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A Definition of "Investment Contracts" and Equitable Defenses to Suit for Rescission for Nonregistration under the Arkansas Securities Act

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NOTES

NOTE: A DEFINITION OF "INVESTMENT CONTRACTS" AND EQUITABLE DEFENSES TO SUIT FOR RESCISSION FOR NONREGISTRATION UNDER THE ARKANSAS SECURITIES ACT

The plaintiffs, Schultz and Watkins, each purchased from the defendant, Rector-Phillips-Morse, Inc. (RPM), joint venture interests in a proposed apartment complex to be constructed and managed by RPM.[1] Each plaintiff's investment of $47,000 represented twenty percent of the equity capital invested in the project.[2] The equity capital was used to leverage a Federal Housing Administration loan.[3] At no time were the joint venture interests registered as securities with the Arkansas Securities Commission, nor was an exemption from registration obtained.

Plaintiffs learned of the investment opportunity from an associate who had received "confidential information" from RPM outlining the project. The "confidential information" amounted to an offer to sell ten percent interest units in a tax shelter type of investment. Plaintiffs invested in the project primarily as a tax shelter.[4]

The Internal Revenue Service, however, disallowed a substantial portion of plaintiffs' claimed deductions from the project on their 1972 returns.[5] Plaintiffs then tendered their interests back to RPM, claiming that the joint venture interests were unregistered securities[6] and that, under the Arkansas Securities Act, they were

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1. The joint venture agreement was executed by Schultz, Watkins, and two other investors, together with Apartment Developers Corp., Pickens-Bond (a subsidiary of Rector-Phillips-Morse, Inc. (RPM)), and Phillips-Morse Construction Co. A separate trust agreement placed title to the project in Stuttgart Apartments, Inc., holding for the benefit of the joint adventurers. Under the trust agreement, Stuttgart Apartments, Inc., was given full power to develop, manage, mortgage, and sell the property. Schultz v. Rector-Phillips-Morse, Inc., 261 Ark. 769, 774, 552 S.W.2d 4, 7 (1977).

2. Other private investors purchased the remainder of the joint venture shares.

3. Stuttgart Apartments, Inc., whose directors and officers were employees of RPM, had effective total control over the project, and the plaintiffs and other investors had no obligation or right to manage the property or otherwise exercise ownership over it.

4. The "confidential information" also promised that a partnership income tax return would be furnished annually by an independent certified public accountant showing the deductions allowable for that year. Schultz v. Rector-Phillips-Morse, Inc., 261 Ark. 769, 773, 552 S.W.2d 4, 6 (1977).

5. The IRS made a deficiency assessment against both plaintiffs, based largely upon the IRS contention that many of the "start up" expenses should have been capitalized and deducted over a period of years, rather than taken the first year. *Id.* at 775, 552 S.W.2d at 7.

6. Ark. Stat. Ann. § 67-1256 (Repl. 1966).

entitled to rescind the purchase.[7] There was no allegation of any fraud or misrepresentation in connection with the sale. RPM defended on the grounds (1) that the joint venture interests were not "securities" within the meaning of the Act; (2) that if they were securities, they were exempt from registration because they had been offered only to a small number of potential investors; (3) that the plaintiffs were barred by laches and estoppel, as the length of time that had elapsed since the sale was such that plaintiffs, as sophisticated investors with special knowledge of the securities field, should be estopped from seeking rescission of the contract.

The chancellor held that the interests purchased by plaintiffs were "securities" within the meaning of the Arkansas Securities Act but that the private offering exemption provided by the Act was applicable to the transaction and that registration was therefore not required.[8] He further found that plaintiffs' claim of rescission was barred by laches and waiver because of their knowledge and experience in the field of securities.[9]

The Arkansas Supreme Court affirmed, but on somewhat different grounds. The court agreed that plaintiffs' action was barred by equitable principles[10] and also confirmed that the joint venture interests were securities within the meaning of the Arkansas Securities Act. The court concluded, however, that the transaction should have been registered.[11] Two justices dissented, and one did not par-

7. Ark. Stat. Ann. § 67-1241 (Repl. 1966) provides, "It is unlawful for any person to offer or sell any security in this State unless (1) it is registered under this act . . . or (2) the security or transaction is exempted under Section 14 [§ 67-1248]." Ark. Stat. Ann. § 67-1256 (Repl. 1966) provides the remedy of an action at law or in equity for purchase price plus interest and attorney's fees.

8. Ark. Stat. Ann. § 67-1248(b)(9) (Repl. 1966).

9. Both plaintiffs were registered stockbrokers and served as vice-presidents of Stephens, Inc., a Little Rock investment firm.

10. The supreme court based its findings on estoppel and laches rather than on waiver and laches, the bases of the chancellor's decision.

