

# Definition Of A Security: Risk Capital And Investment Contracts In Washington

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## I. INTRODUCTION

After the Washington State Supreme Court recently held that Washington did not follow the "risk capital" concept of securities,<sup>1</sup> the legislature responded by unequivocally defining the term "security" to include risk capital.<sup>2</sup> In so doing, Washington became the seventh western state<sup>3</sup> to espouse the risk capital theory, which originated in the California courts<sup>4</sup> and has

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1. *Sauve v. K.C., Inc.*, 91 Wash. 2d 698, 591 P.2d 1207 (1979). The supreme court, after stating that Washington did not follow the risk capital test, defined the test as "requir[ing] only that risk capital be supplied with a reasonable expectation of a valuable benefit but without the right to control the enterprise." *Id.* at 702, 591 P.2d at 1209. The leading case in the area is *Silver Hills Country Club v. Sobieski*, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961). See also Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?*, 18 W. RES. L. REV. 367 (1967); Hannan & Thomas, *The Importance of Economic Reality and Risk in Defining Federal Securities*, 25 HASTINGS L.J. 219 (1974); Comment, *The Definition of a Security Under the California Corporate Securities Law of 1968: The Risk Capital Test*, 6 PAC. L.J. 683 (1975).

2. WASH. REV. CODE § 21.20.005(12) (1979). The sole legislative history consists of a transcript relating to a point of inquiry on the floor:

### Point of Inquiry

Senator Clarke: "Senator, is it your understanding that the purpose of the House amendment is to establish the risk capital definition as a part of the Washington law in view of the recent Washington Supreme Court case of *Sauve v. K.C. Inc.* reported in 91 Wn. 2d 698 which held that the current law does not include that definition?"

Senator Bausch: "Yes, the amendment does establish the risk capital definition as a part of the Washington State Law."

1979 WASH. SENATE J. 1688.

3. In the Ninth Circuit, Alaska, California, Hawaii, Idaho, Nevada, and Oregon also follow the risk capital theory. See text accompanying notes 40-73 *infra*.

4. *Silver Hills Country Club v. Sobieski*, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr.

the endorsement of the Ninth Circuit Court of Appeals.<sup>5</sup> The theory developed in response to shortcomings in the federal interpretation of an "investment contract" security, particularly the requirements of investor nonparticipation and profit expectation.<sup>6</sup> Thus, the Washington Legislature expanded the applicability of the securities act to reach financing schemes that heretofore were unregulated. Despite the benefit to investors of broader protection, the risk capital theory is not without its critics.<sup>7</sup> It complicates existing law and requires flexibility in interpretation and application. To understand and apply the theory, it is desirable to review the evolution of the investment contract concept under the securities acts.<sup>8</sup> Viewing risk capital in the light

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186 (1961). Some commentators indicate that *Silver Hills* may not have been the first decision based upon the risk capital approach. See Coffey, *supra* note 1, at 381-82; Long, *An Attempt To Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135, 168-70 (1971).

5. *El Khadem v. Equity Sec. Corp.*, 494 F.2d 1224, 1229 (9th Cir.), *cert. denied*, 419 U.S. 900 (1974).

6. The Securities Act of 1933 and the Washington State Securities Act have as a prerequisite to their application the finding of a "security." See 15 U.S.C. §§ 77c-77d (1976); WASH. REV. CODE § 21.20.010 (1979). Because the Washington Act sets forth a specific list of instruments classified as securities, WASH. REV. CODE § 21.20.005(12) (1979), many promoters have attempted to devise arrangements which would keep them outside the scope of the act. A court's primary tool for curtailing evasion of the law is classification of a scheme as an "investment contract," the most indefinite category under the definition of "security." Thus, refinement of the investment contract definition necessarily restricts its applicability, reducing a court's authority to bring novel arrangements within the ambit of the securities acts.

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The major problem with the risk-capital theory of *Silver Hills* is that the court never adequately defined what it meant by "risk-capital." It could mean (1) capital used to promote a previously nonexistent project, (2) capital invested in a risky chance or venture, or (3) capital with a very risky chance of return. . . .

Risk-capital has been criticized as being too subjective a concept. Some commentators have suggested that acceptance of this theory would necessitate a day-by-day evaluation of an enterprise to determine whether enough risk existed to classify the investment as a security. . . . Other criticisms are that the theory's emphasis on risky ventures would seriously impede the necessary flow of capital to innovative enterprises, and that abuses can occur in the most solidly established corporations.

*Securities Regulation*, 1974 WASH. U.L.Q. 815, 822 n.28 (citations omitted). For further discussion of risk capital, see text accompanying notes 141-65 *infra*.

8. In 1959, Washington enacted the Uniform Securities Act, which included "investment contract" among the subcategories of the definition of security. Securities Act of Washington, ch. 282, § 60(11), 1959 Wash. Laws 1350 (codified at WASH. REV. CODE § 21.20.005(12) (1979)). The definition section of the Uniform Act was derived in turn from the federal Securities Act of 1933. UNIFORM SECURITIES ACT § 401(1), Commissioners' note (amended 1958). The 1933 Act purported to define the term "security" by enumerating a long list of instruments traditionally called securities and adding the "investment con-

of that evolution, one can more accurately predict the Washington courts' new answer to the old question, "What is a security?"

The purpose of this article is to guide practitioners and jurists in understanding this complex area of the law as applied in Washington. The most notable developments in the federal law dealing with investment contract securities, particularly as the Washington courts interpreted them, and the development of the risk capital theory in other jurisdictions are explored for the purpose of understanding what the Washington Legislature intended by its definition. To this end, this article examines the various elements of the new risk capital definition. The conclusion indicates areas in which the definition might apply and suggests practical steps a careful practitioner might follow in response to this new aspect of securities law in Washington.

## II. HISTORY OF THE FEDERAL DEFINITION OF INVESTMENT CONTRACT

### A. *Pre-Howey Interpretations of "Security"*

The first comprehensive attempt to define the term "security" was in the federal legislation enacted during the early 1930's. The Securities Act of 1933<sup>9</sup> and the Securities Exchange Act of 1934<sup>10</sup> defined "security" by use of nonexclusive lists of instruments commonly considered securities, such as stocks, bonds, and debentures. Although generally descriptive of securities, it was never clear how or why these instruments were securities or whether they were always securities. In addition, inclusion of the broader but less descriptive term "investment contract" complicated the lists.<sup>11</sup> Thus the task of defining

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tract," the origin of which is largely unknown. According to Professor Mofsky, the term "investment contract" first appeared in a statutory definition of security in the Minnesota Blue Sky Law of 1917. Mofsky, *The Expanding Definition of "Security" Under the Blue Sky Laws*, 2 SEC. REG. L.J. 217, 218 n.2 (1973). Congress left the scope of the term open to judicial interpretation. Note, *Securities Regulation—United Housing Foundation, Inc. v. Forman: The Supreme Court Refines the Howey Formula*, 54 N.C.L. REV. 731, 732 (1976). Much interpretive effort has focused on the elusive investment contract. On no less than seven occasions, the United States Supreme Court has addressed the meaning of investment contract, the most famous of the decisions being SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

9. Securities Act of 1933, ch. 38, § 2, 48 Stat. 74 (current version at 15 U.S.C. § 77b (1976)).

10. Securities Exchange Act of 1934, ch. 404, § 3, 48 Stat. 882 (current version at 15 U.S.C. § 78c (1976)).

11. For the purposes of this article, the definitions contained in the 1933 Securities and 1934 Securities Exchange Acts will be treated as equivalent. The 1934 Act definition

exactly what Congress meant by the term "security" and, most importantly, by the term "investment contract," fell to the courts.

The United States Supreme Court's first opportunity to define the scope of the term "investment contract" as used in the Securities Act of 1933 came in *SEC v. C.M. Joiner Leasing Corp.*<sup>12</sup> To finance the drilling of a test well on his Texas property, an oil promoter sold subleaseholds on several adjacent parcels. The subleases would greatly appreciate in value if the promoter struck oil in his test well. In this first encounter with the term "investment contract," the Court emphasized the functional and policy aspects of the transaction and looked to whether the scheme presented the abuses addressed by the securities acts. In finding the subleases to be securities, the Court did not define "investment contract," choosing rather to base its holding on the belief that Congress intended the securities acts to be flexible.<sup>13</sup> This substance-over-form approach allowed the Court to include within the scope of the securities laws any device that those laws

is:

The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

15 U.S.C. § 78c(10) (1976). The term "investment contract" is perhaps the least clearly understood term in the definition of a security. As such, it has become a catchall phrase to snare the schemes which regulators feel should come within the ambit of the securities acts but which do not fit neatly into one of the more commonly recognized subcategories. *Sirva, Inc. v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 253 F. Supp. 359 (S.D.N.Y. 1966). See *Tcherepnin v. Knight*, 389 U.S. 332 (1967); *Continental Mktg. Corp. v. SEC*, 387 F.2d 466 (10th Cir.), cert. denied, 391 U.S. 905 (1967).

12. 320 U.S. 344 (1943). Justice Murphy indicated that the *Joiner* Court was adopting a definition first announced in *State v. Gopher Tire & Rubber Co.*, 146 Minn. 52, 56, 177 N.W. 937, 938 (1920). 320 U.S. at 349. For a survey of relevant federal and state cases preceding *Joiner*, see Long, *supra* note 4.

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[T]he reach of the Act does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as a matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as "investment contracts," or as "any instrument commonly known as a security."

320 U.S. at 351.

were intended to reach, but placed the Court in the position of proceeding on a case-by-case basis. No clear definition of an investment contract was apparent.

### B. *The Howey Test*

Within three years of the *Joiner* decision, the Court, in *SEC v. W.J. Howey Co.*,<sup>14</sup> again addressed the scope of the term "investment contract." The W.J. Howey Co., a Florida corporation, was engaged in a program to sell interests in orange groves coupled with an optional service contract. Under the optional service contract, the seller's affiliate, the Howey-in-the-Hills Service Corporation, maintained and harvested the orange trees and shared the profits of the grove with the investor-purchasers. Most of the purchasers were nonresidents of Florida who lacked the knowledge, skill, and equipment necessary for the care and harvest of the trees, but who nevertheless were attracted to the scheme by the expectation of profits.

Determining that the sales scheme involved a security, the Court set down its now classic definition that a security is present whenever "the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others."<sup>15</sup> The test is usually broken down into four components:<sup>16</sup> (1) an investment of money (2) in a common enterprise (3) with an expectation of profits (4) to come solely from the efforts of others. The Court, while warning lower courts of the problems that might arise through a mechanistic application of this test, indicated that the test permitted "fulfillment of the statutory purpose of compelling full and fair disclosure."<sup>17</sup>

Subsequent federal cases have substantially refined the *Howey* test.<sup>18</sup> Some lower courts, ignoring the Court's admonition in *Howey*, have applied the test inflexibly.<sup>19</sup> Others have

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

15. *Id.* at 301.

16. In some cases the third and fourth elements are combined. *See, e.g., SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473 (5th Cir. 1974).

17. 328 U.S. at 299-301. The Court also warned that "[t]he statutory policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae." *Id.* at 301. *See* 1 L. LOSS, *SECURITIES REGULATION* 491 (2d ed. 1961).

18. *See, e.g., SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 479-83 (5th Cir. 1974); *SEC v. Glenn W. Turner Ents.*, 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

19. *See, e.g., SEC v. Koscot Interplanetary, Inc.*, 365 F. Supp. 588 (N.D. Ga. 1973), *rev'd*, 497 F.2d 473 (5th Cir. 1974). For an inept analysis, *see Commonwealth ex rel. Pa. Sec. Comm'n v. Consumers Research Consultants, Inc.*, 414 Pa. 253, 199 A.2d 428 (1964).

avoided dogmatic application of the test principally by expansive use of the term "profit" and by elimination of the fourth requirement that the profits come solely from the efforts of others.<sup>20</sup> Until 1975, the Court, although continuing to cite the *Howey* case as controlling,<sup>21</sup> did not reconsider the basic problems raised by the case or clarify the language it used. As a result, state and lower federal courts were left with the task of interpreting *Howey*.

### C. The Forman Test

In 1975, *United Housing Foundation v. Forman*<sup>22</sup> reached the Supreme Court. The plaintiffs were residents of a New York low-cost housing cooperative. The housing project was built largely with funds procured under the New York Private Housing Finance Law, known as the Mitchell-Lama Act.<sup>23</sup> Under the act, the state of New York provided private developers with long-term, low-interest loans and special tax exemptions to build housing cooperatives to be operated on a nonprofit basis. United Housing Foundation, a nonprofit organization, financed construction of the project partly through sales of "stock" in the cooperative. To acquire an apartment, each prospective tenant had to purchase an amount of stock based upon the number of rooms acquired. The stock was severely restricted; there was no possibility of capital appreciation because stock could only be sold to current tenants and had to be tendered to the cooperative or an approved prospective tenant at cost. Further, the shares could not be pledged or encumbered and would descend, along with the apartment, only to a surviving spouse. The tenant plaintiffs sued United Housing Foundation after unanticipated construction costs caused the actual monthly rental charges to escalate over seventy percent above the projected rental charges.

