin v. Levine*, 195 Cal. App. 2d 13, 15 Cal. Rptr. 587 (2d Dist. 1961); *Farnsworth v. Nevada-Cal Mgmt., Ltd.*, 188 Cal. App. 2d 382, 10 Cal. Rptr. 531 (2d Dist. 1961).

87. See, e.g., *People v. Rankin*, 160 Cal. App. 2d 93, 325 P.2d 10 (2d Dist. 1958); *People v. Hoshor*, 92 Cal. App. 2d 250, 206 P.2d 882 (2d Dist. 1949); *People v. Woodson*, 78 Cal. App. 2d 132, 177 P.2d 586 (2d Dist. 1947); *People v. Dutton*, 41 Cal. App. 2d 866, 107 P.2d 937 (2d Dist. 1940); *Curtis v. Johnson*, 92 Ill. App. 2d 141, 234 N.E.2d 566 (1968); *Conroy v. Schultz*, 80 N.J. Super. 443, 194 A.2d 20 (Ch. 1963).

88. *Hathaway v. Porter Royalty Pool, Inc.*, 296 Mich. 90, 102, 295 N.W. 571, 576 (1941). See also *Grabendike v. Adix*, 335 Mich. 128, 55 N.W.2d 761 (1952), utilizing a test of sharing of profits and losses, contribution by all to a common undertaking, and a community of interest in and control over the subject matter; and *Brown v. Cole*, 155 Tex. 624, 291 S.W.2d 704 (1956), relying on community of interest, participation, and joint control of the enterprise.

89. *Hathaway v. Porter Royalty Pool, Inc.*, 296 Mich. 90, 104, 295 N.W. 571, 577 (1941). See also *Polk v. Chandler*, 276 Mich. 527, 268 N.W. 732 (1936).

90. See, e.g., *Goldberg v. Paramount Oil Co.*, 143 Cal. App. 2d 215, 300 P.2d 329 (2d Dist. 1956) (alleged joint venturers had total lack of knowledge about oil operations). But see *People v. Miller*, 192 Cal. App. 2d 414, 13 Cal. Rptr. 260 (2d Dist. 1961), and *Oakley v. Rosen*, 76 Cal. App. 2d 310, 173 P.2d 55 (2d Dist. 1946), a pair of California decisions in which a "joint venture" claim received more credit than probably was due.

91. *Polikoff v. Levy*, 55 Ill. App. 2d 229, 235, 204 N.E.2d 807, 810 (1965).

92. Section II, B, 2 *supra*.

a. *X* purchases Blackacre from *Y*. *Y* makes no representations as to the chances that Blackacre will increase in value. *X*'s purchase is motivated by his own analysis of economic conditions in the area; he thinks it is a "good buy" and will appreciate in value even if he makes no improvements on the premises.

b. *X* buys a small parcel of land from *Y*. *Y* states that an oil well may be drilled by *Z* on some adjacent property in the near future. *Y* has no control over *Z*.

Example *a* will not give rise to a "security." Although *X* will receive a profit when the land appreciates in value, and this increase will result from the efforts and activities of "others," the "others" are the amorphous entity that we might label as "the market." Economic factors throughout the country may be responsible for *X*'s profit. His profit will result from the activities of unknown and unpredictable persons. In reality, *X* will profit, if at all, from his own efforts in reading the market conditions. Thus, he is relying on himself, and not on "others," for a successful investment; for the same reason, there is no "common enterprise."

As the "others" from whom profits are to result become more discernible, the chances of a finding of a "security" increase. Example *b* touches on some of these problems. As a starting point, the language in *Joiner* is helpful. In describing the sale of the small parcels there involved, where the well was to be drilled by the issuer, the Court noted that "the drilling of this well was not an unconnected or uncontrolled phenomenon to which salesman pointed merely to show the possibilities of the offered leases."⁹³ This hint—that "unconnected or uncontrolled others" will not give rise to a "security"—has been severely curtailed. As the court stated in *Roe v. United States*:⁹⁴

In *Howey* the element of expectation of "profits solely from the efforts of the promoter or a third party" . . . certainly overcomes any imputation that language in *Joiner* that the "drilling of this well was not an unconnected or uncontrolled phenomenon" etc. meant to require that the collateral activity be that of the seller or one under his control.⁹⁵

93. *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 348 (1943).

94. 287 F.2d 435 (5th Cir. 1961).

95. *Id.* at 439 n.5. See also *Continental Marketing Corp. v. SEC*, 387 F.2d 466 (10th Cir. 1967); *Craft v. Brooks*, 204 Cal. App. 2d 187, 191-92, 22 Cal. Rptr. 68, 71 (2d Dist. 1962):

The adjudged cases have given the phrase "from activities of other persons" a broad meaning and application extending to situations in which the buyer of the oil interest expected to reap his reward through participating in the excitement arising from bringing in a wildcat well upon property in the general area, especially upon an adjacent parcel.

See also *SEC v. Orange Grove Tracts*, 210 F. Supp. 81, 83 (D. Mass. 1962): "The fact that that third party may be legally distinct from the defendants does not bring the activity outside the coverage of Section 5(a)."

Some courts have taken a stricter view. For example, in *Union Land Associates v. Ussher*,⁹⁶ the purchaser of oyster beds was told that he *could* become a member of an oyster cooperative which would market the oysters. The seller had no connection at all with the cooperative:

In the instant case there was no sale of any security or "investment contract" within the meaning of the act. There was no obligation on the part of the plaintiff vendor to do anything under the contract other than deliver the deed upon payment of the purchase price. Neither was the contract of purchase connected with any promotion scheme involving the sharing of expected profits. . . . Here the vendor had nothing whatever to do with the cultivation, harvesting, or sale of oysters.⁹⁷

What this problem of "connection with the seller" really means is this: If the enterprise is connected with, or conducted by, the issuer, he has sold an interest in his own venture. If the enterprise is not to be conducted or controlled by the seller, he is merely *selling securities in someone else's venture*. So the problem of "connection" is not crucial; the real problem is whether or not what is sold is a "security"—and that determination returns us once again to evidentiary characteristics such as economic feasibility of individual exploitation. For example, if the oyster beds in *Ussher* were incapable of individual exploitation, it could well be argued that the bed was merely a disguise for an interest in the marketing operation—a "security" in the venture of someone other than the seller. But if the beds were capable of individual exploitation, the act of turning them over to the marketing service would merely be a manifestation of individual control and decision-making.

There are, therefore, several evidentiary characteristics at play in the area of "others" being in some "connection with the seller." If the "others" are not presently visible or reasonably predictable,⁹⁸ and, therefore, not connected with the seller, a presumption may arise that the purchaser is relying on his own forecasting skills. If the "others" are in existence, a presumption might arise that the purchaser is relying on them for his profit, whether or not the "others" are related to or connected with the seller. But both of these presumptions may be overcome by the *nature* of the interest conveyed. If the transferred asset is incapable of individual exploitation, "securities" have been sold even if the "others" are not in existence.⁹⁹ If the interest could be individually exploited, "securities" may not have been sold, depending on other representations, even if the "others" are connected with the seller.

96. 174 Ore. 453, 149 P.2d 568 (1944).

97. *Id.* at 458, 149 P.2d at 570.

98. In *Darwin v. Jess Hickey Oil Corp.*, 153 F. Supp. 667 (N.D. Tex. 1957), the seller made no collateral promise. "Reliance upon the efforts of others . . . was unjustified and unreasonable," so no "securities" were sold. *Id.* at 672.

99. *See, e.g.*, *Moore v. Stella*, 52 Cal. App. 2d 792, 127 P.2d 300 (2d Dist. 1942); *People v. Daniels*, 25 Cal. App. 2d 64, 76 P.2d 556 (2d Dist. 1938).

c. What kind of efforts?

