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Approaches to the Regulation of Franchises, Founder-Member Contracts, and Referral Sales Agreements Student Symposium - Interpreting the Statutory Definition of a Security: Some Pragmatic Considerations.

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APPROACHES TO THE REGULATION OF FRANCHISES, FOUNDER-MEMBER CONTRACTS, AND REFERRAL SALES AGREEMENTS

Judicial consideration of franchises, founder-member contracts, and referral sales agreements as securities represent the change and uncertainty in the expanding field of securities regulation. The purpose of the securities laws is to provide disclosure and protect the investor, and since each of these methods of securing capital possess inherent dangers which may grievously affect the unwary investor, each should be the subject of regulation in proper instances.

THE NEED FOR REGULATION

One of the most common means of expanding a retail business or of securing the proprietorship of a business is accomplished through the sale or purchase of a franchise. Franchising provides businessmen the opportunity to enlarge the number of outlets for his product in a controlled environment without the frustration involved in competing with similar products in the same retail store. The scheme also allows individuals with limited capital resources to become owners of small but high-volume businesses.[1]

Franchise marketing operations are also quite susceptible to abuse in that a high pressure or emotional sales pitch is often used in making appeals to unsophisticated investors in the lower and middle income groups, those investors most likely to fall prey to false representations and half-truths.[2] Further problems result from the failure of the fanchisor to deliver the business within a reasonable time after the investor has purchased it and from imposition by the franchisor of unreasonable termination provisions.[3] In light of the phenomenal growth of franchise sales and the attendant expansion of problems, effective regulation is needed.[4]

The marketing of founder-member contracts[5] and its often less complex

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1. *See* Comment, *Franchise Sales: Are They Sales of Securities?* 34 ALBANY L. REV. 383 (1970).

2. *See* Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135, 136 (1971).

3. The first abuses to receive narrow legislative attention were unjust termination provisions, which led to the passing of the Automobile Dealer Franchise Act in 1956. 15 U.S.C. §§ 1221-33 (1970). Several states have enacted similar statutes.

4. In 1969 it was reported that franchise operators enjoyed an annual $90 billion business, accounting for 10 percent of the total United States output of business services and a remarkable 28 percent of retail sales. Time, April 18, 1969, at 88.

5. The typical founder-member contract involves a situation where an "organizer,"

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counterpart, referral sales agreements,[6] also requires regulation due to the considerable potential for fraud, misrepresentation and eventual economic failure.[7] In founder-member schemes for example, the need is obvious, since once the new founder-member distributes his authorized buyers cards to a group of individuals, the plan allows those persons, as well as other recruits, to undertake to become "distributors" in a similar fashion. As there is invariably a limit on the number offered,[8] eventually the number of distributorships is exhausted, leaving those participants induced to contribute at late stages little opportunity to recruit other persons. The latecomer must thus resign himself to accept his poor investment. Additional abuses are evident and frequently reveal themselves. If the organizer sells a $70 product to the 5,000 founder-members for $320 paying an average $60 commission to the founder-members, the corporation realizes an immediate gain of almost one million dollars. There is often no guarantee that a store will indeed be opened or that a particular type of merchandise will be sold, and further, the founder-member is typically without a voice in corporate activities. Obviously, the shady promoter has considerable opportunity for exploitation of the unwary under this financing scheme.

The troublesome aspects of the simpler referral agreement are equally manifest. The investor may be required to purchase an article worth only $300 for $700 because he is led to believe that he may easily secure a $100 commission for each buying customer he refers to the merchant. Since few investors actually locate prospective purchasers of the merchant's prod-

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at recruitment meetings entreats individuals to buy a product from the organizer-merchant at a highly inflated price. This purchase gives the buyer or new founder-member a chance to gain a specific fee or share of the corporation's profits on all purchases made at the *proposed* corporate outlet by persons to whom the new "distributor" has distributed authorized buyers cards. The dispersal of these buyers cards is the extent of the typical founder-member's efforts in the business, unless he desires to go on to the stage of a supervisor. As a supervisor, the founder-member is required to make a more expensive initial purchase, but in reality he need not invest much more time or effort. The corporation is usually not to be set up until sufficient founder-members capital has been solicited.

For a description of a typical-member purchasing contract see State Comm'r of Sec. v. Hawaii Mkt. Center, Inc., 485 P.2d 105, 106-07 (Hawaii 1971).