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20. *SEC v. Glenn W. Turner Ents.*, 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973); *accord*, *McCowan v. Heidler*, 527 F.2d 204, 209 (10th Cir. 1975); *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 483 (5th Cir. 1974); *Georgia Mkt. Centers, Inc. v. Fortson*, 225 Ga. 854, 171 S.E.2d 620 (1969); *State v. Hawaii Mkt. Center, Inc.*, 52 Hawaii 642, 485 P.2d 105 (1971). See generally *D.M.C. of Colo., Inc. v. Hays*, [1954-1971 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 70,897 (Colo. Dist. Ct. 1971).

21. *United Hous. Foundation v. Forman*, 421 U.S. 837 (1975); *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967); *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202 (1967); *SEC v. Variable Annuity Co.*, 359 U.S. 65, 72 (1959).

22. 421 U.S. 837 (1975).

23. Ch. 803, 1961 N.Y. Laws 2164 (current version at N.Y. PRIV. HOUS. FIN. LAW §§ 1-908 (McKinney 1976 & Supp. 1978)).

The *Forman* Court held that the shares issued with the apartments were not securities either as stock or as investment contracts. The Court rejected the claim that there was an investment contract security because the transaction lacked a key element of the *Howey* test—expectation of profit. The Court indicated that a profit expectation sufficient to satisfy the *Howey* requirement may arise through capital appreciation, through participation in earnings, or perhaps income to be yielded on investment. However, the Court apparently rejected two of the three indicia of profit the Second Circuit Court of Appeals used to find a security—tax benefits and discounts—because the cooperative did not represent these benefits as profits, nor would the tenants obtain them through the efforts of the cooperative or third parties. The Court did admit that the circuit court's third indication of profit, income from commercial leases for the convenience facilities in the cooperative, "is the kind of profit traditionally associated with a security investment."<sup>24</sup> In this particular setting, however, the Court found this income "far too speculative and insubstantial to bring the entire transaction within the Securities Act."<sup>25</sup>

The *Forman* Court's cautious definition of profits places limits on the *Howey* test beyond which the Court cannot be expected to go without evidence of strong investment representations. The added requirement that a significant, realistic expectation of profit or income that will motivate investors to risk their capital, tends to exclude schemes that attract consumers rather than investors. Persons who purchase an interest with the intent of personal consumption do not at the same time, the *Forman* Court implied, expect to realize *Howey*-type profit.<sup>26</sup> This conclusion is consistent with the facts in *Forman* where a tenant's stock could not appreciate or provide a profit-like return, but does not seem to apply very broadly. Unlike the facts in *Forman*, many interests sold to consumers will show capital appreciation upon resale regardless of use during ownership.<sup>27</sup> If the appreciation results from the enterprise efforts of third parties, a security may still be found. Two points emerge, therefore, from the "profits" discussion in *Forman*: (1) the purchase of the inter-

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24. 421 U.S. at 856.

25. *Id.*

26. *Id.* at 852-53.

27. *Id.* at 853 n.17. See, e.g., *Lowery v. Ford Hill Inv. Co.*, 192 Colo. 125, 556 P.2d 1201 (1976). Time-sharing interests and club memberships are possible examples.

est must be induced by the expectation of substantial economic gain, and (2) the purchase must be *primarily* for investment as opposed to personal occupancy or consumption.

In a further move, the *Forman* Court rewrote two of the *Howey* requirements: "solely from the efforts of others" and "common enterprise." The *Forman* Court restated the *Howey* test as follows: "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."<sup>28</sup> Unlike the *Forman* Court's conservative position on profits, these changes appear to broaden the investment contract test.

A literal application of the "solely from the efforts of others" requirement of *Howey* would result in a finding that no investment contract exists if investors are asked to perform even a token effort. By leaving out the word "solely," the *Forman* Court apparently changed that test to profits derived from the "essential managerial efforts of others." As a consequence, token investor effort or nonmanagement investor participation will not preclude finding an investment contract. The Court seemingly approved the erosion of the "solely" test that had occurred primarily in cases involving pyramid schemes or franchises,<sup>29</sup> thereby acknowledging that in many cases the investor may be required to make some genuine effort in behalf of the enterprise yet still lack control over the management of his investment.<sup>30</sup> As a result of this change, the "profits through the efforts of others" test is largely a factual question that will require courts to determine the degree of management participation and control by investors in order to decide whether a particular transaction involves a security.

The *Forman* Court also substituted the term "common venture" for "common enterprise." What effect, if any, this substitution will have is not yet clear, although two inferences are possible. First, to find an investment contract, the Third and

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28. 421 U.S. at 852 (emphasis added).

29. In these cases the investor may be required to make some genuine effort on behalf of the enterprise, yet the investor still lacks control over the management of his investment. See, e.g., *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473 (5th Cir. 1974); *SEC v. Glenn W. Turner Ents.*, 474 F.2d 476 (9th Cir.), cert. denied, 414 U.S. 821 (1973).

30. 421 U.S. at 852 n.16 (citing *SEC v. Glenn W. Turner Ents.*, 474 F.2d 476, 482 (9th Cir.), cert. denied, 414 U.S. 821 (1973)). See, e.g., *Smith v. Gross*, 604 F.2d 639 (9th Cir. 1979) (raising earthworms); *Miller v. Central Chinchilla Group, Inc.*, 494 F.2d 414 (8th Cir. 1974) (breeding chinchillas).



Seventh Circuits require a common enterprise among investors.<sup>31</sup> Other circuits that have considered the question of common enterprise, including the Ninth Circuit, find this element satisfied if there is an enterprise between the investor and promoter.<sup>32</sup> By altering the language from "common enterprise" to "common venture," the Supreme Court may have indicated that it does not intend to be held to a narrow interpretation. Second, as speculative as it may seem, the use of the term "venture" may signify that the Supreme Court is moving closer to adopting some aspects of the risk capital concept. The term "venture" connotes raising venture capital and frequently has been used by those courts that have applied the risk capital test.<sup>33</sup> Use of "venture" may well demonstrate the Supreme Court's flexibility and willingness to move away from a rigid application of *Howey* to more closely align itself with the risk capital approach. While the Court declined to adopt this test under the facts in *Forman*, footnote twenty-four of the opinion suggests that the Court is not foreclosing future consideration of risk capital as an alternative to the *Howey* test.<sup>34</sup>

#### D. The Daniel Case

Following *Forman*, the Supreme Court, in *International Brotherhood of Teamsters v. Daniel*,<sup>35</sup> reviewed an employee's interest in a compulsory, noncontributory, fixed-benefit pension

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31. See, e.g., *Milnarik v. M-S Commodities, Inc.*, 457 F.2d 274, 276-78 (7th Cir.), cert. denied, 409 U.S. 887 (1972); *Wasnowic v. Chicago Bd. of Trade*, 352 F. Supp. 1066, 1068 (M.D. Pa. 1972), aff'd mem., 491 F.2d 752 (7th Cir. 1973). Both *Milnarik* and *Wasnowic* involved discretionary commodities trading accounts.

32. A majority of the circuits view the degree of control the promoter exercises over the enterprise as the key factor. Focusing the inquiry on the efforts of others arguably eliminates the element of common enterprise from the *Howey* test. See *SEC v. Continental Commodities Corp.*, 497 F.2d 516 (5th Cir. 1974); *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 479 (5th Cir. 1974); *SEC v. Glenn W. Turner Ents.*, 474 F.2d 476, 482 n.7 (9th Cir.), cert. denied, 414 U.S. 821 (1973); *Securities Investor Protection Corp. v. Associated Underwriters, Inc.*, 423 F. Supp. 168, 178-79 (D. Utah 1975); *Rochkind v. Reynolds Sec., Inc.*, 388 F. Supp. 254, 257 (D. Md. 1975).

33. See, e.g., *Silver Hills Country Club v. Sobieski*, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961); *State v. Hawaii Mkt. Center, Inc.*, 52 Hawaii 642, 485 P.2d 105 (1971); *State ex rel. Healy v. Consumer Business Sys., Inc.*, 5 Or. App. 19, 482 P.2d 549 (1971).

34. 421 U.S. at 857 n.24. This would seem to follow if the risk capital test includes some expectation of profit. See, e.g., *Amfac Mortgage Corp. v. Arizona Mall, Inc.*, 583 F.2d 426 (9th Cir. 1978); *Great W. Bank & Trust v. Kotz*, 532 F.2d 1252 (9th Cir. 1976); *El Khadem v. Equity Sec. Corp.*, 494 F.2d 1224 (9th Cir.), cert. denied, 419 U.S. 900 (1974).

35. 439 U.S. 551 (1979).

plan. Daniel, a Chicago truck driver, worked continuously for approximately twenty-three years except for a four-month involuntary layoff. Throughout Daniel's employment, in accordance with a multi-employer collective bargaining agreement, his employer contributed to a pension plan trust fund. Contributions to the fund were not measured by an employer's obligation to any individual employee. Upon retirement in 1973, Daniel discovered that to receive benefits the pension plan required twenty years continuous employment, which he failed to satisfy because of the four-month period of unemployment.

The Court, reversing the decisions below,<sup>36</sup> held that the pension interest was not a security because Daniel had not invested money or its equivalent and there was insufficient expectation of profit under the investment contract test. The Court found that Daniel's labor was exchanged *primarily* for salary and could not be allocated to constitute investment consideration.<sup>37</sup> Additionally, the Court held that although Daniel might in some sense expect "profits" from a pension plan, his participation in any profit was insubstantial and speculative.<sup>38</sup> The *Daniel* case did not alter the *Howey-Forman* investment contract test but did tighten the interpretation of "money or its equivalent" to require the contribution of definable and tangible consideration, which the Court pointed out would include goods and services.<sup>39</sup> Continuing to follow *Forman*, the Court demanded that to find an investment contract, there must be a substantial expectation of profit.

### III. DEVELOPMENT OF THE RISK CAPITAL TEST

#### A. Silver Hills

Not all courts have agreed with the restrictive federal definition of investment contract.<sup>40</sup> Under both *Howey* and *Forman*, regardless of the risks involved in the contribution of capital, the securities acts are applicable only if the investor expects some profit from the investment. The federal courts have imposed the

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36. See *Daniel v. International Bhd. of Teamsters*, 410 F. Supp. 541 (N.D. Ill. 1976), *aff'd*, 561 F.2d 1223 (7th Cir. 1977).

37. 439 U.S. at 560.

38. *Id.* at 561-62.

39. *Id.* at 560 n.12.

40. See, e.g., *Lowery v. Ford Hill Inv. Co.*, 192 Colo. 125, 130 n.1, 556 P.2d 1201, 1205 n.1 (1976). See also Hunt, *Madame El Khadem, The Ninth Circuit and The Risk Capital Approach*, 57 OR. L. REV. 3, 6-7 (1978).

expectation of profit element even though the definitions of security under the securities acts do not expressly require a promise of profit to the suppliers of capital. By taking a broader view of the securities acts, however, it may be argued that the purpose behind the acts is to give those who risk their capital a reasonable chance of meeting their investment objectives regardless of whether profit is the primary motivation.<sup>41</sup>

Against this background the California Supreme Court, in *Silver Hills Country Club v. Sobieski*,<sup>42</sup> was the first to articulate a new test for defining security. The promoters of a country club bought property with a small down payment, intending later to develop a club and operate it for a profit. To finance both the purchase and development of the property, the promoters sold memberships. Members were entitled to use the facilities but received no right to share in the income or assets of the club. Despite the lack of a *Howey*-type expectation of profit, Justice Traynor held that the memberships constituted securities within the meaning of the California Corporate Securities Act.

In approach, *Silver Hills* supplanted the *Howey* requirement of expectation of profit with a requirement of expectation of any significant and valuable benefit one might be induced to purchase. The *Silver Hills* benefit approach conflicts with the *Howey* decision and the later *Forman* decision, wherein the United States Supreme Court took the conservative view that profit is usually limited to pecuniary return such as capital appreciation or participation in earnings.<sup>43</sup> Although the *Silver Hills* court held that the purchase of a membership constituted an investment of risk capital and thus a security, the court failed adequately to define risk capital,<sup>44</sup> deciding the case more on policy grounds than upon specific statutory definitions of security. The opinion does not clearly indicate whether the risk capital test was based on an expansion of the investment contract approach or on something entirely new. Outside of California, the case was not widely relied upon for many years.

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41. *Silver Hills Country Club v. Sobieski*, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961).

42. *Id.*

43. 421 U.S. at 588 (plaintiffs in *Forman* had urged the Court to adopt the *Silver Hills* benefit analysis and accept as "profit" the savings allowed by government subsidy of purchase price, rent, and taxes). See Comment, *The Definition of a Security Under the California Corporate Securities Law of 1968: The Risk Capital Test*, 6 PAC. L.J. 683, 696 (1975).

