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The Common Enterprise Test: Getting Horizontal or Going Vertical in Wals v. Fox Hills Development Corp.

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THE COMMON ENTERPRISE TEST: GETTING HORIZONTAL OR GOING VERTICAL IN *WALS v. FOX HILLS DEVELOPMENT CORP.*

I. INTRODUCTION

[T]hose circuits that believe . . . only "vertical commonality" is required to create an investment contract would deem the combination of sale and rental agreement in this case an investment contract.[1]

The Seventh Circuit Court of Appeals' decision in *Wals v. Fox Hills Development Corp.*[2] serves as an important reminder of the split in the jurisdictions on the definition of a "common enterprise." In the seminal case of *SEC v. W. J. Howey*,[3] the U.S. Supreme Court defined the term "investment contract" for purposes of the federal securities acts as an investment of money in a common enterprise with an expectation of profits to be derived solely from the efforts of others.[4]

However, in the forty years since *Howey*, the courts in applying the test have been unable to agree on the second prong: what is a "common enterprise?"[5] The federal circuit court of appeals are divided, the Securities & Exchange Commission ("SEC") has hedged, and the Supreme Court has avoided the issue,[6] leaving commentators clamoring for a swift resolution to what has been termed "the 'most elusive factor' in the 'elusive definition' of a security."[7]

1. Wals v. Fox Hills Dev. Corp., 24 F.3d 1016, 1017 (7th Cir. 1994).
2. *Id.*
3. 328 U.S. 293 (1946).
4. *Id.* at 298-99; Wals v. Fox Hill Dev. Corp., 828 F. Supp. 623, 624 (E.D. Wis. 1993).
5. James D. Gordon, *Common Enterprise and Multiple Investors: A Contractual Theory for Defining Investment Contracts and Notes*, 1988 COLUM. BUS. L. REV. 635.
6. *Wals*, 24 F.3d at 1017-18.
7. Gordon, *supra* note 5, at 635-36. In one article, referring to the inability of the courts to define a "security," the authors called it "[o]ne of the notable intellectual failures of American corporate law." 3 HAROLD S. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW § 2.02 (1992) (quoting William J. Carney and Barbara G. Fraser, *Defining a 'Security'; Georgia's Struggle with the 'Risk Capital' Test*, 30 EMORY L.J. 73 (1981), *reprinted in* 14 SEC. L. REV. 503 (1982)).

The circuits have split on whether the second prong of the *Howey* test requires "vertical commonality" or "horizontal commonality."[8] Vertical commonality, the broader of the two, requires only that the "fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties."[9] Horizontal commonality requires a pooling of interests, usually combined with a pro rata sharing of profits.[10]

This Note reviews the definition of a "security" under the federal securities acts and *Howey's* subsequent test for finding an "investment contract." Furthermore, this Note examines the historical support for the Seventh Circuit's requiring "horizonal commonality" and concludes that such a requirement is not supported by the federal securities acts or *Howey*.[11] Consequently, in this case, the Seventh Circuit Court of Appeals should have required only vertical commonality to satisfy the "common enterprise" prong of the *Howey* test. Had it done so, the court would have found that the purchase and rental agreements constituted an "investment contract" subject to the federal securities acts. Therefore, the defendant's motion for summary judgment should have been denied and the case remanded to the district court for adjudication on the facts.

8. The Third, Sixth, and Seventh Circuits require horizontal commonality. *See, e.g.*, Deckebach v. La Vida Charters, Inc., 867 F.2d 278, 282 (6th Cir. 1989); Stenger v. R.H. Love Galleries, Inc., 741 F.2d 144 (7th Cir. 1984); Salcer v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 682 F.2d 459, 460 (3d Cir. 1982). The Fifth, Eighth, Tenth, and Eleventh Circuits use the vertical commonality test. *See, e.g.*, McGill v. American Land & Exploration Co., 776 F.2d 923, 925-26 (10th Cir. 1985); Villeneuve v. Advanced Business Concepts Corp., 698 F.2d 1121, 1124 (11th Cir. 1983) (en banc); SEC v. Continental Commodities Corp., 497 F.2d 516, 521-22 (5th Cir. 1974); SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 478-79 (5th Cir. 1974); Miller v. Central Chinchilla Group, Inc., 494 F.2d 414, 418 (8th Cir. 1974). The Ninth Circuit now accepts either vertical or horizontal commonality. Hocking v. Dubois, 839 F.2d 560, 566 (9th Cir. 1988). The First and Fourth Circuits have declined to decide the issue, leaving their district courts split. *See* Shawn H. Crook, Comment, *What is a Common Enterprise? Horizontal and Vertical Commonality in an Investment Contract Analysis*, 19 CUMB. L. REV. 323, 333-40 (1989). Though not yet expressed as a requirement, the Second Circuit appears to favor a horizontal commonality requirement. *See* Revak v. SEC Realty Corp., 18 F.3d 81, 87-88 (2d Cir. 1994).

9. *Hocking*, 839 F.2d at 566 (emphasis omitted).

10. *Id.*

11. This Note does not intend to offer a comprehensive review of the historical evolution of the definition of an "investment contract" nor a critical analysis of vertical or horizontal commonality. For such a review and analysis, see Gordon, *supra* note 5. Similarly, for a more complete discussion of the split in the Federal Circuits, see Crook, *supra* note 8.