This area presents the most intriguing problems of all and returns us full circle to the "investment of money" problem.¹⁰⁰ Basically, the problem, as stated in that section, was to determine what sort of efforts could properly be "merged" with invested funds, so as to result in a "solely from the efforts of others" plan, without unnecessarily confusing the realities of the "security" relationship.

The example posed in section II, B, 1, *supra*, was this:

d. The purchaser desires to purchase a tract from the Howey Co., but he has insufficient funds and is required to come down to the orange groves and work.

The problem, of course, is whether the work that is done can be merged as "additional consideration," or whether it is of the type of "effort" that prevents a "security" from existing. Basically, there are three major types of "efforts" that can be involved in a given scheme. The first type may be labeled a "sham" or "condition precedent" type of effort. An example of this type of effort is where the purchaser must perform a task such as "solving a puzzle or writing an essay."¹⁰¹ The following example is illustrative:

X purchases a 10% interest in the profits of the Howey Co. citrus operation; but in order to receive the proceeds of his interest, he must run a four-minute mile.

This example reveals one important premise: "Profits solely from the efforts of others" means profits *to the venture* in which the interest has been sold and not necessarily profits *to the investor*. Here, the investor cannot receive any money without "working"; but no one would contend that this condition precedent makes his 10% interest something other than a security. The key is that he is not being paid for running the mile; rather, he can realize a profit only if the individuals who are to produce the fund—those responsible for running the citrus grove—operate in a successful manner. A "sham" or "condition precedent" effort is totally unrelated to the profit-generating functions of the enterprise from which profits are to come and in which the purchaser has invested. Therefore, this sort of activity cannot serve to give any control over his financial fortunes to the investor. Even if he breaks the world record in the mile run, or runs hundreds of miles, his interest is in the grove; if that operation does not prosper, he will receive nothing. This type of effort can properly be merged with money invested, or it can be disregarded entirely.

The second type of "effort" that might be involved in a program

100. See section II, B, 1 *supra*.

101. SEC v. Glenn W. Turner Enterprises, Inc., 348 F. Supp. 766, 775 (D. Ore. 1972), *aff'd*, 474 F.2d 476 (9th Cir.), *cert. denied*, 94 S. Ct. 117 (1973).

can be labeled a "consideration effort." A "consideration effort" would be similar to the following example:

X purchases a 10% interest in the Howey Co. operations, paying partly in cash and partly by rendering personal services to the president of the company; the services are unrelated to the venture.

When the "consideration" efforts are unrelated to income production, they cannot confer upon the investor any control over his chances for success. Thus, they can properly be merged. However, the more closely related the efforts are to the activities of the venture, the closer the "securities" question becomes. Consider the following:

X purchases a 10% interest in the Howey Co. enterprise. He pays partly in cash, and partly by rendering labor in the field. An employee of the Howey Co. supervises him constantly, telling him where to dig, how to plant, and how to cultivate.

This example raises the crucial question of *independence*. Because the purchaser here has a position in the enterprise, it might be contended that the "solely from the efforts of others" test is avoided; but, since the investor's efforts are totally directed by the seller, they cannot be the sort of efforts that give the purchaser some control over his financial fortunes. The success of his agricultural efforts is dependent upon the quality of the instructions and supervision supplied by the seller.¹⁰² This "dependent" effort can properly be merged as "additional consideration" and the interest is still a "security."

The third type of effort that may be involved may be labeled "independent income-producing efforts."¹⁰³ This type of effort *cannot* be merged with money paid in and treated as just another form of consideration; to do so distorts the concept as well as the purpose of the act. As was pointed out in Section II, B, 1, d, *supra*, merger of this sort of activity could cast even true partnerships into the shadow of the acts. If the purchaser is independently, inherently and inextricably caught up in the income-producing activities of an enterprise so that he retains some control over his chances for a successful investment, something other than a "security" results.¹⁰⁴ *Howey* recognizes this analysis when it states that "*profits*" are to come "solely from the efforts of others."

102. This is not to say that independent operators cannot be trained by the seller prior to becoming independent. See, e.g., *Goldsmith v. American Food Serv., Inc.*, 123 Ga. App. 353, 181 S.E.2d 95 (1971).

103. A fourth possible type of effort might be one for which the investor receives an entirely independent compensation, such as an employee's stock option plan, or the plan in *State v. Bushard*, 164 Minn. 455, 205 N.W. 370 (1925). There, the investor received a share in the profits of the business and also obtained employment as a bus driver, for which he received wages. Similarly, in *People v. Woodson*, 78 Cal. App. 2d 132, 177 P.2d 586 (2d Dist. 1947), defendant sold fractional interests in a ranching operation, and the investors received employment on the ranch for a separate and distinct wage.

104. One court has made this point quite succinctly: "Participation on the part of an

d. Franchises, distributorships, and referral-sales marketing plans—selling the right to sell

Franchises, distributorships, and referral-sales plans all have one element in common: they spread the risk of a successful investment over two parties. In the typical “securities” relationship, one person—either the issuer or the third party who is to “drill the well”—bears all of the responsibility for success. Hence, profits are dependent “solely on the efforts” of someone other than the investor. In a franchise, distributorship, or referral-sales program, however, the responsibility for success is spread between the parent (franchisor) and the investor.

[a] “franchise” . . . has been defined as a contract by which a person who desires to operate a business, the franchisee, obtains from a business organization, the franchisor, the right to use a trademark or trade name owned by the franchisor, and agrees to operate his business in accordance with a uniform plan of operation prescribed by the franchisor.¹⁰⁵

It is apparent that the franchisee is dependent in a significant manner upon the success of the franchisor. A Ford dealership would certainly be in severe trouble, regardless of how hard the individual distributor worked, if Ford Motor Co. failed. On the other hand, if the franchisee does not operate properly, his individual enterprise will fail in spite of the success of the franchisor.

The “inactive” distributor or franchisee presents the fewest problems. *United States v. Herr*¹⁰⁶ is typical. There, the promoters sold distributorships for motivational courses built around recordings and manuals. The “inactive distributors” were promised that the promoters’ sales force would sell the records and manuals for them, issuing monthly earnings checks to the investors. *Howey* was easily applied.

Once the franchisee-distributor-investor is a participant, though, the cases become much closer. Some decisions travel under a quantitative analysis, looking to *how much* the franchisee does; others, more properly, look to the *nature* of the work done and to whether that work affords some control of his fortunes to the investor. *Chapman v. Rudd Paint & Varnish Co.*¹⁰⁷ involved the sale of a “turn key” distributorship for the sale of “Run Guard,” a substance designed to prevent runs in nylon hosiery. The promotional literature contained representations “which seem to minimize the amount of effort which a distributor must exert, and maximize that which Rudd would contribute.”¹⁰⁸ The literature

investor in a way which is not controlling or decisive in the profit-making aspects of the business” will not preclude the existence of a “security.” *Venture Invest. Co., Inc. v. Shaefer*, 3 BLUE SKY L. REP. ¶ 71,031 at 67,234 (D. Colo. 1972).

105. *Id.* at 67,233.

106. 338 F.2d 607 (7th Cir. 1964).

107. 409 F.2d 635 (9th Cir. 1969).

108. *Id.* at 641.

characterized the distributor as an "investor" and described the distributorship as

a "Turn-Key" operation into which the investor merely steps, whereupon he is immediately involved in . . . a substantial and profitable undertaking with a minimum obligation on his time or resources. . . .

On the other hand, the very fact that the brochure emphasizes the amount of assistance the company will provide implies that the distributor is also to contribute an effort.¹⁰⁹

*Mr. Steak, Inc. v. River City Steak, Inc.*¹¹⁰ concentrated more heavily upon the nature of the franchisee's efforts. In the franchised restaurant operation, the franchisor provided a trained manager and retained the power to supervise:

Both the franchise agreement and the restaurant manager's agreement contemplated that River City Steak would play an active, if severely circumscribed, role in the conduct of the restaurant. It is also evident that neither a manager nor subsidiary personnel could be totally unresponsive to River City Steak, which had the power to terminate their employment. . . .