44. See note 7 *supra*.

### B. Hawaii Market

In the effort to establish a definition of risk capital, the Hawaii Supreme Court in 1971 picked up where *Silver Hills* left off. In *State v. Hawaii Market Center, Inc.*,<sup>45</sup> a corporation sought capital to open a retail store through the sale of founder memberships. The purchaser of a membership received an appliance, the wholesale value of which was only a small portion of the invested capital, and a promise of future income from participation in various promotional schemes to be conducted by the corporation. The court in *Hawaii Market* based its risk capital approach on a test proposed by Professor Ronald J. Coffey, a noted writer in securities law.<sup>46</sup> Coffey's test, expanding the concept used in California, requires not only a demonstration of risk to initial value, but also a showing that the offeror induced investment through promises of a valuable benefit. This benefit, according to Coffey, must accrue over and above initial contributed value and must be a result of the operation of an enterprise over which the offeree exercises no control. Impressed by the *Hawaii Market* decision, the SEC immediately adopted it in a release as consistent with *Howey*.<sup>47</sup>

### C. Other States

The western states have been strong proponents of the risk capital theory. In addition to California and Hawaii, Oregon and Idaho have adopted a risk capital test by judicial decision. In *State v. Consumer Business Systems, Inc.*,<sup>48</sup> the Oregon Court of

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45. 52 Hawaii 642, 485 P.2d 105 (1971).

46. See Coffey, *supra* note 1.

47. SEC Securities Act Release No. 5211, [1971-1972 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78,446 (Nov. 30, 1971). See Nev. Op. Att'y Gen. No. 186, [1971-1978 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 71,200 (March 1975); Wis. AD. CODE § 1.02(6)(b) (1979).

48. 5 Or. App. 19, 482 P.2d 549 (1971). The court declared a franchise arrangement to be an investment contract under the Oregon Securities Act in spite of its conclusion that the scheme could not meet the *Howey* requirement of profits resulting solely from the efforts of others. The court relied on *Silver Hills* and adopted the risk capital test. *Id.* at 25-26, 482 P.2d at 552-54. In so doing, the Oregon court apparently restricted the application of the test to the initial capital furnished, something which was not required by the California court in *Silver Hills*. This distinction allowed the Oregon court to conclude in a subsequent case that travel club memberships were not investment contracts under the Oregon securities law. *Jet Set Travel Club v. Corporation Comm'r*, 21 Or. App. 362, 535 P.2d 109 (1975). Recent Oregon decisions have made it clear that the risk capital test is a part of Oregon law. *Fulsaas v. Janitorial Ent.*, 3 BLUE SKY L. REP. (CCH) ¶ 71,453 (D. Or. 1978); *Pratt v. Kross*, 276 Or. 483, 490, 555 P.2d 765, 769 (1976); *Marshall v. Harris*, 276 Or. 447, 452, 555 P.2d 756, 759 (1976); *Bergquist v. International Realty*,

Appeals selected the risk capital test as an alternative to the *Howey* interpretation of investment contract. Consumer Business Systems was selling franchise agreements that did not meet the requirement of the *Howey* test that the investor's profits must result solely from the efforts of others. The court, finding a security under a risk capital analysis, held that use of the *Howey* test should not foreclose other methods of analysis when warranted. In a later case, *Jet Set Travel Club v. Corporation Commissioner*,<sup>49</sup> the Oregon Court of Appeals circumscribed the risk capital test, applying it only to unproven enterprises.<sup>50</sup> The court indicated that because Jet Set Travel Club had been in operation more than a year and because members in other states realized benefits prior to any sales in Oregon, the risk capital test could not be used.

Idaho, in a reported trial court opinion, also has adopted the risk capital test. In *State ex. rel Park v. Glenn W. Turner Enterprises, Inc.*,<sup>51</sup> the Fourth Judicial District Court of Idaho agreed that while the risk capital tests enunciated in *Hawaii Market* and *Consumer Business Systems* went a long way in the right direction, these cases were incorrectly construed to limit risk capital to "initial capital," capital invested in newly formed enterprises. Rather, the Idaho court held that risk capital could apply to schemes to raise capital for any existing but unproven business.

Alaska also currently adheres to the risk capital theory. In 1975, Alaska adopted the risk capital concept by statute,<sup>52</sup> drawing its definitional language from Professor Joseph C. Long,<sup>53</sup> who also drafted the Oklahoma risk capital statute.<sup>54</sup> It is perhaps significant to note that the Alaska statutory language is nearly

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Ltd., 272 Or. 416, 424 nn.6 & 7, 537 P.2d 553, 558 nn.6 & 7 (1975).

49. 21 Or. App. 362, 535 P.2d 109 (1975). *But see* 50 Ops. Cal. Att'y Gen. 20 [1954-1971 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 70,750 (Aug. 1967).

50. Nothing, however, in the *Silver Hills* opinion or in risk capital analysis compels this conclusion; the test may be applied to any undercapitalized operating enterprise seeking to finance the development of new products or markets. *See* Spencer, *Private Placement of Securities in Oregon: The Legal Framework*, 53 OR. L. REV. 131, 139-42 (1974). One federal district court has suggested that the test should apply only to situations involving exceptionally high risk. *See* Mr. Steak, Inc. v. River City Steak, Inc., 324 F. Supp. 640, 647 (D. Colo. 1970), *modified and aff'd*, 460 F.2d 666 (10th Cir. 1972).

51. *State ex rel. Park v. Glenn W. Turner Ents.*, [1971-1978 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 71,023 (Idaho Dist. Ct. 1972).

52. Act of July 2, 1975, ch. 217, 1975 Alaska Sess. Laws (codified at ALASKA STAT. § 45.55.130(12) (Supp. 1979)).

53. *See* Long, *supra* note 4.

54. OKLA. STAT. tit. 71, § 2(20)(P) (Supp. 1977): "'Security' means any: . . . (P)

identical to that in the new Washington statute.<sup>55</sup> The Alaska definition has been discussed in *State v. Vacation Internationale, Ltd.*,<sup>56</sup> an administrative proceeding in which the Department of Commerce and Economic Development established a four-part test for determining whether an offering qualifies under the Alaska risk capital security definition.<sup>57</sup> The Alaska proceeding is noteworthy because it did not limit the application of risk capital to initial capital.

#### D. Federal Decisions in the Ninth Circuit

The federal courts, as would be expected, have been slow to acknowledge the risk capital approach. Contrary to most other federal courts, however, those in the Ninth Circuit have gradually embraced it. As early as 1965, in *SEC v. Latta*,<sup>58</sup> a federal district court may have employed risk capital analysis, although the facts of the case also fit within the framework of the *Howey* test. Federal courts largely ignored the risk capital test for the next nine years, while the courts of Oregon,<sup>59</sup> Hawaii,<sup>60</sup> and Idaho<sup>61</sup> adopted the risk capital approach as enunciated by the California court in *Silver Hills*.

In 1973, a federal district court, in *SEC v. Glenn W. Turner*

investment of money or money's worth including goods furnished and/or services performed in the risk capital of a venture with the expectation of some benefit to the investor where the investor has no direct control over the investment or policy decision of the venture . . . ." See *In re Royal Am. Chinchilla, Inc.*, [1971-1978 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 71,330 (Okla. Dep't of Sec. 1977).

55. "[I]nvestment of money or money's worth including goods furnished or services performed in the risk capital of a venture with the expectation of some benefit to the investor where the investor has no direct control over the investment or policy decision of the venture . . . ." ALASKA STAT. § 45.55.130(12) (Supp. 1979).

56. [1971-1978 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 71,294 (Alaska Dep't of Com. & Econ. Dev. 1976). Michigan and Oklahoma reached similar results concerning *Vacation Internationale's* program in those states. See *In re Vacation Internationale, Ltd.*, [1971-1978 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 71,287 (Mich. Dep't of Com. 1976); Okla. Dep't of Sec. Op. Letter, 2 BLUE SKY L. REP. (CCH) ¶ 39,726 (Oct. 28, 1975). See also *In re Fed. Resources Corp.*, 3 BLUE SKY L. REP. (CCH) ¶ 71,476 (Alaska Dep't of Com. & Econ. Dev. 1978).

57. *State v. Vacation Internationale, Ltd.*, [1971-1978 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 71,294 (Alaska Dep't of Com. & Econ. Dev. 1976).

58. 250 F. Supp. 170 (N.D. Cal. 1965), *aff'd per curiam*, 356 F.2d 103 (9th Cir.), *cert. denied*, 384 U.S. 940 (1966). See Coffey, *supra* note 1, at 382.

59. See note 48 *supra*.

60. *State v. Hawaii Mkt. Center, Inc.*, 52 Hawaii 642, 485 P.2d 105 (1971).

61. *State ex rel. Park v. Glenn W. Turner Ents.*, [1971-1978 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 71,023 (Idaho Dist. Ct. 1972).

*Enterprises, Inc.*,<sup>62</sup> finally adopted the risk capital test. On the heels of this decision, the Ninth Circuit Court of Appeals, in *El Khadem v. Equity Securities Corp.*,<sup>63</sup> appeared to apply the risk capital approach to a case involving money borrowed for investment purposes. The court construed an assignable note and pledged collateral as an investment contract.<sup>64</sup> Giving credibility to *El Khadem*, the United States Supreme Court in *Forman* indicated its belief that *El Khadem* indeed applied a risk capital test.<sup>65</sup>

Since the *Forman* holding, several Ninth Circuit Court of Appeals cases concerning the definition of a security have indicated that *El Khadem* was intended to adopt the risk capital approach.<sup>66</sup> In a 1976 case, *Great Western Bank & Trust v. Kotz*,<sup>67</sup> the Ninth Circuit continued to utilize risk capital analysis, citing *El Khadem*.<sup>68</sup> In *Kotz*, the court relied heavily upon the economic realities test discussed in *Forman* and listed six factors it felt should be examined to determine whether a promissory note is an investment contract: (1) time, (2) collateralization, (3) form of the obligation, (4) circumstances of issuance, (5) relation between the amount borrowed and the size of the borrower's business, and (6) contemplated use of the funds.<sup>69</sup> The court held that unsecured notes given to the bank were not securities. *Kotz* was followed in 1977 by *United California Bank v. THC Financial Corp.*,<sup>70</sup> wherein Judge Wright reiterated the Ninth Circuit's approach to the risk capital test as developed in *Kotz* and *El Khadem*. In analyzing the promissory notes being sold, the court focused on the expertise of the purchasing financial institution and the commercial character of the transaction and found no risk capital.<sup>71</sup> In a more recent case, *Amfac Mortgage Corp. v. Arizona Mall of Tempe, Inc.*,<sup>72</sup> the court expressed that the Ninth Circuit risk capital test is derived from

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62. 348 F. Supp. 766 (D. Or. 1972).

63. 494 F.2d 1224 (9th Cir.), cert. denied, 419 U.S. 900 (1974).

64. *Id.*

65. 421 U.S. at 857 n.26.

66. *Hector v. Wiens*, 533 F.2d 429 (9th Cir. 1976); *Great W. Bank & Trust v. Kotz*, 532 F.2d 1252 (9th Cir. 1976); *Parker v. Davis Oil Co.*, 524 F.2d 112 (9th Cir. 1975). See generally *Hunt*, *supra* note 40, at 16-27.

67. 532 F.2d 1252 (9th Cir. 1976).

68. *Id.* at 1256-59.

69. *Id.*

70. *United Cal. Bank v. THC Fin'l Corp.*, 557 F.2d 1351 (9th Cir. 1977).

71. *Id.* See *Hunt*, *supra* note 40, at 21-28.

72. 583 F.2d 426 (9th Cir. 1978).

both the *Howey* and *Forman* holdings of the United States Supreme Court. The *Amfac* court stated that the ultimate inquiry was whether *Amfac* contributed risk capital subject to the entrepreneurial or managerial efforts of others. The court found, however, that the secured, short-term note in *Amfac* was not a security.

The Ninth Circuit cases indicate that, where profit motive is present, the courts should not confine analysis to a classical application of the *Howey* case. The Ninth Circuit risk capital standard analyzes the underlying risks and economic realities within the framework of the *Joiner*, *Howey*, and *Forman* cases. In not finding a security under risk capital analysis in the *Kotz*, *United California Bank*, and *Amfac* decisions, the court has shown merely that banks and financial institutions are not favored in suits under the securities laws because they already have adequate means to protect themselves. Results might well be different in actions brought by individual investors. With regard to the putative distinction between initial and ongoing risk capital, in spite of Oregon's limitation in *Jet Set Travel*, the Ninth Circuit significantly has not been inclined to limit risk capital to initial capital.<sup>73</sup>

#### IV. THE INVESTMENT CONTRACT AND RISK CAPITAL TESTS IN WASHINGTON

##### A. *McClellan v. Sundholm*

"Investment contract" has been a subcategory of the definition of security since Washington adopted the Uniform Securities Act in 1959.<sup>74</sup> Not until 1969 was the term construed, however, and then only by a federal court.<sup>75</sup> The Washington Supreme Court first confronted the investment contract theory in *McClellan v. Sundholm*.<sup>76</sup> The appeal in *McClellan* centered on the liability of a sales agent in a silver purchase scheme. The salesman, acting on behalf of Universal Trade Company of Port-

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73. *Amfac* was decided after *Jet Set Travel*, yet the court showed no inclination to endorse the Oregon court's limitations relating to initial capital.

