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Notes

UNREGULATED INVESTMENT IN CERTAIN DEATH: *SEC v. LIFE PARTNERS, INC.*

I. INTRODUCTION

Over the past eight years a new financial service has developed that offers terminally-ill persons—most frequently acquired immunodeficiency syndrome (AIDS) patients in their final six months to two years of life—access to potentially enormous financial resources.¹ This new financial service simultaneously offers large and small investors the opportunity to reap tremendous investment returns.² This service has come to be known as viatical settlement.³

1. See Keith Stone, *Brokers, Terminally Ill Turning Death Into Cash*, L.A. DAILY NEWS, Oct. 25, 1992, at N1. Stone explained that “[s]ince the first viatical settlement company opened in 1988, nearly 30 more have begun doing business in a market that industry officials predict will expand.” *Id.* Stone’s prediction was correct as the viatical settlement industry has continued to grow, surpassing \$200 million per year in 1995, with projected growth to a more than \$1 billion per year industry within the next decade. See Albert B. Crenshaw, *Tackling an Issue of Agony; Ruling May Ultimately Aid the Business of Buying Death Benefits*, WASH. POST, Sept. 1, 1995, at C01; see also *SEC v. Life Partners, Inc.*, 898 F. Supp. 14, 17 (D.D.C. 1995) (explaining growth of viatical settlement industry), *remanded by* 87 F.3d 536 (D.C. Cir. 1996); Shanah D. Glick, Comment, *Are Viatical Settlements Securities Within the Regulatory Control of the Securities Act of 1933?*, 60 U. CHI. L. REV. 957, 957 (1993) (recognizing financial resources that viatical settlements provide for terminally-ill AIDS patients).

2. See Glick, *supra* note 1, at 957-58 (explaining innovative methods through which individual investors have taken advantage of opportunities presented by viatical settlements in recent years); see also Crenshaw, *supra* note 1, at C01 (explaining advantages that investments in viatical settlements offer individual investors); Stone, *supra* note 1, at N1 (recognizing morbidity and potential high-return investment in viatical settlements represent).

3. See Stone, *supra* note 1, at N1. The concept embodied in what has come to be known as viatical settlement has been given many names, however, viatical settlement is the most common and has gained the most widely accepted usage. See *id.* This term has two Latin origins. See *id.* The term originated in the Latin word “viaticum,” referring to money provided for a journey. See *id.* This Latin term lent its name to the Roman Catholic sacrament administered to an individual who is in danger of dying. See *id.* In the late 1980s, and throughout the 1990s, this term has been associated with the practice of purchasing terminally-ill individuals’ life insurance policies. See *id.*; see also *SEC v. Life Partners, Inc.*, 87 F.3d 536 (D.C. Cir. 1996) (discussing viatical settlement as investment contract through which investors purchase interests in life insurance policy of terminally-ill individuals); Glick, *supra* note 1, at 957 (referring to practice of purchasing terminally-ill individuals’ life insurance policies as “viatical settlement”); John F.X. Peloso & Stuart M. Sarnoff, *Viatical Settlements: Another Form of Unregulated Investment*, N.Y. L.J., Aug. 15, 1996, at 3 (defining viatical settlement as process whereby third party purchases interest in life insurance policy of terminally-ill individual at discount to face value

In a viatical settlement, a terminally-ill insured typically transfers ownership of his or her life insurance policy to a buyer for a one-time lump-sum payment.⁴ This payment is usually equal to sixty to eighty-five percent of the face value of the life insurance policy.⁵ The buyer maintains the policy, becomes the named beneficiary of the policy and collects a return on his or her investment by claiming the death benefit due upon the death of the insured.⁶

Large investment companies that purchase life insurance policies through viatical settlements often resell fractional interests in these settlements to individual retail investors.⁷ This practice has increased competition to purchase policies, has enabled thousands of small investors to take advantage of the lucrative investment opportunities this service offers and has dramatically increased the capital available to companies investing in

of policy); Crenshaw, *supra* note 1, at C01 (explaining that viatical settlement companies purchase life insurance policies from terminally-ill individuals for large one-time lump-sum payment).

4. See Glick, *supra* note 1, at 957.

5. See *Life Partners*, 87 F.3d at 537 (explaining that life insurance policies purchased in viatical settlements are typically purchased for amount that represents 20% to 40% discount to face value); *Life Partners*, 898 F. Supp. at 17 (discussing method viatical settlement firms employ to sell fractional interests in life insurance policies of AIDS patients to retail investors); Glick, *supra* note 1, at 957 (noting that life insurance policies are purchased in viatical settlements for 50% to 80% of face value); Peloso & Sarnoff, *supra* note 3, at 3 (discussing that life insurance policies are purchased in viatical settlements for 60% to 80% of face value); Crenshaw, *supra* note 1, at C01 (noting that life insurance policies are purchased in viatical settlement for 70% to 80% of face value); Stone, *supra* note 1, at N1 (noting that life insurance policies are purchased in viatical settlements typically for no less than 60% of face value, but sometimes such policies have been purchased for 50% to 80% of face value, and even as low as 27% to 30% of face value).

6. See *Life Partners*, 87 F.3d at 537 (explaining that investors' returns from viatical settlements come at maturation of death benefits claim, in other words, only upon death of insured); Glick, *supra* note 1, at 957 (same); Peloso & Sarnoff, *supra* note 3, at 3 (explaining that investor, who purchases interest in terminally ill individual's life insurance policy, receives benefits of policy upon death of insured); Crenshaw, *supra* note 1, at C01 (noting that viatical settlement firms purchase terminally-ill individuals' rights to obtain death benefits from their life insurance policy); Stone, *supra* note 1, at N1 (explaining that investors reap benefits upon death of terminally-ill patients).

7. See Glick, *supra* note 1, at 957-58. Viatical settlement companies typically fall into two categories: those that match investors with terminally insured who wish to sell their life insurance policies for an immediate cash settlement and those more sophisticated companies, financed through private funds or the sale of stock, who purchase policies from the insured, hold all rights to the policies, become the named beneficiaries of the policies and resell fractional interests in the policies to retail investors. See *id.* at 957; see also *Life Partners*, 87 F.3d at 545-46 (explaining three methods of investment in viatical settlement offered by Life Partners, encompassing two typical methods with optional variations); Peloso & Sarnoff, *supra* note 3, at 3 (explaining two typical types of investments offered by viatical settlement companies).

viatical settlements.⁸ The influx of individual unsophisticated investors into this unregulated market and the large number of start-up firms offering individual investors access to this market has dramatically increased the potential for investors to be defrauded or abused by inexperienced or sham investment companies.⁹ Experts differ as to whether investments in viatical settlements should be regulated by the Securities and Exchange Commission (SEC) in order to protect consumers from possible abuse or fraud.¹⁰

The issue of whether the purchase of a fractional interest in a viatical settlement falls within the regulatory powers of the SEC was recently addressed by the United States Court of Appeals for the District of Columbia

8. See Stone, *supra* note 1, at N1. Stone explains that rapid growth in the viatical settlement industry has been beneficial to both buyers and sellers. See *id.* Buyers have benefitted because competition to purchase policies has kept purchase prices high. See *id.* Sellers have benefitted because the rush of investors into the market has prompted heady competition between major insurance companies attempting to enter the market and start-up companies already in the market. See *id.* Competition for investment dollars has kept dealing above board overall. See *id.* This flurry of activity has also alerted some states and the Securities and Exchange Commission (SEC) to the need to regulate this booming industry. See *id.*; see also *Life Partners*, 898 F. Supp. at 17-18 (recognizing benefits investors and terminally ill derive from viatical settlements, potential for investor fraud and lack of grievances filed by investors against viatical settlement companies); Glick, *supra* note 1, at 958-84 (discussing regulation of investment contracts in viatical settlements under federal securities laws); Peloso & Sarnoff, *supra* note 3, at 3 (discussing if and when viatical settlement is subject to federal securities laws); Crenshaw, *supra* note 1, at C01 (noting SEC's desire to regulate investment in viatical settlement and congressional considerations of tax consequences of viatical settlements).

9. See *Life Partners*, 87 F.3d at 538-39 (recognizing potential for abuse of individual investors in rapidly growing viatical settlement industry and fact that many viatical settlement companies currently register these investments as securities with SEC); *Life Partners*, 898 F. Supp. at 17 (same); Stone, *supra* note 1, at N1 (noting California's concern over unregulated viatical settlement companies and states' efforts to develop effective regulation in absence of federal regulation).

10. See *SEC v. Life Partners, Inc.*, No. 94-1861, 1996 WL 195136, at *1 (D.D.C. Mar. 19, 1996) (granting emergency order enjoining Life Partners from resuming sale of investment contracts in viatical settlements because of perceived need for regulation of investments), *remanded by* 87 F.3d 536 (D.C. Cir. 1996); *SEC v. Life Partners, Inc.*, 912 F. Supp. 4, 6 (D.D.C.) (reiterating need to regulate investments in viatical settlements sold by Life Partners to individual investors), *remanded by* 87 F.3d 536 (D.C. Cir. 1996); *Life Partners*, 898 F. Supp. at 17-18 (recognizing need for federal regulation of investments in viatical settlements under auspices of SEC); Crenshaw, *supra* note 1, at C01 (explaining potential ramifications of failure to regulate viatical settlements and industry reaction to lower court's disposition of *Life Partners* case); Stone, *supra* note 1, at N1 (explaining need for regulation and states' efforts to enact regulation). *But see* *Life Partners*, 87 F.3d at 548 (finding investment contracts in viatical settlements were not able to be regulated by SEC pursuant to federal securities laws); Glick, *supra* note 1, at 984 (concluding that viatical settlements are not within regulatory ambit of SEC pursuant to federal securities laws); Peloso & Sarnoff, *supra* note 3, at 3 (explaining D.C. Circuit's decision in *Life Partners* that investments in viatical settlements are not within regulatory authority of SEC).

in *SEC v. Life Partners, Inc.*¹¹ In order to make this determination, the D.C. Circuit first addressed the issue of whether a fractional interest in a viatical settlement constitutes a “security.”¹² Resolving this issue is a prerequisite to determining whether sales of these fractional interests fall within the regulatory power of the SEC.¹³ The SEC may only regulate fractional interests in viatical settlements if these interests constitute securities.¹⁴

An investment contract is considered a security within the scope of the Securities Act of 1933 (“the Act”) if it is purchased with an expectation of profits, arising from a common enterprise that depends upon the efforts of others.¹⁵ In *Life Partners*, the D.C. Circuit held that investment contracts, through which individuals purchased fractional interests in viatical settlements, were not securities.¹⁶ This holding precludes the SEC from regulating these investment contracts, which are otherwise unregulated, in an effort to protect individual investors from potentially fraudulent schemes.¹⁷

This Note discusses the applicability of federal securities laws to fractional investments in viatical settlements. It focuses primarily on the definition of investment contracts constituting securities and, therefore, falling within the regulatory authority of the SEC in an effort to determine whether viatical settlements should fall within the ambit of the SEC’s regulatory authority. Part II of this Note explains the background of the Act and the development of a test for determining whether an investment contract is within the SEC’s regulatory authority.¹⁸ Part II also focuses on the

11. 87 F.3d 536 (D.C. Cir. 1996).

12. *See id.* at 538; *see also* Securities Act of 1933, 15 U.S.C. § 77k (1994) (governing regulatory authority of SEC regarding primary offering of securities). The Securities Act of 1933 confers authority on the SEC to regulate any investment instrument that fits within the Act’s definition of a security. *See id.* § 77(b)(1).

13. *See* 15 U.S.C. § 77(b)(1).

14. *See Life Partners*, 87 F.3d at 540.

15. *See SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946) (holding that investment is “security” subject to Act if investors purchase with expectation of profits arising from common enterprise that depends upon efforts of others). In *Howey*, the Supreme Court announced what has come to be accepted as the definitive test of whether an investment contract constitutes a security for purposes of the Securities Act of 1933 (“the Act”). *See Life Partners*, 87 F.3d at 543 (“[W]hether [the viatical settlements] are properly characterized as securities within the terms of the 1933 Act . . . is controlled by the Supreme Court’s decision in *Howey*.”).

16. *Life Partners*, 87 F.3d at 548. Announcing its holding, the court explained that:

[T]he SEC is unable to show that the promoter’s efforts have a predominant influence upon investors’ profits; and because all three elements of the *Howey* test must be satisfied before an investment is characterized as a security, we must conclude that the viatical settlements marketed by [Life Partners] are not securities.

Id. (citations omitted).

17. *See* 15 U.S.C. § 77k (governing SEC’s regulatory authority).

18. For a further discussion of the background of the Act, see *infra* notes 28-38 and accompanying text.

evolution of this test.¹⁹ Part III describes the development of viatical settlements as investment vehicles.²⁰ Part III also depicts the viatical settlements offered by Life Partners, Inc. and the factual background leading up to the D.C. Circuit's decision in *Life Partners*.²¹ Part III further explains the procedural history of *Life Partners*.²² Part IV outlines the court's application of the Act, in light of relevant precedent, to the investment contracts sold by Life Partners, Inc.²³ Part IV also critically examines the D.C. Circuit's disposition of *Life Partners* and the dissent's counterpoints.²⁴ Part V discusses the potential legal ramifications of the D.C. Circuit's alteration of the test of whether an investment contract is within the SEC's regulatory authority.²⁵ Further, Part V discusses the potential impact of *Life Partners* on individuals investing in viatical settlements.²⁶ Finally, Part VI concludes that *Life Partners* shifts the heavy burden of regulating investment in viatical settlements to the states and questions how and whether the states will undertake this burden.²⁷

II. BACKGROUND: FEDERAL SECURITIES REGULATION AND CASE LAW

A. *The Securities Act of 1933 and Its Traditional Application*

The Act is a broad remedial statute that attempts to protect individual investors from fraud by regulating primary offerings of securities.²⁸ The Act was promulgated in an effort to stabilize the American securities indus-

19. For a further discussion of the test for determining whether an investment contract may be considered a security and regulated by the SEC, see *infra* notes 39-115 and accompanying text.

20. For a further discussion of the history of viatical settlements, see *infra* notes 116-26 and accompanying text.

21. For a further discussion of the investment vehicles offered by Life Partners, see *infra* notes 127-36 and accompanying text.

22. For a further discussion of the procedural history of the *Life Partners* decision, see *infra* notes 137-43 and accompanying text.

23. For a further discussion of the court's reasoning in the *Life Partners* decision, see *infra* notes 144-83 and accompanying text.

24. For a further discussion of the critical analysis of the *Life Partners* decision, see *infra* notes 184-237 and accompanying text.

25. For a further discussion of the potential legal ramifications of the *Life Partners* decision, see *infra* notes 238-44 and accompanying text.

26. For a further discussion of the potential impact of the *Life Partners* decision on the viatical settlement industry, see *infra* notes 238-44 and accompanying text.

27. For a further discussion of the impact of the *Life Partners* decision on the states, see *infra* note 240-44 and accompanying text.

28. See *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298 (1946) (explaining that Act was intended to be broadly construed and applied to all schemes that would ordinarily be considered securities); *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943) (recognizing that Act does not stop regulating with obvious and commonplace, but extends coverage to novel, uncommon and irregular devices if they appear to be securities); H.R. REP. NO. 85, at 11 (1933) (explaining that Act is intended to apply to any investment scheme that falls within ordinary concept of security).

try and restore public confidence in domestic financial markets.²⁹ Consistent with its broad purpose, the Act defines the term "security" very broadly, conferring broad regulatory power on the SEC.³⁰

The Act's comprehensive definition of the term "security" includes the term "investment contract."³¹ Inevitably, definition of the vague term "investment contract", as it is used to define the term "security", has been the subject of litigation since the passage of the Act.³² The landmark case of *SEC v. W.J. Howey Co.*³³ defined this term for purposes of the Act and provided a test for determining whether the Act is applicable to any given investment contract.³⁴

The Supreme Court decided *Howey* in 1946.³⁵ In this decision, the Court defined the term "investment contract."³⁶ The Court also stated that the test of whether an investment contract is a security within the

29. See *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 756 F.2d 230, 237 (2d Cir. 1985) (stating that Act was "intended to encourage 'honest dealing in securities and thereby bring back public confidence' in the investment markets" (quoting Letter from President Franklin D. Roosevelt to Congress (March 29, 1933) *reprinted in* 77 CONG. REC. 937 (1933))).