6. The simple referral agreement contract typically provides that the investor purchase an item from a merchant at an inflated price. Under the contract the merchant agrees to compensate the investor for promoting the sale of his goods and referring customers to him by paying the investor either a share of the profits or a specific fee per referral.

For an example of a typical referral agreement, see Emery v. So-Soft of Ohio, Inc., 199 N.E.2d 120, 121 (Ohio Ct. App. 1964).

7. The SEC has stated that the pyramid sales promotions often employed in connection with the sale of franchises and founder-member contracts may be inherently fraudulent. *See* Securities Act Release No. 5211 (November 30, 1971); Securities Exchange Act Release No. 9387 (November 30, 1971).

8. A typical limit is 3000 to 5000 members.

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uct, a significant number of investors are left with a substantial loss.[9] The potential for misrepresentation and the perpetration of fraud upon unknowledgeable investors can be readily ascertained.

Regulation of these marketing schemes has been attempted through the use of securities laws at both the federal and state levels, as is evidenced by the Securities Act of 1933, the Securities Exchange Act of 1934, and the appropriate state Blue Sky laws. Within each of these legislative enactments is a detailed, but purposefully broad, definition as to what constitutes a security.[10] Generally, franchises, founder-member contracts, and referral agreements are sought to be classified under the catch-all term of "investment contracts"[11] contained within most state laws as well as in the federal acts. Consequently, the forthcoming analysis will consider these three types of financing schemes together in determining whether they should be treated as securities because the courts have so ordained them by terming the plans to be "investment contracts."[12] The effect of classifying these schemes as investment contracts is to require the promoter to com-

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9. *See, e.g.*, Emery v. So-Soft of Ohio, Inc., 199 N.E.2d 120 (Ohio Ct. App. 1964).

10. The Securities Act of 1933 defines a security as

> [A]ny note, stock, treasury stock . . . evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, . . . *investment contract* . . . or, in general, any interest or instrument commonly known as a 'security' . . . .

15 U.S.C. § 77b(1) (1970) (emphasis added). The definition is substantially similar in the Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(10) (1970) and in the Uniform Securities Act § 401(1), 1 CCH BLUE SKY L. REP. ¶ 4931 (1958).

It was the express intention of Congress to define the term "security" in sufficiently broad and general terms so as to include within that definition the many types of transactions that fall within the ordinary concept of a security. *See* H.R. REP. No. 85, 73d Cong., 1st Sess. 11 (1933).

11. The term "investment contract" appears in at least 30 state statutes. 1 L. LOSS, SECURITIES REGULATION 483 n.77 (2d ed. 1961).

12. At times these three types of arrangements have been held to be securities under the definition of a security as "certificates of interest or participation in a profit-sharing agreement," but generally the investment contract classification is relied upon. For general information and case discussion of the investment contract area see Annot., 47 A.L.R.3d 1375 (1973); Annot., 3 A.L.R. Fed. 592 (1970); Annot., 163 A.L.R. 1050 (1946); 69 AM. JUR.2d *Securities Regulation—Federal* § 26, at 611 (1973); 69 AM. JUR. 2d *Securities Regulation—State* § 27, at 1089 (1973).

The landmark case considering the term investment contract prior to the Securities Act of 1933 was State v. Gopher Tire & Rubber Co., 177 N.W. 937 (Minn. 1920), from which came the definition quoted by Justice Murphy in SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946) that an investment contract is a scheme for "[t]he placing of capital or laying out of money in a way intended to secure income or profit from its employment." *Id.* at 938. The *Gopher* case interpreted the Minnesota Blue Sky Law which was the first statute to use the phrase "investment contract" in the definition of a security.

See Moore v. Stella, 127 P.2d 300 (Cal. Dist. Ct. App. 1942); McElfresh v. State, 9 So. 2d 277 (Fla. 1942); Lewis v. Creasey Corp., 248 S.W. 1046 (Ky. 1923). *See generally* 1 L. LOSS, SECURITIES REGULATION 489-94 (2d ed. 1961).