74. Ch. 282, § 60(11), 1959 Wash. Laws 1350 (codified at WASH. REV. CODE § 21.20.005(11) (1979)). See UNIFORM SECURITIES ACT § 401(e) (amended 1958).

75. *Chapman v. Rudd Paint & Varnish Co.*, 409 F.2d 635, 639-41 (9th Cir. 1969). The *Chapman* opinion is criticized in *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 484 n.15 (5th Cir. 1974), and probably is superseded by *SEC v. Glenn W. Turner Ents.*, 474 F.2d 476 (9th Cir.), cert. denied, 414 U.S. 821 (1973). See *State v. Williams*, 17 Wash. App. 368, 563 P.2d 1270 (1977).

76. 89 Wash. 2d 527, 574 P.2d 371 (1978).



land, Oregon, convinced the Washington plaintiff to invest in bars of silver bullion. In conjunction with the purchase, the company offered services that included selection, storage, and resale of silver bars and apparently some ongoing advice on the silver market. Not only was the Oregon company in poor financial condition at the time of sale of the silver, but the principal of the company also diverted the purchaser's funds to land speculation and personal use. Although silver was delivered to other customers, none was delivered to the plaintiff.

The trial court reasoned that the transaction was the sale of a security solely because of the diversion of funds for which the sales agent was not responsible. Disagreeing, the Washington Supreme Court found that the sale of unidentified silver bullion was an investment contract within the Washington State Securities Act and held the sales agent liable. The court listed three tests for considering a purported investment contract: (1) the *Howey* test, (2) the risk capital test, and (3) the Minnesota test.<sup>77</sup> The court chose the federal test based on *Howey*.<sup>78</sup>

In applying the traditional *Howey* formulation, the Washington court faced several difficulties. First, the court had to decide the "common enterprise" issue<sup>79</sup> because there appeared to be no common enterprise among the company's purchasers of silver.<sup>80</sup> The court followed the *Glenn W. Turner*<sup>81</sup> decision, however, which held that an "interdependence of fortunes" between the seller and the purchaser was all that was necessary to satisfy the common enterprise requirement.<sup>82</sup> Second, a literal reading

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77. *Id.* at 531-32, 574 P.2d at 373. In *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1948), the Court defined an investment contract as an investment of money in a common enterprise where the investor expects to reap profits from the efforts of the promoter or a third party. *Id.* at 298. See notes 14-21 *supra* and accompanying text. In contrast to *Howey*, the Minnesota test asks whether the contract in issue operates to place capital in a manner intended to secure a profit. *State v. Gopher Tire & Rubber Co.*, 146 Minn. 52, 177 N.W. 937 (1920).

78. 89 Wash. 2d at 532, 574 P.2d at 373.

79. *Id.*, 574 P.2d at 374. For a discussion of the common enterprise issue, see text accompanying notes 29-34 *supra*.

80. See, e.g., *Milnarik v. M-S Commodities, Inc.*, 457 F.2d 274 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972) (individual discretionary commodity accounts lack commonality necessary to meet common enterprise requirement). In fact, in the *McClellan* case funds apparently were sufficiently pooled and commingled to satisfy the narrow *Milnarik* reading of the *Howey* case. See also *Lowery v. Ford Hill Inv. Co.*, 192 Colo. 125, 556 P.2d 1201 (1976) (control by common agent satisfies the common enterprise test).

81. 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

82. *Id.* at 482 n.7 (citing *Los Angeles Trust Deed & Mortgage Exch. v. SEC*, 285 F.2d 162, 172 (9th Cir. 1960), *cert. denied*, 366 U.S. 919 (1961)).

of *Howey* requires that all profit expectation come "solely from the efforts of others." Although the sales agent made representations about services, the purchaser sought delivery of the bullion and presumably would be responsible for its further management and disposition. In this event, some of the efforts to gain a profit would involve the purchaser, thereby precluding a security under *Howey*.<sup>83</sup> Again following the functional approach of the *Glenn W. Turner* case, however, the court found no involvement of the purchaser in "those essential managerial efforts which affect the failure or success of the enterprise."<sup>84</sup>

At this point, the court was stretching for a just result. Although the purchase of a commodity does not preclude the existence of a security,<sup>85</sup> all elements of an investment contract must be present. The facts only indicated the incidental offer of services in conjunction with the sale of a commodity for which the purchaser sought delivery.<sup>86</sup> There was no guarantee of profits, and no repurchase or resale agreement was tendered. The court found a security only on the basis that the plaintiff was offered a commodity and additional services.<sup>87</sup> It may be questioned whether in *McClellan* the economic benefits of silver ownership derived from the managerial efforts of any person other than the purchaser and the vagaries of the silver market, and further whether the services offered amounted to those "essential managerial efforts" upon which a silver purchaser

83. Literally, *Howey* would require the expectation of profits to come solely from the efforts of others. In *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943), sublessees would be expected to sell their interests in order to derive a profit. This effort would have precluded the *Joiner* Court from finding a security under a strict application of the *Howey* test.

84. 474 F.2d at 482.

85. See, e.g., *Bell v. Health-Mor, Inc.*, 549 F.2d 342 (5th Cir. 1977).

86. Bare commodities are not usually regarded as securities because they have inherent value and can be immediately possessed. *King Commodity Co. v. State*, 508 S.W.2d 439 (Tex. Civ. App. 1974); 3 H. BLOOMENTHAL, *SECURITIES AND FEDERAL CORPORATE LAW* § 2.16[1] (1978 rev.) ("The sale of commodity futures does not involve the sale of securities; commodity trading is subject to regulation outside of the federal securities laws."); 1 A. BROMBERG, *SECURITIES LAW FRAUD—SEC RULE 10b-5* § 4.6(410) (1977); Long, *Definition of a Security*, 6 ST. MARY'S L.J. 96, 100 n.21 (1974).

87. Under similar facts the SEC has given "no action" letters. See SEC Securities Act Release No. 5552, [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,037 (Dec. 26, 1974) (granting "no action" position to certain gold offerings based in part on finding that: 1) the economic benefits to the gold purchaser would not be derived from the managerial efforts of the seller, 2) the purchaser would pay full value and purchases would not be made on margin, 3) depository arrangements would be limited to storage and documentary right of purchasers to take possession, and 4) there would be no obligation on the part of the seller to repurchase or resell gold).

must rely to make a profit in the silver market.<sup>88</sup>

On the facts presented, the court could well have applied the risk capital test and been on firmer ground. At the time of sale, the company had no specific silver ingots in inventory or identified with any particular investor's contract, and delivery was to be made in the future.<sup>89</sup> Never was there sufficient bullion on hand to satisfy all outstanding silver purchase contracts; deliveries were made only to those who complained. The company was probably insolvent at the time of the sale and in fact became so one month later.<sup>90</sup> In effect, the purchaser contributed risk capital that allowed the enterprise to keep trading water.<sup>91</sup> Whether figuring significantly in the transaction or not, the incidental representations regarding the services of selection, storage, resale, and advice were not necessary to find a security. The very nature of the transaction placed the silver purchaser in the position of financing the company and its principal's endeavors without any management control on the part of the purchaser.<sup>92</sup>

The Washington court also failed to take note of *United Housing Foundation v. Forman*.<sup>93</sup> As previously discussed,<sup>94</sup> *Forman* reformulated the *Howey* test by dropping from its definition the "common enterprise" and "solely" elements discussed in the *McClellan* case.<sup>95</sup> This shift by the United States Supreme Court signals a less literal approach, suggesting more than ever that

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88. See SEC Securities Act Release No. 5552, [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,037 (Dec. 26, 1974). Loss states the case in this manner:

The line is drawn, however, where neither the element of a common enterprise nor the element of reliance on the efforts of another is present. For example, no "investment contract" is involved when a person invests in real estate, with the hope perhaps of earning a profit as the result of a general increase in values current with the development of the neighborhood, as long as he does not do so as part of an enterprise whereby it is expressly or impliedly understood that the property will be developed or operated by others.

1 L. Loss, *supra* note 17, at 491-92. See also 3 H. BLOOMENTHAL, *supra* note 86, at § 2.19[3].

89. Brief for Appellant at 8, *McClellan v. Sundholm*, 89 Wash. 2d 527, 574 P.2d 371 (1978).

90. *Id.* at 9.

91. See SEC v. Western Pac. Gold & Silver Exch. Corp., [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,064 (D. Nev. 1975).

92. For a discussion of the legislative definition of risk capital, see text accompanying notes 110-212 *infra*.

93. *United Hous. Foundation v. Forman*, 421 U.S. 837 (1975).

94. See text accompanying notes 28-34 *supra*.

95. See *United Hous. Foundation v. Forman*, 421 U.S. at 852; *McClellan v. Sundholm*, 89 Wash. 2d 527, 574 P.2d 371 (1978).

the underlying economic realities of a transaction will prevail.<sup>96</sup> In substance, *McClellan* is at least as much a risk capital case as it is a *Howey* case.

### B. *Sauve v. K.C., Inc.*

The second opportunity for the Washington Supreme Court to interpret the definition of a security appeared in *Sauve v. K.C., Inc.*<sup>97</sup> The defendant, K.C., Inc., was in the business of leasing household appliances with purchase options. To raise funds to purchase appliances for leasing, an agent of the corporation borrowed at least \$250,000 from approximately forty-five persons. The plaintiff, interested in obtaining an interest rate greater than her savings bank offered, loaned the corporation \$15,120 for three years at twelve percent per annum. Contemporaneously with the loan, the corporation gave the plaintiff eighty-four conditional sale contracts representing security interests in the newly leased appliances purchased with her loan funds. Upon default, the plaintiff sued the insolvent corporation, the officers, and the unregistered sales agent. The trial court failed to find fraud but concluded that the arrangement constituted a collateral trust,<sup>98</sup> an enumerated subclass of security under the Securities Act of Washington. The court of appeals affirmed but found instead a security under the risk capital test.<sup>99</sup> The supreme court affirmed on different grounds, holding that the arrangements for borrowing money constituted an investment contract. In so deciding, the court rejected the risk capital approach, stating in dictum: "*Howey*, not 'risk capital,' is the rule in Washington."<sup>100</sup>

The court, relying upon *McClellan v. Sundholm*,<sup>101</sup> once more applied the *Howey* investment contract formula. In support of its *Howey* analysis the court cited *El Khadem v. Equity Securities Corp.*,<sup>102</sup> a case that turns on risk capital analysis.<sup>103</sup>

96. See Coffey, *supra* note 1, at 367-83.

97. 91 Wash. 2d 698, 591 P.2d 1207 (1979).

98. *Sauve v. K.C., Inc.*, 19 Wash. App. 659, 664, 577 P.2d 599, 603 (1978), *aff'd on other grounds*, 91 Wash. 2d 698, 591 P.2d 1207 (1979).

99. *Id.* at 666, 577 P.2d at 604. For prior risk capital cases in Washington, see note 111 *infra*.

100. 91 Wash. 2d at 702, 591 P.2d at 1209.

101. 89 Wash. 2d 527, 574 P.2d 371 (1978). See text accompanying notes 14-21 *supra*.

102. 494 F.2d 1224 (9th Cir.), *cert. denied*, 419 U.S. 900 (1974).

103. In *United Hous. Foundation v. Forman*, 421 U.S. 837, 857 n.24 (1975), the United States Supreme Court cited *El Khadem* as representative of the "risk capital"

Under the third element of the *Howey* test, the court encountered the issue of whether a promised fixed interest rate constituted an expected "profit." Finding that it did, the court again cited *El Khadem* as precedent but ignored the *United Housing Foundation v. Forman* holding that profits meant capital appreciation, a participation in earnings,<sup>104</sup> or income yielded by investment.<sup>105</sup>

Although the court did not follow the risk capital test, it nonetheless took the opportunity to define risk capital: "The 'risk capital' approach used by the court of appeals requires only that risk capital be supplied with a reasonable expectation of a valuable benefit but without the right to control the enterprise."<sup>106</sup> In a mild contradiction, the Washington Supreme Court cited *Glenn W. Turner* as support for risk capital.<sup>107</sup> The court had cited this case extensively in *McClellan* to support its application of the *Howey* investment contract test.<sup>108</sup>

On the facts of the *Sauve* decision it is easy to agree that the risk capital test was not needed because the plaintiff sought and was promised a high interest rate. Nonetheless, the court should not have ruled out the test. Plaintiff contributed funds to a thinly capitalized corporation: funds that were necessary to purchase and lease appliances and carry out the scheme.<sup>109</sup> In effect, plaintiff invested risk capital to finance an appliance leasing venture over which she had no management control. As an alternative to *Howey*, the risk capital test also would have fit well to protect the unwary investor.

### C. Legislative Definition of Risk Capital

Even before the appellate court opinion in *Sauve*,<sup>110</sup> many thought the risk capital test to be the law of Washington, espe-

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approach. See Hunt, *supra* note 40.

104. 421 U.S. at 852.

105. *Id.* at 855. See *State v. Hawaii Mkt. Center, Inc.*, 52 Hawaii 642, 651, 485 P.2d 105, 110 (1971) (cited in *Hamilton Jewelers v. Department of Corps.*, 37 Cal. App. 3d 330, 334, 112 Cal. Rptr. 387, 389 (1974)).