30. See 15 U.S.C. § 77(b)(1) (1994). The definition of security contained within the Act is very broad. See *id.* Section 77(b)(1) reads as follows:

When used in this subchapter, unless the context otherwise requires—

- (1) The term 'security' means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, *investment contract*, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, . . . or, in general, any interest or instrument commonly known as a 'security', or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

Id. (emphasis added).

31. See *id.* (defining term security as, among other things, investment contract).

32. See, e.g., *Howey*, 328 U.S. at 293 (holding that fractional interests in orange groves are investment contracts constituting securities and explaining reasons for this determination); *Joiner*, 320 U.S. at 344 (holding that fractional interests in oil leases are investment contracts constituting securities).

33. 328 U.S. 293 (1946).

34. *Id.* at 298-99. In *Howey*, the Supreme Court laid down what was to become the definitive three-pronged test for determination of whether an investment instrument capable of being described as an investment contract was a security. See *id.* at 299. The *Howey* Court stated that an investment contract that involved the "investment of money in a common enterprise with profits to come solely from the efforts of others" constituted a security. *Id.* at 301. Subsequent judicial modification by the Supreme Court and several federal courts of appeals have transformed this statement into a simple, well recognized three-pronged test requiring (1) an expectation of profits arising from (2) a common enterprise that (3) depends upon the efforts of others. See *SEC v. Life Partners, Inc.*, 87 F.3d 536, 542 (D.C. Cir. 1996).

35. *Howey*, 328 U.S. at 293.

36. See *id.* at 301. In *Howey*, the Supreme Court stated that the test of whether an investment contract constitutes a security is:

meaning of the Act is “whether the scheme involves the investment of money in a common enterprise with profits to come solely from the efforts of others.”³⁷ This statement has since been distilled, with little substantive alteration, into a three-pronged test for determining whether an investment contract constitutes a security for purposes of the Act.³⁸

B. *Application of the Howey Test*

An investment contract is a security, subject to regulation by the SEC, if investors purchase it with (1) an expectation of profits arising from (2) a common enterprise that (3) depends upon the efforts of others.³⁹ Subsequent to the statement of this test in *Howey*, each of the three prongs has been further explained and interpreted.⁴⁰ These interpretations have broadened the scope of the *Howey* test as courts have systematically applied each prong of the test.⁴¹

1. *The First Prong: Expectation of Profits*

The *Howey* Court determined that an expectation of profits arising from an individual’s investment was crucial to an investment contract being considered a security.⁴² Holding that investors’ purchases of frac-

[W]hether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others. If that test be satisfied, it is immaterial whether the enterprise is speculative or non-speculative or whether there is a sale of property with or without intrinsic value. The statutory policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae.

Id. (citations omitted).

37. *Id.*

38. See *Life Partners*, 87 F.3d at 542.

39. See *id.*

40. See *United Hous. Found. v. Forman*, 421 U.S. 837, 854 (1975) (holding that shares of stock that entitled purchasers to lease apartment in state-subsidized nonprofit housing cooperative were not securities under *Howey* test); *Tcherepnin v. Knight*, 389 U.S. 332 (1967) (holding that liquid capital share in Illinois savings and loan association was security under *Howey* test); *Life Partners*, 87 F.3d at 536 (interpreting common enterprise requirement of second prong of *Howey* test); *Rodriguez v. Banco Cent. Corp.*, 990 F.2d 7, 11 (1st Cir. 1993) (same); *Guidry v. Bank of LaPlace*, 954 F.2d 278, 284-85 (5th Cir. 1992) (using “fair resemblance” test to determine whether postdated check satisfied first prong of *Howey* test); *Noa v. Key Futures, Inc.*, 638 F.2d 77, 79 (9th Cir. 1980) (*per curiam*) (interpreting third prong of *Howey* test); *SEC v. Glenn W. Turner Enters., Inc.*, 474 F.2d 476, 481-82 (9th Cir. 1973) (interpreting third prong of *Howey* test).

41. See *Life Partners*, 87 F.3d at 542. Courts typically attempt to examine each prong of the *Howey* test independently, as the court in *Life Partners* explained, “[t]o the extent practical we examine each component of the [*Howey*] test separately.” *Id.*

42. *Howey*, 328 U.S. at 299-300. Examination of the *Howey* opinion clearly demonstrates that the Supreme Court considered an expectation that profit, as it understood the meaning of the word, was pivotal to a determination that an investment contract constituted a security. See *id.* The Court observed that the companies selling the real-estate-based investment contracts involved in *Howey* were offering something more than fee simple interests in land, something different

tional interests in a productive tract of farm land coupled with a management contract met this criteria, the Court observed that the investors had been offered an opportunity that was far in excess of a mere interest in land accompanied by management services.⁴³ The determinative factor establishing this prong of the test was the fact that investors were drawn to purchase their interests by the prospect of receiving profits on their purely monetary investments.⁴⁴ The scope of the definition of "profits" in the *Howey* test has been the subject of much debate.⁴⁵

The Supreme Court's decision in *Howey* closely tracked the only analogous precedent existing at the time, *SEC v. C.M. Joiner Leasing Corp.*⁴⁶

from a farm or orchard coupled with management services. *See id.* The Court stated:

They [were] offering an opportunity to contribute money and to share in the profits of a large citrus fruit enterprise managed and partly owned by [investors]. They [were] offering this opportunity to persons who reside in distant localities and who lack the equipment and experience requisite to the cultivation, harvesting and marketing of the citrus products. Such persons have no desire to occupy the land or to develop it themselves; they are attracted solely by the prospects of a return on their investment.

Id. With this statement, the Court provided a key insight into its reasoning and also laid the ground work for the profit test, which was eventually developed in the first prong of the test set down in *Howey*. *See id.* The Supreme Court in *Forman* further clarified the profit test of the first prong of the *Howey* test stating: "What distinguishes a security transaction . . . is an investment where one parts with his money in the hope of receiving profits from the efforts of others, and not where he purchases a commodity for personal consumption." *Forman*, 421 U.S. at 858. In *Forman*, the Court clarified its view of profit for the purposes of federal securities laws. *See id.* For these purposes profit must, "in conformity with ordinary usage, be in the form of a financial return on investment, not in the form of consumption. This principle distinguishes between buying a note secured by a car and buying the car itself." *Life Partners*, 87 F.3d at 543.

43. *See Howey*, 328 U.S. at 299.

44. *See id.* at 300; *see also Tcherepnin*, 389 U.S. at 339 (stating that capital shares paying dividends tied directly to profit of savings and loan association have essential attributes of investment contracts constituting securities for purposes of federal securities laws); *Joiner*, 320 U.S. at 352 (finding that offering and selling investment contracts for fractional interests in land that is subject of oil leases constitutes sale of securities when language promoting investment emphasized prospect of splendid returns on one's investment); *Guidry*, 954 F.2d at 284 (stating that expectation of profit on investment contract that constitutes security carries with it connotation of risk including potential appreciation or depreciation in value of investment contract).

45. *Howey*, 328 U.S. at 300.

46. 320 U.S. 344 (1943). Prior to its decision in *Howey*, the Supreme Court decided *Joiner*. *Joiner*, 320 U.S. at 344. In *Joiner*, the Court found that investors' purchases of fractional interests in oil leases and the tract of land subject to the leases, coupled with an agreement that the promoter drill exploratory wells, were investment contracts that constituted securities. *See id.* at 348. Announcing its holding in *Joiner*, the Court relied heavily on the fact that the individual investors purchased the fractional interests in the land and leases in an effort to obtain a financial return on their investment. *See id.* at 346-47, 349.

Howey, like *Joiner*, involved the sale of an investment that was based upon the ownership of a fractional interest in a larger tract of land tied to a fractional interest in a common venture that was aimed at providing returns to investors by dra-

Deciding *Joiner*, the Court determined that sales of fractional interests in oil leases constituted sales of securities.⁴⁷ The profits anticipated by purchasers of fractional interests in *Joiner* were to come from capital appreciation, resulting from the development of the individuals' initial capital investments.⁴⁸ The *Howey* Court built its comprehensive three-pronged test around the *Joiner* decision, recognizing that, for purposes of determining whether an investment contract constituted a security, anticipated profit included an expectation of capital appreciation resulting from a purely monetary investment in a venture that depended entirely on the efforts of others to succeed.⁴⁹

matically improving the value of the land underlying the transaction. See *Howey*, 328 U.S. at 293 (noting individual investors purchased fractional shares of citrus grove and 85% also engaged *Howey* to operate their fraction of grove along with its cultivation of larger property in exchange for return that was estimated to be between 10% and 20% of their original investment); *Joiner*, 320 U.S. at 345-46 (noting that individual investors purchased fractional shares of tract of land in McCulloch County, Texas that were coupled with assignment of oil leases covering tract purchased and promoter promised to drill test wells that, when shown to be productive, would produce dramatic appreciation in investors' initial investment). In each of these cases, the fractional shares of land were too small, or configured in such a manner as to be too inconvenient to facilitate any use other than that for which they were sold, as portions of a tract to be operated for a specific purpose. See *Howey*, 328 U.S. at 295; *Joiner*, 320 U.S. at 345-46. Observing the similarity of these cases, the Court relied heavily on *Joiner* in formulating the *Howey* test. See *Howey*, 328 U.S. at 300-01.

47. *Joiner*, 320 U.S. at 355.

48. See *id.* at 346-47. Evaluating the promotion of the investment contracts offered and sold, the *Joiner* Court found sufficient evidence that the assigned leases and underlying tracts of land were sold solely as a method of securing financial profit to investors. See *id.* at 346. Promotional materials circulated by the promoters of the investment contracts read:

[W]e are submitting this proposition to you in language that will appeal only to business people who are interested in making an investment where they have a good chance for splendid returns on the investment [I]f you send in an order for twenty acres . . . you will get ten acres Free in the next block of acreage we drill which is most likely to be in Concho County, Texas. You will really be in the oil business. Remember, if you do not make money on your investment it will be impossible for us to make money Fortunes made in oil go to those who invest.

Id. at 346-47 n.3.

49. *Howey*, 328 U.S. at 299. Observing that the *Joiner* Court had elevated substance over form in reaching its conclusion that the investment contracts at issue were securities, the *Howey* Court stated its view that:

[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 party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise. Such a definition necessarily underlies this Court's decision in *SEC v. Joiner Corp.*, 320 U.S. 344, and has been enunciated and applied many times by lower federal courts.

Id. at 298-99. With this statement, the *Howey* Court set down the framework of what has come to be the modern *Howey* test. *Id.*

Participation in earnings resulting from the use of investors' funds was included in the *Howey* test's definition of "profits" by the Supreme Court's decision in *Tcherepnin v. Knight*.⁵⁰ In *Tcherepnin*, the Court observed that the payment of dividends on investment contracts indicated that investors expected to receive profits as a return on their investments.⁵¹ This expectation of profits through the receipt of dividends gave the subject investment contracts the most essential attribute of investment contracts constituting securities.⁵²

In contrast, the Court in *United Housing Foundation, Inc. v. Forman*⁵³ declined to characterize "stock" held by individuals in a housing cooperative as a security.⁵⁴ The stock failed to satisfy the first prong of the *Howey* test because individuals were attracted to purchase it by the prospect of acquiring a place to live, rather than the prospect of receiving a financial return on their investment.⁵⁵ The Court held that this type of return on

50. 389 U.S. 332 (1967). In *Tcherepnin*, the Court determined that the profit prong of the *Howey* test was satisfied by the fact that the holders of capital shares in a savings and loan association paid dividends "tied directly to the amount of profits [the savings and loan] makes from year to year." *Id.* at 339. Because these dividends were an apportionment of the profits made by the venture in which the individuals had invested, the dividends were considered profits for purposes of the *Howey* test. *See id.* Accordingly, the definition of "expectation of profit" typically employed in the *Howey* test was expanded to include dividends on capital investments in a venture that met all other prongs of the test. *See id.* After concluding that the capital shares in *Tcherepnin* were investment contracts constituting securities for purposes of federal securities laws, it continued to observe that these shares could likely meet the definition of security if the Court were to apply another portion of the definition. *See id.* The Court said:

[W]e need not rest our decision on that conclusion alone. "Instruments may be included within any of [the Act's] definitions, as a matter of law, if on their face they answer to the name or description." The . . . shares fit well within several other descriptive terms contained in [the definition of security]. For example, the . . . shares can be viewed as "certificate[s] of interest or participation in any profit-sharing agreement" [The] same factors make the shares "stock" under [federal securities laws]. Finally, the . . . shares can be considered "transferable share[s]"

Id. (citations omitted) (quoting *Joiner*, 320 U.S. at 351).

51. *Id.*

52. *See id.*

53. 421 U.S. 837 (1975).

54. *Id.* at 853.

55. *See id.* *Forman* involved the sale of shares of "stock" in a state-subsidized housing cooperative. *Id.* at 837. Prospective tenants were required to purchase a requisite number of shares—18 shares at \$25 per share for each room desired in the housing project—in order to obtain an apartment. *See id.* at 838. The shares were nontransferable, except on death to a surviving spouse. *See id.* The shares could only be sold back to the developer, for the original purchase price of \$25, on termination of occupancy in the housing project. *See id.* In light of the economic realities of the instruments purchased, the Court stated that the purchasers could not have realistically believed that "federal securities laws governed their purchase." *Id.* at 851. The Court stated: "Common sense suggests that people who intend to acquire only a residential apartment in a state-subsidized cooperative, for their personal use, are not likely to believe that in reality they are purchasing investment securities" *Id.*

individuals' capital is outside the definition of profit that satisfies the *Howey* test.⁵⁶ The Court ruled that federal securities laws do not apply when investors purchase investment contracts with the expectation of personally consuming or using the interest acquired.⁵⁷ The Court narrowed

56. *See id.* at 852-58. Three theories of profit were advanced in the *Forman* case. *Id.* These theories included (1) acquiring a place to live through the investment, (2) deductibility for tax purposes of the portion of the investors' monthly rental charge applied to interest paid on the mortgage and (3) the financial benefit received from acquiring a property with rent substantially lower than other comparable properties. *See id.* at 855. The Court summarily dismissed the latter two theories. *See id.* Of the tax deduction profit theory, the Court said, "[w]e know of no basis in law for the view that the payment of interest, with its consequent deductibility for tax purposes, constitutes income or profits. These tax benefits are nothing more than that which is available to any homeowner who pays interest on his mortgage." *Id.* Likewise, the Court stated that the financial benefit received by purchasing a property that offers lower rental charges (or acquisition charges) than comparable properties "is an inappropriate theory of 'profits' that we cannot accept." *Id.* The Court explained that:

The low rent derives from the substantial financial subsidies provided by the State of New York. This benefit cannot be liquidated into cash; nor does it result from the managerial efforts of others. In a real sense, it no more embodies the attributes of income or profits than do welfare benefits, food stamps, or other government subsidies.

Id.

The Court dealt with the "acquisition of a place to live" theory in considerably more detail. Nevertheless, it held that this is not the type of profit that satisfies the *Howey* test. *See id.* at 853. The Court explained that "when a purchaser is motivated by a desire to use or consume the item purchased—to occupy the land or to develop it themselves' . . . the securities laws do not apply." *Id.* at 852-53 (quoting *SEC v. W.J. Howey*, 328 U.S. 293, 300 (1946)).

57. *See id.* Identifying the motivation of the purchasers of "stock" in *Forman*, the Court observed that "[i]n the present case there can be no doubt that investors were attracted solely by the prospect of acquiring a place to live, and not by financial returns on their investments." *Id.* at 853. Examining the actions of the promoters before the sales transactions took place, consistent with *Joiner*, the Court observed that the promotional undertaking of the promoters of the project "emphasized the fundamental nature and purpose of the undertaking" as focused on providing and obtaining housing. *Id.* Accordingly, the promotional materials boasted that "[p]eople find living in a cooperative community enjoyable Most people join . . . for the simple reason that it is a way to obtain decent housing at a reasonable price The purpose of a cooperative is to provide home ownership" *Id.* at 853-54. The Court observed that:

[N]owhere does the [promotional] Bulletin seek to attract investors by the prospect of profits resulting from the efforts of the promoters On the contrary, the Bulletin repeatedly emphasizes the "nonprofit" nature of the endeavor It also informs purchasers that they will be unable to resell their apartments at a profit since the apartment must first be offered back to [the developer] "at the price . . . paid for it."