11. The question of whether the securities qualified for an exemption from registration pursuant to the Arkansas Securities Act is not discussed herein. Briefly, the appellees contended that the transaction was exempt from registration requirements as being one involving a private offering. Ark. Stat. Ann. § 67-1248(b)(9) (Repl. 1966) exempts from registration offerings to twenty-five or fewer people within the state when no commission or remuneration is received directly or indirectly for soliciting prospective buyers. A proof of exemption must be filed with the Commissioner. As no proof of exemption was filed by RPM, they relied on Rule 14(b)(15) of the Securities Commissioner of the State of Arkansas, [1977] 1 Blue Sky L. Rep. (CCH) ¶ 7614. Rule 14(b)(15) dispenses with the requirement for the proof of exemption when five or fewer persons form a corporation or limited partnership if the requirements of Ark. Stat. Ann. § 67-1248(b)(9) (Repl. 1966) are otherwise complied with. The court found that the exemption did not apply to the circumstances because remuneration was paid to RPM both directly and indirectly. The court noted that Rule 14(b)(15) is designed to permit small numbers of investors to form their own business venture, such as family stores, without

ticipate. Schultz v. Rector-Phillips-Morse, Inc., 261 Ark. 769, 552 S.W.2d 4 (1977).

The regulation of securities in this country began on the state level with twentieth century statutes commonly called Blue Sky laws.[12] The primary purpose of these laws is to protect the public from deceit and fraud in securities transactions. Most acts contain three basic elements: antifraud provisions relating to securities transactions, provisions for the registration of securities, and provisions for the regulation of dealers and brokers.[13] These state Blue Sky laws regulate intrastate sales; transactions involving the use of means or instrumentalities of interstate commerce or of the mails are governed by federal securities laws.[14] In 1959 the General Assembly adopted the Arkansas Securities Act,[15] a modification of the Uniform Securities Act.[16]

Whenever a regulatory agency or a court attempts to put securities laws and regulations into effect, a basic question arises: what is a security? The most common and obvious types of securities are stocks and bonds, but many other less conventional investments are included and subject to regulation. Investments in muskrats,[17] tung trees,[18] silver foxes,[19] gold bars,[20] and whiskey warehouse receipts[21] are just a few of the many unconventional investment schemes that have been found to fall under the regulation of state or federal securities acts. Each of these schemes has been found to be an "investment contract." Both the federal act[22] and the Arkansas Securities Act include the term "investment contract" in their defini-

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filing documents to perfect an exemption under the Arkansas Securities Act. Schultz v. Rector-Phillips-Morse, Inc., 261 Ark. 769, 784-85, 552 S.W.2d 4, 12 (1977).

12. 1 L. Loss, Securities Regulation 25 (2d ed. 1951). Such acts were aimed at protecting investors from promoters who "would sell building lots in the blue sky in fee simple." Mulvey, *Blue Sky Laws,* 36 Can. L. Times 37 (1916).

13. 1 L. Loss, *supra* note 12, at 33.

14. Securities which are offered to the public through the mails or channels of interstate commerce must be registered with the SEC by the issuer. The Commission does not approve any security or pass on its merits. It merely assures the public that the registration statement is accurate and complete. A prospectus containing basic information about the security must be given to the buyer. 1 L. Loss, *supra* note 12, at 130. The facts of this case did not fall under SEC regulation because only intrastate commerce was involved.

15. Ark. Stat. Ann. §§ 57-1235 to -1261 (Repl. 1966).

16. The Uniform Securities Act has been adopted by thirty-three states. Schultz v. Rector-Phillips-Morse, Inc., 261 Ark. 769, 778, 552 S.W.2d 4, 8 (1977).

17. State v. Robbins, 185 Minn. 202, 240 N.W. 456 (1932).

18. SEC v. Tung Corp., 32 F. Supp. 371 (N.D. Ill. 1940).

19. SEC v. Payne, 35 F. Supp. 873 (S.D.N.Y. 1940).

20. SEC v. Brigadoon Scotch Distributors, Ltd., 388 F. Supp. 1288 (S.D.N.Y. 1975).

21. Glen-Arden Commodities, Inc., v. Costantino, 493 F.2d 1027 (2d Cir. 1974).

22. Federal Securities Act of 1933, 15 U.S.C. § 77(b)(1) (1970).

tions.[23] The Arkansas Act also includes the term "certificate of participation in a profit-sharing agreement." These catch-all phrases increasingly have been the focal point of litigation on the question of the scope of securities regulation. Recent cases on this point have resulted in the application of securities laws, both state and federal, to a wide variety of schemes and promotions not commonly thought of as "securities."[24] The Arkansas court had not previously construed these terms. At least four tests have been applied to this problem by other courts: the *Howey* test, the revised *Howey* test, the "risk capital" test, and the nondefinitional or case-by-case approach.