106. *Sauve v. K.C., Inc.*, 91 Wash. 2d at 702, 591 P.2d at 1211.

107. *Id.* The court's citation of *Glenn W. Turner* as support for risk capital is justified because the district court relied in part upon that approach. See *SEC v. Glenn W. Turner Ents.*, 348 F. Supp. 766 (D. Or. 1972), *aff'd*, 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

108. *McClellan v. Sundholm*, 89 Wash. 2d at 532-33, 574 P.2d at 374.

109. Record at 72-76, *Sauve v. K.C., Inc.*, No. 787-564 (Wash. Super. Ct. Thurston County March 8, 1976).

110. 19 Wash. App. 659, 577 P.2d 599 (1978).

cially after its application in two earlier superior court decisions.<sup>111</sup> Careful securities practitioners followed risk capital analysis in evaluating whether a proposal fell within the securities laws, utilizing one or more of the leading cases in other jurisdictions.<sup>112</sup> The opinion of the court of appeals in *Sauve*<sup>113</sup> seemed to confirm the trend. The Washington Supreme Court's dictum in the *Sauve* case foreclosed as a practical matter further application of the risk capital approach.<sup>114</sup>

In reaction to the court's opinion, the forty-sixth legislature adopted a risk capital definition<sup>115</sup> in the form of an amendment reading as follows: "'Security' means any . . . investment of money or other consideration in the risk capital of a venture with the expectation of some valuable benefit to the investor where the investor does not receive the right to exercise practical and actual control over the managerial decisions of the venture . . . ."<sup>116</sup> This amendment to the definition of security is in addition to the existing term, "investment contract."<sup>117</sup> With this amendment, courts and practitioners face the difficulty of inter-

111. *Lundquist v. American Campgrounds, Inc.*, [1971-1978 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 71,196 (Wash. Super. Ct. 1973); *Ackerson v. Jet Set Travel Club*, No. 772120 (Wash. Super. Ct. King County 1974). See *Hunt*, *supra* note 40, at 5.

112. See, e.g., Letter from Mike Liles, Jr., of Bogle & Gates, Attorneys-at-Law, to Financial Institutions Committee, Washington State House of Representatives (April 9, 1979) (on file with the University of Puget Sound Law Review) (concerning risk capital definition in SB 2314, currently codified at WASH. REV. CODE § 21.20.005(12) (1979)).

113. *Sauve v. K.C., Inc.*, 19 Wash. App. 659, 577 P.2d 599 (1978), *aff'd on other grounds*, 91 Wash. 2d 698, 591 P.2d 1207 (1979).

114. 91 Wash. 2d 698, 702, 591 P.2d 1207, 1209 (1979).

115. WASH. REV. CODE § 21.20.005(12) (1979).

116. *Id.* The language of the amendment was derived largely from definitions in ALASKA STAT. § 45.55.130(12) (1961), OKLA. STAT. tit. 71, § 2(20)(P) (Supp. 1977), and State v. Hawaii Mkt. Center, Inc., 52 Hawaii 642, 485 P.2d 105 (1971).

117. WASH. REV. CODE § 21.20.005(12) (1979). Notwithstanding the adoption of a risk capital test, the term "investment contract" is expected to keep its present scope of interpretation, expanding or contracting in sympathy with the decisions of other jurisdictions, especially those of the federal courts. In general, the Washington cases have followed federal law. *Sauve v. K.C., Inc.*, 91 Wash. 2d 698, 591 P.2d 1207 (1979); *McClellan v. Sundholm*, 89 Wash. 2d 527, 574 P.2d 371 (1978); *State v. Williams*, 17 Wash. App. 368, 563 P.2d 1270 (1977). A number of jurisdictions have had difficulty in determining the construction to be placed upon "investment contract" in light of the divergence of the risk capital analysis from the *Howey* formula. See *State v. Investors Sec. Corp.*, 297 Minn. 1, 209 N.W.2d 405 (1973); *State ex rel. Healy v. Consumer Business Sys., Inc.*, 5 Or. App. 294, 482 P.2d 549 (1971). Compare *Silver Hills Country Club v. Sobieski*, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961) with *Tomei v. Fairline Feeding Corp.*, 67 Cal. App. 3d 394, 137 Cal. Rptr. 656 (1977) and *Hamilton Jewelers v. Department of Corps.*, 37 Cal. App. 3d 330, 112 Cal. Rptr. 387 (1974). The problem concerns whether the risk capital approach is an expansion of the *Howey* test or an altogether different analytical approach to finding the existence of a security.

preting and applying a new test. To facilitate this interpretation, this section explores the historical and analytical background of each of the elements of the new statutory risk capital definition.

### 1. Investment

Inherent in the definition of "security" is the investment concept. Investment may be defined in a number of ways but generally constitutes the laying out of money to purchase some kind of property or opportunity. More narrowly, investment involves the contribution of capital to a business venture, usually with the expectation of income or profits.<sup>118</sup> Because these definitions are rather broad, there must be some refinement of the investment concept so that not all connotations of investment are included.<sup>119</sup>

As a rule of construction, however, investment must be given a broad interpretation<sup>120</sup> to ensure that the securities laws reach "novel, uncommon, or irregular devices, whatever they appear to be."<sup>121</sup> A manageable analysis of the investment concept, consequently, must be confined to objective facts and characteristics.<sup>122</sup> Fundamentally, the risk capital approach embodies the view that substance controls over form.<sup>123</sup> Neither the fact that a particular transaction does not appear to involve a security nor the fact that a purchaser does not intend to make an investment in the narrow sense precludes risk capital treatment. In many cases the purchaser has no idea he is making an invest-

118. See WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 2054 (1971).

119. For example, a person who says his car or personal residence is a good investment probably uses the term more broadly than is contemplated by the securities laws.

120. "[R]emedial legislation should be construed broadly to effectuate its purposes." *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967).

121. *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943).

122. See *Hannan & Thomas*, *supra* note 1, at 238-40, 249; *Long*, *supra* note 86, at 109. *But see* *United Hous. Foundation v. Forman*, 421 U.S. 837 (1975). "We decide only that the type of transaction before us, in which the purchasers were interested in acquiring housing rather than making an investment for profit, is not within the scope of the federal securities laws." *Id.* at 859-60. This narrow holding necessitates searching for the purchaser's intent in determining the existence of a security. Unfortunately, such a subjective determination will depend upon facts difficult to ascertain.

123. See, e.g., *Coffey*, *supra* note 1; *Hannan & Thomas*, *supra* note 1; *Long*, *supra* note 86. United States Supreme Court cases have consistently examined the underlying economic realities of a transaction. See *United Hous. Foundation v. Forman*, 421 U.S. 837, 848 (1975); *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967); *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202 (1967); *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1959); *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946); *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943).

ment and, thus, the purchaser's subjective intent has little relevance.<sup>124</sup> The most significant feature is the purchaser's contribution of funds to the economic capital of a venture—this is the essence of an investment.<sup>125</sup> In risk capital analysis, as contrasted with other securities applications, risk and the contemplated use to which funds will be put determine an investment.<sup>126</sup>

In attempting to ascertain the limits of the investment concept, courts and commentators have focused on the apparent distinction between investments and commercial transactions.<sup>127</sup> The Ninth Circuit Court of Appeals has paid special attention to this dichotomy when dealing with notes.<sup>128</sup> For example, in *Great Western Bank & Trust v. Kotz*,<sup>129</sup> the circuit court examined six factors in determining whether a transaction was commercial or for investment: (1) time to maturity, (2) collateralization, (3) form of the obligation, (4) circumstances of issuance, (5) relationship between the amount borrowed and size of borrower's business and, perhaps most important, (6) contemplated use of the funds.<sup>130</sup>

The commercial-investment distinction is not universally accepted. In *Exchange National Bank of Chicago v. Touche Ross & Co.*,<sup>131</sup> the Second Circuit, in an opinion by Judge Friendly, rejected the commercial-investment dichotomy, suggesting instead that all notes be treated as securities "unless the context otherwise requires."<sup>132</sup> The court described six types of note transactions in which the context might lead to a finding that no

124. See *Silver Hills Country Club v. Sobieski*, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961); *Jet Set Travel Club v. Corporation Comm'r*, 21 Or. App. 362, 535 P.2d 109 (1975); Long, *supra* note 86, at 109 n.63. A purchaser's intent to contribute risk capital would be relevant but not essential to a court's finding that a security exists.

125. See Hannan & Thomas, *supra* note 1, at 236; Long, *supra* note 86, at 109.

126. See *El Khadem v. Equity Sec. Corp.*, 494 F.2d 1229 (9th Cir. 1974); Hannan & Thomas, *supra* note 1, at 244-49; Long, *supra* note 86, at 109. See also Coffey, *supra* note 1.

127. See, e.g., *Great W. Bank & Trust v. Kotz*, 532 F.2d 1252 (9th Cir. 1976); *C.N.S. Ents. v. G. & G. Ents.*, 508 F.2d 1354 (7th Cir. 1975); *Zabriskie v. Lewis*, 507 F.2d 546 (10th Cir. 1974); *McClure v. First Nat'l Bank*, 497 F.2d 490 (5th Cir. 1974); *Lino v. City Investing Co.*, 487 F.2d 689 (3d Cir. 1973); *Lipton & Katz*, "Notes" Are Not Always Securities, 30 Bus. Law. 763 (1975); *Lipton & Katz*, "Notes" Are (Are Not?) Always Securities—A Review, 29 Bus. Law. 861 (1974); Long, *supra* note 86, at 110.

128. See *United Cal. Bank v. THC Fin'l Corp.*, 557 F.2d 1351 (9th Cir. 1977); *Great W. Bank & Trust v. Kotz*, 532 F.2d 1252 (9th Cir. 1976).

129. 532 F.2d 1252 (9th Cir. 1976).

130. *Id.* at 1257-58.

131. 544 F.2d 1126 (2d Cir. 1976).

132. *Id.* at 1131-39. See Securities Act of 1933, § 2, 15 U.S.C. § 776 (1976). See also WASH. REV. CODE § 21.20.005 (1979).



security was involved: (1) a note delivered in a consumer financing, (2) a note secured by a home mortgage, (3) a short-term note secured by a lien on business assets, (4) a note evidencing a character loan to a bank customer, (5) a short-term note secured by accounts receivable, and (6) a note on an open account in the ordinary course of business.<sup>133</sup> Notes without the above characteristics and having a maturity exceeding nine months would be presumed securities.<sup>134</sup> The choice of the term "investment" suggests that the commercial-investment dichotomy may be applicable in the interpretation of the legislative definition of risk capital. The test set forth by the Ninth Circuit in *Kotz* may prove helpful in determining the presence of a risk capital investment. In those cases, however, where all other elements of the risk capital test are present—a contribution to the risk capital in a venture with an expectation of some valuable benefit without management control—the reasoning of Judge Friendly is superior. A risk capital security should exist unless the context involves one of Judge Friendly's six exceptions, or similar circumstances, and overwhelmingly indicates that the transaction was for commercial purposes. If all elements of the risk capital test are present, the presumption clearly should be in favor of investment and, therefore, of finding a security.

## 2. Money or Other Consideration

Money plays the dominant role as consideration in the offer or sale of securities. But in defining a security, is money the only consideration that should be recognized? The language of the *Howey* test obviously contemplated money, ordinarily cash.<sup>135</sup> Most courts have not limited themselves to a literal interpretation of "money" and, consistent with investment intent, have allowed other valuable consideration.<sup>136</sup> In many transactions

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133. *Exchange Nat'l Bank v. Touche Ross & Co.*, 544 F.2d at 1138.

134. *Id.*

135. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946).

136. See *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 560 n.12 (1979); *Hector v. Wiens*, 533 F.2d 429, 432-33 (9th Cir. 1976) (promissory note); *El Khadem v. Equity Sec. Corp.*, 494 F.2d 1224, 1228 (9th Cir.), *cert. denied*, 419 U.S. 900 (1974) (securities and cash pledged); *Sargent v. Genesco, Inc.*, 492 F.2d 750, 768-69 (5th Cir. 1974) (services and property in formation of organization); *SEC v. Glenn W. Turner Ents.*, 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973) (money and services); *Cordas v. Specialty Restaurants, Inc.*, 470 F. Supp. 780, 784 (D. Or. 1979) (rental payments, lease deposits, and obligation to make lease improvements); *SEC v. Addison*, 194 F. Supp. 709, 722 (N.D. Tex. 1961); *Murphy v. Dare To Be Great, Inc.*, [1971-1978 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 71,053, at 67,276 (D.C. Super. Ct. 1972); *In*

money is not invested or is not the final investment in the enterprise.<sup>137</sup> Securities often are purchased by rendering services or committing property; such consideration consequently should not be overlooked in defining a security. To some extent, the difficulty of recognizing nonpecuniary investment consideration under the *Howey* test led to the formulation of the risk capital test.<sup>138</sup>

The statutory definition leaves no doubt that money is not the only ingredient in the risk capital recipe. The legislature expressly recognized nonpecuniary investment when it used the terminology, "money or other consideration."<sup>139</sup> The use of the broad term "consideration" suggests that a "contracts" test may be applied: any consideration that would be sufficient to create a contract would also be sufficient to find a security. Perhaps this is overbroad,<sup>140</sup> but the type of consideration must be weighed against the background of other elements of the risk capital definition.