Id. at 854. These facts show the lack of profit expectancy relating to the shares offered and sold in *Forman* and provide a dramatic contrast to the promotional materials, emphasizing the prospect of handsome returns, held to be of importance in *Joiner*. Compare *id.* (involving purchase of cooperative housing with no expectancy of profit), with *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 346 n.3 (1943) (involving purchase of land tracts from which investors expected profits derived from oil drilling).

the definition of "profit" by contrasting the return expected in *Forman* with the "financial" returns anticipated in *Howey*, *Tcherepnin* and *Joiner*.⁵⁸

In *Guidry v. Bank of LaPlace*,⁵⁹ the United States Court of Appeals for the Fifth Circuit streamlined the profits test of *Howey*'s first prong.⁶⁰ The court summed up precedent and restated the profit test as either capital appreciation resulting from the development of the initial investment or a participation in earnings resulting from the use of investors' funds.⁶¹ The court added that an expectation of profits from an investment contract must embody some element of risk in the amount of the return or loss of the investors' capital investment.⁶² Considering these elements essential factors, the Fifth Circuit held that investment contracts offering a fixed rate of return, with no possibility of fluctuation or risk to the investors' capital, were not investment contracts constituting securities within the definition of the Act.⁶³ The *Guidry* reformulation, requiring risk to inves-

58. *Forman*, 421 U.S. at 853 (noting that investors were not attracted to buy shares for prospect of financial returns on their investment).

59. 954 F.2d 278 (5th Cir. 1992).

60. *Id.* at 284. In *Guidry*, the Fifth Circuit provided a coherent analysis and comparison of Supreme Court precedent regarding development of the second prong of the *Howey* test to date. *Id.* *Guidry* summed up essential precedent and recognized the continuing importance of *Joiner*, *Howey* and *Tcherepnin* and the limitation the Court placed on the "flexibly" applied securities laws in *Forman*. *See id.* Expounding what has become the widely accepted "profits test" of the second prong of the *Howey* test, the *Guidry* court explained that "profit," for purposes of the *Howey* test is "either capital appreciation resulting from the development of the initial investment . . . or a participation in earnings resulting from the use of investors' funds." *Id.* (quoting *Forman*, 421 U.S. at 852).

61. *See id.*

62. *See id.* In *Guidry*, the Fifth Circuit expressed its view that:

[E]xpectation of profit carries with it a connotation of potential appreciation or depreciation in value of the investment contract. That is, the arrangement *must* be so structured as to contemplate, at the outset, some risk—either that the investor could lose his investment, or that the value of his return could fluctuate.

Id. (emphasis added). This view is contrary to the Supreme Court's statement in *Howey* that "[i]f the [*Howey*] test be satisfied, it is immaterial whether the enterprise is speculative or non-speculative The statutory policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae." SEC v. W.J. Howey, 328 U.S. 293, 301 (1946) (citation omitted).

63. *Guidry*, 954 F.2d at 284. *Guidry* involved a check kiting scheme in which petitioner *Guidry* continuously exchanged checks with respondent *Martin*. *Id.* For each check that petitioner gave respondent, petitioner received two post-dated checks in return. *See id.* One of the checks represented a return of petitioner's capital investment, the second represented profit earned on the capital invested. *See id.*

Applying its requirement that an investment contract constituting a security carry with it a risk of loss, the *Guidry* court determined that this check kiting scheme did not constitute a security. *See id.* The Fifth Circuit stated:

[T]he post-dated checks were [respondent's] legally binding and fully enforceable agreement to pay the amount of the checks on the date they bore. [Petitioner] implies that [respondent] and [petitioner] recognized a risk that the checks would be dishonored if [respondent's] venture was unsuccessful. There is no allegation, however, that [respondent] and

tors' capital or fluctuation in the rate of return, has not been adopted by the Supreme Court.⁶⁴

2. *The Second Prong: Common Enterprise*

The second prong of the *Howey* test requires that the investment contract be tied to a common enterprise.⁶⁵ Finding a common enterprise requires a court to make a two-step determination that (1) investors share commonality and (2) an enterprise exists.⁶⁶ If an investment contract fails

[petitioner] agreed that [respondent] would not be liable to [petitioner] on [respondent's] checks in any circumstances. There was thus no legal way that [respondent] could force [petitioner] to accept less than the amount stated on the post-dated checks in satisfaction of the alleged contract between them.

Id. Thus, applying the Fifth Circuit's fluctuation requirement, these checks failed the first prong of the *Howey* test. *See id.*

64. *Id.* Subsequent to the decision of *Guidry*, the Supreme Court has not voiced an opinion on the fluctuation requirement it imposed. *See id.* As previously noted, however, the requirement appears directly contrary to the Court's statement in *Howey* that "[i]f the [*Howey*] test be satisfied, it is immaterial whether the enterprise is speculative or non-speculative." *Howey*, 328 U.S. at 301.

65. *Howey*, 328 U.S. at 299-300. Applying the common enterprise requirement, the *Howey* Court explained that fractional interests in an orange grove [g]ain utility as citrus groves only when cultivated and developed as component parts of a larger area. A common enterprise managed by [the promoter] or third parties with adequate personnel and equipment is therefore essential if the investors are to achieve their paramount aim of a return on their investments.

Id. at 300. This statement demonstrated the necessity of this requirement to the test. *See id.*

66. *See Rodriguez v. Banco Centr. Corp.*, 990 F.2d 7, 10 (1st Cir. 1993). *Rodriguez* best illustrates the separate components of this principle that are also illustrated in *Howey* and *Forman*. *See id.* ("Each component in the concept matters."); *see also United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 858 (1975) (making separate component distinction as to shares in housing cooperative); *Howey*, 328 U.S. at 300 ("Thus all the elements of a profit-seeking business venture are present here. The investors provide the capital and share in the earning and profits; the promoters manage, control and operate the enterprise."). Relying on *Howey* and *Forman*, the *Rodriguez* court explains:

Each component in the [common enterprise] concept matters. There are many investments obtained by contract, such as one's home, that are not an interest in an enterprise. One may have an interest in an enterprise—an employment contract, for example—that is not an entitlement to profits or increased value. Conversely, in a sole proprietorship the owner could have a claim on all profits of the enterprise but there might be no contract or security involved. Further, the Supreme Court cases mark out a *concept*, not a precise definition. . . .

. . . .

. . . [O]ne who buys raw land or even a building, hoping to profit from rents or the natural increase in the value of the property, is not under normal circumstances treated as purchasing a 'security.'

At some point, however, the commitments and promises incident to a land transfer, and the network of relationships related to the project, can cross over the line and make the interest acquired one in an ongoing business enterprise. At that point, the interest may be treated as a security, even if not so labeled.

to exhibit these criteria, it fails to satisfy the second prong of the *Howey* test and is not an investment contract constituting a security.⁶⁷

a. Commonality

The commonality requirement of the *Howey* test may be satisfied by either horizontal commonality or vertical commonality.⁶⁸ Horizontal commonality refers to the relationship among investors in an enterprise.⁶⁹ It is broadly defined as the tying of each individual investor's fortune to the fortunes of other investors.⁷⁰ This tying together of investors' fortunes is typified by the pooling of individual investor's assets combined with pro-rata distribution of profits from the venture.⁷¹ Simply defined, horizontal commonality among investors is the pooling of investment funds, sharing of profits and sharing of losses.⁷² This type of commonality is universally recognized as sufficient to fulfill the commonality requirement of the *Howey* test.⁷³

Unlike horizontal commonality, vertical commonality refers to the relationship between the investor and the promoter of the venture that is the subject of the investment contracts.⁷⁴ Courts applying the *Howey*

Rodriguez, 990 F.2d at 10-11 (citations omitted) (citing *Forman*, 421 U.S. at 852-53; *Howey*, 328 U.S. at 289-99).

67. *Howey*, 328 U.S. at 300.

68. See *SEC v. Life Partners, Inc.*, 87 F.3d 536, 543 (D.C. Cir. 1996). The D.C. Circuit followed the universally accepted principal that horizontal commonality fulfills the commonality requirement of the *Howey* test. See *id.*

69. See *Revak v. SEC Realty Corp.*, 18 F.3d 81, 87 (2d Cir. 1994) (holding condominium transactions were not investment contracts). Explaining this concept, the Second Circuit stated that

[a] common enterprise within the meaning of *Howey* can be established by a showing of "horizontal commonality": the tying of each individual investor's fortunes to the fortunes of the other investors by the pooling of assets, usually combined with the pro-rata distribution of profits. In a common enterprise marked by horizontal commonality, the fortunes of each investor depend upon the profitability of the enterprise as a whole.

Id. (citations omitted). The Second Circuit borrowed this explanation of horizontal commonality from the Sixth Circuit, which earlier stated that "[h]orizontal commonality ties the fortunes of each investor in a pool of investors to the success of the overall venture. In fact, a finding of horizontal commonality requires a sharing or pooling of funds." *Hart v. Pulte Homes of Mich. Corp.*, 735 F.2d 1001, 1004 (6th Cir. 1984); see also *Salcer v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 682 F.2d 459, 460 (3d Cir. 1982) (explaining that investment contract constituting security must be "part of a pooled group of funds"); *Milnarik v. M-S Commodities, Inc.*, 457 F.2d 274, 276 (7th Cir. 1972) (stating that success or failure of other individual investors' investment contracts must have "direct impact on the profitability of the plaintiffs' contracts" in order for horizontal commonality to be found).

70. See *Revak*, 18 F.3d at 87.

71. See *id.*

72. See *Life Partners*, 87 F.3d at 543.

73. See *id.*

74. See *Revak*, 18 F.3d at 87-88. In *Revak*, the Second Circuit acknowledged the increasing acceptance of vertical commonality as a method of satisfying the second prong of the *Howey* test:

test to investment contracts have identified and defined two types of vertical commonality, strict vertical commonality and broad vertical commonality.⁷⁵

Each type of vertical commonality is easily distinguishable from the other.⁷⁶ As the United States Court of Appeals for the Second Circuit noted: "Strict vertical commonality' requires [only] that the fortunes of investors be *tied to the fortunes* of the promoter."⁷⁷ Broad vertical commonality requires that the fortunes of investors be *linked to the efforts* of the promoter.⁷⁸

The concept of vertical commonality is difficult to establish and not widely recognized as sufficient to satisfy the commonality requirement of the *Howey* test.⁷⁹ Accordingly, while vertical commonality has become a significant factor in many recent cases, it is not as important as horizontal commonality, which is universally accepted as sufficient to satisfy the second prong of the *Howey* test.⁸⁰

Some circuits hold that a common enterprise can also exist by virtue of "vertical commonality," which focuses on the relationship between the promoter and the body of investors In an enterprise marked by vertical commonality, the investors' fortunes need not rise and fall together; a pro-rata sharing of profits and losses is not required.

Id. at 87 (citations omitted); see *Villeneuve v. Advanced Bus. Concepts Corp.*, 698 F.2d 1121, 1124 (1983) (stating that vertical commonality satisfies second prong of *Howey* test), *aff'd*, 730 F.2d 1403 (11th Cir. 1984) (en banc); *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 479 (5th Cir. 1974) (stating that "requisite commonality is evidenced by the fact that the fortunes of all investors are inextricably tied to the efficacy" of promoter); *SEC v. Glenn W. Turner Enters., Inc.*, 474 F.2d 476, 482 n.7 (9th Cir. 1973) (acknowledging existence of commonality between body of investors and promoter as sufficient to satisfy second prong of *Howey* test).

75. See *Revak*, 18 F.3d at 87-88 (identifying two distinct kinds of vertical commonality: "broad vertical commonality" and "strict vertical commonality").

76. See *id.*

77. *Id.* at 88 (emphasis added); see also *Brodt v. Bache & Co., Inc.*, 595 F.2d 459, 461 (9th Cir. 1978) (explaining that strict vertical commonality requires fortunes of individual investors to be "tied" to fortunes of promoter).

78. See *Revak*, 18 F.3d at 88; see also *Long v. Schultz Cattle Co., Inc.*, 881 F.2d 129, 140-41 (5th Cir. 1989) (finding that broad vertical commonality requires that fate of investors' fortunes "need be linked only" to efforts of promoter of investment).

79. See *Revak*, 18 F.3d at 88-89. The language used in *Revak* demonstrates the courts' reluctance to accept the concept of vertical commonality as sufficient to satisfy the second prong of the *Howey* test:

This Court has not previously considered whether vertical commonality (strict or otherwise) satisfies the common enterprise requirement of the *Howey* test. [W]e need not address the question of whether *strict* vertical commonality gives rise to a common enterprise. We do consider whether *broad* vertical commonality satisfies *Howey's* second requirement, and we hold that it does not.

Id. at 88.

80. See *id.* at 88-89.

b. Existence of an Enterprise

The enterprise requirement recently evolved out of *Howey* and its progeny as courts repeatedly sought to deal with schemes that offered investors the opportunity to invest in fractional interests in property.⁸¹ In *Rodriguez v. Banco Central Corp.*,⁸² the United States Court of Appeals for the First Circuit clarified the enterprise requirement and confirmed its necessity.⁸³

In *Rodriguez*, the court explained this requirement, stating that ownership of property alone does not constitute the existence of a business enterprise while, conversely, ownership of a security necessarily constitutes ownership of an interest in a business enterprise.⁸⁴ Therefore, the question of whether a common enterprise exists depends on whether the interest acquired by the investor is simply an interest in property and nothing more, or whether the property interest is an interest in an ongoing business enterprise and, thus, constitutes a security within the definition of the Act.⁸⁵ Some courts ignore this new portion of the test, while others merge it into the third prong, giving the issue short shrift.⁸⁶ In the inter-

81. See *SEC v. W.J. Howey Co.*, 328 U.S. 293, 300 (1946). The original *Howey* test looked for a "common enterprise." See *id.* The *Howey* decision, however, carefully evaluated each component of the second prong, finding both commonality and an enterprise. See *id.* The enterprise requirement was implicitly acknowledged in *Joiner*, before *Howey* was decided, when the Supreme Court acknowledged that individual investors were purchasing more than an interest in real estate, but also a promise by the promoter to perform duties that were calculated to lead the appreciation of the investment. See *id.* at 301; *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 348-49, 352 (1943). More recently in *McCown v. Heidler*, 527 F.2d 204, 209 (10th Cir. 1975), the court recognized that

the offer and sale of lots in [a] development was not only the offer and sale of subdivision lots in a real estate development, but the sale of a contractual promise by [the respondent] to improve the project, including the construction of [various appreciable amenities]. The lot purchasers had no control over, or participation in the improvement of the project, but entrusted their monies solely to the management of [the respondent]. The lots were purchased in expectation that fulfillment of the promise to improve them . . . would result in a substantial increase in the value of the lots.

Id. From this proposition that there must be something more than simply an underlying asset for an investment contract to constitute a security, the *Rodriguez* court divined the principle that "[a]t some point . . . the commitments and promises incident to a land transfer, and the network of relationships related to the project, can cross over the line and make the interest acquired one in an ongoing business enterprise." *Rodriguez v. Banco Centr. Corp.*, 990 F.2d 7, 11 (1st Cir. 1993). This principle may be applied to the purchase of any property, tangible or intangible, with an accompanying promise, and transform the transaction into the sale of a security. See *id.*

82. 990 F.2d 7 (1st Cir. 1993).

83. *Id.* at 11.

84. *Id.*

85. See *id.* ("A security might exist if the defendants had promised, along with land sales, to develop the community themselves.")

86. See *SEC v. Life Partners, Inc.*, 87 F.3d 536, 544, 548 (D.C. Cir. 1996). In *Life Partners*, the court explained that commonality is usually sufficient to satisfy the

est of completeness and caution, this factor must be considered in all applications of the *Howey* test because it is gaining more widespread recognition.⁸⁷

3. *The Third Prong: Profits Derived from the Efforts of Others*

The *Howey* Court stated that in order for an investment contract to constitute a security it must offer profits generated solely by the efforts of others.⁸⁸ Subsequent interpretations of this requirement, in light of the intent of the Act, have splintered this prong into a multi-step inquiry.⁸⁹ Consequently, the third prong of the test currently requires that (1) the investment contract offer profits generated predominantly by the efforts of others and (2) the efforts taken to generate profits must be significant.⁹⁰

a. Profits Derived Predominantly from the Efforts of Others

The *Howey* test's requirement that profits from an investment contract be derived solely from the efforts of others was first questioned in *SEC v.*

second prong of the *Howey* test when it is "obvious that there is (an enterprise) in the picture." *Id.* at 544. From this point, the *Life Partners* court indicated it would consider the issue in its discussion of the third prong of the *Howey* test. *See id.* After resolving that the investment contracts sold by Life Partners were not securities, the court stated, "[w]e see no 'venture' associated with the ownership of an insurance contract from which one's profit depends entirely upon the mortality of the insured." *Id.* at 548.