. . . .

Even though a "turn-key" operation was sold, it remained the sale of a business which the defendant could control and included the normal risks incident to operation of any enterprise. . . .¹¹¹

A "referral-sales marketing plan" is sometimes treated as a franchise, but has important differences. This sort of scheme, which has been characterized as "one of many sales rackets being carried on throughout the nation which are giving public officials serious concern,"¹¹² has surfaced with increasing frequency in the past few years. Basically, the "referral-sales agent" purchases an item—appliances, motivational courses or what-have-you—and pays an additional stipend to belong to the referral-sales program. As an agent, he then receives profit in the form of "commissions" from sales that are made to his "prospects." The "prospecting" can take various forms; the agent may merely provide the company with a list of names, or he may be required to induce the prospects to attend a central meeting, at which point the agent may or

109. *Id.* at 641. See also *Goldsmith v. American Food Serv., Inc.*, 123 Ga. App. 353, 181 S.E.2d 95 (1971); *State v. Heath*, 199 N.C. 135, 153 S.E. 855 (1930).

110. 460 F.2d 666 (10th Cir. 1972).

111. *Id.* at 669-70 (quoting trial court). See also *Beefy Trail, Inc. v. Beefy King Int'l, Inc.*, 348 F. Supp. 799 (M.D. Fla. 1972), in which a very sophisticated purchaser "actively participated in the daily operation of the franchise, overseeing the restaurant's regular operations, its advertising, kept the books and records, and regularly made business decisions affecting the restaurant." *Id.* at 805.

112. *Norman v. World Wide Distrib., Inc.*, 202 Pa. Super. 53, 56-57, 195 A.2d 115, 117 (1963). The court here pointed out that the plaintiff's proof revealed that within twenty months, the referral scheme would require 20 trillion salesmen.

may not continue as a participant in attempting to "close" the sale. One common scheme has operated around a "discount store"; in this plan, the agent distributes cards to various persons, and receives a commission from any sales made by "his" card holders. The "central meeting" is replaced in this program by the "discount center." Often the agents are told that they can set up their own sales force beneath them and receive "override commissions" from sales made by others within their organization. At this point, the scheme might properly be labeled a "referral-sales plan coupled with a multi-level distributorship."

Courts that have attempted to handle these programs through a *Howey* or *Howey*-related theory have battled with the problem of the "efforts" expended by the "investors" along the lines delineated above: Are the "efforts" proper for "merging" as consideration, or are they of such a nature that they preserve for the investor a degree of control over his chances for success? The problems arise from the characteristics that differ from the ordinary franchise arrangement: If the "central meeting"—be it a store, a "success meeting," or a "Go Tour"—fails, the agent can "refer" all the people in Manhattan and not recoup a dime on his investment. On the other hand, if the agents fail to produce prospects, the central meeting can operate from now until eternity and not produce a return for anyone.

Findings of fact are of utmost importance in these cases. What the *Howey*-type jurisdictions are struggling with is this: *Where is the proper place to draw the boundaries of the sale process?* Assuming independence,¹¹³ are these agents actually a part of the *sales process*, the process that produces the fund from which they will recoup their investment? Are they in a position through which they can exercise some control over their chances for success? Or can their efforts be properly merged as additional consideration, since their success so closely parallels the activities and responsibilities of the parties conducting the "central meeting?" There are strikingly different results, depending on one's vantage point: Either the plan involves a chance for the agent to earn money from his own efforts, or the plan is such a bad "security" that the investor is not even entitled to a percentage of the profits of the "central meeting." He invests his money, and as a *condition* to his receiving a return, the "coincidence" that the seller happens to make a sale to one of the prospects supplied by the investor must occur. Under the latter view, the plan resembles either an investment of money plus "additional consideration," or the prior example in section II, B, 4, c, *supra*, in which the investor purchases an interest in a venture, and, as a condition to receiving a portion of the money generated by the seller, he must "run a four-minute mile."

The varying results in the cases involving a "referral-sales marketing plan," therefore, are in a large part attributable to the boundaries the

113. See section II, B, 4, c *supra*.

courts have placed on the *extent of the sales process*. On similar facts, courts have found that “[i]t is the Owner-Advertiser who makes the very important contribution of the list of prospects. Every sales manager in America would recognize the importance of this contribution to the sales process”;¹¹⁴ or that “all they would have to do would be to bring other people to the Go-Tour [“central meeting”] and the program would sell itself to them.”¹¹⁵ Similarly, either the investor does not “stand to profit from the future labors of others,”¹¹⁶ or

the effort required . . . in the distribution of the cards . . . constitutes a minimal effort and the success of the proposed store will depend upon the operation and management of the proposed store and not upon the efforts of the [referral agents] . . . [T]he promoters in reality manage, control and operate [the store].¹¹⁷

Again as to quite similar promotions, one court has described the efforts as “so limited that [the agents] are not even permitted to tell their quarry the nature or purpose of the meeting,”¹¹⁸ while another has found them to be “fundamental and substantial,” noting that the distributors “take an active part in the meetings and actually attempt to convince their prospects to join”¹¹⁹ In short, the question of fact centers on the investor-salesman’s activities: Are they outside the sales process, or is the role “not minimal or a mere walk-on, but one that occupied the center of the stage for most of the play?”¹²⁰

e. The “managerial efforts” theory

Perhaps the most noticeable offspring of the referral-sales programs has been the “managerial efforts” theory.¹²¹ This approach is initiated with a threshold determination that the “sales process” does not include the activities of the referral agents. This determination confines the sales process to the activities of the “store” or “central meeting.” It is then concluded that the agent is subjecting his money “to the risks of an

114. *Commonwealth v. Consumers Research Consultants, Inc.*, BLUE SKY L. REP. ¶ 70,631, at 66,352 (Penn., Mercer County Ct. C.P. 1963), *aff’d*, 414 Pa. 253, 199 A.2d 428 (1964).

115. *Murphy v. Dare to Be Great, Inc.*, 3 BLUE SKY L. REP. ¶ 71,053, at 67,278 (D.C. Super. Ct. 1972).

116. *Hurst v. Dare to Be Great, Inc.*, 3 BLUE SKY L. REP. ¶ 71,012, at 67,165 (D. Ore. 1971), *aff’d*, 474 F.2d 483 (9th Cir. 1973).

117. *D.M.C. of Colorado v. Hays*, 3 BLUE SKY L. REP. ¶ 70,897, at 67,041 (D. Colo. 1971).

118. *SEC v. Glenn W. Turner Enterprises, Inc.*, 348 F. Supp. 766, 775 (D. Ore. 1972), *aff’d*, 474 F.2d 476 (9th Cir.), *cert. denied*, 94 S. Ct. 117 (1973).

119. *SEC v. Koscot Interplanetary, Inc.*, 365 F. Supp. 588 (N.D. Ga. 1973), *appeal docketed*, No. 73-2339, 5th Cir., May 4, 1973.

120. *Bruner v. State*, 463 S.W.2d 205, 215 (Tex. Crim. App. 1970).

121. This theory traces its lineage to *State v. Hawaii Market Centers*, 52 Hawaii 642, 485 P.2d 105 (1971).

enterprise over which he exercises no managerial control"¹²² If "managerial efforts" are equated with "independent income-producing efforts," this theory works no change in the existing law. However, the connotations of the term "managerial" open the door to classifying an arrangement as a "security" if the "investor's" activities are not of the type normally considered as being "managerial" in nature, even though the "investor" has an active, independent role in the income-generating activities so that he retains some control over his chances for success. Indeed, at least one court has seen fit to walk through this door, stating that the "efforts of others" element should be construed as meaning "managerial efforts, and not purely physical efforts."¹²³ If the "managerial efforts" approach is applied on a case by case approach to determine whether the investor's activities preserve some control in him, the label could be used constructively in place of tags such as "sham" or "consideration" efforts.

