

DEFINING AN "INVESTMENT CONTRACT" FOR PURPOSES OF ALASKA BLUE SKY LAW: HAVE THE ALASKA COURTS STRETCHED THEIR TEST BEYOND MEANINGFUL APPLICATION?

I. INTRODUCTION

Courts have focused upon the term "investment contract" to sweep novel forms of public financing which evade the letter, but not the spirit of the state and federal securities laws, within the ambit of such laws.¹ The Alaska courts have broadly construed the tests developed in the federal circuit courts to determine whether an investment scheme constitutes an investment contract. Demonstrating a desire to protect unsophisticated and unwitting investors, the Alaska courts have stretched these tests to hold that gold mining schemes, vending sales contracts, and territorial distributorships² may be securities subject to regulation by Alaska's Blue Sky laws.³ This note will compare the Alaska courts' criteria for determining whether an investment contract exists with the criteria of other courts. In order to protect unsophisticated investors from fraudulent investment schemes, the Alaska courts have loosely construed the tests developed by other courts, stretching such tests beyond previous interpretations. This note will consider an alternative test that the courts might invoke to make this determination: the "risk capital" test. This alternative test would allow the courts to reach similar results, while providing a clearer rationale for their decisions. A clearer rationale would facilitate the planning of transactions under state securities laws by enabling attorneys to more readily predict what type of transaction will be deemed an investment contract, and therefore, a security subject to Blue Sky regulation.

Copyright © 1985 by Alaska Law Review

1. See Hannan & Thomas, *The Importance of Economic Reality and Risk in Defining Federal Securities*, 25 HASTINGS L.J. 219, 223-24 (1974) [hereinafter cited as Hannan & Thomas].

2. See *American Gold & Diamond Corp. v. Kirkpatrick*, 678 P.2d 1343 (Alaska 1984); *Hentzner v. State*, 613 P.2d 821 (Alaska 1980); *Wheeler v. State*, 659 P.2d 1241 (Alaska App. 1983).

3. State securities laws are commonly referred to as "Blue Sky" laws. Alaska's Blue Sky laws are codified at ALASKA STAT. §§ 45.55.010-.270 (1980).

Since the various tests for determining whether an investment contract is a security have developed primarily through judicial construction of the federal securities laws, this note will first consider investment contract tests used by the the Supreme Court and the federal circuit courts.⁴ This note will then analyze the three cases in which the Alaska courts have decided whether innovative investment schemes constituted a security. Finally, this note will consider whether Alaska should adopt the Ninth Circuit's "risk capital" approach. Adoption of the risk capital test would be consistent with the Alaska court's previous investment contract decisions and Alaska's Blue Sky laws. In addition, this test would allow the court to reach the results it desires without stretching the analysis found in decisions of the Supreme Court and the Ninth Circuit.

II. DEFINING AN INVESTMENT CONTRACT: HISTORICAL DEVELOPMENT

Both the federal securities laws and the Alaska Blue Sky laws include within the definition of a security "any note, stock . . . certificate of interest or participation in any profit-sharing agreement . . . investment contract . . . or, in general, any interest or instrument commonly known as a 'security'."⁵ The Alaska legislature has added to the federal securities law definition by including the "investment 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."⁶

The federal courts have developed tests for determining whether

4. In particular, since Alaska has adopted the Ninth Circuit's profits test, the historical development section of this note will focus upon the Ninth Circuit and Supreme Court case law. Although federal law and interpretations thereof are not controlling, federal judicial precedents may assist Alaska courts in interpreting terms in the definition of a security, because Alaska's Blue Sky laws have been modeled after the federal securities statutes.

5. Securities Act of 1933, Pub. L. No. 22, § 2(1), 48 Stat. 74 (1933) (codified as amended at 15 U.S.C. § 77(b)(1) (1982)) ("33 Act"); Securities Exchange Act of 1934, Pub. L. No. 291, § 3(a)(10), 48 Stat. 883-84 (1934) (codified as amended at 15 U.S.C. § 78c(a)(10) (1964)) ("34 Act"); Alaska Securities Act of 1959, ALASKA STAT. § 45.55.130(12) (1980).

6. ALASKA STAT. § 45.55.130(12) (1980). Before 1933, securities regulation was the exclusive province of the states. Congress borrowed extensively from previously enacted state Blue Sky laws when it defined the term "security" in the Securities Act of 1933. See Hannan & Thomas, *supra* note 1, at 220. Section 401(l) of the Uniform Securities Act defines a security in terms modeled after the 1933 Act. UNIF. SECURITIES ACT § 401(l), 7B U.L.A. 580 (1985). When Alaska enacted its state securities laws, it modeled its definition of a security after the definition suggested in the Uniform Securities Act. See 1961 Op. Att'y Gen. 15.

an investment scheme is an investment contract within the meaning of the federal securities laws. State courts, in interpreting their own state securities laws, generally have adopted the tests developed by the Supreme Court and the subsequent federal circuit court interpretations of these tests.⁷

In *Securities Exchange Commission v. W.J. Howey Co.*,⁸ the Supreme Court enunciated the often-cited “*Howey* test” for determining whether an investment scheme constitutes an investment contract and, therefore, a security for purposes of federal securities laws. The *Howey* test became the basis for later formulations of investment contract tests.

The *Howey* Court stated that the term “investment contract” denotes “a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.”⁹ Applying this test, the Court found the existence of an investment contract in a scheme where a Florida company sold parcels of citrus grove property primarily to persons not residing in Florida. The company recommended that the buyers obtain a service contract with a second company; both companies, however, were under direct common control and management.¹⁰ In evaluating these circumstances, the Court made three findings which subsequently have become known as the hallmarks of the *Howey* test.

First, grouping the parcels under the service contracts was essential to the profitability of the enterprise and evidenced a common enterprise. The small size of the parcels meant it was not economically feasible to develop the plots of land individually. “Such tracts gain utility as citrus groves only when cultivated and developed as compo-

7. See, e.g., *Raymond Lee Org., Inc. v. Sec. & Exch. Comm'n*, 36 Colo. App. 417, 543 P.2d 75 (1975); *Sauer v. Hays*, 36 Colo. App. 190, 539 P.2d 1343 (1975); *State v. Bull Inv. Group, Inc.*, 32 Conn. Supp. 279, 351 A.2d 879 (1974); *Tech Resources, Inc. v. Estate of Hubbard*, 246 Ga. 583, 272 S.E.2d 314 (1980); *Dunwoody Country Club v. Fortson*, 243 Ga. 236, 253 S.E.2d 700 (1979); *Comm'r of Sec. v. Hawaii Mkt. Center*, 52 Hawaii 642, 485 P.2d 105 (1971); *Ronnett v. Am. Breeding Herds, Inc.*, 124 Ill. App. 3d 842, 464 N.E.2d 1201 (1984); *Condux v. Neldon*, 83 Ill. App. 3d 575, 404 N.E.2d 523 (1980); *Jost v. Locke*, 65 Or. App. 704, 673 P.2d 545 (1983); *Searsy v. Commercial Trading Corp.*, 560 S.W.2d 637 (Tex. 1977); *Payable Accounting Corp. v. McKinley*, 667 P.2d 15 (Utah 1983); *Christgard, Inc. v. Christensen*, 29 Wash. App. 18, 627 P.2d 136 (1981); *Gaudina v. Haberman*, 644 P.2d 159 (Wyo. 1982). *But see Silver Hills Country Club v. Sobieski*, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961) (developed risk capital test); *State ex rel. Park v. Glen Turner Enterprises*, [1971-1978 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 71,023 (D. Ct. Idaho Mar. 28, 1972); *State ex rel. Healy v. Consumer Business System*, 5 Or. App. 19, 482 P.2d 549 (1971).