87. *See Rodriguez*, 990 F.2d at 10-11 (recognizing enterprise requirement); *Hocking v. Dubois*, 839 F.2d 560, 564 (9th Cir. 1988) (stating that even land bought purely for investment purposes is not security if land is not coupled with something else that constitutes business enterprise), *modified*, 885 F.2d 1449 (9th Cir. 1989) (en banc); *Aldrich v. McCulloch Properties, Inc.*, 627 F.2d 1036, 1039 n.1 (10th Cir. 1980) (noting that incidental promises by seller such as to install access road or electricity are not sufficient to transform purchase of interest in land into business enterprise for purposes of federal securities laws).

88. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 299, 301 (1946). Use of the word "solely" by the *Howey* Court should be noted. *Id.* Subsequent to this statement, the Supreme Court has constantly omitted the word "solely" from the third prong of the *Howey* test. *See United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 852 (1975) (explaining that Court looks for "profits to be derived from the entrepreneurial or managerial efforts of others"); *Tcherepnin v. Knight*, 389 U.S. 332, 338-40 (1967) (acknowledging that Court said "solely" in *Howey*, but actually meant for test to be applied flexibly, even reading out this requirement in effort to elevate substance over form).

89. *See SEC v. International Loan Network, Inc.*, 968 F.2d 1304, 1308 (D.C. Cir. 1992) (noting that investors' profits expected to result, "if not solely, at least predominantly" from efforts of promoter); *Goodman v. Epstein*, 582 F.2d 388, 408 n.59 (7th Cir. 1978) (noting "solely" requirement of *Howey* test should not be read strictly or literally); *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 483 (5th Cir. 1974) (stating that critical inquiry is whether efforts made by promoter or third party are "undeniably significant" to success of enterprise); *SEC v. Glenn W. Turner Enters., Inc.* 474 F.2d 476, 482 (10th Cir. 1973) (same).

90. *See Life Partners*, 87 F.3d at 545.

*Glenn W. Turner Enterprises, Inc.*⁹¹ In this decision, the United States Court of Appeals for the Ninth Circuit modified the third prong of the *Howey* test in order to classify an investment contract that required individual investors to exert some efforts in order to realize a return as a security.⁹² The Ninth Circuit's modification of the *Howey* test was impliedly endorsed by the Supreme Court in *Forman*.⁹³

The Ninth Circuit felt free to depart from the widely criticized bright-line rule requiring that investors' profits be derived solely from the efforts of others because this formalism was unduly restrictive of courts' ability to classify some schemes as securities.⁹⁴ Such formalism led to absurd results in some cases and made it potentially easy for novel schemes to evade securities regulation by simply requiring an investor to contribute some

91. 474 F.2d 476 (1973). Removal of the word "solely" from the requirements of the third prong of the *Howey* test was implicitly endorsed by the Supreme Court in *Forman*. *Forman*, 421 U.S. at 852. The Court stated that

[t]his test, in shorthand form, embodies the essential attributes that run through all of the Court's decisions defining a security. The touch stone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.

Id.

92. See *Turner*, 474 F.2d at 481-82 ("Strict interpretation of the requirement that profits to be earned must come 'solely' from the efforts of others has been subject to criticism."). Removing the "solely" requirement, the Ninth Circuit stated that:

For purposes of the present case, the sticking point in the *Howey* definition is the word "solely," a qualification which of course exactly fitted the circumstances in *Howey*. All the other elements of the *Howey* test have been met here. There is an investment of money, a common enterprise, and the expectation of profits to come from the efforts of others. Here, however, the investor, or purchaser, must himself exert some efforts if he is to realize a return on his initial cash outlay. He must find prospects and persuade them to attend Dare Adventure Meetings, and at least some of them must then purchase a plan if he is to realize that return. Thus it can be said that the returns or profits are not coming 'solely' from the efforts of others.

We hold, however, that in light of the remedial nature of the [federal securities legislation], the statutory policy of affording broad protection to the public, and the Supreme Court's admonitions that the definition of securities should be a flexible one, the word "solely" should not be read as a strict or literal limitation on the definition of an investment contract, but rather must be construed realistically, so as to include within the definition those schemes which involve in substance, if not in form, securities Adherence to [a strict interpretation of the solely requirement of *Howey*] could result in a mechanical, unduly restrictive view of what is and what is not an investment contract. It would be easy to evade by adding a requirement that the buyer contribute a modicum of effort [T]he fact that the investors [are] required to exert some efforts . . . should not automatically preclude a finding that the Plan . . . is an investment contract.

Id.

93. *Forman*, 421 U.S. at 852.

94. See *Turner*, 474 F.2d at 482.

minimal effort as a prerequisite to receiving a return on his or her investment.⁹⁵ The Ninth Circuit's decision embraced the intent underlying the Act and the spirit of post-1933 securities jurisprudence.⁹⁶

Removing the "solely" bright line from the *Howey* test was consistent with the longstanding judicial view that, as remedial measures, federal securities regulations should remain flexible.⁹⁷ Federal securities laws are interpreted broadly and realistically in an effort to regulate all schemes involving securities in substance, if not form.⁹⁸ Flexibility in interpreting federal securities laws, including the Act, affords individual investors the maximum protection possible.⁹⁹

The Supreme Court impliedly endorsed the Ninth Circuit's return to these basic principles and modification of the "solely" bright-line rule in *Forman*.¹⁰⁰ Following the Ninth Circuit opinion in *Turner* and the Supreme Court's omission of the "solely" requirement in *Forman*, lower courts have broadened the sweep of the *Howey* test and the Supreme Court's definition of investment contracts that constitute securities.¹⁰¹

b. Promoter's Efforts to Generate Profit Must Be Significant

Eliminating the only bright line in the *Howey* test, *Turner* introduced a more realistic standard into the third prong of the test.¹⁰² The *Turner* court evaluated the efforts of the investment contract promoter to determine whether the efforts undertaken by the promoter were significant

95. *See id.*

96. *See SEC v. W.J. Howey Co.*, 328 U.S. 293, 299 (1946); *see also Forman*, 421 U.S. at 451-52 (emphasizing substance over form in interpreting and applying federal securities laws); *Tcherepnin v. Knight*, 389 U.S. 332, 337 (1967) (explaining that federal securities laws "embod[y] a flexible rather than a static principle"); H.R. REP. NO. 85, at 11 (1933) (stressing broad application of federal securities laws to "many types of instruments that in our commercial world fall within the ordinary concept of a security").

97. *Howey*, 328 U.S. at 299.

98. *See Forman*, 421 U.S. at 849 ("The primary purpose of the Acts of 1933 and 1934 was to eliminate serious abuses in a largely unregulated securities market."); *Tcherepnin*, 389 U.S. at 336 ("[W]e are reminded that, in searching for the meaning and scope of the word 'security' in the Act, form should be disregarded for substance and the emphasis should be on economic reality."); *Howey*, 328 U.S. at 301 (noting that statutory policy is to afford broad protection to investors).

99. *See Howey*, 328 U.S. at 301 ("The statutory policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae.")

100. *Forman*, 421 U.S. at 852 n.16.

101. *See id.*

102. *SEC v. Glenn W. Turner Enters., Inc.*, 474 F.2d 476, 482 (9th Cir. 1973). Rejecting the "solely" requirement, which was destined to lead to absurd results in several cases, the *Turner* court adopted a test that exalted substance over form. *Id.* The court adopted "a more realistic test, whether the efforts made by those other than the investor are undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise." *Id.*

managerial tasks essential to the success of the enterprise.¹⁰³ The investment contracts in *Turner* constituted securities because the money and efforts of each individual investor purchased the right to share in proceeds resulting from a scheme that was perpetuated by the efforts of the promoter.¹⁰⁴

Following the Ninth Circuit, most circuits have incorporated this significant efforts requirement into the *Howey* test.¹⁰⁵ The United States Court of Appeals for the Tenth Circuit, for example, endorsed the significant efforts requirement in *McCown v. Heidler*.¹⁰⁶ The *McCown* court held that individual investors could prove that their purchases of lots in a planned community were investment contracts constituting securities.¹⁰⁷ The court's holding was premised on its understanding that the sale of lots in this development were actually sales of properties coupled with the promoter's contractual promises to improve the project, thereby substantially increasing the value of the lots.¹⁰⁸ In reaching its determination, the

103. *Id.* at 482-83. The *Turner* court found the investment contracts to be securities because the promoters were performing significant efforts toward to the success of the venture. *Id.* The court said:

The purchaser is sold the idea that he will get a fixed part of the proceeds of the sales [T]o get a share, he invests three things: his money, his efforts to find prospects and bring them to the meetings, and whatever it costs him to create an illusion of his own affluence. He invests them in Dare's get-rich-quick scheme. What he buys is a share in the proceeds of the selling efforts of Dare. Those efforts are the sine qua non of the scheme; those efforts are what keeps [sic] it going; those efforts are what produces the money which is to make him rich. In essence, it is the right to share in the proceeds of those efforts that [the investor] buys.

Id.

104. *Id.* at 482.

105. *See, e.g.*, SEC v. Life Partners, Inc., 87 F.3d 536, 545 (D.C. Cir. 1996) (explaining that promoters' efforts must be "undeniably significant" in order to satisfy third prong of *Howey* test).

106. 527 F.2d 204 (10th Cir. 1975).

107. *Id.* at 209. *McCown* came to the United States Court of Appeals for the Tenth Circuit on appeal of an order granting summary judgment to the defendants. *Id.* at 206. The lower court's grant of defendant's motion for summary judgment was reversed on appeal and the case remanded for further proceedings consistent with the opinion of the court. *See id.* at 207. Overturning the lower court's order, the court of appeals observed that "[t]he plaintiffs presented evidence which could show that the sale of . . . lots constituted more than the mere sale of real estate." *Id.* at 209.

108. *See id.* The situation in *McCown* was closely analogous to the situation presented to the Supreme Court in *Howey*:

The lots were purchased in expectation that fulfillment of the promise to improve them by [the promoter] would result in a substantial increase in the value of the lots. The lots were sold as, and purchased for, investment [A]ffidavits of several lot purchasers indicated that they purchased the lots as an investment.

Id. Like the fractional interests in the orange grove sold by W.J. Howey Co., the subdivided lots in the proposed golf, tennis and equestrian resort sold by Heidler Corporation in *McCown* were found to be not mere interests in land, but interests in land coupled with a promise that made them part of a common enterprise dependent upon the efforts of the promoter in order to return a profit. *Id.*

Tenth Circuit examined the promoter's efforts prior to offering the lots for sale to investors.¹⁰⁹ The court's holding hinged on the significant managerial efforts that the promoter undertook before and after selling the lots in an effort to insure the success of the project.¹¹⁰

The Ninth Circuit further clarified its significant efforts requirement in *Noa v. Key Futures, Inc.*¹¹¹ In *Noa*, the court held that investors' purchases of fractional interests in a larger purchase of silver bars did not constitute securities.¹¹² These investment contracts were not securities because the investors' profits depended solely upon fluctuations of the silver market.¹¹³

The *Noa* court distinguished *McCown*, indicating that the promoter's promises to deliver a specified quantity and quality of silver in the name of each individual investor and the promoter's offer to store the silver free of charge did not satisfy the significant efforts required by the *Turner* standard.¹¹⁴ The court emphasized that the investors did not share in the profits or risks of the silver purchase itself, but simply took delivery of a fixed interest and speculated on the silver market's performance from that point forward.¹¹⁵

109. *See id.* Examining the efforts undertaken by the promoter before offering the investment contracts for sale, the court found that significant efforts had already been undertaken. *See id.* The promoter had sent "employees and salesmen to attend four-week training sessions." *Id.* The promoter also "held public seminars using [professional sales] methods, brochures and films to show the advantages of real estate investment." *Id.* at 210. At seminars, the promoter emphasized individual investors' ability to make "fortunes" and "get rich while sleeping." *Id.* Real estate was touted as the "one safe, sure, successful investment." *Id.* Furthermore, the promoter filed a "General Form for Registration of Securities" with the SEC, stating that the promoter was "selling lots to individual for investment purposes and ultimately for individuals to construct a home and retire." *Id.*

110. *See id.* at 211.

111. 638 F.2d 77 (9th Cir. 1980) (per curiam).

112. *Id.* at 79.

113. *See id.* Applying the *Howey* test to the facts of the *Noa* case, the court observed that "the profits to the investor depended upon the fluctuations of the silver market, not the managerial efforts of [the promoter]." *Id.*

114. *See id.* at 80. The court stated that "[p]urchase of the silver and the free storage do not in our opinion amount to the 'undeniably significant' efforts required by *SEC v. Glenn Turner*." *Id.* (quoting *SEC v. Glenn W. Turner Enters., Inc.*, 474 F.2d 476, 482 (9th Cir. 1973)).

115. *See id.* Observing that the investors returns were not dependent, in any way, on the efforts of the promoter, the court noted that "[t]he decision to buy or sell was made by the owner of the silver." *Id.* at 79. Further, the court noted:

The method by which the silver was to be purchased by the seller did not alter the relationship of the seller and the buyers. It was [the promoters'] obligation to deliver a given amount of silver of .999 purity in return for a fixed price, regardless of the method by which it acquired the silver [T]he buyers did not share in the profits or risks of the silver procurement.

Id. at 80. The promoter in *Noa* was acting like a broker by providing a fixed commodity for a fee. *See id.* Acting in this capacity is clearly insufficient to be considered a promoter of an investment contract constituting a security. *See id.* Like the broker in *Noa*, viatical settlement companies that merely match prospective buyers

III: FACTUAL BACKGROUND OF *SEC v. LIFE PARTNERS, INC.*A. *The Development of Viatical Settlements*

The AIDS epidemic swept through the United States in the 1980s, spreading through every ethnic, racial and social class and giving rise to several new phenomena including the new financial service known as viatical settlement.¹¹⁶ Viatical settlement derives its name from “viaticum,” the Latin name for the Roman Catholic sacrament involving the giving of communion to a dying person.¹¹⁷ This name was deemed appropriate by the industry, as viatical settlement involves the purchase of a terminally-ill person’s life insurance policy.¹¹⁸

The viatical settlement industry has been embroiled in controversy since its beginning in earnest in 1988.¹¹⁹ From its birth, the viatical settle-

with willing sellers have not been thought of as offering securities for sale. See *SEC v. Life Partners, Inc.*, 87 F.3d 536, 545-46 (D.C. Cir. 1996) (explaining mechanics of different methods through which individual investors participate in viatical settlements); see also Glick, *supra* note 1, at 957-59 (reiterating that viatical settlement companies that act as brokers, matching willing buyers with willing sellers for fee, are clearly not selling securities).

116. See Stone, *supra* note 1, at N1 (explaining advance of AIDS epidemic and growth of viatical settlement in late 1980s).

117. See *id.* For a discussion of the origin of the term “viatical settlement,” see *supra* note 3 and accompanying text.

118. Stone, *supra* note 1, at N1.

119. See *id.* (describing opinion of various communities regarding the viatical settlement industry). Viatical settlement has been criticized as exploitive and morbid. See *id.* AIDS activists have neither endorsed nor condemned the practice. See *id.* At least one ethicist has criticized the policy stating “[i]t strikes me as ethically suspect that people would go around haunting the bedside of the dying, trying to hawk get-rich schemes for the terminally ill.” *Id.* The motives of AIDS patients taking advantage of these settlements have been questioned. See *id.* One article about viatical settlements reported that

[a] man, who asked not to be identified for tax reasons, said AIDS sapped his finances and left him with no means of supporting himself.

All he had left was his \$250,000 life insurance policy, but it was payable only when he died. Desperate for money, he sold the policy for \$100,000 to an investment company that will redeem the policy when he dies.

“It is a great thing,” he said. “I was able to take a trip with my mom and dad. I was able to settle up some old debts and I am able to afford my medical coverage.”

Id. Others have stated their arguably noble motives:

[A] 33-year-old . . . man [stated that] the AIDS virus attacked his body and bank account quickly, and left him no time to seek bids. [H]e [was] faced with selling his policy for 27 percent of its face value to a Massachusetts company.

“I have absolutely no money at all,” he said. “I decided this was the only way I could keep my apartment. This is not for a European vacation.”