II. STATEMENT OF THE CASE

A. *Facts and Lower Court History*

In 1990 the plaintiffs, Richard and Sandra Wals, purchased "week 5" of an apartment in the Fox Hills Golf Villas Condominium from the developer and at the same time entered into a "flexible agreement" with the developer whereby the plaintiffs could swap their week in February for a week in the summer.[12] Under a supplement to the flexible time agreement, called the "4-Share Rental Program," the plaintiffs agreed not to occupy the apartment during the week in the summer, but instead to allow the developer to rent it.[13] By participating in the 4-share program, plaintiffs were guaranteed $1,400 of rental income for 1990, which was placed into an escrow account to offset the monthly payments due under the land contract.[14] The plaintiffs claimed that the defendants, in guaranteeing the 1990 rental income, impliedly represented that they would be receiving similar rental income in subsequent years.[15] The Wals claimed that they were unsophisticated and inexperienced in the operation of income producing properties.[16] Further, they alleged that they purchased the time-share as an investment and, had it not been for the guaranteed rental income for 1990 and the prospect of similar receipts in subsequent years, they would not have purchased the unit.[17]

Since diversity of the parties did not exist, the District Court questioned its jurisdiction to hear the matter.[18] Plaintiffs filed a motion for partial summary judgment seeking a determination that the

12. Wals v. Fox Hills Dev. Corp., 24 F.3d 1016, 1017 (7th Cir. 1994).

13. *Id.*

14. Wals v. Fox Hill Dev. Corp., 828 F. Supp. 623, 624 (E.D. Wis. 1993). More generally, under the agreements, the Wals would receive the rental minus the developer's fee of 30 percent. *Wals*, 24 F.3d at 1017.

15. *Wals*, 828 F. Supp. at 624.

16. *Id.* At the time the Wals entered into the time-share purchase, Richard Wals was a programmer/analyst and his wife was an elementary school teacher. They lived approximately 90 miles from the Fox Hills condominiums. *Id.*

17. *Id.*

18. *Id.* The plaintiffs premised federal court jurisdiction on 15 U.S.C. § 77*l*, claiming that the offering and sale of the time-share, combined with the flexible time agreement and the rental pool agreement, was an "offering" and "sale of an investment contract" within the meaning of the Securities Act of 1933. *Id.* In addition, the plaintiffs asserted state law claims seeking cancellation and rescission of the offer to purchase and the land contract, and for return of all payments made under the land contract. *Id.* Thus, the threshold question to justify federal court jurisdiction was whether there was a "security." Both the District Court and the Court of Appeals found that, as a matter of law, the purchase and associated agreements did not constitute an investment contract, thus destroying plaintiffs' basis for federal court jurisdiction. Regarding the asserted state law claims, under 28 U.S.C. § 1367(c)(3), the federal court may decline to

various contracts considered together constituted an investment contract.[19] The defendant responded with its own motion for summary judgment.[20] The District Court granted summary judgment for Fox Hills, holding that the various time-share transactions between the parties did not constitute an investment contract "because it is clear from the record that horizontal commonality does not exist."[21]

B. *Issue*

On appeal, the Wals again contended that the condominium time-share purchase and the associated rental agreement converted the sale of the condominium from a sale of real estate to a sale of an investment contract subject to the Securities Act of 1933.[22] The Wals alleged that the developer was required and failed to register under the Securities Act, thus entitling them to rescind the sale.[23]

III. LAW PRIOR TO THE CASE

A. *Securities Regulation*

The Securities and Exchange Commission ("SEC") and many states' securities laws do not generally consider time-share interests to

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exercise supplemental jurisdiction over state law claims because the court has dismissed all claims over which it has original jurisdiction.

19. *Wals*, 828 F. Supp. at 624.

20. *Id.*

21. *Id.* at 625. In particular, the District Court noted the deposition of the General Manager of Fox Hills Development Corp.:

> Q So every year, when they wanted to opt into the 4-Share rental program, they could choose one of those four months, depending upon availability.
> A Yes. First come first served. Everyone receives—we send out a lease back form each year for those folks that want to put part or all or none or whatever into it. And then they ask them what month would you like to come in to. And, again, depending on the conventions, and whatever else, I mean it's a coin toss in your own mind which one is going to be the best. I'm frank to admit I don't know until the bookings are actually in. September might be the best one year, July might be best next year, and whatever, depending on occupancy.
> Q And if you're lucky enough to have your specific unit you're assigned in a specific month that you pick to be completely rented out, then you get all of the—you get all the income that was generated for that unit for that week.
> A Right. Correct. In other words, it's somewhat of a crap shoot, because you don't come out the same. You know.
> Q So the units are not pooled in a month or in a season, and then they take all the gross income and split it up equally between—
> A We did at one time, and we have changed that. They were never part of that.

Id.

22. *Wals*, 24 F.3d at 1017. The Securities Act is located at 15 U.S.C. §§ 77a-77bbbb (1988 & Supp. 1993).

23. *Wals*, 24 F.3d at 1017 (citing 15 U.S.C § 77*l* (1988) (allowing recovery of consideration paid for any security sold in violation of 15 U.S.C. § 77e (1988))).

be securities, but could characterize them as such if the time-share interests were marketed emphasizing the investment potential of ownership.[24] Section 2(1) of the Securities Act of 1933 defines a "security" as "[a]ny note, stock . . . [or] . . . investment contract . . . ."[25] While time-share interests are not clearly within the usual definition of "stock," "note," "bond," "debenture," or "evidence of indebtedness," as set out in Section 2(1) of the 1933 Act, they may be considered "securities" by reason of being "investment contracts" or "instruments commonly known as securities."[26]

In an effort to better define the applicability of federal securities laws to the condominium market, the SEC stated that the offering of condominium units in conjunction with any of the following would cause the offering to be viewed as an offering of securities in the form of an investment contract:[27] (1) emphasizes the economic benefits to be derived from the managerial efforts of the promoter; (2) includes a rental pool arrangement; or (3) materially restricts the ability of the purchaser to rent or occupy the unit.[28]

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24. Jo Anne P. Stubblefield, *Interval Ownership and Vacation Club Options*, C752 A.L.I.-A.B.A. 287, 300-01 (1992).