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ply with all the applicable provisions of the securities laws, to fulfill the established registration requirements and further, to be liable for fraud or deceptive practices within the meaning of the statutory enactments. The intent or purpose of the securities laws, which is to protect the unknowledgeable investor and provide for full and fair disclosure, is satisfied *if* the courts, in proper instances, construe these franchise, founder-member and referral sales plans as constituting investment contracts and thus subject to securities regulations.[13]

DEVELOPMENT OF THE INVESTMENT CONTRACT CRITERION

The lack of regulation of these three types of financing devices as securities can be directly traced to the failure of the concept embodied in the term "investment contract" to keep pace with the continually varying methods by which promoters seek to acquire capital. Generally stated, the problem is one of philosophical perspective. Securities laws have always been viewed as remedial and paternalistic in nature and thus should be liberally interpreted and applied.[14] Therefore, if these three types of financing arrangements are to be regulated in order to effectuate fully the purposes of the securities laws, they must be viewed as coming within the purview of the securities acts by means of a flexible, adaptive application of the investment contract label, as opposed to a rigid, judicially fixed interpretation of that term.

The present status of the term "investment contract" has evolved from what has been called an "unfortunate decision" of the United States Supreme Court.[15] This decision, *SEC v. W.J. Howey Co.*,[16] enunciated the test as to what constitutes an investment contract. Basically, the *Howey* test of an investment contract requires that the contract, transaction, or scheme contain three elements: (1) the investment of money (2) in a com-

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13. There are actually two types of securities acts relative to purpose. The first is the "fair, just and equitable" type which gives the person administering the statute, power to refuse registration if he feels the offering is not a fair or just investment opportunity. *See, e.g.*, TEX. REV. CIV. STAT. ANN. art. 581 (1964) (Texas Securities Act). The second is the full disclosure type, directed at providing investors with the necessary information needed to make an intelligent decision. The Securities Act of 1933 is an example of this type. *See* 15 U.S.C. § 77a (1970); *see, e.g.*, Llanos v. United States, 206 F.2d 852 (9th Cir. 1953), *cert. denied*, 346 U.S. 923 (1954); United States v. Monjar, 47 F. Supp. 421, 427 (D. Del. 1942), *aff'd*, 147 F.2d 916 (3d Cir. 1944); *cert. denied*, 325 U.S. 859 (1945).

14. Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135, 139 (1971); *see* Llanos v. United States, 206 F.2d 852 (9th Cir. 1953), *cert. denied*, 346 U.S. 923 (1954); Newman v. Weinstein, 229 F. Supp. 440 (S.D. Ill. 1964).

15. Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135, 139 (1971).

16. 328 U.S. 293 (1946).

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mon enterprise (3) with the expectation of profits solely through the efforts of others.[17] Legal scholars,[18] and a number of courts, have often rejected the time-entrenched *Howey* test as being too rigid and unrealistic to cope with the ever-increasing emergence of novel financing schemes.[19] The crucial question thus becomes whether the *Howey* test when proposed was intended to be applied in a strict and inflexible manner, as a number of courts have so construed it, or if it was meant to serve as a much needed adaptable guideline. To answer this question it is necessary to examine the *Howey* test of an investment contract in its proper philosophical setting.

Prior to *Howey*, the first major Supreme Court attempt to define an investment contract under the 1933 Securities Act appeared in *SEC v. C.M. Joiner Leasing Corp.*[20] In concluding that an offer to sell oil and gas leases was an investment contract, the Court stated that in attempting to determine whether such investments are securities "[t]he 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."[21] Thus, the Court in *Howey* had this broad mandate in *Joiner* to draw upon in reaching its conclusion. Of even greater importance, however, is the philosophy expressed in *Joiner* and subsequently endorsed in *Howey*. In *Joiner* it was urged that the leases were not securities because the definition of a security in the Securities Act of 1933 fell short of including them.[22] As explained by the Court:

> [T]he reach of the Act does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as a matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as "investment contracts," or as "any interest or instrument commonly known as a 'security.' "[23]

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17. *Id.* at 298-99; 1 L. LOSS, SECURITIES REGULATION 486 (2d ed. 1961).

18. *See* Coffey, *The Economic Realities of A "Security": Is There a More Meaningful Formula?* 18 CASE W. RES. L. REV. 367, 377 (1967) (the author therein proposed a definition of a security which has been adopted by the Hawaii courts in State Comm'r of Sec. v. Hawaii Mkt. Center, Inc., 485 P.2d 105, 109 (Hawaii 1971)); Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135, 173-74 (1971). Both the above articles contain excellent analyses of the weaknesses inherent in the *Howey* test.