He . . . sought just one bid. “I should have had two or three—but I trusted people.”

Id. This individual proceeded to comment on the profits made by investors in viatical settlements and the low percentage he received as a purchase price for his policy. See *id.* He said: “I don’t mind them making a profit. The problem, though, is there is a limit to profit. Let’s not overdo it.” *Id.* Still other individuals appear to be using viatical settlement as a way of shirking their responsibility for medical

ment industry has blossomed into a financial services behemoth.¹²⁰ This expansion was a function of the ever deepening AIDS crisis and efforts aimed at increasing the ability of individual investors to participate in this investment boom.¹²¹

In 1989, the viatical settlement industry surfaced as a \$5 million per year industry.¹²² The industry's subsequent diversification enabled it to mushroom into a \$200 million per year industry in 1995.¹²³ Projections

bills resulting from expensive treatment for AIDS-related illnesses. *See id.* For example, one periodical reported:

A 35-year-old North Hollywood man with advanced AIDS said he just received a \$106,500 viatical settlement, and does not plan to pay taxes on it.

[H]e also does not plan to spend the money on medical bills.

"Since I am not reporting this, I don't want people to know I have it—and why should I pay for bills?"

He expects that disability payments will cover his living expenses. "Medical bills—I will let them pile up and make small monthly payments . . . I want to use [the money] for good and fun purposes, rather than pay things off . . . I ordered a new car . . . I already spent quite a bit on . . . traveling."

Id.

120. *See id.* (discussing evolution of viatical settlement industry). In the early years of the viatical settlement industry, between the opening of the first viatical settlement company in 1988 and the end of 1992, more than 30 companies entered the industry. *See id.* These companies included several giant insurance companies, such as Prudential, and several companies formed exclusively for the purpose of engaging in the practice of viatical settlement, such as Life Partners. *See id.* Prudential alone spent more than \$34 million on the purchase of life insurance policies in the form of viatical settlements. *See id.* Other insurance companies have entered this market by offering their policy holders the option of accelerated death benefits, which enable them to redeem their life insurance policy in the event they are diagnosed with a terminal illness at a significant discount to the face value upon maturity. *See id.* By 1993, more than \$200 million in viatical settlements were being made per year. *See* Crenshaw, *supra* note 1, at C01. This growth is expected to continue, propelling viatical settlement to a \$1 billion per year industry sometime in the next decade. *See id.*

121. *See* Stone, *supra* note 1, at N1 (describing evolution of viatical settlement industry). In recent years, more, better capitalized companies, formed specifically for the purpose of conducting viatical settlements, have entered the market. *See id.* These companies are typically capitalized through bank loans or public stock offerings. *See id.* They offer individual investors two methods of investing in viatical settlements: by acting as a broker matching buyers and sellers, or by purchasing individual insurance policies and selling fractional interests in the death benefit that is the subject of the settlement, to be collected upon maturity by individual investors. *See* Glick, *supra* note 1, at 957; *see also* SEC v. Life Partners, Inc., 87 F.3d 536, 545-46 (D.C. Cir. 1996) (explaining mechanics of different methods through which individual investors can participate in viatical settlement industry).

122. *See* SEC v. Life Partners, Inc., 898 F. Supp. 14, 17 n.1 (D.D.C. 1995), *remanded by* 87 F.3d 536 (D.C. Cir. 1996).

123. *See* Crenshaw, *supra* note 1, at C01 (speculating that, by 1995, viatical settlement industry had grown to \$200 million per year industry). For a further discussion of the size and growth of the viatical settlement industry, *see supra* note 1 and accompanying text.

and current trends indicate that investments in viatical settlements will surpass \$1 billion per year not long after the millennium.¹²⁴

Viatical settlement companies, including Life Partners, adapted to the needs of individual investors by providing two novel methods that enable individuals to invest in viatical settlements: viatical settlement companies (1) simply act as brokers, matching terminally-ill sellers with individual buyers in exchange for a service fee or (2) purchase the rights to life insurance policies and sell fractional interests in the policies to individual retail investors.¹²⁵ Companies, such as Life Partners, that employ the latter strategy, purchase life insurance policies, obtain all rights to the policies and become the named beneficiary of the policies before selling fractional interests in the policies to retail investors.¹²⁶

124. See Crenshaw, *supra* note 1, at C01 ("Industry officials say that if [legislation] is enacted, viatical settlements could jump . . . to \$1 billion [per year] early in the next decade.").

125. See *Life Partners*, 87 F.3d at 545-46 (explaining mechanics of two major types of viatical settlements that are marketed to individual investors); Glick, *supra* note 1, at 957 (explaining major methods that facilitate participation of individual investors in viatical settlement market: brokered settlements, whereby company matches individual investors and terminally-ill individuals who wish to sell policies for fee, and settlements in which settlement company purchases policy directly from terminally-ill individual and resells fractional interests in policy to retail investors); Peloso & Sarnoff, *supra* note 3, at 3 (recognizing two broad categories of viatical settlement market).

126. See *Life Partners*, 87 F.3d at 539 (explaining Life Partners' sales of fractional interests in viatical settlements to individual investors). The court explained:

[Life Partners] sells fractional interests in insurance policies to retail investors, who may pay as little as \$650 and buy as little as 3% of the benefits of a policy. In order to reach its customers, [Life Partners] uses some 500 commissioned "licensees," mostly independent financial planners. For its efforts, [Life Partners'] net compensation is roughly 10% of the purchase price after payment of referral and other fees.

Id. According to Life Partners' president, Life Partners is the fastest growing firm serving this rapidly growing industry. See *id.* In 1994, Life Partners revenues of approximately \$150 million accounted for more than half of the industry's annual estimated revenues of \$300 million. See *id.* This figure is inconsistent with estimates placing total industry revenues in the neighborhood of just \$200 million in 1995. See Crenshaw, *supra* note 1, at C01. Despite the inconsistency of Life Partners' president's estimates with other estimates of the size of the viatical settlement industry, the fact remains that, at least through 1994, Life Partners was the undisputed leader of the viatical settlement industry. See *Life Partners*, 87 F.3d at 539. Among its various accomplishments in marketing viatical settlements to retail investors, it is also credited as being the first company to develop a method through which investors could participate in viatical settlements through their individual retirement account (IRA). See *id.*; see also Glick, *supra* note 1, at 957 (explaining differences between brokered and nonbrokered viatical settlements); Peloso & Sarnoff, *supra* note 3, at 3 (explaining viatical settlement methods employed by Life Partners).

B. *Life Partners' Viatical Settlements*

Viatical settlement companies that cater to individual investors by offering the opportunity to purchase small inexpensive shares in viatical settlements, have been very successful in recent years.¹²⁷ Life Partners is one of the most successful viatical settlement companies that has employed the fractional shares method.¹²⁸ Providing this type of investment vehicle to individual investors, Life Partners has grown into one of the largest viatical settlement companies in the United States, with revenues in excess of \$150 million in 1995.¹²⁹ Life Partners makes investment contracts available for purchase by individual investors in a number of simple and complex manners. Nevertheless, the essential structure of the contract is always consistent.¹³⁰

Life Partners locates terminally-ill individuals who wish to relinquish all rights to their life insurance policies in exchange for immediate cash settlements.¹³¹ Life Partners' physicians review the individuals' medical records and independently determine the individuals' prognoses and life expectancies.¹³² If an individual is legally competent, has full-blown AIDS

127. See *Life Partners*, 87 F.3d at 539 (speculating that, in 1995, viatical settlement industry had grown to \$300 million per year industry); Crenshaw, *supra* note 1, at C01 (speculating that, by 1995, viatical settlement industry had grown to a \$200 million per year industry and was expected to surpass \$1 billion per year within next decade).

128. See *Life Partners*, 87 F.3d at 539. Life Partners' president and 95% beneficial owner, Brian Pardo, explained that, in 1994, Life Partners' revenues alone accounted for approximately one-half of viatical settlement industry revenues totaling approximately \$300 million. See *id.*

129. See *id.*

130. See *id.* at 545-46. While Life Partners has offered brokerage services and opportunities for individual investors to purchase fractional interests in life insurance policies of which Life Partners holds all interests and has become the named beneficiary, the essential elements of the transactions are consistent. See *id.* Life Partners identifies individuals who wish to sell their rights to the death benefits of their life insurance policies. See *id.* at 539. Life Partners then evaluates the insured's medical condition, reviews his insurance policy, negotiates the purchase price and prepares the legal documents. See *id.* Life Partners then markets the policy, in its entirety or in fractional shares, to individual investors. See *id.*

131. See *id.*

132. See *id.*; see also Crenshaw, *supra* note 1, at C01 (explaining mechanics of how viatical settlements work and particular criteria of individuals and policies sought by viatical settlement firms, including Life Partners). Crenshaw explained: A company agrees to buy the life insurance policy of a dying person. In Life Partner's case, the criteria include:

- 1) Having full blown AIDS
- 2) Have a life expectancy of 24 months or less
- 3) Be mentally fit

The policy is then sold to an investor who will collect the face value of the policy when the patient dies.

The patient is paid based on their life expectancy. General guidelines are:

- 1) 80 percent on the dollar for people with less than six months to live
- 2) 70 percent on the dollar for people with six to 12 months to life.

and an acceptably short life expectancy, Life Partners reviews the life insurance policy to determine whether it is in good standing and whether the eventual eligibility of Life Partners to receive the death benefit is incontestable.¹³³ If these criteria are met, Life Partners negotiates a purchase price and procures the policy.¹³⁴ Life Partners maintains the policy, becomes the sole beneficiary of the policy and collects the death benefit upon the insured's death.¹³⁵ After collecting the death benefit, Life Partners withholds a fee from the funds and distributes the remainder to investors who have purchased fractional shares as a return on their investment.¹³⁶

C. Procedural History of SEC v. Life Partners

In 1995, the SEC filed an action against Life Partners alleging that by selling fractional interests in viatical settlements to individual investors, Life Partners was selling unregistered securities in violation of sections 5(a) and (c) of the Act, and section 15(a) of the Securities Exchange Act of 1934 (collectively, "the Acts").¹³⁷ In August 1995, the district court denied the SEC's request that it enjoin Life Partners from conducting further sales. Nonetheless, the court ordered Life Partners to bring its operations into compliance with the Acts expediently.¹³⁸ The following month, Life Partners' motion for a partial stay of the court's August order pending appeal was denied.¹³⁹ Life Partners failed to comply with the

Id.

133. See *SEC v. Life Partners, Inc.*, 898 F. Supp. 14, 17 (D.D.C. 1995), remanded by 87 F.3d 536 (D.C. Cir. 1996); see also Peloso & Sarnoff, *supra* note 3, at 3 (explaining Life Partners' criteria for purchasing terminally-ill individual's life insurance policy).

134. See *Life Partners*, 87 F.3d at 539-40.

135. See *id.* at 539.

136. See *id.*

137. See *Life Partners*, 898 F. Supp. at 17 (noting that SEC alleged that Life Partners violated federal securities laws). The SEC did not allege, nor did it take the position that all viatical settlements constituted securities. See *id.* at 18. The SEC merely alleged that three of the methods employed by Life Partners constituted sales of securities. See *id.* The SEC alleged that Life Partners' standard policy, IRA investment policy and long-term policy constituted securities. See *id.* The basis for each of these contentions was essentially identical; the SEC contended it was only Life Partners' repackaging of the settlements and selling of fractional interests that constituted sales of securities. See *id.* at 19. The SEC's argument was based on the necessary and beneficial effects that the disclosure requirement of federal securities law would have for individual investors purchasing or investing in fractional interests of viatical settlements held by third parties. See *id.*

138. *Id.* at 17-20. Federal securities laws provide that the SEC is "entitled to seek provisional relief on a 'proper showing' of violative conduct." *Id.* at 19 (quoting 15 U.S.C. §§ 77(b), 78u(d)(1)(1994)). The SEC's burden of proof for obtaining provisional relief is lighter than that of a private litigant. See *id.* The SEC need only show that a "strong prima facie case of previous violations" exists and that there is "a reasonable likelihood that the wrong will be repeated" in order to obtain the provisional relief sought. See *id.*

139. See *Life Partners*, 87 F.3d at 538 (explaining that after district court's disposition of case originally filed by SEC against Life Partners, district court denied

court's prior orders.¹⁴⁰ Consequently, in January 1996, the district court issued a preliminary injunction enjoining Life Partners from offering or selling "unregistered fractional interests in viatical settlements."¹⁴¹ In March 1996, after Life Partners filed an affidavit, sworn by its president, asserting that it had complied with the court's prior orders and planned to resume the sale of fractional interests in viatical settlements, the court granted an emergency motion for supplemental provisional relief filed by the SEC.¹⁴² Granting this motion, the court enjoined Life Partners from selling fractional interests in viatical settlements pending the decision of the District of Columbia Circuit.¹⁴³

IV: ANALYSIS OF THE DECISION IN *LIFE PARTNERS*

A. *Narrative Analysis*

On July 5, 1996, the court of appeals for the District of Columbia decided the *Life Partners* case.¹⁴⁴ Applying the Act and the *Howey* test, the court held that the fractional interests in viatical settlements, offered and sold to individual investors by Life Partners, did not constitute securi-

Life Partners' motion for partial stay of district court's original order, halting its sales of interests in viatical settlements to individual investors). In denying Life Partners' motion for a partial stay of the August injunction, the district court also ordered Life Partners to file a report within 20 days detailing the steps it had taken to comply with the court's original order that it bring its operations into compliance with federal securities laws. *See id.*

140. *See id.*

141. SEC v. Life Partners, Inc., No. 94-1861, 1996 WL 195136, at *1 (D.D.C. March 19, 1996), *remanded by* 87 F.3d 536 (D.C. Cir. 1996). In March 1996, issuing its injunction, the district court observed that:

[T]he defendant's so-called "new" procedures are virtually identical to the old ones from the perspective of the investor. Defendants give investors merely theoretical control over their investment by providing them with an unrealistic option of performing the post-purchase services themselves. Defendants' technical changes have done little to alter the substance of the services provided to investors; thus, the court finds that defendants' sale of fractional interests in viatical settlements is an investment contract subject to the securities laws even under defendants' revised procedures.

Id. Accordingly, the district court enjoined Life Partners from "directly or indirectly" selling fractional interests in viatical settlements, pending the decision of the D.C. Circuit. *See id.*

142. *See id.*

143. *See id.*

144. *See Life Partners*, 87 F.3d at 536. *Life Partners* was argued on April 4, 1996 and decided on July 5, 1996. *Id.* *Life Partners* was a split decision of the United States Court of Appeals for the District of Columbia. *Id.* Judge Henderson joined in the opinion for the Court filed by Judge Ginsburg. *See id.* Judge Wald was in the minority and filed a dissenting opinion. *See id.* at 537.

ties.¹⁴⁵ This decision placed these investment contracts outside the regulatory authority of the SEC.¹⁴⁶

The D.C. Circuit methodically applied each individual element of the *Howey* test.¹⁴⁷ After examining each element, the court reached a 2-1 decision that the subject investment contracts were not securities.¹⁴⁸ Judge Ginsburg and Judge Henderson held that these investment contracts are not securities.¹⁴⁹ Judge Ward, dissenting, argued that these investment contracts should be classified as securities.¹⁵⁰

1. *The First Prong: Expectation of Profits*

The court found that the investment contracts offered and sold by Life Partners satisfied the first prong of the *Howey* test.¹⁵¹ Taking stock of

145. *See id.* at 536. The D.C. Circuit held that [v]iatical settlement contracts are not exempt from the securities laws as insurance contracts. Contrary to the district court, however, we conclude that [Life Partners] contracts are not securities subject to the federal securities laws because the profits from their purchase do not derive predominantly from the efforts of . . . [persons] other than the investors.

Id.

146. *See id.* Deciding that the fractional interests in viatical settlements sold to investors are not securities within the definition of "security" provided by the Act placed these investment vehicles outside the regulatory power of the SEC, which is empowered to regulate all primary offerings of investment contracts that fall within the definition of securities provided in the Act. *See* 15 U.S.C. § 77(b)(1) (1994).

147. *See Life Partners*, 87 F.3d at 542-48. In its own words, the D.C. Circuit examined each prong of the *Howey* test separately "[t]o the extent practical." *Id.* at 542.

148. *See id.* at 536.

149. *See id.* at 537.