25. 15 U.S.C § 77b(1) (1988). The full text definition according to the Securities Act of 1933 is as follows:

> (1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

Id. § 77b(1).

The 1934 Securities Act defines a security in substantially the same manner except that it (1) deletes the term "evidence of indebtedness;" (2) it excludes short-term "commercial paper;" and (3) it uses a "slightly different approach in classifying oil and gas interests as a security." 3 BLOOMENTHAL, *supra* note 7, § 2.02 (citing 15 U.S.C. § 78c(a)(10) (1988)). The Senate report on the 1934 Act makes clear that its definition of a security was intended to be "substantially the same as in the Securities Act of 1933." *Id.*

26. Stubblefield, *supra* note 24, at 301.

27. Hocking v. Dubois, 839 F.2d 560, 564-65 (9th Cir. 1988). The reasoning and conclusions set out in the SEC release should apply to time-shares. According to one securities law treatise, "[e]ssentially the same analysis applicable to resort condominiums should apply to timesharing . . . offerings." 2 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 970 (3d ed. 1989).

28. William J. Ohle, Note, Hocking v. Dubois: *The Ninth Circuit Finds a Security in the Secondary Resort Condominium Market*, 27 WILLAMETTE L. REV. 147, 153 (1991). Guidelines as to the Applicability of the Federal Securities Laws to Offers and Sales of Condominiums or Units in a Real Estate Development, Securities Act Release No. 33-5347, 1 Fed. Sec. L. Rep. (CCH) ¶ 1,049 (Jan. 4, 1973). The Release further stated, "[i]f the condominiums are not offered

In *SEC v. W. J. Howey Co.*, the United States Supreme Court long ago defined an "investment contract" under the federal securities acts as:

> [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 promoters or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise.[29]

Thus, under *Howey*, an investment contract consists of: (1) an investment of money, (2) in a common enterprise, (3) with the expectation of profits produced by the efforts of others.[30] The *Howey* opinion stated that the term "investment contract" had been "broadly construed by state courts so as to afford the investing public a full measure of protection. Form was disregarded for substance and emphasis was placed upon economic reality."[31] The Court reasoned that its definition "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."[32]

Unfortunately, because neither the Court in *Howey* nor any subsequent Supreme Court decision has defined the "common enterprise" prong of the *Howey* test, the federal courts have been left to

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and sold with emphasis on the economic benefits to the purchaser to be derived from the managerial efforts of others, and assuming that no plan to avoid the registration requirements of the Securities Act is involved, an owner of a condominium unit may, after purchasing his unit, enter into a non-pooled rental arrangement with an agent not designated or required to be used as a condition to the purchase, whether or not such agent is affiliated with the offeror, without causing a sale of a security to be involved in the sale of the unit." *Id.*

29. 328 U.S. 293, 298-99 (1946).

30. *Hocking*, 839 F.2d at 564. The third prong of the original *Howey* test requiring profits to be derived "solely" from the efforts of others was subtly changed in United Housing Foundation, Inc. v. Forman, 421 U.S. 837 (1975). In *Forman*, the Court stated that "[t]he touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others." *Id.* at 852. The *Forman* Court acknowledged the changed language of the *Howey* test, but reasoned that "the word 'solely' should not be read as a strict or literal limitation on the definition of an investment contract, but rather must be construed realistically, so as to include within the definition those schemes which involve in substance, if not in form, securities." *Id.* at n.16 (quoting SEC v. Glenn W. Turner Enter., 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973)).

31. *Howey*, 328 U.S. at 298.

32. *Id.* at 299. Interestingly, the *Howey* test has led courts to classify a wide variety of exotic schemes as "investment contracts." *See, e.g.*, Smith v. Gross, 604 F.2d 639, 642-43 (9th Cir. 1979) (earthworms); SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 478-85 (5th Cir. 1974) (cosmetics); Miller v. Central Chinchilla Group, Inc., 494 F.2d 414, 416-18 (8th Cir. 1974) (chinchillas).

disagree.[33] Indeed, the Supreme Court has avoided the opportunity to resolve the definition of a common enterprise.[34] In *Mordaunt v. Incomco*, the Court denied certiorari on the commonality issue over the objection of three justices.[35]

B. *Defining a Common Enterprise*

The courts have developed three approaches in answering the question, "what constitutes a common enterprise?" Some courts require horizontal commonality, which focuses on the "horizontal" relationship among the investors in an enterprise.[36] Other courts hold that a common enterprise can exist by virtue of either narrow or broad vertical commonality, which focuses on the "vertical" relationship between the investor and the promoter.[37]

The Third, Sixth, and Seventh Circuits have held that the existence of a common enterprise under the *Howey* test can be established by a showing of horizontal commonality: the tying of each investor's fortunes to those "of the other investors by the pooling of assets, usually combined with the pro rata distribution of profits."[38] Thus, in a common enterprise evidenced by horizontal commonality, the individual investor's fortunes depend on the profitability of the whole.[39]

The Fifth, Ninth, Tenth, and Eleventh Circuits have adopted the view that only vertical commonality is necessary to establish the existence of a common enterprise.[40] In an enterprise marked by vertical commonality, it is not necessary that the investor's fortunes rise and fall together; a pro rata sharing of profits and losses is not required.[41] The vertical commonality test defines a common enterprise as "one in

33. Crook, *supra* note 8, at 325.

34. Gordon, *supra* note 5, at 642.

35. 469 U.S. 1115, 1117 (1985) (White, J., dissenting, urged the Court to settle the question "[i]n light of the clear and significant split in the Circuits . . ."). Chief Justice Burger and Justice Brennan joined Justice White's dissent. *Id.* at 1115.