III. THE "RISK CAPITAL" THEORY—A DIVERGENT CONCEPT: A SECURITY IS DEFINED NOT BY THE INDUCEMENT HELD OUT TO THE PURCHASER, BUT BY THE USE TO WHICH THE FUNDS ARE PUT

No case in the area of securities regulation, aside from *Howey* itself, has had an impact comparable to that of *Silver Hills Country Club v. Sobieski*.¹²⁴ Prior to that decision, the California courts had followed a basic *Howey*-type theory.¹²⁵ In this one decision, Justice Traynor broadened the scope of the securities acts, opening the door to widespread regulation of economic arrangements that previously had been considered to be outside the scope of the acts. In so doing, Traynor broke completely with several fundamental principles.

In *Silver Hills*, the petitioners had entered into a contract to purchase a 22-acre tract on which they were to build a country club. The purchase price was \$775,000, of which petitioners paid only a \$400 down payment. They took possession and began to make improvements by sowing grass, installing a pool, remodeling, and adding showers, steam rooms, and health and exercise equipment. Petitioners financed these improvements in part by the sale of memberships in the club.

The plan was not the typical venture in which "memberships" were merely a cover-up for an equity interest. The purchasers were to

122. *Id.* at 648, 485 P.2d at 109; identical language was used in *SEC v. Glenn W. Turner Enterprises, Inc.*, 348 F. Supp. 766 (D. Ore. 1972), *aff'd*, 474 F.2d 476 (9th Cir.), *cert. denied*, 94 S. Ct. 117 (1973).

123. *State v. World Market Centers*, 3 BLUE SKY L. REP. ¶ 71,034, at 67,237 (Okla. Okla. Cty. Dist. Ct. 1972).

124. 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961). The lower courts in *Silver Hills* found the name to be quite appropriate, in view of the proposed golf course construction.

125. *See, e.g.*, *People v. Syde*, 37 Cal. 2d 765, 235 P.2d 601 (1951).

actually utilize their memberships by enjoying the facilities of the club. Both the membership applications and the bylaws provided that a member had no rights in the income or assets of the club.

Petitioners argued that the arrangement involved a purchase for actual use, not for investment, since there was no profit expectation. Under the *Howey* theory, this contention would have been decisive.¹²⁶ The lower court agreed, citing *Hacker v. Goldberg*,¹²⁷ an Illinois decision that was absolutely on point. There, the plaintiff purchased a membership in a country club that was in the process of being organized. The corporate charter provided that no member was to receive dividends or share in profits; thus, there was no expectation of profit. The Illinois court held that the Blue Sky Law prohibited the sale of securities from which income or profit was expected to be derived, but not the sale of interests in a club that involved no financial participation.

Under a *Howey*-type theory, if the purchaser is to take possession, his expectation is that any profits will come from his own efforts, and thus he retains control over his financial fortunes. *Silver Hills* broke sharply with these basic premises, and in a two-step analysis proceeded to change the entire course of securities regulation.

First, the court relied heavily on an obscure section of the California act that extended coverage even to non-interest bearing notes. Citing this provision, Traynor stated:

It bears noting that the act extends even to transactions where capital is placed without expectation of any material benefits. . . . Since the act does not make profit to the supplier of capital the test of what is a security, it seems all the more clear that its objective is to afford those who risk their capital at least a fair chance of realizing their objectives in legitimate ventures whether or not they expect a return on their capital in one form or another.¹²⁸

This break with one of *Howey*'s principles was the foundation for the court's major premise: That the Blue Sky Law "defines a security broadly to protect the public against spurious schemes, however ingeniously devised, to attract risk capital."¹²⁹ In short, the *Silver Hills* court concluded that *risk capital could not be raised without involving the sale of "securities."*

This funding concept was bound to run a collision course with the *Howey* principles. The first collision occurred in *Silver Hills*, where the profit-expectation premise was destroyed. An even more serious collision was quite foreseeable: Could a "security" exist even where the purchaser

126. See section II, B, 3 *supra*.

127. 263 Ill. App. 73 (1931).

128. *Silver Hills Country Club v. Sobieski*, 55 Cal. 2d 811, 815, 361 P.2d 906, 908-09, 13 Cal. Rptr. 186, 188-89 (1961).

129. *Id.* at 814, 361 P.2d at 907, 13 Cal. Rptr. at 187.

depended on his own efforts, if his money served a funding purpose? If the overriding criterion is the use to which the funds are put, how are partnerships, joint ventures and franchise operations to be treated when the monetary contributions provide the venture capital?

This particular conflict was brought to light in an opinion of the Attorney General of California. *Silver Hills* lay relatively quiet until 1967 when the Attorney General issued an opinion that has had far-reaching effects on decisions involving the applicability of the securities acts to franchising arrangements. In the opinion, he proposed three factual situations involving franchises: (1) The franchisee participates only nominally in the franchised business in exchange for a share in the profits; (2) The franchisee participates actively in the franchised business and the franchisor agrees to provide certain goods and services to the franchisee; (3) The franchisee participates actively in the franchised business and the franchisor agrees to provide certain goods and services to the franchisee, *but* the franchisor intends to secure a substantial portion of the initial capital that is needed to provide such goods and services from the fees paid by the franchisee or franchisees.¹³⁰

The Attorney General handled the first two examples through application of a *Howey*-type theory: the first was a security and the second was not. It was the third hypothetical situation that was the most troublesome point. There, although profits were attributable to the franchisee's own efforts, an "additional step" was said to be necessary to determine if a "security" existed:

This method of analysis does not depend on the pecuniary profit anticipated by the franchisee from the franchised business but looks to the non-pecuniary benefits to be obtained from the franchisor's agreement to provide goods and services for which this initial capitalization is needed.¹³¹

Prior to *Silver Hills*, the Attorney General noted, the cases had either stated or implied that pecuniary profit to the investor was an essential element. He then concluded that the elements of lack of pecuniary profit and the presence of active investor participation did *not* preclude the existence of a security under the *Silver Hills* test. Under this analysis, then, even though the "investor" retains control over his chances for success, a "security" can exist, depending on the uses to which invested funds are put.

Following *Silver Hills* and the interpretative opinion of the Attorney General, several other approaches surfaced, all traveling under the label of the "risk capital theory." In *Mr. Steak, Inc. v. River City Steak, Inc.*,¹³² plaintiff sold defendant a franchised restaurant operation under

130. 49 OP. ATT'Y GEN. 124 (Cal. 1967).

131. *Id.* at 128.

132. 324 F. Supp. 640 (D. Colo. 1970), *modified and aff'd*, 460 F.2d 666 (10th Cir. 1972) [hereinafter referred to as *Mr. Steak*].

an arrangement that left a degree of control in the purchaser, with certain controls designed to provide the seller assurances of product uniformity. Since the franchisee was active in the venture, the ultimate conflict between *Howey* and *Silver Hills* arose. The court considered *Silver Hills* and the interpretations of the Attorney General and concluded that the latter had gone too far:

While we consider the "risk capital" analysis appropriate in some instances where franchises are involved, . . . [w]e also realize that the franchisor's success and reputation depend upon the performance, qualitative and quantitative, of the local franchisee's operation. For that reason, the Attorney General's pronouncement must be considered too extreme. We believe the import of *Sobieski* and the better view would limit the 1933 Act to situations where exceptionally high risk, speculative franchises are involved. . . . In other situations, we consider the risk undertaken by the franchisee as incidental to the conduct of his business.¹³³

More in line with the Attorney General, but still in accord with the "initial capitalization" theory of *Mr. Steak* and *Silver Hills*, was the decision in *State ex rel. Healy v. Consumer Business System, Inc.*¹³⁴ The plan under scrutiny was a multi-level distributorship coupled with a referral-sales marketing plan. Franchisees could sell defendant's product and recruit others into the system as a part of the franchisee's organization. Defendant's initial working capital was only \$5,000.