19. *See, e.g.*, State Comm'r of Sec. v. Hawaii Mkt. Center, Inc., 485 P.2d 105 (Hawaii 1971); Silver Hills Country Club v. Sobieski, 13 Cal. Rptr. 186 (1961).

20. 320 U.S. 344 (1943).

21. *Id.* at 352-53.

22. In *Joiner* the Court rejected the "respondent's invitation to constrict the more general terms substantially to the specific terms which they follow" by the principle of *ejusdem generis*. *Id.* at 350.

23. *Id.* at 351. Further, the Court stated that it would be necessary in any case to prove the documents being sold were securities in order to gain relief. In some cases this may be done by proving the document itself. In others, proof need go *outside* the instrument as was done here. *Id.* at 355. This reveals that even prior to *Howey* the

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These statements from *Joiner* reveal that the Supreme Court significantly committed itself to a liberal construction of the definition of a security, arguing that this perspective was necessary in order to carry out express legislative purpose and intent.[24]

Three years later the flexible outlook favored in *Joiner* was incorporated into the *Howey* test of an investment contract. Criticism of the *Howey* test is not unfounded, but it is submitted that the *Howey* formula[25] has seldom been viewed in the proper light. Through numerous statements, the Court in *Howey* evidenced its acceptance of a flexible approach to investment contract analysis. In determining that an offering of units in a citrus grove development coupled with a contract for cultivating, marketing, and remittance of the proceeds to the investor composed an investment contract, the Court in *Howey* indicated the term 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 to use the money of others on the promise of profits."[26] Thus, the three-pronged test of an investment contract as delineated in *Howey* should be applied in light of its stated flexible background.[27] In concluding the opinion, Mr. Justice Murphy further revealed the Court's intent not to strictly construe the securities laws: "The statutory policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae."[28] Thus, the Supreme Court has expressly ratified an expansive concept of a security by maintaining that "[f]orm [is] . . . disregarded for substance and emphasis [is] . . . placed upon economic reality."[29] A more recent reiterative example of the Supreme Court's intention to construe the securities laws broadly to fully effectuate their purposes is *Tcherepnin v. Knight*.[30] The

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Court would not allow slight deviations from statutory rules to lead to avoidance of security classification. The same holds true of judicial rules.

24. *Id.* at 351.

25. The *Howey* formula has been interpreted to apply to a great variety of transactions and schemes, under both state and federal statutes. *See* 1 L. LOSS, SECURITIES REGULATION 483-511 (2d ed. 1961).

26. SEC v. W.J. Howey Co., 328 U.S. 293, 299 (1946).

27. Though it may be argued that *Howey* could have been decided without positing any new formulary tests by basing the decision on prior federal and state precedent, the point seems moot.

28. SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946). Some persons have concluded that this statement is ironic in light of future developments where courts reached unrealistic results through a strict application of the *Howey* test.

29. *Id.* at 298. The phrase economic reality should be remembered as its significance will be revealed in discussing the radical approach adopted by some courts relative to defining investment contracts.

Substance over form was the rule of the day even in earlier decisions. *See* Penfield Co. v. SEC, 143 F.2d 746, 751 (9th Cir. 1944); SEC v. Crude Oil Corp., 93 F.2d 844, 848 (7th Cir. 1937); SEC v. Wickham, 12 F. Supp. 245, 247 (D. Minn. 1935).

30. 389 U.S. 332 (1967). This case presented the Court with its first opportunity to construe the definition of a security as set out in the Security Exchange Act of 1934. *Id.* at 335.

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Court in that case held withdrawable capital shares in a savings and loan association to be securities[31] after expressing reliance upon the *Joiner* and *Howey* flexible philosophies.[32] This *Joiner-Howey-Tcherepnin* overview clearly emphasizes the Supreme Court's insistence that securities acts be interpreted liberally and pliantly.[33] The purpose of these statutes will be violated if they are construed to apply only to familiar and conventional transactions and are not held capable of adaptation to the novel and irregular schemes covered by the intent of the statute and the decisions elucidating them.[34]

Many recent decisions indicate a number of courts have failed to view the *Howey* test within its proper framework. The *Howey* formula actually is composed of two parts: one is the expressed three-pronged test of an investment contract and the other is the expressly liberal philosophy requiring recognition of elements other than merely those acknowledged in the test. If both aspects of the test are simultaneously considered, many of the problems which emerge from a rigid and mechanistic application of the *Howey* formula may be avoided.