The federal view of the meaning of "investment contract" is commonly referred to as the *Howey* test. In *SEC v. C.M. Joiner Leasing Corp.*[25] the Supreme Court laid the groundwork for the *Howey* definition by emphasizing substance over form in securities regulation. The offerings in *Joiner* were leasehold subdivisions of two and a half to twenty acres surrounding the proposed drilling site of an exploratory oil well. The sales literature emphasized the character of the scheme as an investment.[26] In construing these contracts to be within the meaning of "investment contracts," the Court said it was not the nature of the assets offered that determines the applicability of the act, but rather the character given to the investment by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect.[27]

In *SEC v. W.J. Howey Co.*[28] the Court elaborated on the *Joiner* ideas and defined "investment contract" as "any 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."[29] The offerings in *Howey* were a combi-

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23. Ark. Stat. Ann. § 67-1247(1) (Repl. 1966) defines "security" as

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; variable annuity contract; voting-trust certificate; certificate of deposit for a security; certificate of interest or participation in an oil, gas, or mining title or lease . . . , 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, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

24. *See generally* cases cited notes 17-21 *supra*.

25. 320 U.S. 344 (1943).

26. *Id.* at 346.

27. *Id.* at 352-53. Both lower courts had found that the scheme amounted simply to sales and assignments of legal and legitimate oil and gas leases. *Id.* at 348.

28. 328 U.S. 293 (1946).

29. *Id.* at 298.

nation of a land sales contract and a service contract for citrus groves in Florida. Most purchasers were tourists from other areas of the country who lacked the knowledge or resources to manage the groves themselves. The land was sold in single strips of one or more rows of trees with forty-eight trees to a row. The average purchase was 1.33 acres.[30] In deciding that this offering was a "security" subject to federal regulation, the Court emphasized the following elements of an investment contract: (1) the investment of money (2) in a common enterprise (3) with the expectation of profit (4) to be derived "solely" from the efforts of others.[31] Although this definition has been widely criticized,[32] it has been followed in many states, as well as in the federal courts.[33]

Most criticism of the *Howey* test centers on its mechanical nature, particularly the requirement that the management of the project come *solely* from the promoter or a third party.[34] Under a strict application of the *Howey* test, any participation by the investor renders the contract a nonsecurity.

Recent case law has resulted in the development of a revised *Howey* test.[35] In these cases courts claiming to adhere to the *Howey* test have dispensed with the requirement that the profits come "solely" from the efforts of the promoter or a third party. Instead, they have recognized that securities regulation may easily be circumvented by requiring a modicum of investor effort.[36] In addition, these cases recognize that in some schemes the efforts of the investor are not material to the success or failure of the enterprise, leaving him still at the mercy of the promoters for realization of profit on his investment.[37] This new interpretation of *Howey* has been applied to pyramid type schemes typified by *SEC v. Glen W. Turner Enter-*

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30. *Id.* at 295.

31. *Id.* at 298.

32. *See* Bitter v. Hoby's Int'l, Inc., 498 F.2d 183 (9th Cir. 1974); Miller v. Central Chinchilla Group, Inc., 494 F.2d 414 (8th Cir. 1974); Nash Assocs., Inc., v. Lum's of Ohio, Inc., 484 F.2d 392 (6th Cir. 1973); Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?*, 18 Case W. Res. L. Rev. 367 (1976); Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 Okla. L. Rev. 135 (1971).

33. For a list of states recognizing the *Howey* test, *see* Annot. 47 A.L.R.3d 1375, 1380-82 (1973 & Supp. 1977).

34. SEC v. Glen W. Turner Enterprises, Inc., 474 F.2d 476, 482 (9th Cir. 1973). The *Howey* court itself said, "The statutory policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae." SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946).

35. SEC v. Koscot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974); SEC v. Glen W. Turner Enterprises, Inc., 474 F.2d 476 (9th Cir. 1973).

36. SEC v. Glen W. Turner Enterprises, Inc., 474 F.2d 476, 482 (9th Cir. 1973).

37. *Id.*

prises, Inc.[38] Although Turner's organization ostensibly sold self-improvement courses, it actually induced persons to invest money in the company in return for the right to earn commissions by inducing others to invest.[39] Strict application of the *Howey* test would have allowed this type of frequently fraudulent scheme to escape the securities laws, since the "investor" was actively engaged in sales work. Revising the *Howey* test, the Ninth Circuit recognized the need for liberal construction of the term "securities" to cover "[n]ovel, uncommon or irregular devices, whatever they appear to be."[40] Quoting from *Howey,* the court concluded that the definition of a security "embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."[41]

In *SEC v. Koscot Interplanetary, Inc.*,[42] almost factually identical, the Fifth Circuit found that literal application of the *Howey* test would frustrate the remedial purpose of the Federal Securities Act.[43] The court also found that *Howey* did not require the literal application of the "solely from the efforts of others" test.[44] The *Koscot* court concluded that the critical inquiry is "whether the efforts made by those other than the investors are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."[45]

Another approach to the problem of defining "investment con-

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38. 474 F.2d 476 (9th Cir. 1973).

39. *Id.* at 478. For an investment of $2000, the buyer could purchase "Adventure III" and receive a portable tape recorder, a number of tape-recorded lessons, notebooks, and 110 hours of "group sessions," plus the right to sell "Adventures" to others. For such a $2000 sale, the seller received a commission of $700. "Adventure IV" was at the peak of the pyramid, selling for $5000 and entitling the buyer to $2500 for each sold. The Adventurer's actual function was bringing in prospects to "Adventure Meetings," at which high-pressure sales tactics were used by Turner employees to sell the plan through extravagant promises of almost instant wealth. Methods used by the employees included cheering and chanting, exuberant handshaking, standing on chairs, shouting, and "money-humming." *Id.* at 479.