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*re* Continental Mktg. Assoc., Inc., [1971-1978 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 71,016 at 67,179 (Ind. Sec'y of State 1969); *State v. Davis*, 131 N.W.2d 730, 733 (N.D. 1964) (exchange of stock for notes); Coffey, *supra* note 1, at 380; Long, *supra* note 4, at 174-75; Long, *supra* note 86, at ¶14; Newton, *What Is a Security?: A Critical Analysis*, 48 Miss. L.J. 167, 174 (1977).

137. Typically, money is paid to acquire property that is then immediately recommit-  
 ted or redelivered to the seller or promoter. In these cases the purchaser often takes  
 title but the property is never possessed by or delivered to the purchaser. *See, e.g.*, SEC  
 v. W.J. Howey Co., 328 U.S. 293 (1946). For situations involving the sale and lease back  
 of property, see *Huberman v. Denny's Restaurants, Inc.*, 337 F. Supp. 1249 (N.D. Cal.  
 1972); *Financial Analytics Corp.*, [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶  
 79,498 (SEC Ruling Aug. 15, 1973) (cited in Long, *supra* note 86, at 99); *Rice v. Bogart*,  
 272 Ill. App. 292 (1933); *Bergquist v. International Realty, Ltd.*, 272 Or. 416, 537 P.2d  
 553 (1975). For a situation involving the sale and redelivery of property, see *People v.*  
*Witzerman*, 29 Cal. App. 3d 169, 105 Cal. Rptr. 284 (1972) (cattle care contract). *See also*  
 Long, *supra* note 86, at 115-16 nn.93-95. Analytically, these types of transactions may be  
 viewed as investments of either money or property in the promoter's enterprise. Coffey,  
*supra* note 1, at 386-90; Long, *supra* note 86, at 116. For situations involving services  
 rendered in exchange for securities, see *SEC v. Addison*, 194 F. Supp. 709 (N.D. Tex.  
 1961); Coffey, *supra* note 1, at 380; Newton, *supra* note 136, at 174. Organizational and  
 promotional stock would fall within this category even though the promoter would not  
 normally expect benefits through the managerial efforts of others. *See* WASH. AD. CODE §  
 460-10A-050(1) (1977).

138. Long, *supra* note 86, at 116-17, 125.

139. WASH. REV. CODE § 21.20.005(12) (1979) (emphasis added).

140. Professor Long's definition reads as follows: "A security is the investment of  
 money or money's worth including goods furnished and/or services performed in the risk  
 capital of a venture . . . ." Long, *supra* note 86, at 128 (emphasis added).

### 3. Risk Capital

The term "risk capital" is found in the leading case, *Silver Hills Country Club v. Sobieski*,<sup>141</sup> but without adequate definition.<sup>142</sup> Most jurisdictions employing the risk capital test, whether by statute, rule, or decisional law, have avoided defining risk capital, leaving it to the facts of each case to demonstrate the term.<sup>143</sup> Although the Washington legislative definition does not expressly define risk capital, two fundamental aspects are involved: (1) the risk of value furnished,<sup>144</sup> and (2) the financing of a venture.<sup>145</sup>

#### a. Risk to Initial Investment

The risk of loss of the initial value contributed to a venture is often an essential attribute of a security.<sup>146</sup> Ordinarily, courts

141. 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961).

142.

We have here nothing like the ordinary sale of a right to use existing facilities. Petitioners are soliciting the risk capital with which to develop a business for profit. The purchaser's risk is not lessened merely because the interest he purchases is labelled a membership. Only because he risks his capital along with other purchasers 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.

The *Silver Hills* opinion emphasizes the lack of existing club facilities and the use of the purchaser's funds to develop a business. Because the club facilities were not complete and operating, a membership would not achieve real value until the facilities were available for use. The purchaser's objectives could not be realized immediately upon purchase but were subject to many financing and construction contingencies. See text accompanying notes 40-44 *supra*.

143. For jurisdictions employing the risk capital test by statute, see, for example, ALASKA STAT. § 45.55.130(12) (Supp. 1979) and OKLA. STAT. tit. 71, § 2(20) (P) (Supp. 1977). For jurisdictions employing the test by decisional law, see, for example, *Amfac Mortgage Corp. v. Arizona Mall, Inc.*, 583 F.2d 426 (9th Cir. 1978); *Silver Hills Country Club v. Sobieski*, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961); *State v. Hawaii Mkt. Center, Inc.*, 52 Hawaii 642, 485 P.2d 105 (1971); *Jet Set Travel Club v. Corporation Comm'r*, 21 Or. App. 362, 535 P.2d 109 (1975); *State ex rel. Healy v. Consumer Business Sys., Inc.*, 5 Or. App. 19, 482 P.2d 549 (1971).

144. See generally Coffey, *supra* note 1, at 381-96. Benefit of the bargain may also be a fundamental aspect in the risk capital definition but is not often discussed.

145. See generally Hannan & Thomas, *supra* note 1, at 244-49.

146. See *El Khadem v. Equity Sec. Corp.*, 494 F.2d 1224, 1228 (9th Cir.), cert. denied, 419 U.S. 900 (1974). See also *Great W. Bank & Trust v. Kotz*, 532 F.2d 1252 (9th Cir. 1976). Professor Coffey cites the following language from *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 349 (1943), to support his assertion that the risk of loss of initial value is an essential attribute of a security:

It is clear that an economic interest in this [enterprise] . . . was what brought into being the instruments [evidencing real property interests] that defendants were selling and gave to the instruments *most of their value* and all of their lure. The trading in these [interests] . . . had all the evils inherent in the

find this risk capital component when the purchaser's funds or property are placed at risk in a venture.<sup>147</sup> The type of risk contemplated involves nothing more than a substantial risk of loss.<sup>148</sup> For the definition to apply, the purchaser's contribution need not be lost; it need only in some manner be subject to the *risk* of either being totally or partially diminished.<sup>149</sup> Therefore, as a basic observation, risk capital is not defined as a "risky" transaction or limited to speculative undertakings<sup>150</sup> but applies whenever a substantial part of the risk of loss is shifted to the purchaser, whether he knows it or not.<sup>151</sup> On the other hand, when the purchaser is fully secured and may realistically avoid loss upon liquidation of the security, risk capital arguably may not have been contributed.<sup>152</sup>

Risk to value furnished, of course, must be analyzed in relation to other elements of the test. Generally there will be representations which lead to the expectation of a valuable benefit. Relying on these representations, the purchaser parts with funds or property which are then subjected over a substantial period of time to risks not within the purchaser's control. At least two types of risks are apparent: (1) that the funds contributed will be dissipated in the venture and (2) that the purchaser will have no management control over the funds or the venture.<sup>153</sup> The risk in not having control over an investment may be treated as sepa-

securities transactions which it was the aim of the Securities Act to end.

Coffey, *supra* note 1, at 381 (emphasis by Coffey).

147. See Coffey, *supra* note 1, at 380-81; Hannan & Thomas, *supra* note 1, at 244-45. See also *Great W. Bank & Trust v. Kotz*, 532 F.2d 1252 (9th Cir. 1976).

148. Coffey, *supra* note 1, at 381-84. See *Great W. Bank & Trust v. Kotz*, 532 F.2d 1252 (9th Cir. 1976).

149. See *SEC v. Latta*, 250 F. Supp. 170 (N.D. Cal.), *aff'd per curiam*, 356 F.2d 103 (9th Cir. 1965), *cert. denied*, 384 U.S. 940 (1966) (discussed in Coffey, *supra* note 1, at 382 & n.72). See also *El Khadem v. Equity Sec. Corp.*, 494 F.2d 1224 (9th Cir.), *cert. denied*, 419 U.S. 900 (1974).

150. See Coffey, *supra* note 1, at 403. *But see Mr. Steak, Inc. v. River City Steak, Inc.*, 324 F. Supp. 640, 647 (D. Colo. 1970), *modified and aff'd*, 460 F.2d 666 (10th Cir. 1972). See also *Great W. Bank & Trust v. Kotz*, 532 F.2d 1252 (9th Cir. 1976); *Motel Co. v. Commissioner*, 340 F.2d 445 (2d Cir. 1965).

151. Coffey, *supra* note 1, at 381-96. See, e.g., *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202 (1967); *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1959) (both discussed in Hannan & Thomas, *supra* note 1, at 226-28, 246-47).

152. *Hamilton Jewelers v. Department of Corps.*, 37 Cal. App. 3d 330, 112 Cal. Rptr. 387 (1974); *cf. Great W. Bank & Trust v. Kotz*, 532 F.2d 1252, 1257-58 (1976) (collateralization). See also *El Khadem v. Equity Sec. Corp.*, 494 F.2d 1224 (9th Cir.), *cert. denied*, 419 U.S. 900 (1974); *Sauve v. K.C., Inc.*, 19 Wash. App. 659, 577 P.2d 599 (1978), *aff'd on other grounds*, 91 Wash. 2d 698, 591 P.2d 1207 (1979).

153. See text accompanying notes 195-212 *infra*.

rate from the venture risk, which is of special concern here. Typically, such a risk will arise when funds are committed to an undercapitalized venture.<sup>154</sup> It is not possible to describe all the circumstances in which the venture risk is manifest. Professor Coffey, however, has set forth five distinct risk capital categories,<sup>155</sup> all of which may be applicable under the Washington legislative definition.

### b. *Financing the Venture*

The second often-present feature of the risk capital concept is the use of the investor's money to finance the venture. In this respect, risk capital is akin to venture capital in that it serves as a functional substitute for conventional debt or equity financing.<sup>156</sup> In instances such as those presented in *Silver Hills*, risk capital amounts to nothing more than hidden financing.<sup>157</sup> The promoters of the country club might have chosen to finance through banks or other institutions, or employed a stock or debenture offering to meet capital needs, or placed their own capital at risk. Instead, they offered club memberships to the public to finance the promised benefits.<sup>158</sup> Because the public

154. *Bitter v. Hoby's Int'l, Inc.*, 498 F.2d 183, 185 (9th Cir. 1974) (*semble*). *But see Mr. Steak, Inc. v. River City Steak, Inc.*, 324 F. Supp. 640 (D. Colo. 1970), *modified and aff'd*, 460 F.2d 666 (10th Cir. 1972); 49 Ops. Cal. Att'y Gen. 124 (1967).

155. Coffey's risk categories are essentially:

- (1) Intangible proprietary interest in the enterprise: risk of repayment upon termination plus share of profits and losses;
- (2) Intangible claim against the enterprise: creditor's risk of receiving repayment and interest;
- (3) Tangible or intangible property: purchaser's risk who retains specific ownership but recommits property to use or employment by the enterprise;
- (4) Tangible or intangible property: purchaser risks original value paid in recognition of the yet-unrealized success of an enterprise; no legal relationship with enterprise is necessary;
- (5) Property with fair market value less than initial value: purchaser's risk of conditional right to receive payments.

Coffey, *supra* note 1, at 384-85.

156. *Silver Hills Country Club v. Sobieski*, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961); Coffey, *supra* note 1, at 399; Hannan & Thomas, *supra* note 1, at 244-45. *See also* SEC Securities Act Release No. 3890, 1 FED. SEC. L. REP. (CCH) ¶ 1041 (Jan. 25, 1958) (trading stamps, theater tickets, gift certificates, and the like, may be securities if used for corporate financing).

157. Hannan & Thomas, *supra* note 1, at 246 n.110.

158. Commenting on the scheme in *Silver Hills*, Justice Traynor said:

Hence the act is as clearly applicable to the sale of promotional memberships in the present case as it would be had the purchasers expected their return in some familiar form as dividends. Properly so, for otherwise it could too easily be vitiated by inventive substitutes for conventional means of raising risk

often will not recognize that such memberships are a type of financing, the protection of the securities laws is greatly needed. Consequently, courts using the risk capital test subject this financing method to the same rigors required of traditional debt or equity offerings.<sup>159</sup> Requiring compliance with the securities laws will mean that the antifraud and registration provisions of the acts (demanding disclosure of all material facts) will aid and protect the otherwise unwary public.

Risk capital financing most often entails expenditures for facilities, capital items, or enterprise formation. On this basis, some courts distinguish between raising funds for capital items and operating expenses.<sup>160</sup> In many instances this distinction may apply. If, however, an entity could not operate without raising capital to meet current needs, the risk capital test might still apply.<sup>161</sup> In these instances, the investor's money would be doing something more than maintaining the current financial position of the venture. Even though funds are raised only to cover current operating expenses, risk capital may still be apposite if the represented benefits are not immediately available or fall far short of the value contributed.

Of course, not every funding of an enterprise falls within the accepted scope of the test. As with almost all investments, the purchaser's funds become a portion of an enterprise's capital.<sup>162</sup> Both the source and use of all funds fueling the enterprise are very important. The key question is whether the purchaser's funds are significant in providing or maintaining the expected benefits. If a substantial portion of the capital raised comes from purchasers who cannot realize benefits within a reasonably short period of time, risk capital financing may well be present.<sup>163</sup> But

capital.