36. Gordon, *supra* note 5, at 640.

37. Gordon, *supra* note 5, at 641.

38. Revak v. SEC Realty Corp., 18 F.3d 81, 87 (2d Cir. 1994).

39. *Id.* The court went on to quote Hart v. Pulte Homes of Michigan Corp., 735 F.2d 1001, 1004 (6th Cir. 1984): "Horizontal commonality ties the fortunes of each investor in a pool of investors to the success of the overall venture. In fact, a finding of horizontal commonality requires a sharing or pooling of funds." *Id.*

> "Pooling" has been interpreted to refer to an arrangement whereby the account constitutes a single unit of a larger investment enterprise in which units are sold to different investors and the profitability of each unit depends on the profitability of the investment enterprise as a whole.

Savino v. E.F. Hutton & Co., 507 F. Supp. 1225, 1236 (S.D.N.Y. 1981).

40. Gordon, *supra* note 5, at 641 n.42.

41. *Revak*, 18 F.3d at 87.

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."[42]

Under the rubric, vertical commonality, two distinct kinds have been identified.[43] First, under the narrow view, the success or failure of the manager must correlate with the individual investor's profit or loss.[44] Stated another way, "the manager's fortunes must rise and fall with those of the investor."[45] Second, the broad view of vertical commonality simply requires that the fortunes of the investors be linked to the efforts of the promoter.[46] In employing this approach, "the critical inquiry is confined to whether the fortuity of the investments collectively is essentially dependent on promoter expertise."[47]

IV. DECISION

In *Wals v. Fox Hills Development Corp.*,[48] the court found no horizontal commonality, "that is, a pooling of interests not only between the developer or promoter and each individual 'investor' but also

42. Gordon, *supra* note 5, at 641 (quoting SEC v. Glenn W. Turner Enter., Inc., 474 F.2d 476, 482 n.7 (9th Cir. 1973)).

43. *Revak*, 18 F.3d at 87.

44. Gordon, *supra* note 5, at 641 (citing Brodt v. Bache & Co., 595 F.2d 459, 461 (9th Cir. 1978)).

45. Gordon, *supra* note 5, at 641 (citing Savino v. E.F. Hutton & Co., 507 F. Supp. 1225, 1237 (S.D.N.Y. 1981)).

46. *Revak*, 18 F.3d at 88. The broad approach to commonality has been criticized by some courts that argue it "essentially eliminates the 'common enterprise' prong of the *Howey* test because the only inquiry required becomes whether the success or failure of the investment is dependent upon the promoter's efforts, which is also the third prong of the *Howey* test." Crook, *supra* note 8, at 331 n.41 (quoting Kaplan v. Shapiro, 655 F. Supp. 336, 340 (S.D.N.Y. 1987)); *see also* Copeland v. Hill, 680 F. Supp. 466, 468 (D. Mass. 1988) (citing Holtzman v. Proctor, Cook & Co., 528 F. Supp. 9 (D. Mass. 1981) ("the broad vertical commonality merges the second element of the *Howey* test with the third element, thus eliminating one prong")).

The Fifth Circuit has recognized the criticism that under its relaxed vertical commonality requirement "the second and third prongs of the *Howey* test may in some cases overlap to a significant degree." Jayne E. Zanglein, *Securities Laws*, 22 TEX. TECH L. REV. 685, 705 (quoting Long v. Shultz Cattle Co., 881 F.2d 129, 141 (5th Cir. 1989)). In response to the criticism, the Fifth Circuit Court stated:

> We are not convinced that it would be desirable to adopt a rigid requirement that profits and losses be shared on a *pro rata* basis among investors, or that the promoter's fortunes correlate directly to the profits and losses of investors. *Howey* sought to establish a standard which would "embod[y] 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." It may be that in declining to adopt the rigid formulae of other circuits, our standard comports more fully with *Howey*'s desire to fulfill the remedial purposes of the federal securities laws.

Id. (quoting *Long*, 881 F.2d at 141-42) (citation omitted).

47. Gordon, *supra* note 5, at 642 (quoting SEC v. Continental Commodities Corp., 497 F.2d 516, 521-22 (5th Cir. 1974)).

48. 24 F.3d 1016 (7th Cir. 1994).

among the 'investors.'"[49] Thus, the condominium time-share purchase and rental agreement was not an investment contract.[50] The court noted that the rental agreements connoted a pooling of weeks because the Wals chose their summer swap week from a "pool" of available weeks, but concluded there was no sharing of profits, which is essential to horizontal commonality.[51]

In affirming the District Court's refusal to recognize vertical commonality as satisfying the "common enterprise" prong of the *Howey* test, the Court of Appeals noted that the Supreme Court has ducked the issue, and the SEC has hedged.[52] The court further concluded that requiring horizontal commonality better comported with the purpose of the Securities Act of 1933.[53] In the court's view, the statutory language "suggests that the term 'investment contract' has the limited purpose of identifying unconventional instruments that have the essential properties of a debt or equity security."[54] In that context, the court noted that a share of stock is an undivided interest in an enterprise entitling the owner to a pro rata share of the profits.[55] In contrast, the court reasoned, the owner of a condominium does not own an undivided share of the building.[56] Rather, the condominium owner owns only his condominium, and if it is rented out on his behalf by the developer, he receives only the rental on that unit, not an undivided share of the total rentals of all the rented units.[57]