8. 328 U.S. 293 (1946).

9. *Id.* at 298-99.

10. *Id.* at 294-95.

nents of a large area. A common enterprise managed by (the company) . . . is therefore essential if the investors are to achieve their paramount aim of a return on their investments."¹¹ Second, the promoters managed, controlled and operated the enterprise. Through the promoter's service company, the promoters effectively controlled the cultivation and development of eighty-five percent of the groves, as well as the harvesting and marketing of crops grown on these parcels.¹² Third, the investors injected their capital into the venture with the expectation of sharing the earnings and profits. As the Court noted, the promoters offered the investment opportunity to persons residing in distant localities and lacking the requisite equipment and experience necessary to profitably cultivate, harvest, and market citrus products. "Such persons have no desire to occupy the land or develop it themselves; they are attracted solely by the prospects of a return on their investment."¹³

The Court has subsequently modified the literal scope of *Howey* by incorporating an "economic realities" standard into the *Howey* test, focusing on the *Howey* Court's admonition that the definition of an investment contract "embodies a flexible, rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."¹⁴ The Court invoked this flexible standard to modify the *Howey* test in *United Housing Foundation, Inc. v. Forman*.¹⁵ Later Supreme Court decisions have relied upon *Howey* and

11. *Id.* at 300.

12. Eighty-five percent of the acreage sold under the *Howey* scheme was covered by service contracts with the promoter's service company, "Howey-in-the-Hills Service, Inc." *Id.* at 295.

13. *Id.* at 299-300.

14. *Id.* at 299. The Court had developed the "economic realities" standard several years before it announced the *Howey* test. In *Sec. & Exch. Comm'n v. C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943), the defendant sold assignments of oil leases, representing that it would drill a test well on the leased land. The Court found that the leaseholds were part of an oil exploration enterprise which was "woven into these leaseholds, in both an economic and a legal sense; the undertaking to drill a well runs through the whole transaction as the thread on which everybody's beads were strung." *Id.* at 348. In determining whether the interests sold were investment contracts within the meaning of federal securities laws, the Court stated, "The test . . . is what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect." *Id.* at 352-53. The Court concluded that the scheme was an investment contract since, in reality, the defendant was selling the chance to participate in an investment enterprise. *See also Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967) ("in searching for the meaning and scope of the word 'security' in the [Securities Act of 1933], form should be disregarded for substance and the emphasis should be on economic reality").

15. 421 U.S. 837 (1975).

Forman's modification of the *Howey* test to determine whether an investment contract exists.

In *Forman*, the Court stated that an investment contract is "an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others."¹⁶ Looking to the "economic realities" of the transaction, the *Forman* Court found that no investment contract existed within a scheme in which tenants in a government subsidized cooperative housing development purchased stock in the development. Even though the tenants purchased an instrument called "stock," the Court held that in economic reality the instrument was not a security because it did not have the usual attributes of a security; the tenants had purchased it to secure housing, rather than to derive economic gain in the form of profits from the efforts of others.¹⁷ Since the requisite "reasonable expectation of profits" element was not present, the Court held the stock was not an investment contract.¹⁸

While the Supreme Court has elaborated on the common enterprise and expectation of profits components of the *Howey* test, it has not focused on the requirements that the profits arise "solely" from the efforts of others.¹⁹ Other federal and state courts have attempted to define this term. Recognizing that the securities laws were enacted to protect unwary investors from fraudulent schemes, the Ninth Circuit has led the circuit courts in broadening the definition of an investment contract through a new interpretation of the *Howey* test. In *Securities & Exchange Commission v. Glen W. Turner Enterprises, Inc.*,²⁰ the Ninth Circuit decided "the word 'solely' should not be read as a strict or literal limitation on the definition of an investment contract."²¹ Instead, the court adopted what has since been labeled the

16. *Id.* at 852 (quoting *Howey's* "solely" language merely for reference purposes).

17. *Id.* at 851. The Court noted the usual attributes of a security as consisting of the following: right to receive dividends, negotiability, right to pledge, voting rights, ability to appreciate in value. *Id.*

18. *Id.* at 854.

19. *See, e.g.,* *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551 (1978). Subsequent federal circuit court decisions and commentators, however, have disparaged the *Howey* Court's language that profits must come "solely" from the efforts of the promoter. *See, e.g.,* *Bauer v. Planning Group, Inc.*, 669 F.2d 770, 779 (D.C. Cir. 1981); *Piambino v. Bailey*, 610 F.2d 1306, 1317-18 (5th Cir. 1980); *Parvin v. Davis Oil Co.*, 527 F.2d 112, 116 (9th Cir. 1975); *Miller v. Central Chinchilla Group, Inc.*, 494 F.2d 414, 416-17 (8th Cir. 1974); *Lino v. City Investing Co.*, 487 F.2d 689, 692-93 (3d Cir. 1973); *Sec. & Exch. Comm'n v. Glen W. Turner Enterprises, Inc.*, 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973); *Hentzner v. State*, 613 P.2d 821 (Alaska 1980); Note, *Securities Regulation Incident to Certificates of Deposit and Privately Negotiated Agreements: Departures from a Functionally Operative Security Definition*, 62 NEB. L. REV. 579, 586 n.40 (1983); Annot. 47 A.L.R. 3d 1375, 1379 (1973).