55 Cal. 2d at 815-16, 361 P.2d at 909, 13 Cal. Rptr. at 189.

159. This was the contention of the petitioner in *Silver Hills*:

The commissioner contends not only that a membership in the club is a beneficial interest in the title to property and therefore a security within the literal language of subdivision (a) of section 25008 but also that the purchase of such an interest is attended by the very risks the corporate securities act was designed to minimize.

*Id.* at 813, 361 P.2d at 907, 13 Cal. Rptr. at 187.

160. *Cordas v. Specialty Restaurants, Inc.*, 470 F. Supp. 780 (D. Or. 1979). See *Great W. Bank & Trust v. Kotz*, 532 F.2d 1252, 1257-58 (9th Cir. 1976); *McClure v. First Nat'l Bank*, 497 F.2d 490 (5th Cir. 1974).

161. *Great W. Bank & Trust v. Kotz*, 532 F.2d 1252 (9th Cir. 1976).

162. See *id.* at 1258; *Cordas v. Specialty Restaurants, Inc.*, 470 F. Supp. 780 (D. Or. 1979). See also SEC Securities Act Release No. 3890, 1 FED. SEC. L. REP. (CCH) ¶ 1041 (Jan. 25, 1958).

163. See, e.g., *State v. Consumer Business Sys.*, 5 Or. App. 19, 482 P.2d 549 (1971).

if the profits or benefits expected may be provided from the existing operating revenues of the enterprise, courts probably would not view the further contribution of funds as risk capital. In that instance, while funds advanced may be "at risk" in the enterprise, the funds are not essential to finance the expected benefits. At least one court has observed that risk capital must constitute the primary source of capital of the enterprise to afford application of the test.<sup>164</sup> The percentage of risk capital necessary to trigger the definition should depend, however, upon the facts of each case. In summary, the risk capital concept provides only that, as a matter of policy, any promotional venture using other people's money at their risk upon a promise of some valuable benefit should be treated as a security to protect the people's money.<sup>165</sup>

#### 4. *Venture*

There is a great deal of similarity between "venture" as used by the legislature and "common enterprise" as articulated in the *Howey* opinion.<sup>166</sup> Cases subsequent to *Howey* have not uniformly defined a common enterprise.<sup>167</sup> In the Ninth Circuit, an undertaking between an investor and a promoter satisfies the common enterprise definition.<sup>168</sup> The Third<sup>169</sup> and Seventh Circuits,<sup>170</sup> on the other hand, require a relationship between investors, which is most often found with a pooling of investor funds.<sup>171</sup> The better view appears to be that adopted by the Ninth Circuit.<sup>172</sup> It should not matter whether one or several

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*See also* *Jaciewicki v. Gordarl Assocs.*, 132 Ga. App. 888, 209 S.E.2d 693 (1974); *Jet Set Travel Club v. Corporation Comm'r*, 21 Or. App. 362, 535 P.2d 109 (1975).

164. *Cordas v. Specialty Restaurants, Inc.*, 470 F. Supp. 780 (D. Or. 1979).

165. Coffey, *supra* note 1, at 401-03.

166. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946).

167. *Compare* *Milnarik v. M-S Commodities, Inc.*, 457 F.2d 274 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972) (horizontal privity) *with* *SEC v. Glenn W. Turner Ents.*, 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973) (vertical privity).

168. *El-Khadem v. Equity Sec. Corp.*, 494 F.2d 1224 (9th Cir.), *cert. denied*, 419 U.S. 900 (1974); *SEC v. Glenn W. Turner Ents.*, 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

169. *Wasnowic v. Chicago Bd. of Trade*, 352 F. Supp. 1066 (M.D. Pa. 1972), *aff'd mem.*, 491 F.2d 752 (3d Cir. 1974).

170. *See, e.g., Hirk v. Agri-Research Council*, 561 F.2d 96 (7th Cir. 1977); *Milnarik v. M-S Commodities, Inc.*, 457 F.2d 274 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972).

171. *Hirk v. Agri-Research Council*, 561 F.2d 96 (7th Cir. 1977) (pooling of funds or a pro rata distribution of profits required).

172. *SEC v. Glenn W. Turner Ents.*, 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973). *See* *SEC v. Continental Commodities Corp.*, 497 F.2d 516 (5th Cir. 1974); *Glen-*

investors are involved—the focus of the inquiry is on the relationship between investor and promoter. This must be the point of reference because the need for the protection of the securities laws arises not from the relationship between investors but from that between investor and promoter.<sup>173</sup> For similar reasons, “venture” should not be interpreted as limited to a single legal entity or as dependent upon the finding of a legal entity.<sup>174</sup>

The United States Supreme Court has not yet reviewed the common enterprise issue although, in *United Housing Foundation v. Forman*,<sup>175</sup> the Court referred to the relationship between the investor and the promoter as the “common venture.”<sup>176</sup> The use of the term “venture” by the Court may imply greater flexibility in the required relationship between promoter and investor. As previously discussed, in making this change the Court may have leaned toward the majority view. Nevertheless, in an effort to avoid this problem, the legislative definition dropped “common” from the description of venture, thereby emphasizing the receipt of capital by the promoter rather than other ties with the investor or between investors. This would seem to follow closely the approach of the Ninth Circuit in *SEC v. Glenn W. Turner Enterprises, Inc.*,<sup>177</sup> wherein the court focused upon whether “the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties.”<sup>178</sup> The *Glenn W. Turner* decision seems to be an adequate interpretation; accordingly,

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*Arden Commodities, Inc. v. Constantino*, 495 F.2d 1027 (2d Cir. 1974); *Andrews v. Blue*, 489 F.2d 367 (10th Cir. 1973). See also *Miller v. Central Chinchilla Group, Inc.*, 494 F.2d 414 (8th Cir. 1974).

173. Of course, the number of investors or the pooling of funds may play a part in determining the applicability of any exemption from registration. See *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473 (5th Cir. 1974).

174. See *Hannan & Thomas*, *supra* note 1, at 237; *Long*, *supra* note 4, at 163-64.

175. 421 U.S. 837 (1975).

176. *Id.* at 852.

177. 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973). See also *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473 (5th Cir. 1974).

178. 474 F.2d at 482 n.7 (citing *Los Angeles Trust Deed & Mortgage Exch. v. SEC*, 285 F.2d 162, 172 (9th Cir.), *cert. denied*, 366 U.S. 919 (1961)); *accord*, *SEC v. Continental Commodities Corp.*, 497 F.2d 516 (5th Cir. 1974); *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 478 (5th Cir. 1974). In *McClellan v. Sundholm*, 89 Wash. 2d 527, 574 P.2d 372 (1978), the court stated: “Under the federal test, a common enterprise need not be a common fund. The term denotes rather an interdependence of fortunes, a dependence by one party for his profit on the success of some other party in performing his part of the venture.” *Id.* at 532, 574 P.2d at 373-74; see *Continental Mktg. Corp. v. SEC*, 387 F.2d 466, 470 (10th Cir. 1967) (“The more critical factor is the nature of the investor’s participation in the enterprise.”).



no further definition need be given "venture" under the legislative test.

### 5. *Expectation of Some Valuable Benefit*

The investor's expectation merely of "some valuable benefit" as opposed to a "profit" amounts to a substantial departure from federal law and is the single most controversial element of the risk capital formulation.<sup>179</sup> This sharply contrasts with the *Howey* test, which requires an expectation of "profits."<sup>180</sup> Under the federal cases, the term "profits" was beset with ambiguity,<sup>181</sup> especially prior to *United Housing Foundation v. Forman*.<sup>182</sup> In *Forman* the Supreme Court addressed the meaning of "profits." The Court indicated that a profit expectation may arise through capital appreciation, through participation in earnings, or in the form of income to be yielded by investment, but ventured nothing further.<sup>183</sup> Many forms of compensation may amount to profits consistent with the *Forman* case, including "dividends, interest, commissions, bonuses, or similar remuneration."<sup>184</sup> Profits

179. See 3 H. BLOOMENTHAL, *supra* note 86, at § 2.19[11]-[13]; Coffey, *supra* note 1, at 403; Faust, "What Is a Security?" *How Elastic Is the Definition?*, 3 SEC. REG. L.J. 219 (1975); Hannan & Thomas, *supra* note 1, at 545; Newton, *supra* note 136, at 195-98. Although the Court in *United Hous. Foundation v. Forman*, 421 U.S. 837 (1975), purported to leave the risk capital question open, the strong language of the opinion leaves little doubt that profit expectation will be retained in some form by the Court.

Most of the federal decisions dealing with risk capital have involved the control and management features of franchises, pyramid sales arrangements, or notes. *But see* SEC Securities Act Release No. 5211, [1971-1972 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78,446 (Nov. 30, 1971) (adopting *State v. Hawaii Mkt. Center, Inc.*, 52 Hawaii 642, 485 P.2d 105 (1971)). Decisions involving notes include *United Cal. Bank v. THC Fin'l Corp.*, 557 F.2d 1351 (9th Cir. 1977), and *Great W. Bank & Trust v. Kotz*, 532 F.2d 1252 (9th Cir. 1976). Federal decisions involving franchises include *Bitter v. Hoby's Int'l, Inc.*, 498 F.2d 183 (9th Cir. 1974), *Wieboldt v. Metz*, 355 F. Supp. 255 (S.D.N.Y. 1973), and *Mr. Steak, Inc. v. River City Steak, Inc.*, 324 F. Supp. 640 (D. Colo. 1970), *modified and aff'd*, 460 F.2d 666 (10th Cir. 1972). Finally, federal decisions dealing with pyramid sales arrangements include *SEC v. Koscot Interplanetary, Inc.*, 365 F. Supp. 588 (N.D. Ga. 1973), *rev'd*, 497 F.2d 273 (5th Cir. 1974) and *SEC v. Glenn W. Turner Ents.*, 348 F. Supp. 766 (D. Or. 1972), *aff'd*, 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

180. "By profits, the Court has meant either capital appreciation resulting from the development of the initial investment, as in *Joiner*, . . . or a participation in earnings resulting from the use of investors' funds, as in *Tcherepnin v. Knight* . . ." *United Hous. Foundation v. Forman*, 421 U.S. 837, 852 (1975). See *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551 (1979).

181. See, e.g., *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473 (5th Cir. 1974). See also Coffey, *supra* note 1, at 375.

182. 421 U.S. 837 (1975).

183. *Id.* at 852. See *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551 (1979).

184. See *SEC v. Glenn W. Turner Ents.*, 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973); *State v. Hawaii Mkt. Center, Inc.*, 52 Hawaii 642, 485 P.2d 105 (1971);

could take the form of stock dividends or stock in trade.<sup>185</sup> Under both the *Howey* and *Forman* tests, however, a security may not be found to exist if a purchaser's motive is not profit, but rather a "desire to use or consume the item purchased."<sup>186</sup>

The lack of expected profits was a central feature in the *Silver Hills* decision,<sup>187</sup> in which the California Supreme Court abandoned the need for the promise of profits in favor of the promise of any valuable benefit, tangible or intangible. Following *Silver Hills*, courts,<sup>188</sup> administrative tribunals,<sup>189</sup> and state legislatures,<sup>190</sup> generally recognizing the limitations of *Howey* and *Forman*, moved away from the strict "profits" test, either giving a more expansive interpretation to profits<sup>191</sup> or discarding it altogether in favor of the broader term, "benefits."<sup>192</sup> The Washing-

Long, *supra* note 86, at 117.

185. Long, *supra* note 86, at 117.

186. *United Hous. Foundation v. Forman*, 421 U.S. at 852-53. As the Court appears to point out, transactions in which a purchaser seeks both consumption and investment may still constitute securities. *Id.* at 853 n.17. With regard to the consumer-investment distinction, see Newton, *supra* note 136, at 181-83. *But see Coffey, supra* note 1, at 380-81 ("[T]he question is still whether the transaction exhibits the 'economic realities' of a security.")

187.

It bears noting that the act extends even to transactions where capital is placed without expectation of any material benefits. Thus from its exemption of securities of certain nonprofit companies the act specifically excepts "notes, bonds, debentures, or other evidences of indebtedness *whether* interest bearing or not." (Italics added.) Since the act does not make profit to the supplier of capital the test of what is a security, it seems all the more clear that its objective is to afford those who risk their capital at least a fair chance of realizing their objectives in legitimate ventures whether or not they expect a return on their capital in one form or another.

55 Cal. 2d at 815, 361 P.2d at 908-09, 13 Cal. Rptr. at 188-89.

188. *See, e.g., State v. Hawaii Mkt. Center, Inc.*, 52 Hawaii 642, 485 P.2d 105 (1971); *Jet Set Travel Club v. Corporation Comm'r*, 21 Or. App. 362, 535 P.2d 109 (1975); *State ex rel. Healy v. Consumer Business Sys., Inc.*, 5 Or. App. 19, 482 P.2d 549 (1971).