SUBSEQUENT JUDICIAL APPLICATION OF THE INVESTMENT CONTRACT CRITERION

In determining the existence or non-existence of an investment contract, there have developed three distinct approaches[35] to investment contract analysis; there is also discernible in recent cases an extension of one of these approaches. First, there are those decisions which pay strict homage to the letter of *Howey*. Second, there is the more radical view adopted by those courts wishing to reject or at least substantially alter *Howey*. Third, there is the line of cases which seek to apply an expansive and workable *Howey* test in a flexible manner without the necessity of formulating "new" tests which may later result in problems similar to those inherent in the strict *Howey* test. From this latter approach an extension has recently emerged and this "flexible composite" approach has gained encouraging support.

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31. Tcherepnin v. Knight, 389 U.S. 332, 340, 345 (1967).

32. The Court here mentioned the *Howey* principle that form should be disregarded for substance. *Id.* at 336. Further, it relied on the liberal outlook professed in *Joiner* in quoting its pertinent statements. *Id.* at 338.

33. Of course states have the right to develop their own law in cases where, for example, founder-member contracts are not sold nor solicited in interstate commerce. *See* 15 U.S.C. §§ 77c(a)(11), 77(r) (1970). But the *Howey* test has been used, relied upon, mentioned or rejected in almost every state case that considered the existence of an investment contract. Consequently, this analysis will be appropriate for state courts as well as for their federal counterparts.

34. SEC v. Glenn W. Turner Enterprises, Inc., 348 F. Supp. 766, 771 (D. Ore. 1972), *aff'd*, 474 F.2d 476 (9th Cir.), *cert. denied*, — U.S. —, 94 S. Ct. 117, 38 L. Ed. 2d 53 (1973).

35. For a brief discussion of this trend see Note, 51 TEXAS L. REV. 788, 794-99 (1973).

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Strict Application

In the first category are franchise and pyramid sales cases in which the courts strictly applied the *Howey* investment contract test without regard to the expressed intent of that decision. In *Chapman v. Rudd Paint & Varnish Co.*[36] the Court of Appeals for the Ninth Circuit held a distributorship agreement standing alone was not an investment contract because the agreement neither expressly, nor by implication, provided that the plaintiff would obtain profits *solely* from the efforts of others as required by *Howey*.[37] The court fully discussed the active role the investor-plaintiff was required to play in order for his investment to reap any profit.[38] The "background facts"[39] were also examined in determining whether the transaction was an investment contract, but the question was still resolved negatively, the court failing to note the expressed adaptive nature of the *Howey* formula in its superficial application of the test.

In a suit by a franchisor for amounts due under the terms of a franchise contract, the Court of Appeals for the Tenth Circuit in *Mr. Steak, Inc. v. River City Steak, Inc.*,[40] held the franchise which the defendant had purchased was not a security and rejected the defendant-franchisee's counterclaim for rescission.[41] When the defendant's franchise failed, he breached the franchise, sublease, and equipment lease agreements. The defendant revealed that although the franchisor did not direct the daily operations of the business, he had substantial control of the enterprise.[42] In refusing to find the existence of a security, the court remarked that the franchise had both experience and control and cited *Chapman* in support of their conclusion.[43] The court remarked that "[t]o characterize the contracts which cre-

36. 409 F.2d 635 (9th Cir. 1969).

37. *Id.* at 640. The plaintiff was to receive an exclusive distributorship for two states on a product designed to protect runs in nylon hose. For a more recent franchise decision in accord with *Chapman* see Wieboldt v. Metz, 355 F. Supp. 255, 258 (S.D.N.Y. 1973).

38. Chapman v. Rudd Paint & Varnish Co., 409 F.2d 635, 640-41 (9th Cir. 1969). The court stated that the very fact that the brochure offered by the promoter to investors to read which explained the investment as being one in which the company provided substantial assistance, implied that the distributor-investor was also to contribute an effort. *Id.* at 641. This reasoning seems weak since nowhere in the opinion is the extent or nature of the efforts required suggested.

39. The court believed it was also necessary to consider the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect as encompassing background facts.

40. 460 F.2d 666 (10th Cir. 1972).

41. *Id.* at 670-71.