20. 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

21. *Id.* at 482. The *Turner* court based its decision not to interpret the *Howey* test

“profits test.” This test looks to “whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.”²²

Applying the profits test, the *Turner* court found an investment contract in a multi-level distributorship scheme in which investors were induced to purchase distributorships entitling them to finder's fees or commissions for each investor-distributor they recruited.²³ The *Turner* court found two elements of the *Howey* test present, namely, an investment of money and a common enterprise.²⁴ Because the investors had to convince others to purchase distributorships before they could realize a return on their investments, the profits could not be said to have come “solely from the efforts of others.”²⁵ Nevertheless, the court found an investment contract present because the “undeniably significant efforts” were made by the promoters.²⁶

Although the Supreme Court has recognized the Ninth Circuit's profits test, it has never directly ruled on the test's validity. Two years after *Turner*, in *Forman*, the Court recognized the profits test, but did not adopt it.²⁷ In a footnote, the *Forman* Court noted the Ninth Circuit's rejection of “solely” as an unduly restrictive limitation on the definition of an investment contract.²⁸ The Court declined, however, to express a view on the Ninth Circuit's formulation.²⁹

The Ninth Circuit's formulation of the *Howey* test found in *Turner* has been adopted by both the Fifth Circuit³⁰ and the Alaska

literally on the *Howey* Court's “admonition that the definition of securities should be a flexible one,” and on the remedial nature of the securities laws. *Id.* Similarly, *Turner* is consistent with the *Forman* Court's emphasis on the economic realities of a scheme; both courts recognized that since the securities laws are remedial legislation, they must be construed broadly in order to effectuate their purpose of protection of investors.

22. *Id.* See also *Noa v. Key Futures, Inc.*, 638 F.2d 77, 79 (9th Cir. 1980); *Smith v. Gross*, 604 F.2d 639, 642 (9th Cir. 1979); *Parvin*, 524 F.2d at 116; *Bitter v. Hoby's Int'l, Inc.*, 498 F.2d 183, 184-85 (9th Cir. 1974).

23. For a discussion of the scheme involved in *Turner*, see Hannan & Thomas, *supra* note 1, at 233-35.

24. *Turner*, 474 F.2d at 481-82. The court defined a common enterprise as “one in which the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties.” *Id.* at 482 n.7.

25. *Id.* at 482.

26. *Id.*

27. 421 U.S. 837, 852 n.16 (1975).

28. *Id.*

29. *Id.*

30. See, e.g., *Sec. & Exch. Comm'n v. Koscot Interplanetary, Inc.*, 497 F.2d 473 (5th Cir. 1974). For a discussion of Fifth Circuit decisions which have applied the profits test, see Centner, *Retained Equities of Agricultural Cooperatives and the Federal Securities Acts*, 31 U. KAN. L. REV. 245, 263-64 (1983).

Supreme Court.³¹ The Alaska Supreme Court, however, has liberalized the Ninth Circuit's profits test, and thereby broadened the reach of Alaska's securities laws.

III. THE ALASKA INVESTMENT CONTRACT TEST

Since 1980, Alaska courts on three occasions have considered whether particular investment schemes constituted investment contracts and, hence, securities for purposes of Alaska's Blue Sky laws.³² In accordance with the Ninth Circuit's profits test, Alaska courts have found an investment contract whenever an investor has invested in a common enterprise with the expectation of profits and "the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."³³

A. *Hentzner v. State*

The Alaska Supreme Court first considered whether an investment scheme constituted a security for purposes of Alaska's Blue Sky laws in *Hentzner v. State*.³⁴ The promoter in *Hentzner* had advertised in Alaska newspapers, offering investors "[a] chance to double and even triple [their] money within the next six to eight months."³⁵ The promoter intended to use solicited funds to mine gold that he would then deliver to the investors. An investment of eighty dollars would entitle the investor to one ounce of gold, provided the promoter struck gold.³⁶

The court found that *Hentzner's* scheme involved an investment contract under the modified *Howey* test developed by the Ninth Circuit in *Turner*. First, a common enterprise existed because the investors' financial interests were "inextricably interwoven" with those of

31. *Hentzner v. State*, 613 P.2d 821, 824 (Alaska 1980).

32. See *supra* note 2. Alaska's Blue Sky definition of a security is defined in pertinent part *supra*, text accompanying notes 3-4.

33. *Sec. & Exch. Comm'n v. Glen W. Turner Enterprises*, 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

34. 613 P.2d 821 (Alaska 1980). *Hentzner* involved the petitioner's conviction on two counts of offering and two counts of selling unregistered and non-exempt securities in violation of ALASKA STAT. § 45.55.070 (1980). The court reversed the convictions, holding that section 45.55.210(a) required a finding of intent or awareness of wrongdoing. Since the jury was not instructed properly on the requirement of conscious wrongdoing, reversible error was committed. See 613 P.2d at 828-29. Although *Hentzner* was a criminal case, the definition of a security is the same in both criminal and civil state statutes. See ALASKA STAT. § 45.55.130(12) (1980) (statute governs both civil and criminal cases).

35. 613 P.2d at 822 n.2.

36. *Id.* at 822.

the promoter or third parties.³⁷ The investors' money was to be pooled to enable the promoter to buy mining equipment and supplies. In addition, the court thought that the advertisement's reference to a "1% chance of failure" plainly implied that a mining failure would result in no return on the investment.³⁸ Second, the investors expected profits to come from the efforts of others. The court stated that the investors' continuing dependence on the promoter's efforts to extract gold satisfied the "efforts of others" requirement.³⁹

The court distinguished the *Hentzner* gold mining scheme from the more common transaction where an investor purchases gold with the hope that its price will rise. The latter would not usually be regarded as an investment contract because the expected return on the investment does not depend on the seller's managerial efforts.⁴⁰ In contrast, the *Hentzner* promoters were engaged in significant managerial efforts because the success or failure of the venture depended upon their efforts to arrange for the physical extraction of gold from the ground.⁴¹

The court, in determining that *Hentzner* had made the essential managerial efforts necessary to constitute an investment contract, failed to consider a potentially important distinction between the conduct of the *Hentzner* investors and that of other investors. At least one commentator has suggested that the importance of the *Howey* test's requirement of "solely from the efforts of the promoter or third party" is to distinguish whether the investor has exercised managerial control over the venture, rather than merely undertaking the physical efforts required to complete the transaction.⁴² This distinction rests upon the traditional elements of a security: an investor places his money or capital with a promoter, the promoter represents that the investor will recognize a gain on this investment, and the investor relinquishes control over the methods through which the gain will be

37. *Id.* at 824. The Ninth Circuit had previously developed this formulation of the common enterprise element. See *Sec. & Exch. Comm'n v. Commodity Options Int'l, Inc.*, 553 F.2d 628, 633 (9th Cir. 1977); *Turner*, 474 F.2d at 482 n.7.

38. *Hentzner*, 613 P.2d at 824.

39. *Id.*

40. *Id.*

41. First, the court stated, "Add to the buyer-seller relationship a continuing dependency by the buyer on the seller's expertise and ability in managing the investment and the efforts of others test is met." *Id.* In the same paragraph, the court continues, "Since the investors were in a position of continuing dependency on *Hentzner's* efforts to extract gold from the ground, the efforts of others test was satisfied." *Id.*

42. See generally, Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135, 145-46 (1971); see also Hannan & Thomas, *supra* note 1, at 249-51.

realized.⁴³ In other words, the promoter is expected to “manage” the investment. The usual purchase of goods to be delivered in the future, on the other hand, does not require managerial efforts by the seller. The purchaser gives his money to the seller, expecting that the seller will undertake whatever physical efforts are necessary to procure the goods and deliver them to the purchaser. In determining whether Hentzner’s scheme constituted an investment contract or merely a purchase of goods, therefore, the court should have scrutinized the investors’ efforts more carefully to discern whether their efforts were merely physical and not managerial.