V. ANALYSIS OF *WALS V. FOX HILLS*

The decision in *Wals* is important because it is a significant reminder of the split in the jurisdictions on the definition of a "common enterprise." The court acknowledged the split, but went on to adhere strictly to the "horizontal commonality" test of a common enterprise.[58]

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49. *Id.* at 1018.
50. *Id.* at 1019.
51. *Id.* The appellate court stated that "they did not receive an undivided share of some pool of rentals or profits. They received the rental on a single apartment, albeit one not owned by them (for it was not their week)." *Id.*
52. *Wals*, 24 F.3d at 1018.
53. *Id.*
54. *Id.*
55. *Id.*
56. *Wals*, 24 F.3d at 1018.
57. *Id.*
58. Wals v. Fox Hills Dev. Corp., 24 F.3d 1016, 1017-18 (7th Cir. 1994).

While the Court of Appeals was perhaps correct about the Supreme Court and the SEC, it was wrong in its suggestion that horizontal commonality better comported with the 1933 Act and wrong in its decision in this case.

A. *Applicability of SEC Release 5347*

The Court of Appeals' entire analysis as to the applicability of Securities Act Release No. 5347 "Guidelines as to the Applicability of the Federal Securities Laws to Offers and Sale of Condominiums or Units in a Real Estate Development," was to suggest that "the SEC has hedged."[59] However, another federal court saw Release No. 5347 as stating "unequivocally that it will view a condominium as a security if it is offered with any one of three specified rental arrangements."[60]

The three types of rental arrangements the SEC specified as causing the offering to be viewed as an investment contract are where the offer: (1) emphasizes the economic benefits to be derived from the managerial efforts of the promoter; (2) includes a rental pool arrangement; or (3) materially restricts the ability of the purchaser to rent or occupy the unit.[61] In *Wals*, it is clear that the second and third SEC-specified rental arrangements are not present. Because the rental arrangement in Fox Hills did not combine the rents received and the expenses attributable to all units, and remit the proceeds to the investors on a pro rata basis, it did not constitute a rental pool as contemplated by the SEC release.[62] In addition, because the "flexible time" and "4-Share" agreements were optional, the Wals were not materially restricted in their use of the unit.

However, the first specified rental arrangement, the so-called "economic emphasis test,"[63] may arguably apply in the instant case.

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59. *Id.* at 1018.

60. Hocking v. Dubois, 839 F.2d 560, 565 (9th Cir. 1988).

61. Ohle, *supra* note 28, at 153.

62. The SEC Release stated:

> Typically, the rental pool is a device whereby the promoter or a third party undertakes to rent the unit on behalf of the actual owner during that period of time when the unit is not in use by the owner. The rents received and the expenses attributable to rental of all the units in the project are combined and the individual owner receives a ratable share of the rental proceeds regardless of whether his individual unit was actually rented.

SEC Release No. 33-5347, *supra* note 28.

63. Ohle, *supra* note 28, at 154. The SEC probably relied on the language of SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 353 (1943), stating that it is "not inappropriate that promoters' offerings be judged as being what they were represented to be." However, it should be noted that the broad language of *Joiner*, while not specifically being overruled, was narrowed by *Howey*. *Id.*

Under this test, an investment contract will be found if "[the] condominiums . . . with a[ny] rental arrangement[s or similar service], . . . are offered and sold . . . [with] emphasi[s on] the economic benefits to the purchaser to be derived from the managerial efforts of the promoter . . . [from the rental of the units]."[64] Applying this approach, the court should generally look to the terms of the offer, the distribution plan, and the economic inducements.[65] Apparently, the Court of Appeals in *Wals* found the plaintiffs' claim that the defendant impliedly represented future rental income insufficient to satisfy the economic realities test of Release No. 5347, or perhaps the court failed to even consider the Release.

Whatever the reason, the plain language of Release No. 5347 concerning the first rental arrangement, and the support of *Hocking* when combined with the facts in the instant case, suggests that the Court of Appeals could have reversed the district court's grant of defendant's motion for summary judgment.[66] For purposes of summary judgment, the Wals' allegation that the defendant represented the receipt of rental income for subsequent years should be accepted. That fact establishes that Fox Hills offered the purchase and rental agreements which emphasized the economic benefits of the purchase, and thereby fell under the first rental arrangement specified by SEC Release No. 5347. Consequently, in applying the economic emphasis test, Fox Hills' offer can arguably be viewed as offering the Wals an investment contract.

However, the reading of Release No. 5347 by the *Hocking* court may be overly broad with respect to the "economic emphasis test."[67] Generally, in considering condominiums and other potential investment contracts, courts have limited the use of the economic emphasis test to the third element of *Howey*.[68] Indeed, it has been suggested that the economic emphasis test, as used by the SEC and federal courts, is simply one of many factors to be considered when determining if a given offer satisfies the last element of the *Howey* test.[69] This reading of the first rental arrangement specified by Release No. 5347

64. SEC Release No. 33-5347, *supra* note 28.

65. Robert B. Brannen, Jr., Comment, *The Economic Realities of Condominium Registration Under the Securities Act of 1933*, 19 GA. L. REV. 747, 759 (1985).