42. The contract allowed the franchisee to select a manager, but provided that the franchisor could do so if the franchisee failed to act. The manager's salary was specified, and he was required to invest in Mr. Steak stock. The franchisor could fire the manager and supervise his activities, and further the franchisor controlled the accounts and inventory. *Id.* at 669.

43. *Id.* at 670.

ate this relationship as a security would work an unwarranted extension of the Securities Act of 1933,"[44] thereby stipulating as "unwarranted" the very extension *Howey* invited.

Five years earlier in *Continental Marketing Corp. v. SEC*,[45] the Court of Appeals for the Tenth Circuit had held a promoter's sale of live beavers at an inflated price to investors who left their animals in the promoter's control to be the sale of securities.[46] Further, the court quoted the liberal *Joiner* philosophy and proclaimed that a court must look beyond the mere formal appearance of these agreements and accept substance over form, by viewing the nature of the investor's participation and by emphasizing the "economic realities" as required by *Howey*.[47] In this case the court correctly administered the *Howey* mandate by applying "a flexibile rather than a static principle . . . ."[48]

In *SEC v. Koscot Interplanetary, Inc.*,[49] the Federal District Court for the Northern District of Georgia considered a distributorship agreement involving the sale of cosmetics. Under the investment scheme presented therein, an investor became a "distributor" by paying Koscot a fee which gave the investor the opportunity to make money by marketing cosmetics *or* by locating and recruiting other distributors for Koscot. In failing to find the existence of an investment contract, the court declined to follow the position adopted by the Court of Appeals for the Ninth Circuit or the risk capital approach.[50] The court cautiously stated:

> [T]he Court of Appeals for this Circuit, as well as the Supreme Court, has repeatedly stated the "solely" test as the standard for an investment contract. This district court sees no freedom to coin a new, different and more expansive standard in light of these binding higher court decisions.[51]

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44. *Id.* at 670. The court rejected the application of the risk capital approach due to the facts of the case. *Id.* at 670-71. The district court in this case felt the better view would be to limit the 1933 Act to situations where exceptionally high-risk, speculative franchises were involved. Mr. Steak, Inc. v. River City Steak, Inc., [1961-1971 Transfer Binder] CCH BLUE SKY L. REP. ¶ 70,882 at 67,016 (D. Colo. September 30, 1970). *See also* Beefy Trail, Inc. v. Beefy King Int'l, Inc., 348 F. Supp. 799 (M.D. Fla. 1972).

45. 387 F.2d 466 (10th Cir. 1967), *cert. deniea*, 391 U.S. 905 (1968). This case is placed here in order to reveal the Tenth Circuit's prior, differing application of the *Howey* philosophy.

46. *Id.* at 471.

47. *Id.* at 469-70. It was quite easy for the court to state that the crucial inquiry was the quality of investor participation when, in fact, his participation was well inside the literal *Howey* boundaries.

48. *Id.* at 471, *quoting* SEC v. W.J. Howey Co., 328 U.S. 293, 299 (1946).

49. 365 F. Supp. 588 (N.D. Ga. 1973).

50. The risk capital concept will be discussed in the next section of this paper. The precise meaning is unsettled but presently it involves almost any situation where a person invests his money with the hope of some return in an enterprise over which he has no significant control. *See* Silver Hills Country Club v. Sobieski, 13 Cal. Rptr. 186 (1961).

51. SEC v. Koscot Interplanetary, Inc., 365 F. Supp. 588, 592 (N.D. Ga. 1973).

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Ironcially, in view of this statement, the court had earlier in the decision stressed the *Joiner-Howey-Tcherepnin* philosophies as guidelines.[52] Nevertheless, in finding that no investment contract existed under the facts presented, the court not only relied on the unfulfilled "solely" requirement but also stated that the distributor was promised not profits, as strictly ordered by *Howey*, but rather a fixed fee which took the arrangement outside the scope of *Howey*.[53]

Thereafter, a Georgia Court of Appeals decision of *Carlton Brown v. Computer Credit System, Inc.*,[54] held that an individual who entered into a "master franchise agreement" with a right to sell memberships in a company's computerized credit card business in a territory exclusively assigned to him did not enter into an investment contract.[55] The court relied on *Howey* and *Georgia Market Centers, Inc. v. Fortson*[56] in holding that this franchise agreement was not an investment contract. The court announced that the "solely" condition of *Howey* was not met and that although the *Howey* or the *Fortson* tests were not sufficient to meet the flood of franchise systems being sold across the United States, those tests were still controlling.[57] The Georgia Supreme Court in *Fortson* considered the typical founder-member financing scheme and held the plan did not compose a security.[58] In arriving at this decision the Georgia court relied on both *Howey* and the Alabama Supreme Court decision in *Gallion v. Alabama Market*

52. *Id.* at 590-91.