40. *Id.* at 481.

41. *Id.;* SEC v. W.J. Howey Co., 328 U.S. 293, 299 (1946).

42. 497 F.2d 473 (5th Cir. 1974).

43. Koscot, a subsidiary of Glen W. Turner, Inc., marketed a pyramid promotion scheme for the sale of cosmetics. The controlling issue in the case was "whether a literal or functional approach to the 'solely from the efforts of others' test should be adopted, *i.e.*, whether the exertion of some efforts by an investor is inimical to the holding that a promotional scheme falls within the definition of an investment contract." *Id.* at 479.

44. *Id.* at 480. The court declared that the *Howey* test had no "talismanic quality" and that its strict application no longer occupied an "exalted position" in investment contract adjudication. *Id.* at 481.

45. *Id.* at 483 (quoting from SEC v. Glen W. Turner Enterprises, Inc., 474 F.2d 476, 482 (9th Cir. 1973)).

tract" was first articulated by Justice Traynor in *Silver Hills Country Club v. Sobieski.*[46] The promoters of the Silver Hills Country Club financed the purchase of the property and the development of club facilities by selling club memberships. The club's bylaws stated that the members had no rights in the income or assets of the club, only the usual rights to use of facilities.[47] Justice Traynor found the transaction to be one subject to regulation by California securities laws because members were risking their capital in the hope that club facilities would be built. He contrasted this risk with the usual membership fee entitling the purchaser to use *existing* facilities, where there would be no risk.[48] Under Justice Traynor's risk capital test, it does not matter whether the investor expects a "return" on his capital in the usual sense.[49] The essential element is the investment of risk capital in the business venture of another. The test, by submitting the venture to regulation, affords "those who risk their capital at least a fair chance of realizing their objectives in legitimate ventures *whether or not they expect a return on their capital in one form or another*"[50] (emphasis added).

In *Commissioner of Securities v. Hawaii Market Center, Inc.*,[51] the Hawaii court applied the risk capital test to a pyramid sales scheme whereby investors become "founder-members" of a proposed retail distribution center.[52] In deciding that the scheme in-

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46. 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961). Although Justice Traynor did not find the security in this case to be an "investment contract" (a term not discussed in this case), his reasoning has been applied to later discussions of the term's meaning.

47. Members could be expelled only for misconduct or failure to pay dues. Memberships were transferable, but only to persons approved by the board of directors. *Id.* at 813, 361 P.2d at 907, 13 Cal. Rptr. at 187.

48. "Petitioners are soliciting the risk capital with which to develop a business for profit. The purchaser's risk is not lessened because the interest he purchases is labelled a membership. Only because he risks his capital . . . can there be any chance that the benefits of club membership will materialize." *Id.* at 815, 361 P.2d at 908, 13 Cal. Rptr. at 188.

49. He found the test applicable to "transactions where capital is placed without expectation of any material benefits." *Id.*

50. *Id.* at 815, 361 P.2d at 908-09, 13 Cal. Rptr. at 188-89. A later California case illustrative of the "risk capital" test's application to investment contracts is Hamilton Jewelers v. Department of Corporations, 37 Cal. App. 3d 332, 112 Cal. Rptr. 387 (1974). In this case the court reiterated that California adheres to the risk capital test, finding that the sale of unmounted diamonds for $500 when the usual price was $500 or more was not a security because the purchase was adequately secured. The seller promised to pay five percent interest if the purchaser wished to sell the diamond back within three years. The court ruled that since the diamonds were not sold for more than their usual value, there was no risk of capital and therefore no security. *Id.* at 336, 112 Cal. Rptr. at 390-91.

51. 52 Haw. 642, 485 P.2d 105 (1971).

52. Hawaii Market Center, Inc., had the express purpose of opening "a retail store which would sell merchandise only to persons possessing purchase authorization cards." To raise capital to finance this enterprise, the corporation recruited founder-members who were told they could earn money by becoming founder-member distributors or founder-member

volved investment contracts, the Hawaii court focused on the "substantial premiums" paid by the investors[53] as consideration for the right to receive future income from the corporation. The court found that this money constituted the offeree's investment or contribution of initial value and, as such, was subject to the risks of the enterprise. Citing *Silver Hills Country Club,* the court characterized the salient feature of securities sales as "public solicitation of venture capital to be used in a business enterprise."[54] The court emphasized the "economic reality" of the scheme rather than the labels attached to it by the promoters. As for the participation of the investors in the scheme, the court focused on the quality of the participation and said that investor control would have to include "practical and actual control over managerial decisions" in order to negate the finding of a security.[55]

Minnesota takes still another approach to the problem of defining "investment contract," refusing to adopt the *Howey* definition or any other inflexible test. Minnesota was one of the first courts to discuss the term in *State v. Gopher Tire & Rubber Co.*[56] in 1920. The court said that an "investment" is the placing of capital or laying out of money in a way intended to secure income or profit from its employment and that a contract or certificate fitting this description is an "investment contract."[57] The court then said, "It is better

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supervisors. To become a *distributor,* the investor had to purchase either a cookware set or a sewing machine for $320. The wholesale value of either was $70. Then the distributor could earn money by distributing the purchase authorization cards or signing up other distributors, eventually becoming a founder-member *supervisor,* at which level he would earn higher fees and commissions. This scheme is a classic example of a pyramid sales structure. *Id.* at 648-49, 485 P.2d at 107.