66. "In ruling on a motion for summary judgment, the evidence of the party against whom summary judgment has been entered is to be believed." Revak v. SEC Realty Corp., 18 F.3d 81, 84 (2d Cir. 1994).

67. *See* Ohle, *supra* note 28, at 154-55.

68. Ohle, *supra* note 28, at 154-55.

69. Brannen, *supra* note 65, at 769.

is probably better. It is doubtful that the economic emphasis test was intended to displace a *Howey* analysis. Rather, it was likely offered as one factor courts should consider in determining whether an offer satisfies the last element in *Howey*.[70]

Thus, even though the Seventh Circuit Court of Appeals did not specifically address the applicability of SEC Release No. 5347 in the instant case, it likely concluded that Release No. 5347 alone was not determinative on the existence of an investment contract. Consequently, the Court proceeded to apply the *Howey* test, requiring horizontal commonality for the "common enterprise" prong of that test.

B. *The Horizontal Commonality Requirement*

1. Horizontal Commonality and the Securities Act of 1933

"The primary policy of the federal securities acts is to protect investors through disclosure."[71] Congress broadly defined the term "security" in the 1993 Act in order to protect the public by preventing crooked promoters from eluding the provisions of the securities laws through "countless and variable schemes."[72] "Congress cast ['security'] 'in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security.'"[73]

The remedial purpose of the 1933 Act was to "prevent further exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentation; to place adequate and true information before the investor; to protect honest enterprise, seeking capital by honest presentation, against the competition afforded by dishonest securities offered to the public through crooked promotion."[74] By including the term "investment contract," the 1933 Act provided for securities of a more variable character.[75]

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70. *See* Ohle, *supra* note 28, at 154-55. The SEC likely included the economic emphasis test in Release No. 5347 to act as a catchall to prevent circumvention of the release. However, in adding the first rental arrangement provision in Release No. 5347, the SEC "sacrificed clarity in favor of investor protection." Brannen, *supra* note 65, at 759-60.

71. Gordon, *supra* note 5, at 659.

72. Hocking v. Dubois, 839 F.2d 560, 563-64 (9th Cir. 1988) (quoting SEC v. W.J. Howey Co., 328 U.S. 293, 299 (1946)). The *Hocking* court noted that the sections defining the term "security" in the Securities Act of 1933 and the Securities Exchange Act of 1934 were substantially identical. *Id.* at 563.

73. *Id.* (quoting H.R. REP. No. 85, 73d Cong., 1st Sess. pt.1, at 11 (1933)).

74. *Id.* at 564 n.3 (quoting S. REP. No. 47, 73d Cong., 1st Sess. 1 (1933)).

75. *Howey*, 328 U.S. at 297. The Supreme Court noted in 1943 that the term "security" included "by name or description many documents in which there is common trading for speculation or investment.' Some, such as notes, bonds, and stocks, are pretty much standardized and

State courts took the initiative to define the term "investment contract."[76] Although state laws had failed to define the term, it was broadly construed to afford the investing public full protection.[77] "Form was disregarded for substance and emphasis was placed upon economic reality."[78] Thus, an investment contract was construed to mean a contract or scheme for "the placing of capital or laying out of money in a way intended to secure income or profit from its employment."[79]

In *Howey*, Justice Murphy suggested that state courts should uniformly apply this definition where individuals are led to invest in a common enterprise with the expectation that they would earn a profit solely through the efforts of another.[80] In addition, Justice Murphy concluded that by bringing the term investment contract within the scope of section 2(1) of the 1933 Act, "Congress was using a term the meaning of which had been crystallized by this prior judicial interpretation. It is therefore reasonable to attach that meaning to the term as used by Congress, especially since such a definition is consistent with the statutory aims."[81]

Justice Murphy's analysis is flawed because after suggesting Congress intended to use the *Gopher Tire*[82] definition of an investment contract (i.e., a contract or scheme for "the placing of capital or laying out of money in a way intended to secure income or profit from its employment"), he proceeded to announce a different test.[83] In *Howey*, he wrote: "In other words, an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led

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the name alone carries well settled meaning. Others are of more variable character and were necessarily designated by more descriptive terms, such as . . . 'investment contract,' and 'in general any interest or instrument commonly known as a security.'" 3 BLOOMENTHAL, *supra* note 7, at 2.11 to .12 (quoting SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943)).

76. Gordon, *supra* note 5, at 637. The term "investment contract" originated in the state securities acts ("blue sky laws") enacted before the federal securities acts. The first state securities act was enacted by Kansas in 1911. The statutes are called "blue sky laws" because they were directed at speculative schemes which have no more basis than so many feet of blue sky. *Id.* at 637 n.14.

77. *Howey*, 328 U.S. at 298.

78. *Id.*

79. *Id.* at 298 (quoting State v. Gopher Tire & Rubber Co., 177 N.W. 937, 938 (Minn. 1920)).

80. *Id.*

81. *Id.*

82. *Gopher Tire & Rubber Co.*, 177 N.W. at 937.