Other state court decisions in the Ninth Circuit provide a framework for analyzing the efforts of the promoter in *Hentzner*. In *McClellan v. Sandholm*,⁴⁴ the Washington Supreme Court considered a scheme in which promoters sold bars of silver bullion to investors. The promoters represented that they would select the silver, store the bars, and resell the silver at the investor’s request for a commission. In addition, the promoters said they would continue to advise the investors regarding the fluctuations of the silver market.⁴⁵

Using the same test for an investment contract that was used in *Hentzner*,⁴⁶ the Washington Supreme Court decided that the promoter had exercised “those essential managerial efforts which affect the failure or success of the enterprise.”⁴⁷ According to the court, the investor had “relied totally on the expertise of the [promoter] to select and purchase an appropriate grade and quantity of silver, arrange for its shipment and delivery to him, and, in the future, obtain the best price on resale.”⁴⁸ Unlike the *McClellan* scheme, the *Hentzner* case merely involved a promoter’s representation that gold would be mined and delivered to investors in the future. The reported facts of *Hentzner* did not mention any representations by the promoter that he would either advise investors about the gold market or sell their gold for them. Therefore, on the face of the opinion, the promoter in *Hentzner* apparently did not engage in activities that would affect the ultimate return on investments. Rather, the investors in *Hentzner* must have expected

43. See Hannan & Thomas, *supra* note 1, at 249; Long, *Partnership, Limited Partnership, and Joint Venture Interests as Securities*, 37 MO. L. REV. 581, 611 (1972).

44. 89 Wash. 2d 527, 574 P.2d 371 (1978).

45. 89 Wash. 2d at 529, 574 P.2d at 372.

46. In explaining its test for finding the existence of an investment contract, the Washington Supreme Court first articulated a modified version of the *Howey* test, whether the “investor expects to reap profits from the efforts of the promoter or a third party.” *Id.* at 531, 574 P.2d at 373 (citations omitted). Then, the court cited the *Turner* definition of “efforts of promoter or third party.” See *id.* at 532, 574 P.2d at 374.

47. *Id.* (quoting *Turner*, 474 F.2d at 482).

48. *Id.*

to engage in substantial efforts to sell their gold and realize a profit on their investment. The *Hentzner* court should have scrutinized these efforts to discern whether they constituted managerial efforts essential to the success of the venture.

The Montana Supreme Court has also noted the significance of the promoters' managerial efforts in determining the existence of an investment contract. In *State v. Duncan*,⁴⁹ promoters induced investors to enter into package-sealer contracts. The promoters sold the investors unsealed bags. The investors then undertook the physical efforts necessary to seal the bags. Under the contract, the investors would reap profits from the venture when the sealed bags were sold.⁵⁰ Using the *Howey* test as modified by *Forman*,⁵¹ the court held that the package-sealer contracts were investment contracts. The court found that the promoters, not the investors, had exercised the requisite managerial control. According to the court, "sealers had no voice or part in the actual sale of the final product."⁵² Consequently, promoters had exclusive control over the part of the venture through which the profits were to be realized, namely, the sale of the sealed bags. In contrast, the promoters in *Hentzner* had no control over the final sale of gold on the market. The *investors* alone controlled the vehicle through which final profits from the venture would be realized—the sale of the gold.

B. *Wheeler v. State*

In 1983, Alaska continued its solicitous treatment of investors in *Wheeler v. State*.⁵³ The Court of Appeals of Alaska affirmed Wheeler's convictions for selling unregistered securities and for fraudulent sale of securities.⁵⁴ Although the trial court had found Wheeler guilty under both the "investment contract" and "risk capital"⁵⁵ definitions of a security, the court of appeals held the evidence sufficient

49. 181 Mont. 382, 593 P.2d 1026 (1979).

50. *Id.* at 394, 593 P.2d at 1032.

51. The *Forman* test, although similar to the test used by the *Hentzner* court, does not distinguish between managerial and physical efforts. *See supra* text accompanying notes 15-16. Nevertheless, the Montana court did distinguish between managerial and physical efforts. *See* 181 Mont. at 394, 593 P.2d at 1032.

52. 181 Mont. at 391, 593 P.2d at 1032.

53. 659 P.2d 1241 (Alaska App. 1983).

54. Wheeler was convicted under ALASKA STAT. § 45.55.010(3) (1980) (anti-fraud provision); *id.* § 45.55.070 (1980) (prohibiting sale of unregistered securities); *id.* § 45.55.210 (1980) (imposing criminal penalties for wilful violations of this chapter).

55. The "risk capital" definition of a security is embodied in ALASKA STAT. § 45.55.130(12) (1980): "'security' means [an] investment 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 interest or policy decision of the venture."

to sustain a finding that an investment contract existed without reaching the question of how to construe the risk capital definition of a security.

According to the investment scheme in *Wheeler*,⁵⁶ Spectrum, a Colorado corporation, would sell each investor a minimum of ten vending machines. Spectrum would place a purchase order for the machines only after the investor had paid approximately twenty percent of the total purchase price.⁵⁷ Spectrum agreed to "provide the services of experienced 'locators,' who would arrange for the machines to be placed in desirable, high traffic locations around Anchorage."⁵⁸ Spectrum also agreed to supply candy and snacks to fill the machines at a specified price.⁵⁹ Finally, the investors were led to believe that the investment plan gave them exclusive selling rights to the Anchorage territory and that Spectrum guaranteed minimum first-year net income from the machines to be 110% of the initial purchase price.⁶⁰

After citing the *Howey* test, the *Wheeler* court applied "the flexible interpretation of the *Howey* standard approved by *Hentzner*."⁶¹ The court scrutinized the scheme in *Wheeler* to determine (1) whether the investors' financial interests were "inextricably interwoven" with those of the promoter⁶² and (2) whether the acts of the investors met the *Turner* efforts of others test.⁶³

First, the *Wheeler* court found that the common enterprise element existed because "investors depended on Spectrum's continued financial security to assure that the company would be capable of fulfilling its commitments to arrange for supplies of candy at favorable prices, to furnish both present and future financing, to make additional machines available for future expansion, and to live up to its obligation

56. The investment scheme in *Wheeler* involved the sale of vending machines under two alternative plans: Plan A and Plan B. Since the court found, however, that *Wheeler* never intended to use Plan A, only Plan B will be discussed herein. See 659 P.2d at 1243.

57. *Id.* at 1244.

58. *Id.*

59. *Id.*

60. *Id.*

61. *Id.* at 1247.

62. *Id.* at 1248 (citing *Hentzner*, 613 P.2d at 824); *Commodity Options Int'l*, 553 F.2d at 634.