The court acknowledged that the *Howey* test for a "security" could not be met, and turned to *Silver Hills* and the attorney general's opinion, noting that the third hypothetical situation (risk capital coupled with active participation) was "similar to the situation which exists in the case at bar."¹³⁵ The court reached a result contrary to that in *Mr. Steak*, finding that "securities" had been sold despite active participation. Once again, however, the test extended only to *initial* capitalization. The court noted that the "risk capital" test gave protection by informing investors that their capital would be risked "before the working foundations of the enterprise are firmly in place."¹³⁶ The court concluded by holding that "if a substantial portion of the initial capital which a franchisor uses to initiate its operations is being provided by the franchisees, then the franchisor must register his enterprise"¹³⁷

133. *Mr. Steak, Inc. v. River City Steak, Inc.*, 324 F. Supp. 640, 647 (D. Colo. 1970), *aff'd*, 460 F.2d 666 (10th Cir. 1972).

134. 5 Ore. App. 19, 482 P.2d 549 (1971) [hereinafter referred to as *Consumer Business System*].

135. *Id.* at 27, 482 P.2d at 553.

136. *Id.* at 29, 482 P.2d at 554.

137. *Id.* at 29, 482 P.2d at 554. See also *State v. American Campground, Inc.*, 3 BLUE SKY L. REP. ¶ 71,064 (Ore., Multnomah Cty. Cir. Ct. 1972), following the *Consumer Business System* test of initial capitalization quite carefully. But see *Hurst v. Dare to Be Great, Inc.*, 3 BLUE SKY L. REP. ¶ 71,012 (D. Ore. 1971), *aff'd*, 474 F.2d 483 (9th Cir. 1973), in

By way of guidelines, the court approvingly cited a bulletin of the California Corporation Commission¹³⁸ to the effect that an implication of a "security" would arise if the franchisor cannot show:

- (1) adequate capital to operate the franchising program for an indefinite length of time, without the necessity of resorting to the funds to be contributed by the franchisee; (2) successful business operations in the past; and (3) adequate facilities to successfully administer the franchising program.¹³⁹

Shortly thereafter, the Supreme Court of Hawaii formulated its theory, which, although under the "risk capital" label, curiously showed signs of moving back toward *Howey*. *State v. Hawaii Market Centers, Inc.*¹⁴⁰ involved the sale of founders' contracts which were the basis of a referral-sales plan and a multi-level distributorship program.¹⁴¹ The defendant was capitalized with \$1,000 and used the receipts from the sale of distributorships to finance the opening of a retail discount store, to which the sales personnel would refer their prospects. The court rejected *Howey* as being "too mechanical to protect the investing public adequately" and as being "based on a narrow concept of investor participation."¹⁴² The court also noted that the United States Supreme Court had yet to deal with "an investment plan involving non-managerial investor participation . . ."¹⁴³

Commenting that the "subjection of the investor's money to the risks of an enterprise over which he exercises no managerial control is the basic economic reality of a security transaction,"¹⁴⁴ the court set out the following test:

- (1) an offeree furnishes initial value to the 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

which the lower court twisted and distorted Consumer Business System in finding a "security."

138. Cal. Div. of Corp. Bull. No. 67-8 (July 14, 1967).

139. *State ex rel. Healey v. Consumer Business System, Inc.*, 5 Ore. App. 19, 30 n.10, 482 P.2d 549, 554 n.10 (1971).

140. 52 Hawaii 642, 485 P.2d 105 (1971) [hereinafter referred to as *Hawaii Market Centers*].

141. See the plan described in section II, B, 4, d *supra*.

142. *State v. Hawaii Market Centers, Inc.*, 52 Hawaii 642, 485 P.2d 105, 108 (1971).

143. *Id.* at 647 n.3, 485 P.2d at 108 n.3.

144. *Id.* at 648, 485 P.2d at 109.

(4) the offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise.¹⁴⁵

While the court's comment that this test would provide coverage to all forms of financing enterprises indicates that it is a type of "funding" theory, several elements of this test are quite noteworthy. First, element three is at odds with *Silver Hills*. Under *Silver Hills*, profit-expectation is not required; but here the investor must expect something above and beyond *quid pro quo* for his invested dollar. Additionally, element four breaks with the attorney general's opinion so that active participation of the *proper type* will preclude coverage. This test, as does *Silver Hills*, looks to initial capitalization, but the similarity ends there. This is actually a "managerial efforts" test, and, in that respect, might be viewed more as a refinement of *Howey* than as a spin-off of *Silver Hills*.¹⁴⁶

The emphasis on "managerial efforts" was based on the court's premise that minor investor participation is irrelevant, and that he must have practical and actual control over the decision-making. Here, he had no power to influence the utilization and accumulation of capital, nor authority over decisions involving the operation of the store. On the other hand, while having no voice in the running of the discount store, the participant retained full decision-making power as to the conduct of his own individual distributorship operation.

Just as *Hawaii Market Centers* had turned away from the strict *Silver Hills* doctrine, subsequent cases turned in various directions from the *Hawaii Market Centers* test. In *State v. Glenn Turner Enterprises, Inc.*,¹⁴⁷ the court expanded *Silver Hills* even further, noting that neither *Hawaii Market Centers* nor *Silver Hills* would protect the investor from a "well-heeled, corruption-minded company which had been in business for a long time."¹⁴⁸ Thus, the court concluded, "a test which is restricted to the obtaining of *initial* capital only, is not a satisfactory test."¹⁴⁹ The "risk capital" test was held to include schemes to raise capital for exist-

145. *Id.* at 649, 485 P.2d at 109.

146. Nonetheless, the lower court in *Turner Enterprises* picked up the language in *Hawaii Market Centers* that "the subjection of the investor's money to the risks of an enterprise over which he exercises no managerial control is the basic economic reality of a security transaction" and attributed it to *Silver Hills*, concluding that the "managerial efforts" test is equivalent to a "risk capital" analysis:

Over ten years ago, the *California Supreme Court* articulated a test which simply recognized that the subjection of the investors' money to the risk of an enterprise over which he exercises no managerial control is the basic economic reality of a security transaction. *Silver Hills Country Club v. Sobieski*

SEC v. Glenn W. Turner Enterprises, Inc., 348 F. Supp. 766, 773 (D. Ore. 1972), aff'd on "investment contract" issue, 474 F.2d 476 (9th Cir.), 49 S. Ct. 117 (1973) (emphasis added to show error).

147. 3 BLUE SKY L. REP. ¶ 71,023 (Idaho 4th Dist. 1972).

148. *Id.* at 67,201.

149. *Id.* at 67,201.

ing but unproven businesses as well as schemes to raise initial capital. The court adopted this test:

- (1) a common enterprise,
- (2) expectation of monetary profit or some other benefit, and
- (3) either (a) nonparticipation or (b) a double-investment situation of risk capital, as well as non-participation in the franchisor's separate business.¹⁵⁰

This test is broader than *Hawaii Market Centers*, but in agreement with *Silver Hills*, on the "profit-expectation" question; additionally, if risk capital is provided, the franchisee must have a voice in the parent concern, as well as control over his own operation. Also, the expansion away from "initial capitalization" is, of course, broader than *Silver Hills*.

Hurst v. Dare to be Great Inc.,¹⁵¹ an Oregon decision subsequent to *Consumer Business System*, follows an even more variant avenue of attack. Involved was a referral-sales plan centered around the sale of a motivational course, the physical products of which involved tape recorders and briefcases. The court did not discuss *capitalization* at all, either initial or otherwise. Instead, it relied on testimony that some of the money was earmarked for paying instructors, researching material, and purchasing tape recorders and briefcases. The court concluded that "even though the Defendant had a product in being when it started soliciting business,"¹⁵² the risk capital theory of *Consumer Business System* applied.