83. Gordon, *supra* note 5, at 648.

to expect profits solely from the efforts of the promoter or a third party."[84]

However, none of the state cases relied on by Justice Murphy had announced the *Howey* test. Rather, the test appears to be the product of Justice Murphy's case synthesis.[85] Moreover, none of the state cases cited in *Howey* even used the term "common enterprise."[86] Consequently, the state cases cited in *Howey* offer little insight into Justice Murphy's meaning of the term "common enterprise."[87] Indeed, the state cases cited actually provide a strong argument against the requirement of horizontal commonality.[88] In six of the seven state cases, investment contracts were found and in three of those six, horizontal commonality was absent.[89]

Consequently, the Seventh Circuit's belief that a horizontal commonality requirement better comported with the purpose of the Securities Act of 1933 appears to be misguided. The court agreed that the 1933 Act is a disclosure statute, but it further reasoned that the disclosure requirement only makes sense if investors obtain the same thing, namely an undivided share in the same pool of assets and profits.[90] However, form of ownership of an enterprise and the manner of dividing profits are largely formal distinctions.[91] As explained by *Howey* in defining the term investment contract, the pre-1933 Act "blue sky" cases made clear that "[f]orm was disregarded for substance and emphasis was placed on economic reality."[92]

In *Wals*, the court rigidly adhered to the horizontal commonality test, requiring a pooling of profits.[93] In doing so, it focused on factors largely unrelated to the policy of the Securities Acts and effectively elevated form over substance.[94] The Seventh Circuit Court of Appeals in Wals should have followed the *Howey* command that "[t]he

84. *Howey*, 328 U.S. at 298-99.
85. Gordon, *supra* note 5, at 649.
86. Gordon, *supra* note 5, at 651. The state cases cited which used the terms "enterprise" and "common operation" are ambiguous. *Id.* at 651-52.
87. Gordon, *supra* note 5, at 652.
88. Gordon, *supra* note 5, at 652.
89. Gordon, *supra* note 5, at 652. Horizontal commonality was not present in Prohaska v. Hemmer-Miller Dev. Co., 256 Ill. App. 331 (1930); State v. Evans, 191 N.W. 425 (Minn. 1922); or Steven v. Liberty Packing Corp., 161 A. 193 (N.J. 1932). Horizontal commonality was present in Moore v. Stella, 127 P.2d 300 (Cal. Dist. Ct. App. 1942); People v. White, 12 P.2d 1078 (Cal. Dist. Ct. App. 1932); and State v. Gopher Tire & Rubber Co., 177 N.W. 937 (Minn. 1920).
90. Wals v. Fox Hills Dev. Corp., 24 F.3d 1016, 1019 (7th Cir. 1994).
91. Gordon, *supra* note 5, at 660-61.
92. Gordon, *supra* note 5, at 661 (quoting *Howey*, 328 U.S. at 298)).
93. *Wals*, 24 F.3d at 1019.
94. Gordon, *supra* note 5, at 662.

statutory policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae."[95]

2. Horizontal Commonality and *Howey*

In requiring horizontal commonality to satisfy the "common enterprise" prong of the *Howey* test, the Seventh Circuit read *Howey* to require that investors pool their investments and receive pro rata profits.[96] However, *Howey* is susceptible to an alternative reading.[97]

Recall that in *Howey* the seller offered investors tracts in a citrus grove along with an optional ten-year service contract under which the seller would jointly cultivate the groves and harvest and market the fruit.[98] Thus, the investments unquestionably involved vertical commonality.[99] However, horizontal commonality was not implicated in *Howey*, "because each investor individually owned a specific tract of land."[100] Indeed, in hearing *Howey*, the Fifth Circuit Court of Appeals noted that "[a]ll sales have been an out-right sale of a definitely identified tract of land."[101] When the Supreme Court considered *Howey*, it noted that the produce was pooled,[102] but it likely meant that produce was put together for marketing purposes.[103] However, that is not what is generally intended by the term "pooling" in the horizontal commonality test.[104]

Moreover, there was no pro rata sharing or pooling of profits in *Howey*.[105] The Supreme Court noted that "[t]he company is accountable only for an allocation of the net profits based upon a check made at the time of picking."[106] More persuasively, the Fifth Circuit Court of Appeals stated:

> In no instance has there been a sale of a right to share with others in the profits of land held in common with the defendant Companies or others. . . . In the care of each grove, as in the yield of the fruit, the cost of the care and the proceeds of the fruit may be, and are,

95. SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946).
96. *Wals*, 828 F. Supp. at 625.
97. Gordon, *supra* note 5, at 645; *see also*, Jerry C. Bonnett, *How Common Is a 'Common Enterprise'?*, 1974 ARIZ. ST. L.J. 339, 349-50.
98. *Howey*, 328 U.S. at 295-96.
99. Gordon, *supra* note 5, at 645.
100. Gordon, *supra* note 5, at 645.
101. SEC v. W.J. Howey Co., 151 F.2d 714, 716 n.5 (5th Cir. 1945), *rev'd*, 328 U.S. 293 (1946).
102. *Howey*, 328 U.S. at 296.
103. Gordon, *supra* note 5, at 645.
104. Gordon, *supra* note 5, at 645.
105. Gordon, *supra* note 5, at 645.
106. *Howey*, 328 U.S. at 296.