63. *Wheeler*, 659 P.2d at 1247 (quoting *Turner*, 474 F.2d at 482). See also *Hentzner*, 613 P.2d at 824. This flexible interpretation of *Howey* is consistent with the Oregon Supreme Court's decision in *Pratt v. Kross*, 276 Or. 483, 497, 555 P.2d 765, 773 (1976), which concluded that "the *Howey* test should be modified so that the requirements are (1) an investment of money (or money's worth), (2) in a common enterprise, (3) with the expectation of a profit, (4) to be made through the management and control of others." For a discussion of *Pratt*, see *infra* text accompanying notes 79-83.

under the 110% first year guarantee."⁶⁴ Similarly, the court determined that Spectrum depended upon the financial success of its investors because Spectrum assured investors it would reimburse them up to the 110% earnings guarantee. Spectrum might, therefore, have incurred vast liability for unprofitable or even marginally profitable operations by investors. The court concluded that this financial interdependence of promoter and investor supported a finding of a common enterprise.⁶⁵

Second, the *Wheeler* court found the investment scheme satisfied the second prong of the *Howey* test.⁶⁶ Under *Hentzner's* relaxed construction of the *Howey* Court's language of "solely from the efforts of the promoter," the *Wheeler* court found that Spectrum's activities provided the essential managerial efforts that "would ultimately determine the profitability of the venture."⁶⁷ While the court acknowledged that investors were required "to service and stock their vending machines regularly, to collect money from their machines, and to keep basic records"⁶⁸ in order to obtain profits, the court characterized these "substantial efforts" as "only routine efforts of a ministerial nature to advance their investments."⁶⁹ On the other hand, the court characterized Spectrum's efforts as "managerial" since it was responsible for:

negotiating for and obtaining high traffic locations for the machines at nominal rates, installation of the machines on location, providing supplies at advantageous wholesale prices to stock the machines, providing future guidance as to relocation of machines operating at unprofitable locations, assuring exclusive sales territory to investors, providing financing for acquisition of machines, and making additional machines and locations available to investors for future expansion.⁷⁰

By characterizing Spectrum's efforts as "managerial" and the investors' efforts as "ministerial," the court was able to conclude "that the 'sole efforts' requirement of the *Howey* standard was met."⁷¹ Consequently, the court held that the scheme constituted an investment contract which was a "security" within the meaning of Alaska Blue Sky laws.⁷²

The *Wheeler* decision again illustrates the Alaska courts' willingness to construe the term "investment contract" expansively. Only by

64. *Wheeler*, 659 P.2d at 1248.

65. *Id.*

66. *Id.* at 1249.

67. *Id.*

68. *Id.*

69. *Id.*

70. *Id.*

71. *Id.*

72. *Id.*

expanding the *Howey* test and the Ninth Circuit's profits test was the court able to produce the result it desired: protecting Alaska's investors from sham transactions initiated by out-of-state residents.

Consideration of the "solely through the efforts of others" portion of the *Howey* test illustrates the expansive reach of the court's decision in *Wheeler*. In this context, the distinction between managerial control and physical control becomes critical. A universal characteristic of traditional forms of securities is that the investor loses managerial control over his investment.⁷³ Consequently, the *Howey* court's "solely" requirement was likely intended to distinguish between investments in which the investor exercised managerial control and investments in which managerial control remained completely in the hands of the promoter.

Not only is this interpretation consistent with *Howey* itself, it also comports with the traditional notion of a security. For example, an investment in a franchise chain such as McDonald's would not be an investment contract if the franchisee depended upon his own efforts for the success of his franchise rather than upon the efforts of the franchise system's promoters. On the other hand, a court could decide that a franchise agreement was an investment contract if the promoter solicited franchise operators who had little money to invest and no experience in managing or operating such an enterprise. The franchisee's inexperience, coupled with agreements mandating that he purchase supplies exclusively from the franchisor, maintain uniform standards of quality, and receive training from the franchisor, renders the franchisee almost totally dependent on the franchisor.⁷⁴ Although the franchisee exerts physical control over the day-to-day operations of the franchise, the franchisor retains managerial control; he makes the decisions regarding training, supplies, and quality control in the enterprise. Securities laws were enacted to protect unsophisticated investors who, like the franchisee dependent on the franchisor's management, find themselves absorbing the financial risks of ventures managed and controlled by others.⁷⁵

73. Long, *supra* note 42, at 170-71. Long's article argues that one of the principal reasons for the enactment of the securities laws was to protect investors who do not have a direct voice in the management and control of the enterprise, and who, therefore, are not in a position to protect their investment.

74. The Ninth Circuit has held that an agreement for a restaurant franchise was not an investment contract where the franchisee was responsible for "continuous operation of the restaurant, production and sale of roast beef sandwiches and related products, purchase of materials, merchandise and supplies from sources selected at his sole discretion, preparation of monthly operating statements, and employment of personnel to accomplish the foregoing." See *Bittner v. Hoby's Int'l, Inc.*, 498 F.2d 183, 185 (9th Cir. 1974).

75. See *Hannan & Thomas*, *supra* note 1, at 254-56; see also Long, *supra* note 43, at 602 n.81 and accompanying text.

An examination of the "ministerial" duties of the investors in *Wheeler* in light of this managerial/physical control dichotomy discloses that the investors' duties included both managerial and physical control of the enterprise. The court noted that investors had to service and stock the machines, collect money from the machines and keep basic service and revenue records.⁷⁶ While these efforts could be considered merely physical or "ministerial," the court failed to mention whether the investors had undertaken any of the managerial efforts essential to the profitability of the venture. Although Spectrum helped choose the location for the machines and provided supplies, the investors decided the type of candy or snacks to be sold, the price to charge for these items, and whether or not to discontinue selling unprofitable items. The selection of both the product line and the price to be charged for the product constitutes a "managerial" decision which affects the failure or success of the venture.⁷⁷

The *Wheeler* decision is also consistent with decisions by the Oregon Supreme Court recognizing that the exercise of some control by investors will not necessarily preclude the finding of an investment contract.⁷⁸ In *Pratt v. Kross*,⁷⁹ the Oregon Supreme Court decided that a limited partnership agreement was an investment contract, even though the plaintiff, a limited partner, was an employee of the limited partnership.⁸⁰ The *Pratt* court modified the *Howey* test's language to read, "expectations of a profit . . . to be made through the management and control of others."⁸¹ The court then considered whether the investor had exercised managerial or merely physical, ministerial efforts. According to the court, "An investor who labors without having an opportunity to participate in management is just as helpless to govern what happens to his investment as is a purely passive investor."⁸² Because the court determined that the plaintiff was employed

76. *Wheeler*, 659 P.2d at 1249.

77. It is sufficient to constitute managerial control that the investor had the right to managerial control irrespective of whether he chooses to exercise this right. See Long, *supra* note 42, at 171 n.158.

78. Furthermore, the *Wheeler* decision is consistent with Louisiana's interpretation of a similar vending machine sales agreement. See *EK v. Nationwide Candy Div., Ltd.*, 403 So.2d 780 (La. App. 1971).