53. These premiums were the "overcharges" to investors for the merchandise (the difference between the wholesale value and the amount charged for the cookware and sewing machines). *Id.* at 648-49, 485 P.2d at 107-08.

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

55. *Id.* at 652, 485 P.2d at 111. The Hawaii court adopted the following test taken from Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?,* 18 Case W. Res. L. Rev. 367, 377 (1967):

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

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

56. 146 Minn. 52, 177 N.W. 937 (1920).

57. *Id.* at 53, 177 N.W. at 938.

to determine in each instance whether a security is in fact of such a character as fairly to fall within the scope of the statute."[58] The Minnesota court reaffirmed this view in 1946 in *State v. Lorentz*[59] and in 1973 in *State v. Investors Security Corp.*[60] when the court specifically rejected the *Howey* test or any other definition.

The Arkansas Supreme Court in *Schultz* adopted the Minnesota approach for determing what an "investment contract" is and refused to give a definition of "investment contract," "security," or "certificate of interest or participation."[61] Because of the Act's essentially remedial nature, the court expressed a preference for keeping the definition of "security" flexible enough "to encompass the endless succession of new and innovative or old and tried promotional schemes, where the promoters, by design seek to risk the money or property of others in their venture."[62] Among the examples given by the court were the current uses of limited partnerships with public investors as the vehicle for conducting business ventures such as oil and gas leases or herds of cattle.[63] While not stating that these schemes are always securities, the court did say that the definition must be broad and flexible enough to allow analysis of all the factors involved in transactions such as these.[64]

Applying this flexible approach in *Schultz,* the court based its conclusion that the joint venture interests were "securities" on several factors including the "package" nature of the offering, the "passive" position of the investors, and the manner in which the project was financed. The court emphasized that the entire scheme for marketing and managing the apartment complex was put together by RPM which, either directly or through its affiliates, was to organize, construct, manage, and control the properties. Since interests in the project were sold as "units" to investors primarily interested in tax shelters, the court said these sales were clearly not mere sales of an interest in real estate.[65] Another factor in the court's analysis was the "passive investor" status of the plaintiffs.[66] The

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58. *Id.*

59. 221 Minn. 366, 22 N.W.2d 313 (1946)(the sale of cemetery lots for investment purposes constituted a sale of securities).

60. 297 Minn. 1, 209 N.W.2d 405 (1973).

61. The court preferred not to give a narrow construction to the definition of "securities" within the meaning of the Arkansas Securities Act, favoring instead a case-by-case review of facts to determine whether a particular scheme falls within the act. Schultz v. Rector-Phillips-Morse, Inc., 261 Ark. 769, 781, 552 S.W.2d 4, 10 (1977).

62. *Id.* at 777, 552 S.W.2d at 8.

63. *Id.*

64. *Id.*

65. *Id.* at 781, 552 S.W.2d at 11.

66. The court said the scheme was not "a partnership in which a number of persons

court found that the substance of the financing amounted to a security transaction, no matter what label it was given.[67] The court concluded by limiting its holding to the particular facts of *Schultz,* stressing that not all general partnerships or joint ventures are securities within the Arkansas Securities Act.[68]

Schultz's holding is significant because it establishes the Arkansas Supreme Court's flexible approach to determining whether a transaction is an investment contract. While the factual conclusion that the joint venture interest in the apartment complex was a security is not altogether surprising in light of relevant cases from other jurisdictions,[69] it is the court's approach that is important. The court's refusal to adopt the *Howey* test or its modified version takes Arkansas out of what is probably the majority view on this subject and leaves the potential seller of and investor in unconventional types of investments without clear guidelines.

It should be noted that the scheme in *Schultz* would have been a security under the *Howey* test, the revised *Howey* test, or Justice Traynor's "risk capital" test. The court could have reached the same result by applying any one of the commonly used definitions.[70] Although the court claimed not to be applying any test in particular, a substantial amount of "risk capital" language is used in the opinion.[71]

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expected to pool their talents and capital and reap the benefits of their own expertise and abilities. The . . . investors were mere passive contributors of risk capital who placed their money in an investment program labeled a 'joint venture.'" *Id.* at 782, 552 S.W.2d at 11.