> definitely and distinctly accounted for with respect to the specific property owned by the individual.[107]

Thus, it appears clear that while the profits of the entire *Howey* enterprise were to be divided (based on the selling of the pooled produce), each individual investor's return was based on the production from his own specific tract of land.[108] Notwithstanding those facts, however, the Supreme Court in *Howey* found an investment contract. That makes it all the more surprising that some courts require a pro rata sharing of profits and find no common enterprise if each investor's return depends on the income from his own asset.[109]

C. *Wals* Revisited

Because the requirement of horizontal commonality appears unrelated to the purposes of the Securities Act[110] and the seminal case defining the term "investment contract" arguably did not involve horizontal commonality,[111] the Seventh Circuit Court of Appeals should recognize vertical commonality as satisfying the "common enterprise" prong of the *Howey* test. If vertical commonality were applied in *Wals*, the decision appears to be an easy one. As the Court of Appeals noted, referring to the supplemental rental agreement,

> the resulting division of rental income makes the developer and the condominium owner coventurers in a profit-making activity, imparting to the condominium interest itself the character of an investment for profit . . . those circuits that believe . . . only "vertical commonality" is required to create an investment contract would deem the combination of sale and rental agreement in this case an investment contract.[112]

In addition, simply comparing the facts in *Wals* to those in *Howey* strongly suggests that an investment contract should be found in the instant case. Like the investor's differentiated assets in *Howey*,[113] in

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107. SEC v. W.J. Howey Co., 151 F.2d 714, 715-16 n.5 (5th Cir. 1945). There was a real disparity in citrus production among the individual tracts of land since purchasers could buy tracts with trees of different maturities. SEC v. W.J. Howey Co., 60 F. Supp. 440, 441 (S.D. Fla.), *aff'd*, 151 F.2d 714 (5th Cir. 1945), *rev'd*, 328 U.S. 293 (1946). Indeed, of 51 sales involving 195.26 acres, eight of those sales were of non-bearing trees totaling 103.21 acres, and 43 were sales of bearing trees totaling 92.05 acres. *Howey*, 151 F.2d at 715-16 n.5.

108. Gordon, *supra* note 5, at 645. These independent returns were one reason the Fifth Circuit Court of Appeals found that *Howey* did not involve a security. *Id.* at 645-46.

109. Gordon, *supra* note 5, at 646.

110. See discussion *supra* part V.B.1.

111. See discussion *supra* part V.B.2.

112. *Wals*, 24 F.3d at 1017.

113. *See supra* notes 100-01 and accompanying text.

Wals, the plaintiffs' investment was in a specific time slice of a specific apartment whose physical and temporal characteristics (including price) differed from those of the other units.[114] Similarly, like the pooling of produce in *Howey*,[115] the pooling of weeks in *Wals*[116] does not satisfy the requirements of horizontal commonality.[117] Finally, like in *Howey* where there was no pro rata sharing or pooling of profits,[118] the investors in defendant's time-shares "did not receive an undivided share of some pool of rentals or profits. They received the rental on a single apartment . . . ."[119]

Moreover, in *Howey*, the citrus grove investment opportunity was offered to persons residing in distant localities, who lacked the necessary equipment and experience to cultivate, harvest, and market the produce.[120] The Court noted that such persons "have no desire to occupy the land or to develop it themselves; they are attracted solely by the prospects of a return on their investment."[121] Further, the Court observed that the individual tracts only gained utility as a citrus grove when developed and cultivated as components of a larger area.[122] Thus, the Court in *Howey* reasoned, "[a] common enterprise managed by respondents or third parties with adequate personnel and equipment is therefore essential if the investors are to achieve their paramount aim of a return on their investments."[123]

In *Wals*, the plaintiffs, for purposes of defendant's motion for summary judgment, were residents of a distant locality, living some 90 miles from the condominium project.[124] They were unsophisticated and inexperienced in the ownership and operation of income producing properties,[125] intended not to occupy the time-share,[126] and purchased the time-share as an investment, for the guaranteed rental

114. *Wals*, 24 F.3d at 1019.
115. *See supra* notes 102-04 and accompanying text.
116. *Wals*, 24 F.3d at 1019.
117. *Id.*
118. *See supra* notes 105-07 and accompanying text.
119. *Wals*, 24 F.3d at 1019. The court went on to say, "Their return was tied to another space-time slice with its own unique characteristics. Every week of every apartment was a different product." *Id.*
120. *Howey*, 328 U.S. at 299-300.
121. *Id.* at 300.
122. *Id.*
123. *Id.*
124. *Wals*, 828 F. Supp. at 624.
125. *Id.*
126. As evidenced by their participation in the "4-Share Rental Program." *Wals*, 24 F.3d at 1017.

income for 1990 and the prospect of similar receipts in future years.[127] Additionally, it is reasonable to argue that, like the tracts of land in the *Howey* citrus groves, the individual Fox Hills time-shares only gained utility as a recreational golf course condominium project[128] when marketed as part of a larger enterprise.

Thus, not only is the Seventh Circuit Court of Appeal's requirement of horizontal commonality misguided, viewed against the purposes of the federal securities acts, but its decision in *Wals* (so factually similar to *Howey*), exposes the Seventh Circuit's "form over substance" approach.

VI. CONCLUSION

The Court of Appeals' decision in *Wals* exposes again the significant split in the federal courts on the definition of a "common enterprise," and illustrates the need for the Supreme Court to take a definitive position. The court in *Wals* required horizontal commonality to satisfy the "common enterprise" prong of the *Howey* test. However, the horizontal commonality requirement does not harmonize well with the remedial purposes of the federal securities laws or *Howey*. The federal securities acts defined the term "security" broadly to afford the widest possible protection to the investing public. In seeking to fulfill the remedial purposes of the federal securities laws, *Howey* declined to adopt a rigid formula, instead setting out a flexible approach. As the result in *Wals* illustrates, the horizontal commonality requirement is entirely too rigid and ultimately elevates form over substance.

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127. *Wals*, 828 F. Supp. at 624.

128. *Wals*, 24 F.3d at 1017. Also, recall the deposition of the Fox Hills General Manager who spoke of "conventions, and whatever else" and "bookings," which connotes the need for a large scale, sophisticated marketing effort. Something quite arguably beyond the abilities of individual time-share investors like the Wals. *See supra* note 21.