150. *See id.* at 549-57 (Wald, J., dissenting). Disagreeing with the opinion of the court regarding its method of evaluating the third prong of the *Howey* test and its determination that the subject investment contracts did not satisfy this prong, Judge Wald stated:

I believe that the majority's position, precluding pre-purchase managerial activities of a promoter from ever satisfying the third prong of the *Howey* test, is unwarranted and will serve to undercut the necessary flexibility of our securities laws. An approach that allows pre-purchase activities of the promoter to satisfy the third prong when the realization of investors' profits depends predominantly on these activities offers a means of distinguishing between ordinary investments and securities that both better conforms to precedent and has a less restrictive effect on the securities laws.

Id. at 557 (Wald, J., dissenting).

151. *See id.* at 543. Finding the first prong of the *Howey* test satisfied, the court stated:

The asset acquired by [a Life Partners] investor is a claim on future death benefits. The buyer is obviously purchasing not for consumption—unmatured claims cannot be currently consumed—but rather for the prospect of a return on his investment. As we read the *Forman* gloss on *Howey*, that is enough to satisfy the requirement that the investment be made in the expectation of profits.

precedent and relying principally on *Joiner*,¹⁵² *Tcherepnin*¹⁵³ and *Forman*,¹⁵⁴ the court restated the profit test: profits must be expected to come in some form of financial return on the individual's investment, not in any form of consumption.¹⁵⁵

Investors purchasing fractional interests in Life Partner's viatical settlements acquired a claim to future death benefits.¹⁵⁶ These unmatured claims could not be consumed, therefore, and the court reasoned that investors necessarily purchased the interests for the prospect of receiving a financial return on their investment.¹⁵⁷ This type of purchase is sufficient to satisfy the requirement that the investment contract be purchased with an expectation of profits.¹⁵⁸ Accordingly, the court ruled that the investment contracts offered and sold by Life Partners satisfied the first requirement of the *Howey* test.¹⁵⁹

2. *The Second Prong: Common Enterprise*

Applying the second prong of the *Howey* test, the court determined that horizontal commonality existed among investors purchasing Life Partners' investment contracts.¹⁶⁰ The court found all three essential elements of horizontal commonality to be present: pooling of investors' funds, profit sharing and loss sharing.¹⁶¹

Id. The dissent agreed with the position of the majority regarding the first prong of the *Howey* test. *See id.* at 549 (Wald, J., dissenting).

152. *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 355 (1943) (holding sales of fractional interest in oil leases were sales of securities).

153. *Tcherepnin v. Knight*, 389 U.S. 332, 339 (1967) (holding that payment of dividends on investment contracts indicated investors expected to receive return on their investment).

154. *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 853 (1975) (declining to characterize stock held for purpose of living in housing cooperative as security under Act).

155. *See Life Partners*, 87 F.3d at 543. The D.C. Circuit's interpretation of the first prong of the *Howey* test "is only that the expected profits must, in conformity with ordinary usage, be in the form of a financial return on the investment, not in the form of consumption." *Id.*

156. *See id.* at 546.

157. *See id.* at 543.

158. *See id.*

159. *See id.*

160. *See id.* The D.C. Circuit acknowledged that horizontal commonality is "ordinarily sufficient to satisfy the common enterprise requirement" of the *Howey* test. *See id.*

161. *See id.* at 543-45. Applying the second prong of the *Howey* test to the facts in *Life Partners*, the D.C. Circuit described the facts giving rise to its determination that horizontal commonality was present in Life Partners' investment scheme. *See id.* at 543. The court stated:

[Life Partners] brings together multiple investors and aggregates their funds to purchase the death benefits of an insurance policy. If the insured dies in a relatively short time, then the investors realize profits; if the insured lives a relatively long time, then the investors may lose money or at best fail to realize the return they had envisioned; i.e., they experience a loss of the return they could otherwise have realized in some alter-

The *Life Partners* court declined to address the argument that a common enterprise did not exist between the investors.¹⁶² The court acknowledged *Life Partners'* argument that commonality itself is insufficient to satisfy the second prong of the *Howey* test.¹⁶³ After finding horizontal commonality, the court stated that the second prong of the *Howey* test was satisfied and reserved judgment on whether an enterprise existed for consideration in its evaluation of the third prong of the test.¹⁶⁴

3. *The Third Prong: Significant Efforts of Others*

The D.C. Circuit followed the Ninth Circuit's evaluation of the third prong of the *Howey* test.¹⁶⁵ The D.C. Circuit dispensed with the "solely" bright line and examined the facts presented in an effort to determine whether the investment contracts were dependent upon significant efforts

native investment of equivalent risk. Any profits or losses from [a *Life Partners*] contract accrue to all of the investors in that contract; i.e., it is not possible for one investor to realize a gain or loss without each other investor gaining or losing proportionately, based upon the amount that he invested. In that sense, the outcomes are shared among the investors; the sum that each receives is a predetermined portion of the aggregate death benefit.

Id. The court went on to state that "we think that pooling is in practice an essential ingredient of the [*Life Partners*] program." *Id.* at 544. Concluding that these factors are sufficient to establish horizontal commonality, the court did not examine whether vertical commonality existed on the facts. *See id.* Likewise, the court did not express an opinion on whether it considers vertical commonality sufficient to satisfy the second prong of the *Howey* test. *See id.*

162. *See id.* at 545. Declining to address the argument by *Life Partners'* that no enterprise existed under the circumstances of this case, the D.C. Circuit simply reserved judgment on the issue for evaluation in its application of the third prong of the *Howey* test. *See id.* Only after determining that the third prong of the *Howey* test was not satisfied on the facts before it, the D.C. Circuit summarily dispensed with the enterprise argument stating that "[w]e see here no 'venture' associated with the ownership of an insurance contract from which one's profit depends entirely upon the mortality of the insured." *Id.* at 548. Therefore, it is unclear how this issue would have been resolved if the court had evaluated it within the context of the second prong of the *Howey* test.

163. *See id.*

164. *See id.* at 545.

165. *See id.* at 545-48. In *Turner*, the Ninth Circuit eliminated the requirement that investors' profits derive "solely" from the efforts of others in favor of a requirement that investors' profits derive predominantly from the efforts of others and that the efforts of those other than the investor must be "undeniably significant" to the success of the enterprise. *SEC v. Glenn W. Turner Enters., Inc.*, 474 F.2d 476, 482 (9th Cir. 1973). The Supreme Court adopted this application of the third prong of the *Howey* test in *Forman. United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 852 (1975); *see also SEC v. International Loan Network, Inc.*, 968 F.2d 1304, 1308 (D.C. Cir. 1992) (giving federal securities laws broader sweep by eliminating "solely" standard in favor of "predominantly" standard); *Goodman v. Epstein*, 582 F.2d 388, 408 (7th Cir. 1978) (adopting standards enunciated in *Turner* and *Forman*); *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 483 (5th Cir. 1974) (adopting *Turner* standards within third prong of *Howey* test).

of the promoter, Life Partners.¹⁶⁶ Employing this approach, the D.C. Circuit proceeded to draw its own bright-line rule distinguishing between the "pre-purchase" and "post-purchase" efforts of the promoter.¹⁶⁷

The D.C. Circuit's approach clearly distinguished between functions performed by the promoter before and after individual investors purchased their fractional interests in Life Partners' viatical settlements.¹⁶⁸ The D.C. Circuit chose to disregard any efforts, no matter how significant, undertaken by the promoter in an effort to improve the return on individuals' investments before the sale of fractional interests to individual investors.¹⁶⁹ The D.C. Circuit held that pre-purchase efforts are

166. See *Life Partners*, 87 F.3d at 545. Recognizing the applicability of the *Turner* standards in *International Loan Network*, the court observed that "[t]he final requirement of the *Howey* test for an investment to be deemed a security is that the profits expected by the investor must be derived from the efforts of others." *Id.*

167. See *id.* The D.C. Circuit appears to have adopted arguments set forth by Life Partners' in establishing this bright-line rule. See *id.* The court acknowledged that

[Life Partners] argues that its pre-purchase functions are wholly irrelevant and that the post-purchase functions, by whomever performed, should not count because they are only ministerial. On this view, once the transaction closes, the investors do not look to the efforts of others for their profits because the only variable affecting profits is the timing of the insured's death, which is outside [Life Partners'] control.

Id. The court justified its acceptance of this argument stating that "post-purchase entrepreneurial activities are the 'efforts of others' most obviously relevant to the question whether a promoter is selling a 'security.'" *Id.* With this quick step and relatively little explanation of its decision to depart from precedent, the court drew a bright-line rule, disregarding the promoter's pre-purchase activities, and went on to the task of distinguishing between significant and insignificant post-purchase activities. See *id.* at 545-46.

168. See *id.* at 545.

169. See *id.* at 546-48. Adopting Life Partners' argument that pre-purchase activities, no matter how significant to the success of the enterprise, should be disregarded, the D.C. Circuit attempted to square its determination with precedent. See *id.* at 546. The court explained:

[Life Partners'] assertion that its pre-purchase efforts are irrelevant receives strong, albeit implicit, support for the Ninth Circuit decision in *Noa v. Key Futures, Inc.*, 638 F.2d 77 ([9th Cir.] 1980) (per curiam). In that case, which involved investments in silver bars, the court observed that the promoter made pre-purchase efforts to identify the investment and to locate prospective investors; offered to store the silver bars at no charge for a year after purchase and to repurchase them at the published spot price at any time without charging a brokerage fee. . . . [T]hese services were only minimally related to the profitability of the investment [because] "the profits to the investor depended upon the fluctuations of the silver market, not the managerial efforts of [the promoter]."

Id. (quoting *Noa*, 638 F.2d at 79-80). Continuing this line of reasoning, the court reasoned that the Tenth Circuit's decision in *McCown* was based on the same principle. See *id.*; see also *McCown v. Heidler*, 527 F.2d 204, 211 (10th Cir. 1975) (plaintiffs alleging that parcels they purchased were securities). The court stated: "In both *Noa* and *McCown*, the courts of appeals regarded the promoter's pre-purchase efforts as insignificant to the question whether the investments . . . were securities." *Life Partners*, 87 F.3d at 547. Based on its narrow reading of the implicit support lent by this precedent, the D.C. Circuit drew a bright line completely disregarding

insignificant to a determination of whether an investment contract constitutes a security.¹⁷⁰

After disregarding the pre-purchase efforts of the promoter, the D.C. Circuit divided the promoter's post-purchase efforts into two classes: entrepreneurial efforts and ministerial efforts.¹⁷¹ The D.C. Circuit defined post-purchase ministerial efforts as efforts that are insignificant or inessential to the success of the investment venture and held that these efforts can not satisfy the third prong of the *Howey* test.¹⁷² The court defined post-purchase entrepreneurial efforts as efforts that are significant or essential to the success of the investment venture and held that only these efforts are sufficient to satisfy the third prong of the *Howey* test.¹⁷³ After establishing this bright-line rule, the court evaluated Life Partners' efforts to improve the success of the investment contracts it offered and sold to individual investors.¹⁷⁴

a. Post-purchase Efforts

The court quickly dispensed with the post-purchase efforts undertaken by Life Partners.¹⁷⁵ Examining the activities Life Partners performed after selling fractional interests in viatical settlements to investors,

any pre-purchase efforts of the investment promoter, no matter how significant they may be to the success of the enterprise. *See id.*

170. *See Life Partners*, 87 F.3d at 546-48.

171. *See id.* at 545-46.

172. *See id.* at 545. The court's view that ministerial efforts are insufficient to satisfy the third prong of the *Howey* test is consistent with the distinction between "undeniably significant" promoter efforts and insignificant promoter efforts adopted in *Turner* and endorsed in *Forman*. *See SEC v. Glenn W. Turner Enters., Inc.*, 474 F.2d 476, 482 (9th Cir. 1973) ("Rather, we adopt a more realistic test, whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."); *see also United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 852 (1975) (stating profits from investment contract are to be derived from "entrepreneurial or managerial efforts of others"). The distinction between ministerial effort and entrepreneurial effort was born in *Forman*, in which the Supreme Court stated that profits in an investment contract are "to be derived from the entrepreneurial or managerial efforts of others." *Id.*

173. *See Life Partners*, 87 F.3d at 545-46. The D.C. Circuit cited even less support for its decision that only post-purchase entrepreneurial efforts are relevant to a determination of whether an investment contract constitutes a security than it cited for its determination that pre-purchase efforts, no matter how significant, should be disregarded from the determination of whether an investment contract constitutes a security. *See id.* at 545. In support of this proposition, it cited *International Loan Network*, *Goodman*, *Koscot* and *Turner*, all of which support the principle that a promoter's efforts must be significant, but none of which provide support for the principle that a court should look exclusively at post-purchase efforts when conducting its examination of relevant factors. *See id.* (citing *SEC v. International Loan Network, Inc.*, 968 F.2d 1304, 1308 (D.C. Cir. 1992); *Goodman v. Epstein*, 582 F.2d 388, 408 n.59 (7th Cir. 1978); *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 483 (5th Cir. 1974); *Turner*, 474 F.2d at 482).

174. *See id.* at 545-48.

175. *See id.* at 545-47.

the court summarily dismissed all but one of the activities as insignificant, post-purchase ministerial efforts.¹⁷⁶

The court briefly discussed Life Partners' postpurchase efforts to create a secondary market for the fractional interests it offered and sold to individual investors.¹⁷⁷ The court eventually determined that the offer of

176. *See id.* at 545-46. The court examined the three versions of viatical settlement investments offered by Life Partners. *See id.* at 545. The court noted that [i]n Version I of its program, [Life Partners] and not the investor could appear as the owner of record of the insurance policy. [Life Partners'] ownership gave it the ability, post-purchase, to change the party designated as the beneficiary of the policy, indeed to substitute itself as beneficiary. That ability tied the fortunes of the investors more closely to those of [Life Partners] in the sense that it made the investors dependent upon [Life Partners] continuing to deal honestly with them, at least to the extent of not wrongfully dropping them as beneficiaries.

Id. Despite the existence of this necessary trust, the D.C. Circuit observed that this relationship had no effect on investors' profits. *See id.* The court further observed Life Partners' relative inability to affect investors' profits post-purchase. *See id.* The court also remarked that "[n]othing that [Life Partners] could do by virtue of its record ownership had any affect whatsoever upon the near-exclusive determinant of the investors' rate of return, namely how long the insured survives." *Id.*

The court was equally unable to find any significant post-purchase efforts in Version III of Life Partners' investment contracts:

In Version III [Life Partners] provides no post-purchase services. All such services are the sole responsibility of the investors, who may purchase them from [a single financial institution closely associated with Life Partners] or not, as they choose. The district court minimized the significance of this choice, stating "it is neither realistic nor feasible for multiple investors, who are strangers to each other, to perform post-purchase tasks without relying on the knowledge and expertise of a third party [and] the third party in this case will almost certainly be [the financial institution closely associated with Life Partners]."

Id. at 546 (quoting SEC v. Life Partners, Inc., 898 F. Supp. 14 (D.D.C. 1995), *re-manded by* 87 F.3d 536 (D.C. Cir. 1996)). Even accepting the assessment of the district court, the D.C. Circuit reiterated the prohibitive fact that none of the "post-purchase services can meaningfully affect the profitability of the investment." *Id.* The court therefore reasoned that it does not matter whether or not they are performed by Life Partners or another company. *See id.*

The court's evaluation of the second version of Life Partners' investment contracts presented different circumstances:

In Version II [Life Partners] no longer appeared as the record owner of a policy, but [Life Partners] and [its bank] continued to offer the following post-purchase services: holding the policy, monitoring the insured's health, paying premiums, converting a group policy into an individual policy where required, filing the death claim, collecting and distributing the death benefit [if requested], and assisting an investor who might wish to resell his interest.

Id. at 545. The classification of these seemingly significant post-purchase services as insignificant ministerial functions was only questioned by the SEC with regard to Life Partners' attempt to create a secondary market for the fractional interests in viatical settlements that it sold to individual investors. *See id.* Accordingly, this is the only function that the court singled out for specific discussion. *See id.* For a further discussion of Life Partners' attempt to create a secondary market for the fractional interests in viatical settlements that it sold to retail investors, see *supra* note 168 and accompanying text.