The court in *SEC v. Koscot Interplanetary, Inc.*,¹⁵³ viewed the various theories that were travelling under the "risk capital" label and stated that the term would be used "somewhat advisedly," since "its precise meaning is unsettled."¹⁵⁴ This observation is one of the few statements that can be used without reservation to summarize the "risk capital" theory.

IV. "RISK CAPITAL" IN FEDERAL COURT

Because of the basic philosophical differences between the "risk capital" theory and the *Howey* theory,¹⁵⁵ the progress of the risk capital approach in federal courts has understandably been slow. The theory has received the greatest degree of attention in three major cases: *Mr.*

150. *Id.* at 67,201.

151. 3 BLUE SKY L. REP. ¶ 71,012 (D. Ore. 1971), *aff'd*, 474 F.2d 483 (9th Cir. 1973).

152. *Hurst v. Dare to Be Great, Inc.*, 3 BLUE SKY L. REP. ¶ 71,012, at 67,165.

153. 365 F. Supp. 588 (N.D. Ga. 1973), *appeal docketed*, No. 73-2339, 5th Cir., May 4, 1973 [hereinafter referred to as *Koscot*].

154. *Id.* at 592 n.2.

155. These differences are treated at length in section V *infra*.

Steak, Inc. v. River City Steak, Inc.,¹⁵⁶ and the Glenn Turner cases, *SEC v. Glenn W. Turner Enterprises*¹⁵⁷ and *SEC v. Koscot Interplanetary, Inc.*¹⁵⁸

A. *Mr. Steak*

The "securities" claim in *Mr. Steak* arose from defendant's counterclaims to the plaintiff-vendor's suit for money owed. Plaintiff had sold defendant a franchised restaurant operation and had required defendant to enter into a "restaurant manager's agreement" with a manager who had been recruited and trained by plaintiff. Plaintiff was not granted, and did not assume, the power to direct the daily operations of the restaurant, but plaintiff did retain certain supervisory powers. While the contract seemed to afford plaintiff de facto control since the manager was the only person permitted to actively run the operation, the defendant was given an active role in retention or termination of the manager. The court concluded that the *Howey* test could not be met; however, it went on to note that the operation could be viewed in another light. The "risk capital" approach was introduced by pointing to the funding functions that were accomplished in several cases decided under the *Howey* theory:

One salient feature of most cases finding an investment contract has involved the solicitation of funds for speculative, poorly-financed business ventures In these instances, the investor, even if he can participate in or control some phase of the enterprise, is gambling "risk capital", where there is less than an even chance of success, against the opportunity for large profits. . . .

Since no federal court has yet considered the risk capital approach, we must look to state law for its basic tenets.¹⁵⁹

The court then analyzed *Silver Hills* and the attorney general opinion¹⁶⁰ on franchises. The court's comments in general were favorable to the approach but concluded that

the attorney general's pronouncements must be considered too extreme. We believe the import of *Sobieski* and the better view would limit the 1933 Act to situations where exceptionally high risk, speculative franchises are involved.¹⁶¹

156. 324 F. Supp. 640 (D. Colo. 1970), *modified and aff'd*, 460 F.2d 666 (10th Cir. 1972).

157. 348 F. Supp. 766 (D. Ore. 1972), *aff'd*, 474 F.2d 476 (9th Cir.), *cert. denied*, 94 S. Ct. 117 (1973).

158. 365 F. Supp. 588 (N.D. Ga. 1973), *appeal docketed*, No. 73-2339, 5th Cir., May 4, 1973.

159. *Mr. Steak, Inc. v. River City Steak, Inc.*, 324 F. Supp. 640, 646 (D. Colo. 1970), *modified and aff'd*, 460 F.2d 666 (10th Cir. 1972).

160. See section III *supra*.

161. *Mr. Steak, Inc. v. River City Steak, Inc.*, 324 F. Supp. 640, 647 (D. Colo. 1970), *modified and aff'd*, 460 F.2d 666 (10th Cir. 1972).

After analyzing the financial condition of the plaintiff-vendor, the court found that a "security" had not been sold and dismissed the federal claims as well as the pendent claim under the Colorado Blue Sky Act.

On appeal, the Tenth Circuit affirmed,¹⁶² relying basically on the *Howey* theory and noted that "Mr. Steak does not retain the right to direct the daily operations of the restaurant although it does have a right to see that certain standards are met."¹⁶³ As for the risk capital theory, the court briefly stated that "the facts, especially the financial position of Mr. Steak, do not warrant the application of such a doctrine."¹⁶⁴

B. *Dare to Be Great and Koscot*

1. *SEC v. Glenn W. Turner Enterprises, Inc.*¹⁶⁵— "RISK CAPITAL THROUGH THE BACK DOOR"

Turner Enterprises involved a referral-sales marketing plan entitled "Dare to Be Great." The underlying product involved was a series of motivational and self-improvement courses. In addition to the motivational materials, purchasers could also obtain contracts through which they could become "Independent Sales Agents" and earn sales commissions for supplying prospects who eventually made purchases. Technically, this operation did not involve a "multi-level distributorship"¹⁶⁶ since all sales agents were on the same level. Rather than spawning a multitude of subordinate sales personnel who were connected to the many levels of superior personnel through overriding commissions, "Dare to Be Great" involved only two basic levels, the company and the agents.

The Commission moved for an injunction and the appointment of a receiver in the United States District Court for the District of Oregon, contending that the contracts fell within the statutory terms "investment contract," "certificate of interest or participation in any profit-sharing agreement" and "in general, any interest or instrument commonly known as a security." The court agreed with the Commission on all three categories. An "investment contract" was found, based on the court's findings of fact that the agents were not actually involved in the sales process.¹⁶⁷ In so doing, however, the court formulated three clearly erroneous theories. First, the court reasoned that market saturation was likely and that since the agent would be unable to find prospects upon saturation, at such time the "efforts of the investor are simply irrelevant,

162. *Mr. Steak, Inc. v. River City Steak, Inc.*, 460 F.2d 666 (10th Cir. 1972).

163. *Id.* at 669.

164. *Id.* at 670-71.

165. 348 F. Supp. 766 (D. Ore. 1972), *aff'd*, 474 F.2d 476 (9th Cir.), *cert. denied*, 94 S. Ct. 117 (1973).

166. See section II, B, 4, d *supra*.

167. See *id.*

even if he spends all his time in futile efforts to sell the unsellable."¹⁶⁸ Irrelevant efforts, the court concluded, could not be significant to success or failure, and thus the "solely from the efforts of others" test was met. What the court ignored was that it is not the *ultimate effectiveness* of the efforts that is determinative. For example, if *A* and *B* become partners in an oil venture, with *A* to handle the financial matters and *B* to drill the well and produce the oil, what happens if the hole is dry? Is *B* to contend that since his efforts were *unproductive* that they were *irrelevant* and that, therefore, he was offered an opportunity to share in the profits produced solely from someone else's efforts?

The court's second error was its reliance on *State v. Gopher Tire & Rubber Co.*,¹⁶⁹ an early Blue Sky case advocated by the Commission. In *Gopher Tire*, the defendant sold what amounted to some sort of an equity interest in his business. Purchasers of "certificates" could share pro rata in 10% of defendant's profits, but they had to promise to "talk up" defendant's products. There was no connection between doing work and making money; there were no controls on the "booster agent." Indeed, one commentator has noted that these "agents" did nothing more than what any ordinary stockholder would do.¹⁷⁰ Nevertheless, the court in *Turner Enterprises* found the plan in *Gopher Tire* to be "analogous to that in question here"¹⁷¹

Thirdly, the court held that the payment of commissions involved "profit sharing" regardless of the fact that agents were entitled to payment for sales consummated even if the company lost money.