67. *Id.*

68. *Id.*

69. The following cases held that contracts for the sale and management of income-producing realty were securities and subject to regulation: Sire Plan Portfolios, Inc., v. Carpentier, 8 Ill. App. 2d 354, 132 N.E.2d 78 (1956)(sale of fractional, undivided interests in an apartment building); Prohasa v. Hemmer-Miller Development Co., 256 Ill. App. 331 (1930) (sale of crop-producing farm land with terms of one third down and balance to be paid from profits from crop sales); State v. Investors Security Corp., 297 Minn. 1, 209 N.W.2d 405 (1973) (sale of land developers' notes). Cases holding that contracts for the sale and management of income-producing realty are not securities frequently involve sales of condominiums or stock cooperatives for use by the investor as a residence. In United Housing Foundation, Inc., v. Forman, 421 U.S. 837, 851 (1975), the United States Supreme Court ruled that stock purchased in Co-op City, a state-subsidized nonprofit membership corporation, entitling the purchaser to lease an apartment in the complex, was not a security because the sole incentive to purchase was to acquire low-cost living space, not to invest for profit. *Accord,* Grenader v. Spitz, 537 F.2d 612 (2d Cir. 1976).

70. Since the plaintiffs were passive investors, it could be said that they were "led to expect profits solely from the efforts of the promoter or a third party," thus satisfying the *Howey* test or the revised *Howey* test. *See* SEC v. W.J. Howey Co., 328 U.S. 293, 298 (1946). Further, since they were furnishing risk capital or venture capital for RPM's packaged complex, the "risk capital" test would clearly apply, too. *See* Silver Hills Country Club v. Sobieski, 55 Cal. 2d 811, 815, 361 P.2d 906, 908-09, 13 Cal. Rptr. 186, 188-89 (1961).

71. For example, "[t]he investors were mere passive contributors of *risk capital* . . .

In refusing to adopt any definition or test, the court showed a strong preference for looking to the substance of the financing of the venture, as opposed to checking off elements of a strict definition. This approach will allow courts latitude in future determinations of whether unconventional investment schemes constitute securities. The Arkansas Securities Act was designed to protect both investors in ordinary securities, such as stocks and bonds, and persons who invest in securities disguised as business ventures of other people.[72] In *Schultz* the court clearly recognized the remedial nature of the legislation.[73]

An action for rescission of a stock transaction may be barred on equitable principles. Under the theory of equitable estoppel, the voluntary conduct of a party absolutely precludes him, both at law and in equity, from asserting property or contract rights which might otherwise have existed, as against another party who has in good faith relied on his conduct and has been led because of such reliance to change his position.[74] Authorities are not in agreement as to whether the doctrine of equitable estoppel can be invoked by the seller of stock or other securities to defeat a purchaser's action for rescission of a transaction which violates securities regulations. Generally, an agreement or instrument which is illegal because it violates an express mandate of the law or the dictates of public policy cannot be made valid by the application of equitable estoppel.[75] In accordance with this rule, it is frequently held that in the absence of special circumstances, such as the intervening rights of third parties, the doctrine of equitable estoppel cannot be invoked by the seller of securities to defeat the purchaser's claim that the transaction was invalid.[76] The exceptions to this rule of law, however, are as numerous as the instances of its observance, making it difficult to formulate a clear majority rule on the point.

In jurisdictions where the defense of equitable estoppel is avail-

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in an investment program." Schultz v. Rector-Phillips-Morse, Inc., 261 Ark. 769, 782, 552 S.W.2d 4, 11 (1977) (emphasis added). The court also said that the definition of security should be flexible enough "to encompass the endless succession of . . . schemes, where the promoters . . . seek to *risk the money or property* of others in their ventures." *Id.* at 777, 552 S.W.2d at 8 (emphasis added).

72. *Id.*

73. *Id. See also* Chicago Mill & Lumber Co. v. Smith, 228 Ark. 876, 310 S.W.2d 803 (1958).

74. Sovereign Camp Woodmen of the World v. Newsom, 142 Ark. 132, 156, 219 S.W. 759, 768 (1920); 3 J. Pomeroy, Equity Jurisprudence § 804 (5th ed. 1941).

75. Harriman v. Northern Securities Co., 197 U.S. 244 (1905).

76. Martin v. Orvis Bros. & Co., 25 Ill. App. 3d 238, 323 N.E.2d 73 (1974); Loewenstein v. Midwestern Inv. Co., 181 Neb. 547, 149 N.W.2d 512 (1967).

able in securities cases,[77] the question of whether the conduct of the purchaser is sufficient to bar the rescission depends on the facts in each case. Determinative factors in securities registration cases include participation in organization or management of the corporation,[78] acceptance of dividends by the buyer,[79] the buyer's knowledge of the violation at the time of the sale,[80] the reliance of the seller on the buyer's conduct,[81] and, occasionally, the experience and sophistication of the buyer.[82]

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77. In jurisdictions which hold the sale of unregistered securities to be a void contract, equitable estoppel is not available as a defense. California is one such jurisdiction. *See* Regan v. Albin, 219 Cal. 357, 26 P.2d 475 (1933).