79. 276 Or. 483, 555 P.2d 765 (1976).

80. According to the limited partnership agreement in *Pratt*, the defendant, a general partner, was to receive a "management fee" for exercising "full charge of the management, conduct and operation of the business." *Id.* at 485, 555 P.2d at 766. The plaintiff was to receive a salary for the performance of unspecified duties. In return for her initial investment of capital, the plaintiff was entitled to share in the profits generated by the venture. *Id.*

81. *Id.* at 497, 555 P.2d at 773. The Oregon court expressly provided for the possibility of future modifications of its stated test in "situations in which reason seems to so direct when the purpose of the statutory scheme is considered." *Id.*

82. *Id.*

in a non-managerial position, it held that her efforts did not prevent the transaction from being labelled an investment contract.⁸³

In *Marshall v. Harris*,⁸⁴ the Oregon Supreme Court considered a scheme that presented a clear example of control by a promoter and non-control by an investor. The investor purchased a "fractional interest" in a racehorse from the promoter. The court, relying on the *Howey* test, held that the fractional interest was an investment contract because, *inter alia*, the "partnership agreement put management entirely in the hands of [the promoter]."⁸⁵

The efforts exerted by the investors in *Wheeler* were clearly more substantial than the efforts of the investors in *Marshall*. The investors' efforts in *Wheeler* more closely approximated the efforts exerted by the investor in *Pratt*, which were insufficient to avoid a finding of an investment contract. Although the *Pratt* court did not elaborate on the efforts required by the investor's employment, these efforts, like the *Wheeler* investors' efforts, probably were significant, but not significant enough to determine the success of the enterprise.⁸⁶ In *Wheeler*, the investors exercised managerial control over some aspects of the venture. The *Wheeler* court, however, clearly disregarded the management efforts exercised by the investors. This disregard is typical of the Alaska courts' approach to investment contract analysis.

C. *American Gold & Diamond Corp. v. Kirkpatrick*

American Gold & Diamond Corp. v. Kirkpatrick,⁸⁷ the Alaska Supreme Court's most recent pronouncement on transactions that constitute investment contracts, confirms that Alaska courts have continued to apply an increasingly flexible investment contract standard. American Gold was a Utah Corporation that sold territorial distributorships, giving investors an exclusive thirty-four year right to market

83. *Id.* Compare SEC SECURITIES ACT RELEASE NO. 5211 (Nov. 30, 1971). "It must be emphasized that the assignment of nominal or limited responsibilities to the participant does not negate the existence of an investment contract"

84. 276 Or. 447, 555 P.2d 756 (1976).

85. *Id.* at 455, 555 P.2d at 761. The court also quoted 69 AM. JUR. 2D, *Securities Regulation-State* § 28 (1973) which states:

One type of transaction commonly found to be a security under the blue sky laws, often as a type of investment contract, is a transaction in which real or personal property purportedly is sold, but where the 'seller' in fact retains possession and control of such property and the 'buyer' obtains the right to receive profits resulting from the management of it.

Id. at 454-55, 555 P.2d at 760-61.

86. Since the *Pratt* court mentioned the plaintiff's "unspecified employment duties" in the same context as the defendant's full managerial control, it is possible that the investor in *Pratt* did not exercise any managerial efforts. 276 Or. at 485, 555 P.2d at 766.

87. 678 P.2d 1343 (Alaska 1984).

American Gold's gold jewelry and gems in designated geographic territories.⁸⁸ Kirkpatrick, the Director of the Division of Banking and Securities, issued a temporary cease and desist order against American Gold. The *Kirkpatrick* court affirmed the order to cease and desist upon the grounds that American Gold's sale of the territorial distributorships constituted the sale of unregistered securities.

The court again applied the Ninth Circuit formulation of the *Howey* test. It stated that the only part of the *Howey* test in issue was whether American Gold's efforts provided the "essential managerial efforts which affect the failure or success of the enterprise."⁸⁹ The *Kirkpatrick* court reinterpreted the Ninth Circuit profits test, however, by stating that the focal point of this test was "whether the typical investor would accept the promoters' control."⁹⁰ In other words, if the scheme were directed at investors whose lack of sophistication and experience would lead them to accept the promoter's management and control, the court would likely find that the scheme satisfied *Turner's* requirement that the promoter exert significant managerial controls affecting the success of the enterprise. Thus, the court enabled itself to find an investment contract in a scheme where the named plaintiffs did not actually rely on the promoter's managerial efforts, so long as a typical investor would have been likely to rely on the promoter.⁹¹

Reviewing the promoters' sales materials and statements, the court decided that the territorial distributorship program was aimed at investors seeking a passive role — investors who would want the promoters to provide substantial managerial assistance. As a result, the court found that there was sufficient evidence to support the Director's decision that the scheme constituted an investment contract.⁹²

88. *Id.* at 1345.

89. *Id.* at 1346 (quoting *Turner*, 474 F.2d at 482).

90. *Kirkpatrick*, 678 P.2d at 1346. This formulation of the Ninth Circuit test was developed in *Sec. & Exch. Comm'n v. Aqua-Sonic Prods. Corp.*, 687 F.2d 577, 582-83 (2d Cir.), *cert. denied*, 459 U.S. 1086 (1982) (involving sale of licenses to market dental devices in specific geographic regions).

91. *Kirkpatrick*, 678 P.2d at 1347. This expansion of the Ninth Circuit profits test seems to be consistent with the *Howey* decision. In *Howey*, the investors did not have to accept the promoter's management contract; in fact, fifteen percent of them did not accept it. *See Sec. & Exch. Comm'n v. W. J. Howey Co.*, 328 U.S. 293, 295 (1946). Apparently, the *Howey* Court was satisfied that a *typical* investor would have accepted the promoter's management contract because the Court did not discuss the fact that not all investors had actually relied on the promoter's control and management.

92. *Kirkpatrick*, 678 P.2d at 1347. The court pointed to several factors which supported the court's finding of an investment contract. First, promotional materials stressed the tax benefits of the scheme. Second, the promoters agreed to supply gems to investors at a discounted price. Third, the promoters represented that they had the requisite connections and selling expertise to ensure profitability. Moreover, the promoters agreed to "provide education and sales materials, attempt to secure the distributor a business license and insurance, assist with the selection of personnel, distribute

The *Kirkpatrick* decision epitomizes the increasingly liberal standard under which the Alaska courts have scrutinized investment schemes. Recognizing that state and federal securities laws were enacted to protect unsophisticated investors, the court reduced the Ninth Circuit profits test to one question — whether “promoters sought to attract passive investors, the persons whom the securities laws [were] designed to protect.”⁹³ The fact that the court did not even consider whether the efforts exerted by the investor were ministerial or managerial evidences the extreme flexibility of the standard espoused by the court. Moreover, regardless of whether the promotions were aimed at passive investors, the court failed to consider that the investors had at least the legal right to control many “essential managerial” decisions,⁹⁴ whether or not they chose to exercise this right. Had the court adopted a more rigid application of the Ninth Circuit profits test, rather than merely seeking a means to justify a result, it likely would not have found an investment contract because the investors had the right to control essential managerial decisions which would affect the failure or success of the enterprise.