The court's most ingenious effort, however, was in sneaking in a "risk capital" approach through the back door of "commonly known as a 'security.'" The "commonly known as" term is one that is quite lacking in interpretation, although the *Joiner* court used it interchangeably with "investment contract," and stated that "the test . . . is what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect."¹⁷²

The Supreme Court of Utah was probably technically correct when it construed its state's "commonly known as" term as follows:

General terms cannot be given a literal meaning independent of the context in which they are used [C]onsideration of the full text of the law in question manifests that it is directed at securities of the nature that are dealt commercially Securities in the commercial sense usually signifies the invest-

168. *SEC v. Glenn W. Turner Enterprises, Inc.*, 348 F. Supp. 766, 776 (D. Ore. 1972), *aff'd*, 474 F.2d 476 (9th Cir.), *cert. denied*, 94 S. Ct. 117 (1973).

169. 146 Minn. 52, 177 N.W. 937 (1920).

170. Note, *What is a Security*, 25 S. CAL. L. REV. 208 (1952).

171. *SEC v. Glenn W. Turner Enterprises, Inc.*, 348 F. Supp. 766, 776 (D. Ore. 1972), *aff'd*, 474 F.2d 476 (9th Cir.), *cert. denied*, 94 S. Ct. 117 (1973).

172. 320 U.S. 344, 352-53 (1943).

ment of funds with a view to receiving a profit through the efforts of others than the investor¹⁷³

This approach is merely the application of a common rule of statutory construction.

At any rate, the *Turner Enterprises* court felt free to construe the "commonly known as" term as it saw fit. First the court determined that the instrument or interest must be "commonly known" within the *legal or financial community* as a "security." Then the court concluded that state law could determine "commonly known as" and that the "risk capital" test was "an appropriate test to look to for determining what is 'commonly known as a security.'" ¹⁷⁴

This approach opens the door to serious problems, since, rather than focusing on the economic relationships involved, it is based upon *time*. For example, two purchasers of the same program might sue in federal court and reach opposite results if the passage of time had resulted in more state cases holding that such an arrangement was or was not a "security." Chaos is a possibility. In any event, the Ninth Circuit affirmed on the "investment contract" theory only, totally ignoring the "risk capital through the back door" approach.

2. *SEC v. Koscot Interplanetary, Inc.*¹⁷⁵—

CAUTIOUS AWARENESS OF SERIOUS PROBLEMS

Koscot involved a referral-sales marketing plan coupled with a multi-level distributorship system for the sale of cosmetics. Once again the Commission relied on the statutory catch-alls of "investment contract," "profit-sharing agreement," and "interest or instrument commonly known as a security." The crucial findings of fact were that the agents were indeed involved in the sales process, both by recruiting prospects and by helping consummate the sales. Their efforts were found to be "fundamental and substantial"¹⁷⁶ The *Koscot* court rejected any effort to employ the "profit-sharing" term:

[T]o construe the term "profit-sharing" to cover the situation presented here goes . . . beyond broad reading, and becomes plain judicial over-reach. The term "profit-sharing" has an ordinary significance which would be ignored if it were read

173. *Memorial Gardens v. Love*, 5 Utah 2d 270, 273, 300 P.2d 628, 630 (1956). For other holdings applying the *Howey* test to the "commonly known as" term, see *People v. Syde*, 37 Cal. 2d 765, 235 P.2d 60 (1951); *State v. Heath*, 199 N.C. 135, 153 S.E. 855 (1930); *Commonwealth v. Consumers Research Consultants, Inc.*, 414 Pa. 253, 199 A.2d 429 (1964); *Bruner v. State*, 463 S.W.2d 205 (Tex. Crim. App. 1970).

174. *SEC v. Glenn W. Turner Enterprises, Inc.*, 348 F. Supp. 766, 774 (D. Ore. 1972), *aff'd*, 474 F.2d 476 (9th Cir.), *cert. denied*, 94 S. Ct. 117 (1973).

175. 365 F. Supp. 588 (N.D. Ga. 1973), *appeal docketed*, No. 73-2339, 5th Cir., May 4, 1973.

176. *Id.* at 591.

to treat simple commissions and finder's fees as shares of profits.¹⁷⁷

The court also rejected an "investment contract" argument. The *Koscot* court noted that the *Gopher Tire* scheme relied on in *Turner Enterprises* was

materially different from this case. The program in *Gopher Tire* in reality would permit a person to receive a return on the money he invested with minimal or no effort, because each person's return was not directly linked to his own effort.¹⁷⁸

In arguing the "commonly known as" term, the Commission followed two avenues of attack. First it contended that several Blue Sky decisions had held similar types of programs to be "securities." This contention was rejected. The court found the authorities to be widely split and concluded that, without a United States Supreme Court holding that a recognizable national standard existed, chaos and confusion among the jurisdictions would result. The Commission's second approach contended that the "risk capital" theory was a proper standard for interpreting "commonly known as." The court first acknowledged that the term "risk capital" was being used "somewhat advisedly" since several theories were circulating under that label. Recognizing that the risk capital approach was an emerging philosophical trend, the court nevertheless noted that an emerging trend was not equivalent to "commonly known as." The court concluded that, "for now at least," the risk capital theory could not be used to interpret "commonly known as" so as to extend coverage to plans that fell outside of *Howey*'s scope.

The most prominent aspect of these decisions is the degree of difficulty encountered in attempting to apply a "risk capital" approach in federal court. Until there is some final authority on the matter, federal courts will continue to encounter difficulties, since the theory is philosophically and economically at odds with the federal *Howey*-type concept.

V. COMMENTS AND COMPARISONS

The differences between *Howey* and *Silver Hills* come down to this: If you believe that an enterprise cannot raise capital without selling "securities," *Silver Hills* is proper; but if you believe that a "security" is determined by the "character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect,"¹⁷⁹ a *Howey*-type theory is appropriate, regardless of the use to which the funds are devoted. "You pays your money and takes your choice."

177. *Id.* at 591.

178. *Id.* at 591 n.1.

179. *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 352-53 (1943).

On a philosophical level, it might be noted that a *Silver Hills* approach fits best with a *merit regulation* jurisdiction. While the federal acts are devoted solely to full disclosure, regardless of the quality of the offering, some Blue Sky jurisdictions look to the merits of what is being offered. The "risk capital" approach requires inquiry into areas such as capitalization, and it is a short leap from such an inquiry to a determination that the offering is a "bad deal." *Silver Hills* itself reveals such an inquiry: The term "security" is defined "broadly enough to protect the public against *spurious* schemes, however ingeniously devised, to attract 'risk capital.'"¹⁸⁰ "Its objective is to afford those who risk their capital at least a fair chance of realizing their objectives in *legitimate* ventures"¹⁸¹

The Supreme Court of Hawaii, in *State v. Hawaii Market Centers, Inc.*,¹⁸² defined the purposes of that state's Blue Sky Law as being "(1) to prevent fraud, and (2) to protect the public against the imposition of *unsubstantial* schemes. . . ."¹⁸³

Perhaps the most flagrant example of this type of reasoning appears in *State v. Glenn Turner Enterprises, Inc.*,¹⁸⁴ where, after enunciating its own test for the existence of a "security," the court noted—almost as an afterthought—that "[o]f course, the factual situation would have to be one which would fall within the regulatory purpose of the securities law."¹⁸⁵ Such a pronouncement opens the door to a system of securities regulation based on judicial pick-and-choose.

The "full disclosure" system operates through the following sort of analysis: First, it must be determined whether what is being offered is a "security"; then, if a "security" is found to exist, the registration sections of the acts apply, absent some exemption. As Justice Brennan put it, it is not proper to conclude that "because subjection of the contracts in question . . . to federal regulation is desirable, it has in fact been accomplished."¹⁸⁶ Under the various theories traveling under the "risk capital" label, the analysis seems drastically different: The first inquiry is to whether the offering is beneficial; if not, it is labeled a "security" and is subjected to the acts.