177. *See Life Partners*, 87 F.3d at 546.

assistance in liquidating individual investor's interests was insignificant because investors could get the same help with resale from another viatical settlement companies there was no evidence in the record that individual investors actually sought to liquidate their fractional interests in viatical settlements, Life Partners stopped attempting to create this market, and Life Partners specifically warned investors that interests in viatical settlements are not liquid assets and that the policies should only be purchased by those who are willing to hold the contract until the underlying policy matures.¹⁷⁸ Based on these facts, the court concluded that none of Life Partners' post-purchase activities were sufficient to satisfy the third prong of the *Howey* test.¹⁷⁹

b. Pre-purchase Efforts

Continuing its evaluation of the *Life Partners* case in accordance with the bright-line test it formulated, the D.C. Circuit reiterated the district court's findings that Life Partners performed substantial pre-purchase activities in an effort to insure the success of the investment contracts that it offered to individual investors.¹⁸⁰ The court held that these efforts,

178. *See id.* Acknowledging the SEC's position that Life Partners' attempt to create a secondary market for the fractional interests in viatical settlements which it offers is a significant post-purchase activity, the court quickly dismissed the argument. *See id.* The court's dismissal of this argument is troubling because it discounts the potential ramifications of Life Partners' actions on the grounds that no complaints have surfaced and its belief that none are likely to surface. *See id.* This view is inconsistent with the broad remedial nature of federal securities laws. *See United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 849 (1975) (stating that primary purpose of federal securities laws is to eliminate serious abuses in largely unregulated market); *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967) (stating that, when searching for meaning of word "security" under federal securities laws, emphasis should be placed on remedial nature of laws); *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (noting that statutory policy of securities laws seeks to afford broad protection to investors); H.R. REP. NO. 85, at 11 (1933) (explaining that federal securities laws were intended, from their first formulation, to be applied to novel investment schemes falling within conceptual framework of definition of security).

179. *See Life Partners*, 87 F.3d at 546. After dismissing Life Partners' attempt to create a secondary market for the fractional shares in viatical settlements that it marketed to individual investors as insignificant, the D.C. Circuit stated: "In sum, the SEC has not identified any significant non-ministerial service that [Life Partners] performs for investors once they have purchased their fractional interests in a viatical settlement. Nor do we find that any of the ministerial functions have a material impact upon the profits of the investors." *Id.*

180. *See id.* at 547. At the initial trial, the district court found Life Partners' pre-purchase efforts to be significant and considered this evidence weighty, particularly when viewed in light of the efforts that Life Partners continued to conduct after the sale of fractional interests in the viatical settlements to individual investors. *See SEC v. Life Partners, Inc.*, 898 F. Supp. 14, 22 (D.D.C. 1995), *remanded by* 87 F.3d 536 (D.C. Cir. 1996). The trial court commented:

While the Court agrees with [Life Partners] that these post-investment activities are often ministerial in nature, two factors tip the balance in the SEC's favor. The first is the pre-investment work by [Life Partners] which is undeniably essential to the overall success of the investment. The efforts surrounding an investment should be considered in their en-

though significant to the success of the enterprise, were insignificant to the determination of whether the investment contracts should be considered securities.¹⁸¹ Accordingly, the court disregarded Life Partners' pre-purchase efforts, holding that these efforts were not sufficient to satisfy the third prong of the *Howey* test.¹⁸² The court, therefore, concluded that the

tirety. . . . While investors may be asked for input such as 'the amount they would like to spend, . . . T-cell counts, insured's age, insurance company rating, life expectancy and the like,' they are in fact limited by [Life Partners'] evaluation of the patient [which takes place pre-purchase]. Moreover, this investor input is of little practical significance as [Life Partners] claims to accept only policies in insurance companies rated 'A-' or better where the insured has a life expectancy, as determined by [Life Partners], of less than two years. The mere retention of theoretical rights of control [in the hands of investors] are of no consequence where the investor's role is essentially a passive one.

Id. The court of appeals agreed with the lower court's findings that Life Partners' pre-purchase activities were significant to the success of the enterprise. *See Life Partners*, 87 F.3d at 547. The court stated that "[t]he district court appropriately characterized [Life Partners'] pre-purchase efforts as 'undeniably essential to the overall success of the investment.'" *Id.* (quoting *Life Partners*, 898 F. Supp. at 17). The court further noted that "[t]he investors rely heavily, if not exclusively, upon [Life Partners'] to locate insureds and to evaluate them and their policies, as well as to negotiate an attractive purchase price." *Id.* (quoting *Life Partners*, 898 F. Supp. at 22). The court of appeals, nonetheless, considered these efforts insignificant to its determination of whether the subject investment contracts constituted securities for no reason other than the fact that they took place before individual investors purchased their fractional shares in the viatical settlements. *See id.* This decision was premised entirely on the majority's bright-line rule. *See id.* Noting the apparent elevation of substance over form promoted by the majority's decision, and the potential problems this decision presents, the dissent pointed out that

[t]he net effect of the majority's position is to incorporate a bright-line rule into *Howey's* third prong: whatever the surrounding circumstances, an investment is not a security unless managerial activities by the promoter occur post-purchase. The advantage of this approach is that it offers a clear method for distinguishing between investment contracts that are securities and investment contracts that are simply investments. But it does so at a substantial cost. . . . [I]t elevates a formal element, timing, over the economic reality of the investors' dependence on the promoter. Even more troubling, the majority's approach undercuts the flexibility and ability to adapt to 'the countless and variable schemes' that are the hallmarks of the *Howey* test.

Id. at 551 (Wald, J., dissenting) (citations omitted). The dissent further stated that "the third prong of the *Howey* test can be met by pre-purchase managerial activities of a promoter when it is the success of these activities, either entirely or predominantly, that determines whether profits are eventually realized." *Id.* (Wald, J., dissenting).

181. *See Life Partners*, 87 F.3d at 547.

182. *See id.* Explaining the factors leading to its determination, the court observed that because the efforts significant to the success of the venture took place pre-purchase, a finding that the subject investment contracts constituted securities would provide little benefit to the individual investor. *See id.* The court noted that [i]f the investor's profits depend . . . predominantly upon the promoter's efforts, then the investor may benefit from the disclosure and other requirements of federal securities laws. But if the value of the promoter's efforts has already been impounded into the promoter's fees or into the

fractional interests in viatical settlements sold by Life Partners do not constitute securities and placed these investment contracts outside the regulatory authority of the SEC.¹⁸³

B. *Critical Analysis of the Life Partners Decision*

The D.C. Circuit's application of the first two prongs of the *Howey* test to the *Life Partners* case is consistent with precedent.¹⁸⁴ Conversely, the majority's manipulation and application of the third prong of the *Howey* test and its resulting ruling in *Life Partners* is inconsistent with both precedent and the policy of the Act.¹⁸⁵ As the dissent points out, the majority's modification of the *Howey* test is inappropriate and its resolution of the question of whether the investment contracts sold by Life Partners constitute securities is incorrect.¹⁸⁶

The D.C. Circuit's application of the first prong of the *Howey* test is consistent with precedent and conforms with the ordinary application of the profits test.¹⁸⁷ Following the application of the first prong of the

purchase price of the investment, and if neither the promoter nor anyone else is expected to make further efforts that will affect the outcome of the investment, then the need for federal securities regulation is greatly diminished.

Id. Observing what it perceived to be the relative irrelevance of federal securities laws to the specific investment contracts before it, the court drew a bright-line rule that will affect not only these investment contracts, but all future contracts to come before the court, some of which may benefit from a less rigid application of the third prong of the *Howey* test. *See id.* at 556.

183. *See id.* The court justified its holding, and its bright-line rule, stating that "we cannot agree that the time of sale is an artificial dividing line." *Id.* The court further stated that "[i]t is a legal construct but a significant one." *Id.* The court explained its opinion, stating that if the investors' profits depend on the promoter's efforts after purchase of the investment, then the investor may benefit from the disclosure that would be required by classification of the investment as a security. *See id.* The court further observed that, if the value of the promoter's efforts has already affected the purchase price of the investment, and if neither the promoter nor anyone else is expected to make further efforts that will affect the outcome of the investment, then the need for federal securities regulation is greatly diminished. *See id.* Therefore, in cases such as *Life Partners*, in which the promoter performs significant pre-purchase activities and only ministerial post-purchase services, the third prong of the *Howey* test is not satisfied under the D.C. Circuit's new bright-line approach. *See id.* Accordingly, because the court drew a bright-line rule, disregarding Life Partners' pre-purchase efforts to improve the success of investments offered and sold to individual investors, and because the court likewise wholly disregarded Life Partners' ministerial post-purchase activities, the D.C. Circuit held that the investment contracts offered to individual retail investors by Life Partners failed the *Howey* test and were not securities within the definition of the Act. *See id.*

184. *Id.* at 542-45 (discussing first two prongs of *Howey* test).

185. *Id.* at 545-48 (discussing application of third prong of *Howey* test.)

186. *See id.* at 549 (Wald, J., dissenting) (agreeing with majority on application of first two prongs of *Howey* test but disagreeing with majority on application of third prong of test).

187. *See id.* at 542-43 (applying first prong of *Howey* test to facts of Life Partners). Summarizing relevant precedent, the D.C. Circuit coherently enunciated

Howey test in *Joiner*, *Tcherepnin* and *Forman*, the D.C. Circuit determined that the fractional interest in viatical settlements purchased by individual investors were purchased for the purpose of obtaining a financial return on the money they invested.¹⁸⁸ The court determined that the financial profit motivation of the investors satisfied the first prong of the *Howey* test.¹⁸⁹ This determination is consistent with the Supreme Court's prior determinations of this issue.¹⁹⁰

Likewise, the D.C. Circuit's application of the second prong of the *Howey* test is consistent with the Supreme Court's and other circuits' application of this test.¹⁹¹ The court applied the horizontal commonality criteria to the facts of *Life Partners* and systematically determined that pooling

the profit test that makes up the first prong of the test. See *id.* at 542. The D.C. Circuit's statement of the profits prong of the *Howey* test conforms with the ordinary usage of the test. *Id.*

The traditional application of the profits test is demonstrated in *Joiner* and *Tcherepnin*, which together represent the Supreme Court's view that profits, for purposes of the first prong of the *Howey* test, include capital appreciation, or growth of an individuals' original investment capital and dividends, income or a participation in earnings resulting from the use of investors' funds. See *Tcherepnin v. Knight*, 389 U.S. 332, 339 (1967) (noting that petitioner could expect profit from participation in common enterprise); *SEC v. C.M. Joiner*, 320 U.S. 344, 349 (1943) ("It is clear that an economic interest in this well-drilling undertaking was what brought into being the investment that defendants were selling and gave to the instruments most of their value and all of their lure."). By contrast, profits, for purposes of the *Howey* test, do not include, as this court observes and the Supreme Court stated in *Forman*, a purchase motivated by a desire to use, occupy or consume the item purchased. See *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 852-53 (1975) ("By contrast, when a purchaser is motivated by a desire to use or consume the item purchased . . . the securities laws do not apply.").

188. See *Life Partners*, 87 F.3d at 542.

189. See *id.* at 543.

190. For further explanation of the court's application of the profits prong of the *Howey* test to the facts of *Life Partners*, see *supra* notes 151-59 and accompanying text.

191. See *Life Partners*, 87 F.3d at 543-45. The court's failure to specifically address the issue of whether or not an enterprise existed is not inconsistent with precedent. See *id.* at 544; see also *Rodriguez v. Banco Centr. Corp.*, 990 F.2d 7, 11 (1st Cir. 1993) (addressing directly and independently issue of whether common enterprise exists). This issue is consistently ignored when courts feel it is obvious that an enterprise exists. This issue is also commonly addressed in a court's evaluation of the third prong of the *Howey* test, as the *Life Partners* court did. *Life Partners*, 87 F.3d at 548.

The D.C. Circuit's evaluation of the enterprise portion of the second prong of the *Howey* test is analogous to the evaluation undertaken by the Supreme Court in *Forman*. See *Forman*, 421 U.S. at 859; *Life Partners*, 87 F.3d at 544-45. In both cases, the *Life Partners* court and the *Forman* Court reserved the issue in order to address it while evaluating the third prong of the test. See *Forman*, 421 U.S. at 859; *Life Partners*, 87 F.3d at 544-45. Moreover, the issue was summarily dismissed in less than one sentence in each case. See *Forman*, 421 U.S. at 859; *Life Partners*, 87 F.3d at 544-45. Though seemingly cavalier and haphazard, this treatment is consistent with many courts' failure or reluctance to accord this factor significant weight, unless an enterprise is conspicuously absent from the subject investment contract. See *Forman*, 421 U.S. at 859; *Life Partners*, 87 F.3d at 544-45. When the existence of an enterprise is conspicuously absent from the investment contract, this factor typi-

of funds, sharing of profit and sharing of loss were all characteristics of the subject investment contracts.¹⁹² The court, therefore, determined that horizontal commonality of interest was present among investors in Life Partners' investment contracts.¹⁹³ Reaching this determination, and acknowledging that a finding of horizontal commonality alone is normally sufficient to satisfy the second prong of the *Howey* test, the court reserved judgment on the issue of whether a common enterprise existed for evaluation within its application of the third prong of the *Howey* test.¹⁹⁴

The third prong of the *Howey* test requires profits to be derived from the efforts of others.¹⁹⁵ Applying this prong, the D.C. Circuit adhered to the Ninth Circuit's practical interpretation announced in *Turner* and read out the "solely" requirement.¹⁹⁶ At this juncture, however, the majority departed from both the Supreme Court and the federal circuit courts of appeals' interpretation of the third prong of the *Howey* test.¹⁹⁷

The majority's departure from precedent begins at the *Turner* and *Koscot* courts' recognition that efforts giving rise to profits must be "undeniably significant" to satisfy the *Howey* test.¹⁹⁸ Seizing on this principle and relying on what it characterized as "implicit support" from the Ninth Cir-

cally receives independent treatment and is accorded much greater weight. See *Forman*, 421 U.S. at 859; *Life Partners*, 87 F.3d at 544-45.

192. *Life Partners*, 87 F.3d at 543-44. In reaching its conclusion, the court enumerated Life Partners' bringing together of individual investors, aggregation of their funds, the fact that investors experience a profit or loss simultaneously and the interdependency of the investors that "transforms the transaction substantively into a pooled investment." *Id.* at 544.

193. See *id.* at 544. In sum, the court stated, "we conclude that all three elements of horizontal commonality—pooling, profit sharing, and loss sharing—attend the purchase of a fractional interest through [Life Partners]." *Id.*

194. See *id.*

195. See *id.*

196. See *id.*; see also *SEC v. Glenn W. Turner Enters., Inc.*, 474 F.2d 476, 482 (9th Cir. 1973) (eliminating requirement that investor profits derive "solely" from efforts of others in favor of requirement that investor profits derive "predominantly" from efforts of others and efforts of those others must be "undeniably significant" to success of common enterprise).

197. See *Life Partners*, 87 F.3d at 545. For a discussion of the new bright-line rule introduced into the third prong of the *Howey* test by the *Life Partners* court, see *supra* notes 165-83 and accompanying text.

198. See *Life Partners*, 87 F.3d at 545; see also *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 483 (5th Cir. 1974) (adding "undeniably significant" language to interpretation of *Howey* test); *Turner*, 474 F.2d at 482 (same). Grounding its departure from precedent, the court relies heavily on the "undeniably significant" efforts standard established in *Turner* and *Koscot*. For a discussion of this standard, see *supra* notes 91-115 and accompanying text.

From its departure point, the *Life Partners* court hinted at its rationale for forging a new standard by stating that "post-purchase entrepreneurial activities are the 'efforts of others' most obviously relevant to the question whether a promoter is selling a 'security.'" *Life Partners*, 87 F.3d at 545. The court then proceeded to draw its bright line by explaining that only the significant post-purchase efforts of a promoter are sufficient to satisfy the third prong of the *Howey* test, and no other efforts will suffice. See *id.* Pointing to flaws in the majority's rationale, the dissent argued that this standard imposed an artificial and impractical formality, which is

cuit in *Noa* and the Tenth Circuit in *McCown*, the majority took the principle of *Turner* and *Koscot* one step further by drawing a bright line between what it described as pre-purchase efforts and post-purchase efforts of the promoter.¹⁹⁹

The bright line drawn by the majority provides an easily administered method of distinguishing between investment contracts that do and do not satisfy the third prong of the *Howey* test.²⁰⁰ Under this approach, if the promoter's efforts take place before the investment contract is sold to an individual investor, then the investment contract is not a security.²⁰¹ Conversely, if the promoter's efforts take place after the investment is sold to individual investors and the promoter's efforts are "undeniably significant," *only* then does the investment contract constitute a security.²⁰²

This new test enabled the majority in *Life Partners* to reduce the resolution of this case to a formalistic application of a static standard.²⁰³ This new bright-line test enabled the court to dispose of the *Life Partners* decision and, potentially, many securities cases to come in the future, with relative ease.²⁰⁴ Unfortunately, as the dissent points out, this quick and easy method lacks the solid support of precedent and operates contrary to the expressed intent of Congress in promulgating the Act.²⁰⁵

The *Life Partners* dissent points out multiple irreconcilable differences between Supreme Court precedent and traditional applications of the *Howey* test and the majority's application of the third prong of the *Howey* test in *Life Partners*.²⁰⁶ The Supreme Court has steadily maintained its position, originally taken in *Howey*, that securities laws should be applied flexibly.²⁰⁷ This position echoes the express intent of Congress in promulgating the Act, that the Act should be construed broadly, taking

contrary to the flexible nature of the traditional evaluation, upon the *Howey* test. *See id.* at 551 (Wald, J., dissenting).