78. Several cases have held purchasers barred from recovery because of participation in organization or management of the corporation. *See, e.g.*, Krasny v. Richter, 211 So. 2d 612 (Fla. Dist. Ct. App. 1968); Nash v. Jones, 224 Ga. 372, 162 S.E.2d 392 (1968); Moore v. Manufacturers Sales Co., 335 Mich. 606, 56 N.W.2d 397 (1953); Tucker v. McDell's, Inc., 50 Tenn. App. 62, 359 S.W.2d 597 (1961). Other cases have allowed recovery in spite of participation. *See, e.g.*, Commissioner of Banks v. Chase Securities Corp., 298 Mass. 285, 10 N.E.2d 472, *appeal dismissed*, 302 U.S. 660 (1937); Gales v. Weldon, 282 S.W.2d 522 (Mo. 1955); Loewenstein v. Midwestern Inv. Co., 181 Neb. 547, 149 N.W.2d 512 (1967).

79. Plaintiffs were estopped because of acceptance of dividends or attendance of stockholder's meetings or both in *In re* Racine Auto Tire Co., 290 F. 939 (7th Cir. 1923); Farmer's Union Co-op Royalty Co. v. Little, 180 Okla. 178, 77 P.2d 33 (1938). However, rescission was allowed in spite of such participation in Commissioner of Banks v. Chase Securities Corp., 298 Mass. 285, 10 N.E.2d 472, *appeal dismissed*, 302 U.S. 660 (1937).

80. "[T]he buyer's mere knowledge of the violation of the blue sky statute at the time of his purchase will not generally saddle him with the status of one in pari delicto which the courts will not assist." 3 L. Loss, *supra* note 12, at 1677. *Accord*, Brannan, Beckham & Co. v. Ramsaur, 41 Ga. App. 166, 152 S.E. 282 (1930)(buyer's lack of knowledge that the statute had been violated held not to be a condition precedent to his recovery); Sampson v. Sapoznik, 124 Cal. App. 2d 704, 269 P.2d 205 (1954). *Contra*, De Polo v. Greig, 338 Mich. 703, 62 N.W.2d 441 (1954)(stockholders of small corporation who bought second issue knowing the first had not been registered held estopped from recovery); Stonehocker v. Cassano, 154 Cal. App. 2d 732, 316 P.2d 717 (1957); Ladd v. Knowles, 505 S.W.2d 662 (Tex. Civ. App. 1974). However, the buyer has no affirmative duty to investigate to determine whether the sale to him was legal. Commissioner of Banks v. Chase Securities Corp., 298 Mass. 285, 325, 10 N.E.2d 472, 497, *appeal dismissed*, 302 U.S. 660 (1937); 3 L. Loss, *supra* note 12, at 1677.

81. Reliance of the seller on the buyer's conduct is often mentioned as a secondary issue. *See generally* cases cited notes 78-80, *supra*.

82. The sophistication and experience of the buyer is often at issue in fraud and misrepresentation cases when the buyer's reliance on the seller's misrepresentation is a requirement for rescission of the sale. In Lane v. Midwest Bancshares Corp., 337 F. Supp. 1200 (E.D. Ark. 1972), the court, while acknowledging a material misrepresentation by the seller, refused the plaintiff-buyer any relief under either federal or Arkansas securities statutes, holding that the class of investors the securities acts are designed to protect consists of "conscientious buyers and sellers in good faith." *Id.* at 1209 (quoting from City Nat'l Bank v. Vanderboom, 422 F.2d 221, 230 n.10 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970). However, in a Seventh Circuit case involving nonregistration, the court held that, in the absence of specific words of exemption, investors are not denied coverage merely because they are sophisticated investors. Mark v. McDonnell & Co., 447 F.2d 847 (7th Cir. 1971). *Accord*, Martin v. Orvis Bros. & Co., 25 Ill. App. 3d 238, 323 N.E.2d 73 (1974)(Illinois securities act held designed to prevent injury to the investing public and indicated a legislative purpose to impose absolute liability for violation); Jenkins v. Dearborn Securities Corp., 42 Ill. App. 3d 20, 355 N.E.2d 341 (1976).

The doctrine of laches is a second equitable principle applied to actions for rescission of stock purchases:

> A party to a contract for the purchase of stock may, of course, be barred from maintenance of action for rescission by laches. He must act promptly and must repudiate the contract within a reasonable time after discovery of the facts entitling him to do so, or he will be barred.[83]

The plaintiff is chargeable with such knowledge as he might have obtained upon inquiry, provided that the facts already known to him were such as to put the duty of inquiry upon a man of ordinary intelligence.[84]

The Arkansas Supreme Court in *Schultz* applied the doctrines of equitable estoppel and laches, charging the plaintiffs with either actual or constructive knowledge that the plan was subject to registration and that it was in fact unregistered from the time that they entered into the transaction in 1972. The court also stated that RPM, though an established and experienced real estate firm, did not ordinarily deal in the securities field and could not be expected to know that registration was required; while plaintiffs, on the other hand, should have been more knowledgeable.