189. *See, e.g., State v. Vacation Internationale, Ltd.*, [1971-1978 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 71,294 (Alaska Dep't of Com. & Econ. Dev. 1976); *In re Spa Athletic Club, Inc.*, [1971-1978 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 71,136 (Alaska Dep't of Com. & Econ. Dev. 1974); *In re Consumer Cos. of America*, 3 BLUE SKY L. REP. (CCH) ¶ 71,444 (Ky. Dep't of Banking & Sec. 1978). *In re Vacation Internationale, Ltd.*, [1971-1978 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 71,287 (Mich. Dep't of Com. 1976).

190. *See, e.g., ALASKA STAT. § 45.55.130(12)* (Supp. 1979); *OKLA. STAT. tit 71, § 2(20)* (P) (Supp. 1977).

191. *See, e.g., SEC v. Glenn W. Turner Ents.*, 474 F.2d 473 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973); *State v. Hawaii Mkt. Center, Inc.*, 52 Hawaii 642, 485 P.2d 105 (1971). *See also* Long, *supra* note 86, at 117.

192. *See, e.g., In re Vacation Internationale, Ltd.*, [1971-1978 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 71,287 (Mich. Dep't of Com. 1976).

ton Legislature followed the latter course. Because "valuable benefit" has no precise meaning, the courts are left with the task of interpreting the term in order to protect the public.<sup>193</sup> Courts will probably recognize, in addition to conventional "profits," the use of club facilities or time-sharing arrangements and other intangibles as valuable benefits.<sup>194</sup>

#### 6. Control Over the Managerial Decisions of the Venture

Lack of control over the use of invested funds is thought to be an essential element of a security.<sup>195</sup> This carries out the general purpose of the securities laws: protection of persons who are not ordinarily in a position to protect themselves.<sup>196</sup> Conversely, those in control presumably will protect themselves, eliminating the need for the protection of the securities laws.<sup>197</sup> To implement the policy of investor protection, the *Howey* definition demands that expected profits result "solely from the efforts of others." This phraseology, particularly the word "solely," has received sharp criticism.<sup>198</sup> Some courts have taken a literal approach, requiring all efforts involving the enterprise to be conducted by the promoters. Indeed, if investors engaged in any efforts at all, these courts did not find a security.<sup>199</sup> More recently, the focus of the courts and commentators has shifted from the quantity to the quality of investor participation. This approach may be called "management" analysis. Following the *Glenn W. Turner* case in the Ninth Circuit, courts have evalu-

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193. See Hunt, *supra* note 40, at 29-30.

194. For example, two Washington superior court cases have recognized intangibles as valuable benefits. *Ackerson v. Jet Set Travel, Inc.*, No. 772120 (Wash. Super. Ct. King County 1974) (air travel club membership); *Lundquist v. American Campgrounds, Inc.*, [1971-1978 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 71,196 (Wash. Super. Ct. 1973) (camp club membership).

195. "People who put their money in other people's hands are usually powerless to control what is done with the money. Under these circumstances it is appropriate for the promoter to disclose the risks of the enterprise, so that the investor can make an informed judgment." Hannan & Thomas, *supra* note 1, at 249. See also Coffey, *supra* note 1, at 396-98.

196. Hannan & Thomas, *supra* note 1, at 249.

197. "The danger of fraud being practiced upon the buyer is considerably reduced when his initial investment is subjected to the risks of an enterprise with which he is familiar at the time of the transaction and over which he exercises management control." Coffey, *supra* note 1, at 396.

198. See, e.g., *State v. Hawaii Mkt. Center, Inc.*, 52 Hawaii 642, 485 P.2d 105 (1971); Hannan & Thomas, *supra* note 1, at 249-53; Long, *supra* note 86, at 119-22. See also Newton, *supra* note 136, at 185-92; *Securities Regulation*, *supra* note 7, at 835-41.

199. See Long, *supra* note 86, at 119.

ated who is represented as performing the "essential managerial" duties to determine the control issue.<sup>200</sup> The "essential managerial efforts which affect the failure or success of the enterprise" are those the promoter or third party must conduct and the investor may not engage in.<sup>201</sup> This language from the *Glenn W. Turner* opinion appears to have persuaded the United States Supreme Court in *Forman* to recast the *Howey* investment contract definition by dropping the word "solely" and instead requiring that profits come from the "entrepreneurial or managerial" efforts of others.<sup>202</sup>

The statutory definition of risk capital avoids the "solely through the efforts of others" issue by adopting the position that the investor's lack of the right to exercise control over management is of critical importance. Ordinarily courts would find the right of control in documents or in express representations relating to the transaction. In the case of shares of stock or memberships, the articles and bylaws will dictate the purchaser's rights. Control cannot be determined, however, without careful review of all facts and circumstances because in many investment contract cases, express or implied representations override expressly granted rights.<sup>203</sup> In the past this area has been difficult for the courts.<sup>204</sup> A number of decisions regarding joint ventures and partnerships have explored the right-to-control issue.<sup>205</sup> In some cases, the mere *right* to control was sufficient to lead the court to hold that a security was not present.<sup>206</sup> Other cases have empha-

200. *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473 (5th Cir. 1977); *Hector v. Wiens*, 533 F.2d 429 (9th Cir. 1976). See *Long*, *supra* note 86, at 122.

201. 474 F.2d at 482-83.

202. 421 U.S. at 852-57. This appears to be *Forman's* effect even though the Supreme Court specifically stated that it expressed no view as to the *Glenn W. Turner* holding. *Id.* at 852 n.16. But see *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551 (1979).

203. See, e.g., *Miller v. Central Chinchilla Group, Inc.*, 494 F.2d 414, 417 (8th Cir. 1974) ("In determining whether the plaintiffs' contributions were nominal or significant, the issue was not what efforts, in fact, were required of them. Rather, it is what efforts the plaintiffs were reasonably led to believe were required of them at the time they entered into the contract."). See also *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 353 (1943).

204. See *Hirsch v. du Pont*, 396 F. Supp. 1214, 1218-20 (S.D.N.Y. 1975); *Long*, *supra* note 86, at 119.

205. See, e.g., *Hirsch v. du Pont*, 396 F. Supp. 1214 (S.D.N.Y. 1975); *Long*, *Partnership, Limited Partnership, and Joint Venture Interests as Securities*, 37 Mo. L. Rev. 581 (1972); *Newton*, *supra* note 136, at 188.

206. See, e.g., *Hirsch v. du Pont*, 396 F. Supp. 1214 (S.D.N.Y. 1975); *New York Stock Exch., Inc. v. Sloan*, 394 F. Supp. 1303 (S.D.N.Y. 1975); *Polikoff v. Levy*, 55 Ill. App. 2d 229, 204 N.E.2d 807, *cert. denied*, 382 U.S. 903 (1965).

sized an *effective* right to control,<sup>207</sup> and still another viewpoint recommends that there be an *actual exercise* of the right.<sup>208</sup> Beyond the right to control, the test appears to be whether the investor expects to play an active, knowledgeable role in management.<sup>209</sup> With the addition of the words "actual" and "practical," the Washington version<sup>210</sup> ensures the protection of the securities laws to the investor who does not receive a meaningful right to control his contribution of funds.<sup>211</sup> Left open to question is whether control is absent when a promoter offers a realistic right to control but an investor never exercises the right. The interpretations to be placed on the words "practical" and "actual" remain unclear. Practical control may be interpreted to mean majority control or merely a voice in management.<sup>212</sup> Actual control seems to point to some means by which the investor can protect his investment as distinguished from a mere paper right. Undoubtedly, the courts will ultimately have to resolve such issues.

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207. See, e.g., *United Hous. Foundation v. Forman*, 421 U.S. 837 (1975); *Mr. Steak, Inc. v. River City Steak, Inc.*, 460 F.2d 666, 670 (10th Cir. 1972); *Hirsch v. du Pont*, 396 F. Supp. 1214, 1222-26 (S.D.N.Y. 1975); *State ex rel. Fisher v. World Mkt. Centers, Inc.*, [1971-1978 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 71,034 (Okla. Dist. Ct. 1972); *Long*, *supra* note 86, at 122; *Newton*, *supra* note 136, at 185-92.

208. See SEC Securities Act Release No. 5211, [1971-1972 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78,446 (Nov. 30, 1971); SEC Securities Act Release No. 4877, [1967] FED. SEC. L. REP. (CCH) ¶ 77,462 (Aug. 8, 1967). See also *SEC v. Glenn W. Turner Ents.*, 474 F.2d 476, 480-82 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

209. See Coffey, *supra* note 1, at 396.

210. The Washington definitional language, "the investor does not receive the right to exercise practical and actual control over the managerial decisions of the venture," WASH. REV. CODE § 21.20.005(12) (1979), was borrowed almost verbatim from the fourth paragraph of the test set down in *State v. Hawaii Mkt. Center, Inc.*, 52 Hawaii 642, 485 P.2d 105 (1971), which in turn substantially adopted Professor Coffey's definition, see Coffey, *supra* note 1.

211. With regard to control, Professor Coffey states as follows:

Although the joint control concept has been rejected in some quarters, it seems sound in principle and has been included as a component of the author's proposed formula for identifying a security. However, the exception should be applied only when the buyer's position truly reduces the possibility of fraud and gives him the power to affect the risk to his initial investment. At the time of the transaction, the buyer should possess both knowledge of the risk enterprise and the power to influence the course of its future operations. It seems highly questionable whether the joint-control theory should govern where the buyer assumes a management role *after* the purported security transaction but has had no knowledge of the risk enterprise prior thereto.

Coffey, *supra* note 1, at 397-98 (footnote omitted).

212. See *Hirsch v. du Pont*, 396 F. Supp. 1214 (S.D.N.Y. 1975). See also WASH. REV. CODE § 25.04.180(5) (1979).

## V. CONCLUSION

The addition of the risk capital definition to Washington's securities law<sup>213</sup> will expand regulation to many transactions that in the past were excluded. Although its full application is unforeseeable, the risk capital definition should apply to financing arrangements in the formation of clubs, associations, and cooperatives.<sup>214</sup> Practitioners must be keenly aware that ventures not traditionally defined within Washington's securities regulations may now fall under the risk capital definition of a security.<sup>215</sup>

Designed in part to protect the public from fraud, securities regulations traditionally have been applied to investment financing involving such security subclasses as stocks, bonds, and debentures. The risk capital definition in Washington now extends the policy of public protection underlying securities laws to transactions equally susceptible to fraudulent conduct. How courts may react to this new definition greatly depends on their perception of the need to protect the public from providing capital financing to ventures that are without access to conventional

213. The Securities Act of Washington, WASH. REV. CODE ch. 21.20 (1979), creates civil regulatory liability under §§ 21.20.010, .020, and .350, express private civil liability under § 21.20.430, and implied private civil liability under § 21.20.400. See Comment, *Unlawful Securities Transactions and Scierter: An Emasculating Requirement*, 1 U. PUGET SD. L. REV. 366 (1978); Comment, *Securities Fraud Under the Blue Sky of Washington*, 53 WASH. L. REV. 279 (1978). See also Parker, *Attorney Liability Under the Securities Laws After Ernst & Ernst v. Hochfelder*, 10 LOY. L.A.L. REV. 521 (1977). Because of Washington's new risk capital definition, practitioners must be sure to apprise clients of the increased risks of regulatory enforcement in both public and private investor financing schemes. One measure of client protection is to request a "no action" letter or interpretive opinion from the Washington State Securities Division of the Department of Licensing. Such a measure will either indicate that the client's venture comes within state securities regulation or that the licensing division later will take no action, assuming the venture comports with the spirit of the original request.

214. See, e.g., 3 H. BLOOMENTHAL, *supra* note 86, § 2.19[12] at 2-97 (1979 rev.); Comment, *County Club Memberships: Are They "Securities" Under the Federal Securities Laws?*, 26 KAN. L. REV. 439 (1978).

215. Time-sharing arrangements and lifetime care contracts may fall within the risk capital test. See, e.g., *State v. Vacation Internationale, Ltd.*, [1971-1978 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 71,294 (Alaska Dep't of Com. & Econ. Dev. 1976) (time-share interests held securities). Offers and sales of facilities or services prior to construction or rendition will often involve risk capital. 3 H. BLOOMENTHAL, *supra* note 86, § 2.19[12] at 2-97 (1979 rev.). As an example, if condominium units are offered before construction and funds raised through this offer will become an integral part of construction financing, the offer may constitute a risk capital security. Yet if the funds were to be placed in escrow and were not relied upon to finance construction, arguably no risk capital would have been invested. Additionally, clubs or activities that finance themselves through continued sales of memberships should not rule out the test's application. Coffey, *supra* note 1, at 401-03. See also Comment, *supra* note 214.

financing.<sup>216</sup> If convinced that today's public warrants economic protection in the face of an everchanging pattern of financing schemes, courts must rigorously apply the risk capital definition to discourage financial fraud.

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216. The risk capital approach is not limited to public offerings but would apply to all offerings, whether registered or exempt. Although Professor Coffey suggests that his test be so limited, the jurisdictions adopting such an approach, including Washington, have not done so. See Coffey, *supra* note 1, at 408-11.