199. *Life Partners*, 87 F.3d at 546. For a discussion of the court's reliance on *McCown* and *Noa*, see *supra* note 169 and accompanying text.

200. *Life Partners*, 87 F.3d at 551 (Wald, J., dissenting). The dissent acknowledges the ease with which this test can be administered; however, it also points out that this ease of administration comes at the "substantial cost" of elevating form over substance, contrary to the expressed intent of the Supreme Court in *Howey*. *See id.* (Wald, J., dissenting).

201. *See id.* at 547.

202. *Id.* at 546-47.

203. *Id.* at 551 (Wald, J., dissenting).

204. *Id.* (Wald, J., dissenting).

205. *See id.* (Wald, J., dissenting).

206. *Id.* (Wald, J., dissenting).

207. *See United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 849 (1975) (applying Act flexibly because of need to eliminate serious abuses of unregulated abuse prior to enactment of federal securities laws). For a further discussion of the court's evaluation of pre-purchase efforts of an investment promoter and the impact of pre-purchase efforts on the overall success of a common enterprise, see *supra* notes 180-83 and accompanying text.

into account novel schemes.²⁰⁸ Though the third prong of the *Howey* test has been altered since its inception in 1946, courts have never held that the existence of only pre-purchase activities is insufficient to satisfy this prong.²⁰⁹

The cases that the majority cites as providing implicit support for this position do not clearly or entirely support this principle.²¹⁰ In *McCown*, the Tenth Circuit took the substantial pre-purchase efforts undertaken by the promoter into account.²¹¹ The court held that these efforts, coupled with the existence of a promise to perform post-purchase entrepreneurial efforts, transformed the sale of subdivided lots into the sale of investment contracts constituting securities.²¹² The court did not state that the pre-purchase efforts were irrelevant, nor did it state that the post-purchase efforts alone were sufficient to classify these investments as securities.²¹³

In *Noa*, the Ninth Circuit held that the subject investment contracts did not satisfy the third prong of the *Howey* test because the investors' profits depended entirely upon external market forces beyond the control or influence of the promoter.²¹⁴ The investors' profits depended exclusively on fluctuations of the silver market.²¹⁵ Purchase, delivery and stor-

208. See SEC v. W.J. Howey Co., 328 U.S. 293, 295-300 (1946) (applying Act to offering of fractional land interests in citrus grove development coupled with contract for cultivating, marketing and remitting portion of net proceeds to individual retail investor).

209. See *id.* (reasoning that pre-purchase activities alone are sufficient to classify transaction as investment contract within definition of security pursuant to Act).

210. See *Noa v. Key Futures, Inc.*, 638 F.2d 77, 79-80 (9th Cir. 1980) (per curiam) (explaining that court's determination that investments in silver bars are not securities because success of investment is entirely dependent upon market fluctuations); *McCown v. Heidler*, 527 F.2d 204, 209 (10th Cir. 1975) (identifying pre- and post-purchase efforts of promoter as significant to success of enterprise and determination that investment contracts constitute securities).

211. *McCown*, 527 F.2d at 209.

212. See *id.* Citing the holding in *McCown*, the majority in *Life Partners* attempts to find support for its exclusion of pre-purchase efforts of the promoter. See SEC v. Life Partners, Inc., 87 F.3d 536, 547 (D.C. Cir. 1996) (citing *McCown*, 527 F.2d at 209). The *Life Partners* court explained: "[W]ithout the substantial improvements pledged by [the promoters] the lots would not have a value consistent with the price which purchasers paid The utilization of purchase money . . . to build the promised improvements' could bring the scheme within the purview of the securities laws." *Life Partners*, 87 F.3d at 547 (quoting *McCown*, 527 F.2d at 211). Prior to this statement, the *McCown* court discussed the pre-purchase efforts at length, leading to the conclusion that the pre- and post-purchase efforts of the promoter combined led to the determination that these investment contracts could be securities. *McCown*, 527 F.2d at 209-11. This examination leads to the possible conclusion that the majority has taken the statements from *McCown*, from which it draws implicit support of its exclusion of pre-purchase efforts, out of context. See *Life Partners*, 87 F.3d at 547. For a further discussion of the pre-purchase efforts discussed in *McCown*, see *supra* notes 106-10 and accompanying text.

213. See *McCown*, 527 F.2d at 209-11.

214. *Noa*, 638 F.2d at 79 (explaining that investors' returns depended upon fluctuations in silver market, not on efforts of promoter).

215. See *id.*

age of a specified amount and quality of silver did not rise to the level of "undeniably significant" efforts affecting the profitability of the investors' endeavor.²¹⁶ Similar to *McCown*, the Ninth Circuit did not hinge its determination that the subject contracts did not constitute securities on the existence of only pre-purchase efforts, rather the court looked directly at the impact of the promotor's efforts on the success of the common enterprise.²¹⁷ Unlike *Life Partners*, neither the *Noa* court nor the *McCown* court drew the time-of-purchase distinction.²¹⁸

Judge Wald's dissent in *Life Partners* parts company with the majority on only the application of the third prong of the *Howey* test.²¹⁹ Instead of the majority's bright-line approach, the dissent proposes a flexible approach to the third prong of the *Howey* test.²²⁰ The dissent's proposed method of applying the third prong of the *Howey* test is consistent with the precedent cited for implicit support by the majority.²²¹ This approach maintains the congressionally mandated policy of applying federal securities laws in a flexible manner, so as to enable their application to innovative and novel schemes.²²² The dissent's proposed approach would eliminate the majority's bright-line rule and refocus the inquiry on the economic realities surrounding the impact of the promoter's efforts on

216. *See id.* at 80.

217. *See id.* For a further discussion of the factors leading to the court's determination that the investment contracts in *Noa* did not constitute securities, see *supra* notes 111-15 and accompanying text.

218. *Noa*, 638 F.2d at 80; *McCown*, 527 F.2d at 209.

219. *Life Partners*, 87 F.3d at 549-53 (Wald, J., dissenting).

220. *See id.* (Wald, J., dissenting). Instead of imposing a bright-line rule where one has never previously existed, the dissent suggested a flexible approach to the third prong of the *Howey* test that would "focus on the kind and degree of dependence between the investors' profits and the promoter's activities." *Id.* at 551 (Wald, J., dissenting).

221. *See Noa*, 638 F.2d at 79-80 (explaining court's determination that investments in silver bars are not securities because success of investment is entirely dependent upon market fluctuations); *McCown*, 527 F.2d at 209 (recognizing combination of pre- and post-purchase efforts of promoter as significant to determination that investment contracts constitute securities).

222. *See Life Partners*, 87 F.3d at 552 (Wald, J., dissenting). Judge Wald attempted to stick closely to the intent of the Supreme Court and Congress. *See id.* (Wald, J., dissenting). Judge Wald wrote:

The reason I focus on the degree of dependence between the investors' profits and the promoter's activities is twofold. First, I believe that this focus is more in keeping with the tenor of the Supreme Court's opinions applying *Howey* and its concern that regulation be tied to underlying economic reality instead of form.

Id. (Wald, J., dissenting); see SEC v. W.J. Howey Co., 328 U.S. 293, 299-301 (1946) (explaining federal securities laws should be applied flexibly to encompass novel schemes and investment instruments normally considered securities); SEC v. C.M. Joiner, 320 U.S. 344, 354 (1943) (recognizing judicial precedent and legislative intent clearly indicating that federal securities laws are to be construed and applied flexibly and broadly); H.R. REP. No. 85, at 11 (1933) (stating federal securities laws should be applied liberally to all instruments that take form of securities or appear to be securities).

each transaction.²²³ First, in keeping with the standards of *McCown* and *Noa*, under the dissent's approach any "undeniably significant" efforts of the promoter, whether they occur pre- or post-purchase, could satisfy the third prong of the *Howey* test.²²⁴ Second, the dissent would also institutionalize the approach employed in *Noa*.²²⁵ This approach would distinguish between profits realized from the promoter's efforts and profits realized from the operation of external market forces.²²⁶ Any significant efforts of the promoter that directly or indirectly have an undeniably significant impact on the success of the venture could satisfy the *Howey* test.²²⁷ External market forces that impact the success of the venture could not satisfy the third prong of the *Howey* test.²²⁸

Like the majority, the *Life Partners* dissent proposes a new approach to the third prong of the *Howey* test.²²⁹ Unlike the majority, Judge Wald's dissent proposes a flexible test that draws directly, not implicitly, on the position of the Supreme Court and federal appellate court precedent.²³⁰ The majority and the dissent rely on the same precedent for support.²³¹ The question of whether either of these approaches will become the definitive factor in the third prong of the *Howey* test, and if so, how either will affect the test, remains unanswered.²³²

The *Life Partners* decision will dramatically affect the future application of the *Howey* test and the regulation of viatical settlements. *Life Partners* places the application of the third prong of the *Howey* test in a state of

223. See *Life Partners*, 87 F.3d at 552 (Wald, J., dissenting).

224. See *id.* (Wald, J., dissenting).

225. See *id.* (Wald, J., dissenting); see also *Noa*, 638 F.2d at 79-80 (noting that success or failure of ventures dependent upon efforts of promoter satisfies third prong of *Howey* test, profits realized from fluctuation of the market, beyond control of promoter do not satisfy third prong of *Howey* test).

226. See *Life Partners*, 87 F.3d at 552 (Wald, J. dissenting).

227. See *id.* (Wald, J., dissenting).

228. See *id.* (Wald, J., dissenting). Judge Wald explains that distinguishing between profits realized from the promoter's activities and profits realized from the operation of market forces coheres with the belief that investors are protected by access to information. When profits depend on the intervention of market forces, there will be public information available to an investor by which the investor could assess the likelihood of an investment's success. Moreover, where profits depend on the operation of market forces "registration . . . could provide no data about the seller which would be relevant to those market risks."

Id. (Wald, J., dissenting) (citations omitted) (quoting *SEC v. G. Weeks Sec., Inc.*, 678 F.2d 649, 652 (6th Cir. 1982)).

229. *Id.* at 549-52 (Wald, J., dissenting).

230. See *id.* at 549 (Wald, J., dissenting). For a further discussion of support that precedent relied upon by majority provides to dissent's rationale and opinion, see *supra* notes 210-28 and accompanying text.

231. See *Life Partners*, 87 F.3d at 546. For a discussion of the majority's reliance on precedent for implicit support, see *supra* notes 198-99 and accompanying text.

232. For a discussion of the dissent's reliance on precedent, see *supra* notes 210-20 and accompanying text.

flux, particularly within the D.C. Circuit.²³³ It is unclear whether the bright-line test introduced into the third prong of the *Howey* test by the D.C. Circuit in *Life Partners* will achieve the Supreme Court's and SEC's policy objectives.²³⁴ At first glance, the test appears to present a hole through which many investment schemes could escape merely by virtue of the promoters performing all efforts that are significant to the success of the investment before selling the investment to individual retail investors.²³⁵ If this were the result of the application of the bright-line rule introduced by the D.C. Circuit, it would be directly at odds with the policy underlying *Howey* and the expressed intent of the Congress in promulgating federal securities laws.²³⁶ If the *Life Partners* decision leads to a clash between the D.C. Circuit and the Supreme Court, it appears likely the D.C. Circuit's alteration of the third prong of the *Howey* test will be erased and a new test formulated.²³⁷

VI. CONCLUSION

The *Life Partners* decision placed the fractional interest in viatical settlements, sold by Life Partners to individual retail investors, outside the regulatory authority of the SEC.²³⁸ This decision has no immediate practical affect upon sale of these interests.²³⁹ These transactions will most likely continue in the manner in which they have been conducted for the foreseeable future. As a result of this decision, however, these transactions will go unregulated unless individual states step in and promulgate regulations governing these investment vehicles.

The prospect of individual state regulation of viatical settlements is highly realistic.²⁴⁰ Nine states have already taken steps aimed at imple-

233. *Life Partners*, 87 F.3d at 550 (Wald, J., dissenting) (pointing out that majority has drawn bright-line rule where one has previously never existed and that this development will undoubtedly affect application of *Howey* test).

234. *Id.* at 552 (Wald, J., dissenting). The dissent points out that the majority's approach risks introducing inflexibility into the test which will allow investment schemes that are securities in form to escape regulation by the SEC merely by performing all significant efforts before selling the investment to individual investors and performing only insignificant efforts after selling the investment to individual investors. *See id.* (Wald, J., dissenting).

235. *See id.* (Wald, J., dissenting).

236. *See id.* (Wald, J., dissenting); *see also* SEC v. W.J. Howey, 328 U.S. 293, 301 (1946) (explaining that federal securities laws should be applied broadly and flexibly).

237. *See Life Partners*, 87 F.3d at 547.

238. *See* Securities Act of 1933, 15 U.S.C. § 77k (1994) (establishing and explaining scope of SEC's jurisdiction over primary issues of securities).

239. As a result of the decision in *Life Partners*, the previously issued and enforced injunction prohibiting Life Partners from marketing and selling fractional shares of viatical settlements to individual investors was lifted, and Life Partners was allowed to resume its business. *Life Partners*, 87 F.3d at 547.

240. *See* Stone, *supra* note 1, at N1 (explaining that, between 1988 and 1992, at least three states took steps to regulate viatical settlements industry).

menting such regulations.²⁴¹ These regulations typically provide a great measure of protection for the terminally-ill insured who wish to enter into a viatical settlement.²⁴² Conversely, these highly protective regulations provide no protection whatsoever for individuals purchasing fractional shares of viatical settlements from investment companies offering these investment contracts.²⁴³ Thus, the decision in *Life Partners* and the regulations undertaken by the states ignore the huge potential for the perpetration of fraud upon unsophisticated individual investors by companies engaged in the largely unregulated, multimillion-dollar viatical settlement industry.

The viatical settlement industry welcomed the *Life Partners* decision as a giant step toward legitimizing the industry.²⁴⁴ Unfortunately for investors, this decision represents a major set back for consumer protection from the tremendous potential for abuse and fraud that exists in this booming financial services industry.

The *Life Partners* decision placed the mantle of consumer protection from the many possible abuses in this industry on the shoulders of state regulatory agencies. Time will tell whether the states are able and willing to take up this burden and provide individual investors with adequate protection. Additionally, time will tell whether the Supreme Court will reject the D.C. Circuit's bright-line modification of the *Howey* test, potentially enabling the SEC to regulate the sale of fractional interests in viatical settlements sometime in the future.

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241. See *id.* (explaining that, in 1992, California had 12 companies that had applied for licenses under state viatical settlement regulation laws).

242. See *Life Partners*, 87 F.3d at 541. The Model Viatical Settlement Act, drafted by the National Association of Insurance Commissioners, provides protection for insureds who sell their life insurance policies to viatical settlement companies; however, the Model Act and statutes actually enacted by several states provide no protection whatsoever for individual investors purchasing fractional shares of viatical settlements from viatical settlement companies. See *id.*; see also VIACICAL SETTLEMENTS MODEL ACT (National Ass'n of Ins. Comm'rs, Proposed Official Draft 1995).

243. For a discussion of the possible loophole created by the *Life Partners* decision, see *supra* note 234-35 and accompanying text.

244. See Crenshaw, *supra* note 1, at C01. Asked about the *Life Partners* decision, John Banks, chief executive officer of Viaticus, Inc., a large viatical settlement division of one of the nation's largest insurance companies, stated that "in the long term [the decision] legitimizes the industry more than ever, and it will make it . . . even easier for companies to raise money through conventional channels such as bank loans and stock offerings." *Id.*