The court, citing *Lane v. Midwest Bancshares Corp.*,[85] pointed out that plaintiffs were experienced, well-educated businessmen and registered stockbrokers who routinely maintained large personal investment portfolios. Pointing out that the Act is not investment insurance, the court said it was not fitting that the Arkansas Securities Act should be applied to rescue plaintiffs from the results of their own improvidence.[86]

The court found that defendants had been injured by plaintiffs' delay in attempting to rescind for nonregistration and that plaintiffs' action was therefore barred by laches. The court stated that prompt rescission would have allowed RPM to market the interest to other buyers while a large front-end income tax deduction was still available.[87] In addition, had plaintiffs raised the problem of

83. 12A W. Fletcher, Cyclopedia of the Law of Private Corporations § 5610 (rev. perm. ed. 1972).

84. Smith v. Olin Industries, Inc., 224 Ark. 606, 612, 275 S.W.2d 439, 442 (1955).

85. 337 F. Supp. 1200 (E.D. Ark. 1972).

86. Schultz v. Rector-Phillips-Morse, Inc., 261 Ark. 769, 788, 522 S.W.2d 4, 13 (1977).

87. *Id.* The IRS had disallowed a part of the plaintiff's claimed deductions, but, evidently, a large deduction was still allowed. No figures are set out in the opinion. The dissent points out that RPM violated the prospectus requirement, as well as the registration requirement, since the buyers did not receive the income tax deduction promised in the seller's prospectus. *Id.* at 789, 552 S.W.2d at 15 (Byrd, J., dissenting).

registration before the sale, an exemption could have been obtained or the security could have been registered. In sum, the court reasoned that plaintiffs were barred by laches and estoppel from asserting the technicality of RPM's failure to register the securities in order to extricate themselves from an investment that had not proved to be the profitable tax shelter they had expected.

While the result in this case is probably just, it seems to abrogate the registration requirements of the Arkansas Securities Act. Under the Act the requirement of registration rests solely on the seller,[88] and it is an unusual maneuver to shift that burden to the buyer by insisting that he make sure the security is registered before buying it. Whether or not the doctrines of laches and equitable estoppel support the conclusion in this case,[89] the important point is that in future cases equity may bar a purchaser from rescinding a purchase of unregistered securities, in spite of the clear mandate of the Act.

In *Schultz* the parties who sold unregistered securities and who were experts in real estate investments were, in the final analysis, not penalized for this violation of the Act. Furthermore, the buyers are "stuck" with their interests in the project since, being registered stock brokers, they could not sell or assign them for value without committing a felony violation[90] and risking the revocation of their security licenses.[91]

The court has thus delivered a strong warning to purchasers of securities whose background may classify them as sophisticated and experienced investors. Investors may not buy into projects or promotional schemes and reap the tax (or other) benefits accruing from ownership and decide years later whether to keep the securities or

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88. Ark. Stat. Ann. § 67-1241 (Repl. 1966). In General Life of Missouri Inv. Co. v. Shamburger, 546 F.2d 774 (8th Cir. 1976), the court refused to enforce an executory subscription contract for the sale of unregistered securities. The seller of the securities sought to enforce the contract which violated the registration requirements of the Federal Securities Act of 1933, § 5, as amended, 15 U.S.C.A. § 77e (1971). In refusing to enforce the contract, the court said, "[W]here the wrongdoer sues on the contract [to sell unregistered securities], enforcement may properly be denied even though the defendant apparently was aware of the violation and to some extent may have participated therein." 546 F.2d at 784. The court continued, "[T]he legislative purpose of protecting purchasers of securities would be frustrated if the subscription agreement were enforced in favor of GLMIC, a violator of the Act." *Id.* One may speculate whether this decision will affect the Arkansas Supreme Court's handling of nonregistration cases in the future.

89. The court cited no cases which applied equitable remedies to nonregistration cases. The only securities case cited in this section of the opinion was Lane v. Midwest Bancshares Corp., 337 F. Supp. 1200 (E.D. Ark. 1972), which involved fraud and misrepresentation.

90. Ark. Stat. Ann. § 67-1255 (Repl. 1966).

91. Ark. Stat. Ann. § 67-1240 (Repl. 1966).

sue to recoup their money plus interest while retaining such benefits.[92] Although the purpose of the Act is to protect investors, *Schultz* explicitly emphasizes that not all investors are equal in the eyes of law and equity. Implicit in the opinion is the suggestion that an inexperienced purchaser placed in the same position would not have been expected to inquire about registration; however, knowledgeable investors, including stockbrokers, some lawyers, and some accountants, will not be allowed to convert an unwise investment into a successful court action.

Schultz suggests that the court in the future may construe broadly the range of investment schemes which fall under regulation of the Arkansas Securities Act as "investment contracts" to protect the investing public, but will not deal leniently with the sophisticated investor who should know what he is doing.

Anne P. Ritchey

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92. Schultz v. Rector-Phillips-Morse, Inc., 261 Ark. 769, 786, 552 S.W.2d 4, 13 (1977).