The district court in *SEC v. Koscot Interplanetary, Inc.*¹⁸⁷ is the first to officially recognize this phenomenon. In refusing to apply the federal "commonly known as" term by reference to a "risk capital" theory, that court noted that the "risk capital" approach is one that is

180. *Silver Hills Country Club v. Sobieski*, 55 Cal. 2d 811, 814, 361 P.2d 906, 907 (1961) (emphasis added).

181. *Id.* at 815, 361 P.2d at 908 (emphasis added).

182. 52 Hawaii 642, 485 P.2d 105 (1971).

183. *Id.* at 648, 485 P.2d at 109.

184. 3 BLUE SKY L. REP. ¶ 71,023 (Idaho 4th Dist. 1972).

185. *Id.* at 67,201.

186. *SEC v. Variable Annuity Ins. Co.*, 359 U.S. 65, 80 (1959) (concurring opinion).

187. 365 F. Supp. 588 (N.D. Ga. 1973), *appeal docketed*, No. 73-2339, 5th Cir., May 4, 1973.

traditionally reserved to the states. The recent emphasis in state security legislations has been on the *merits* of the offering, while federal regulations has thus far been limited to the aim of honest *disclosure*¹⁸⁸

At a time when criticism of *Howey* is a mark of progressive thought, one is cast into quite a reactionary posture in defending the theory. But *Howey* has certain superior qualities, one of which is *certainty*. The "security" or "non-security" question will not be determined by the identity of the offeror. Since the economic inducements to the purchaser are the crucial factors, a particular deal will be a security regardless of the financial state of the issuer. While other theories are being propounded in an attempt to encompass any plan that shows some sign of involving an *investment*, *Howey* confines itself to investments in *securities*.

Furthermore, while the state statutes—as construed—indicate a legislative intent to regulate a wide range of money-making, investment-oriented schemes, Congress has created specific acts to regulate specific investment-oriented areas. In addition to the securities acts, Congress has passed the mail fraud statutes,¹⁸⁹ the Federal Trade Commission¹⁹⁰ and anti-trust provisions¹⁹¹ and the Interstate Land Sales Act.¹⁹² Thus, there is no intent to cover all arrangements that involve an investment. All investments are not necessarily "securities": the term "security" in the federal acts must be interpreted in light of the legislative intent in 1933 and 1934. *Howey* and *Tcherepnin v. Knight*¹⁹³ provide such an interpretation.

The "risk capital" jurisdictions, especially in the franchise area, are performing what is basically a legislative function in rewriting definitions to include new forms of investments that differ dramatically from investments in "securities."

Certainly, there are instances in which promoters have avoided stock or bond issuance and have raised capital through the sale of other interests, such as franchises. And it cannot be doubted that the franchisee makes an *investment* in the parent level, while he is depending on his own skills in his own level of the enterprise. But not all investments are "securities."

At this writing, the Commission is currently contending in the *Koscot* appeal that "the subjection of one's money to the risk of an enterprise over which he exercises no managerial control" is an appropriate

188. *Id.* at 593 (original emphasis). As of this writing one additional court has seen fit to tailor the definition of "security" in line with the underlying policies of the jurisdiction's regulatory scheme. See *State v. Investors Security Corp.*, — Minn. —, 209 N.W.2d 405 (1973).

189. *E.g.*, 18 U.S.C. §§ 1341, 1342 (1970).

190. *See, e.g.*, 15 U.S.C. § 41 (1970).

191. *See, e.g.*, 15 U.S.C. § 1 (1970).

192. 15 U.S.C. § 1701 (1970).

193. 389 U.S. 332 (1967) (Interpreting definitions in Securities Exchange Act of 1934).

test for applying the "commonly known as" term in the federal acts. This test is derived from the statements in *Hawaii Market Centers*¹⁹⁴ and the district court's decision in *Turner Enterprises*.¹⁹⁵ Such a test would subject every franchise operation in the nation, including all of its gas stations, fast food operations, chain motels, and other familiar features of contemporary society based upon franchising, to the disclosure requirements of the securities acts, since in each of these operations the franchisee exercises no control over the franchisor's level of the operation. One federal court has already made note of this Pandora's box. The Southern District of New York in *Wieboldt v. Metz*¹⁹⁶ analyzed this test and concluded:

In this regard, we think it is only necessary that the franchisee exercise policy-making power over his unit of the enterprise, since to require control over the franchisor's entire system is incompatible with the franchising method and would make all franchises investment contracts.¹⁹⁷

In everyday business and commerce, the subjection of one's money to the risk of an enterprise over which he exercises no managerial control is a common occurrence. When one orders from the Spiegel or Sears, Roebuck catalogue, the transferred funds are subject to the risks of the mail-order company, an enterprise over which the purchaser certainly exercises no "managerial control." Practically every business operation is dependent on, and invests its funds in, other entities for raw materials, parts, or labor. If these other entities do not perform, the dependent operation suffers; but, as the district court in *Mr. Steak* noted,¹⁹⁸ this dependency is oftentimes the ordinary risk incidental to the operation of a business.

The "risk capital" decisions are pursuing a meritorious goal; they attempt to reach operations that are avoiding the issuance of equity or debt interests by selling some other type of interest, usually a franchise. But the economic inducements held out to prospective franchisees are quite different from the inducements held out to the purchaser of stocks or bonds. Unless we are ready to turn control of all investments over to the Securities and Exchange Commission, the risk capital decisions—and the consequences of the various tests—ought to be scrutinized quite closely. The securities acts changed the rule of the market place from *caveat emptor* to *caveat venditor* in one particular area of society. The recent decisions would extend this change in emphasis to much broader

194. 52 Hawaii 642, 485 P.2d 105 (1971).

195. 348 F. Supp. 766 (D. Ore. 1972), *aff'd*, 474 F.2d 476 (9th Cir.), *cert. denied*, 94 S. Ct. 117 (1973).

196. 335 F. Supp. 255 (S.D.N.Y. 1973).

197. *Id.* at 260.

198. 324 F. Supp. 640, 647 (D. Colo. 1970), *modified and aff'd*, 460 F.2d 666 (10th Cir. 1972).

perimeters. While such a change might prove to be immensely beneficial, it is a change that ought to occur through a carefully delineated legislative scheme, rather than by piecemeal judicial transformation.

The lead of California should be followed in enacting separate franchise legislation¹⁹⁹ so that further blurring of the elements of a "security" will be prevented. *Howey*, as properly interpreted, serves its purpose. To discard its test, and to make the securities acts "catch-alls" has serious drawbacks. While the crooked operations that occasionally arise might be controlled (although other statutory weapons are available), unnecessary confusion is created in the business community.

Unless the Supreme Court grants certiorari in one of the SEC actions against the referral-sales operations²⁰⁰ and sets out some definitive guidelines, the current variations in the states will continue to plague the practitioner and his entrepreneur client. The "risk capital" approach and the new variations it has spawned, encompassing any arrangement that shows signs of involving the investment process, engender continued uncertainty. The current state of the law is reflected fairly accurately in one recent opinion: "[I]t is enough to call a security a security."²⁰¹ While Gertrude Stein might agree, it is hard to see how the due process clause—or a system or orderly business regulation—can tolerate such an analysis.

199. CAL. CORP. CODE § 31000 (Deering Supp. 1973). The California Blue Sky act specifically excludes from the definition of "security" "any franchise subject to registration under the Franchise Investment Law. . . ." CAL. CORP. CODE § 25019 (Deering Supp. 1973).

200. SEC v. Glenn W. Turner Enterprises, Inc., 348 F. Supp. 766 (D. Ore. 1972), *aff'd*, 474 F.2d 476 (9th Cir.), *cert. denied*, 94 S. Ct. 117 (1973); SEC v. Koscot Interplanetary, Inc., 365 F. Supp. 588 (N.D. Ga. 1973), *appeal docketed*, No. 73-2339, 5th Cir., May 4, 1973.

201. Continental Marketing Assoc., Inc., 3 BLUE SKY L. REP. ¶ 71,016, at 67,176 (Ind Sec. Comm'n 1969).