IV. THE RISK CAPITAL TEST

The Alaska courts' increasing liberality in applying the Ninth Circuit profits test to justify desired results suggests that the court is not actually adhering to a “test” at all. The court could apparently abandon the tests cited in *Hentzner*, *Wheeler*, and *Kirkpatrick* and still reach the same result. The court should not, however, unnecessarily sacrifice predictability to produce equitable results. Both of these goals can be achieved under an alternate approach to the determination of whether an investment scheme is a security — the “risk capital” test.

Although the *Howey* test as modified by subsequent decisions provides a framework for courts to analyze investment schemes, its structured terms cannot encompass all of the schemes that the securities acts were designed to prohibit. Consequently, many courts, including the Alaska Supreme Court, have stretched the narrow *Howey* test in an attempt to fulfill the purposes of the securities acts: prevention of fraud and protection of the public from transactions in which promoters solicit risk capital from the public.⁹⁵ Because the *Howey* Court did

catalogues and solicitation materials to potential buyers, and generally advise and educate the distributor on how to run the business.” *Id.* at 1345.

93. *Id.* at 1347.

94. See, e.g., *State v. Hawaii Mkt. Center, Inc.*, 52 Hawaii 642, 647, 485 P.2d 105, 109 (1971).

95. See Coffey, *The Economic Realities of a “Security”: Is There a More Meaningful Formula?*, 18 W. RES. L. REV. 367, 376-77 (1967).

not leave room for expansion in the express language of its test, subsequent courts have had to ignore the express terms of the *Howey* test in order to expand its application. In Alaska, as in other states, the expansion accomplished by disregarding the express language of the *Howey* test has rendered the "test" meaningless. As a result, attorneys can no longer accurately predict how the Alaska courts will construe a particular transaction.

To remedy problems caused by the narrow language of the *Howey* test, the Ninth Circuit has developed an alternate test to discern whether a scheme is an investment contract: the risk capital test. The "risk capital" test encompasses transactions that in economic reality are of the type the *Howey* Court sought to regulate. Courts utilizing the risk capital test scrutinize a transaction to see if promoters are soliciting risk capital, the capital necessary to finance a scheme, from passive investors in order to develop a profitable business for themselves.⁹⁶

The risk capital test was first employed by the California Supreme Court in *Silver Hills Country Club v. Sobieski*.⁹⁷ *Silver Hills* involved a partnership that sought to fund the development of a golf and country club through the sale of "memberships." The purchase of a "membership" entitled the buyer to use of the club facilities. The venture was grossly undercapitalized. Pursuant to a contract to purchase a seventy-five thousand dollar parcel of real estate where they could locate the country club, the promoters gave a four hundred dollar down payment; memberships were expected to cover the balance of the contract price, as well as an additional one hundred, sixty-five thousand dollars in construction costs.⁹⁸

Since the purchasers were not led to expect monetary profits, a literal application of the *Howey* test would have denied investment contract status to this scheme. The *Silver Hills* court, however, decided that the investment scheme fell within the "regulatory purpose" of the Blue Sky laws, which is "[t]o 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."⁹⁹ The court recognized that the lack of a profit motive should not shield promoters from regulation by the securities laws if they attempt to finance their ventures by soliciting risk capital from

96. 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*, 52 Hawaii 642, 485 P.2d 105 (1971); *Pratt v. Kross*, 276 Or. 483, 555 P.2d 765 (1976).

97. 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961).

98. *Id.* at 812-13, 361 P.2d at 906-07, 13 Cal. Rptr. at 186-87. For a discussion of *Silver Hills*, see Hannan & Thomas, *supra* note 1, at 231.

99. *Silver Hills*, 55 Cal. 2d at 815, 361 P.2d at 908-09, 13 Cal. Rptr. at 188-89; see Hannan & Thomas, *supra* note 1, at 232.

investors who are not given significant managerial control over the venture.

State courts in Oregon and Hawaii have also adopted the Ninth Circuit's risk capital test. In *State v. Consumer Business System*,¹⁰⁰ the Oregon Court of Appeals held that the *Howey* test is not the exclusive means for determining the existence of an investment contract, and adopted the risk capital test for use with schemes that the *Howey* test could not accurately evaluate.

Consumer Business involved a franchise distributorship scheme where a franchisee would build an organization of managers and representatives. The franchisee, managers and representatives would sell subscriptions to businesses which agreed to display a Consumer Business System, Inc. ("CBS") card at their place of business. In return, CBS agreed to list the business' services or products in Consumer Buyer's Guide without charge.¹⁰¹ Scrutinizing the efforts required by the investor, the court noted, "If a franchisee purchases a franchise, and then does nothing, it is understood that he will not make profits."¹⁰² Since the efforts of the investors were essential to the profitability of the venture, the court could not follow the express language of *Howey* requiring an expectation of profits *solely* from the efforts of others. Instead, the Oregon court scrutinized the transaction to determine whether the promoter depended upon the investors' capital to initiate his operations. The court stated its formulation of the risk capital test for franchise agreements as follows: "if a substantial portion of the investment capital which a franchisor uses to initiate its operations is being provided by the franchisees, then the franchisor must register his enterprise under the [state] Securities Act."¹⁰³

100. 5 Or. App. 19, 482 P.2d 549 (1971).

101. *Id.* at 21-22, 482 P.2d at 550-51.

102. *Id.* at 25, 482 P.2d at 552.

103. *Id.* at 29, 482 P.2d at 554. The *Pratt* court had also stated that "An interest comes within [the risk capital] test if the investor contributes the capital necessary to finance the enterprise and receives in exchange the right to some benefit." 276 Or. at 490, 555 P.2d at 769.

The Ninth Circuit has listed six factors to determine whether a "commercial loan" is actually an investment contract: (1) time; (2) collateralization; (3) form of the obligation; (4) circumstances of issuance; (5) relationship between the amount borrowed and the size of the borrower's business; (6) the contemplated use of the funds. See *AMFAC Mtg. Corp. v. Arizona Mall of Tempe*, 583 F.2d 426, 432 (9th Cir. 1978); see also *United Cal. Bank v. THC Fin. Corp.*, 557 F.2d 1351, 1358 (9th Cir. 1977); *Great Western Bank & Trust v. Kotz*, 532 F.2d 1252, 1257-58 (9th Cir. 1976). Compare the *Consumer Business* risk capital test for franchises set out in the text with Idaho's formulation:

A security would be said to be present if the following could be found:

1. a common enterprise,
2. expectation of monetary profit or some other benefit and,
3. either (a) non-participation or (b) a double-investment situation

In *State Commission of Securities v. Hawaii Market Center, Inc.*,¹⁰⁴ the Hawaii Supreme Court held that a selling scheme in which investors were led to expect profits through the solicitation of other investors constituted an investment contract. In reaching its decision, the court discarded the *Howey* test because "it has led courts to analyze investment projects mechanically, based on a narrow concept of investor participation."¹⁰⁵ In particular, the court noted that the Supreme Court "has not yet decided whether an investment plan involving non-managerial investor participation also falls within the concept of an investment contract security."¹⁰⁶ In light of this fact, the Hawaii court adopted a risk venture capital test developed by Professor Ronald J. Coffey.¹⁰⁷

Professor Coffey has suggested that a court should find an investment contract in transactions in which the buyer furnishes initial value to the promoter and part of this initial value is "subjected to the risks of [the] enterprise."¹⁰⁸ A court also should determine whether the buyer is either unfamiliar with the operation of the enterprise, or "does not receive the right to participate in the management of the enterprise."¹⁰⁹ Finally, the court should consider whether the promoter induced the buyer to furnish the initial value through representations that the buyer could reasonably expect to receive a "valuable benefit of some kind."¹¹⁰ Applying Professor Coffey's test to the facts of *Hawaii Market Center*, the Hawaii court held that the transaction constituted an investment contract.¹¹¹

The Alaska Supreme Court should follow other states in the Ninth Circuit and adopt the risk capital test as an alternative to the *Howey* test and its progeny. The application of the risk capital test would be consistent with Alaska's decisions in *Hentzner*, *Wheeler*, and *Kirkpatrick*. Moreover, the Alaska Blue Sky law expressly recognizes as a security an "investment of money . . . 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

where there is a contribution of risk capital, as well as non-participation in the franchisor's separate business.

State ex rel. Park v. Glen Turner Enterprises, [1971-1978 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 71,023 (D. Idaho Mar. 29, 1972). The Idaho court referred to its formulation as a combination of *Howey* and *Silver Hills*.

104. 52 Hawaii 642, 485 P.2d 105 (1971).

105. *Id.* at 647, 485 P.2d at 108.

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

107. *See Coffey, supra* note 95, at 377.

108. *Id.*

109. *Id.*

110. *Id.*

111. *Hawaii Mkt. Center*, 52 Hawaii at 649-52, 485 P.2d at 109-11.

the venture.”¹¹² Therefore, adopting the risk capital test would provide the Alaska courts with a viable alternative to the *Howey* test and allow the court to apply that test only to transactions that the *Howey* language and the *Turner* modifications thereof can comfortably reach.

The *Howey* test is particularly hard to apply if the profits expected by the investor are difficult to identify and assess.¹¹³ Similar problems arise where the transaction does not actually “subject any of the buyer’s initial value to the risks of an enterprise.”¹¹⁴ Furthermore, the *Howey* test is especially difficult to apply where the investor exerts some managerial control over the venture, because neither the *Howey* test nor its progeny have quantified the amount of managerial control that an investor may exercise before a scheme will be deemed an investment contract. If the transactions involved in such cases violate the spirit of the securities acts but do not fit within the narrow language of the *Howey* test, the court could analyze the transaction using the risk capital theory. Use of both tests would allow the Alaska courts to fulfill the remedial purposes of the securities acts while enhancing the predictability of their decisions.¹¹⁵

For example, in *Hentzner*, at the time he sought out the investors, the promoter did not have the gold in his possession. Therefore, investors risked their capital on the possibility that the promoter would never discover gold. Consequently, if the *Hentzner* court had applied the risk capital test, it still would have found an investment contract. The court would have reached this decision, however, without attempting to distinguish between the “managerial” and “physical” efforts of the promoter and the investors.

Wheeler and *Kirkpatrick* also posed problems in the application of the *Howey* test because both cases involved transactions where investors had to exert some managerial effort in order to reap profits from the venture. The investors’ exercise of managerial control raises troublesome questions regarding the meaning of the “solely through

112. See Alaska Securities Act of 1959, ALASKA STAT. § 45.55.130(12) (1980).

113. See Coffey, *supra* note 95, at 383.

114. *Id.* at 384.

115. For example, in *In re Western Pacific Coin & Silver Exchange*, [1971-1978 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 71,203 (Jan. 23, 1975), the Iowa Commissioner of Insurance applied the risk capital test to a transaction similar to the *Hentzner* scheme. In *Western Pacific*, promoters solicited money and, in return, investors received an invoice for silver bullion or silver coins as an “investment for profit.” *Id.* at 67,735. After first conducting a cursory analysis of the transaction under the *Howey* test, the court applied the risk capital test. *Id.* at 67,736. The court found that *Western Pacific* buyers risked losing venture capital because “Western apparently did not have the contracted commodity in vault or on hand and therefore risked the investor’s money on the open market.” *Id.* The court then concluded that the invoices were investment contracts and thus securities within the meaning of Iowa Blue Sky laws. *Id.*

the efforts of others” component of the *Howey* test. Using the risk capital test would have alleviated these problems, while allowing the court to reach the same result. Indeed, both *Wheeler* and *Kirkpatrick* involved transactions where promoters sought to fund their own profit-making venture with the capital of arguably uninformed and unsophisticated investors. In addition, the ventures involved “risk capital” because the court determined that the investors were never guaranteed a return on the investment unless the promoter himself made a profit. Therefore, if the venture failed, the investor lost everything.

V. CONCLUSION

The Supreme Court’s test for an investment contract, as developed by the *Howey* Court, has been subsequently modified by the federal circuit courts, including a particularly significant modification by the Ninth Circuit. In *Securities Exchange Commission v. Glen W. Turner Enterprises*, the Ninth Circuit articulated a flexible version of the *Howey* test. This modification evidences the narrowness of the language used in *Howey* and the resultant need to stretch this test to uphold the purpose of the securities acts — protection of unsophisticated investors.

By stretching the *Turner* profits test, the Alaska courts have moved themselves one step further from the *Howey* standard. While broadening the sweep of Alaska’s Blue Sky laws, the courts have made it increasingly difficult for attorneys to plan or review transactions because the boundaries of the “tests” invoked by the courts are now unclear.

Adoption of a risk capital test would allow the Alaska courts to achieve the results they desire and provide clearer rationales for their decisions. Using the risk capital test as an alternative to the *Howey* test would enable the courts to continue finding an investment contract whenever the economic realities of the transaction indicate that a security is involved, even though the literal terms of *Howey* cannot be satisfied. This alternative test would enhance the predictability of the courts’ decisions because the courts would not have to stretch the *Howey* test beyond meaningful application. Consequently, Alaska would have two distinct tests for an investment contract: a risk venture capital theory and a test based upon *Howey* and modifications thereof developed by the Ninth Circuit. The courts could develop a consistent analysis under each test, and apply each in the appropriate circumstances.

Nancy K. Jones