53. *Id.* at 590-91. The court recognized that other courts had held this and similar plans to be securities. In accord with this decision is Koscot Interplanetary, Inc. v. King, 452 S.W.2d 531 (Tex. Civ. App.—Austin 1970, writ ref'd n.r.e.). In *King*, the court seemed to accept the argument of Koscot that the sale of these distributorships was not the sale of securities because the investor and promoter were not engaged in a common enterprise as *Howey* strictly required since the distributor here ran a business legally separate from the parent corporation. *Id.* at 538-39.

In Bruner v. State, 463 S.W.2d 205 (Tex. Crim. App. 1970), the Texas Court of Criminal Appeals was faced with a fact situation nearly identical to *King* and was required to determine if the pyramid scheme was an investment contract within the scope of a criminal proceeding. The court adopted the "solely" test and held no investment contract existed. It was stated, however, that *Howey* was to be interpreted as offering a workable guideline and that mere token participation by the investor would not defeat recognition of an investment contract. *Id.* at 211-13. It is relevant that the Texas Securities Act is viewed as penal in nature and thus is strictly construed. *Id.* at 215; *accord*, State v. Allen, 5 S.E.2d 844, 846 (N.C. 1939); State v. Heath, 153 S.E. 855, 857 (N.C. 1930).

54. 3 CCH BLUE SKY L. REP. ¶ 71,061 (Ga. Ct. App. March 7, 1973).

55. *Id.* at 67,302.

56. 171 S.E.2d 620 (Ga. 1969). The problems caused by these Georgia Market Center cases have been practically resolved by an amendment to the securities definition. *See* GA. CODE ANN. § 97-102(16) (Supp. 1973).

57. Carlton Brown v. Computer Credit Sys., Inc., 3 CCH BLUE SKY L. REP. ¶ 71,061, at 67,302 (Ga. Ct. App. March 7, 1973).

58. Georgia Mkt. Centers, Inc. v. Fortson, 171 S.E.2d 620, 623-24 (Ga. 1969); *cf.*, Goldsmith v. American Food Servs., Inc., [1961-1971 Transfer Binder] 3 CCH BLUE SKY L. REP. ¶ 70,899 (Ga. Ct. App. February 19, 1971) (franchising situation).

Centers, Inc.,[59] which involved one of the appellant-defendants in the *Fortson* decision and the identical *Fortson* fact situation. The Georgia Supreme Court further stated that the *Howey* formula was "workable" and agreed with the philosophy expounded in *Howey* of disregarding form for substance and viewing liberally the economic realities.[60] The court nevertheless determined that the investor could realize no return except in connection with his own efforts and therefore the financing scheme was held not to be an investment contract.[61] The very similar *Gallion* decision in Alabama rested upon the *Howey* formula which the court said precluded the finding of a security in a founder-member scheme since the commissions which the investor received were to be acquired through his own efforts and not solely upon the efforts of others as *Howey* required.[62] Rather than finding the existence of a security, the court, interestingly enough, found "that what is involved here is a unique merchandising method."[63] In reaching this determination, the Alabama Supreme Court believed the case most equivalent to *Gallion* was *Emery v. So-Soft of Ohio, Inc.*[64] In *Emery*, a referral sales case, the buyer of a water conditioner sought to have the purchase contract declared void. The plaintiff bought the $300 water conditioner from the defendant for $648 and under the same contract the defendant agreed to pay $100 for each prospective purchaser's name submitted to him by the plaintiff which resulted in a final sale. The court held this agreement to be merely an offer for a unilateral contract on the part of the seller and thus not a security.[65] The Ohio court stated that the distinguishing feature between a referral sales agreement and a security was that any profit or return to a party based on the referral agreement in question must have

59. 213 So. 2d 841 (Ala. 1968).

60. Georgia Mkt. Centers, Inc. v. Fortson, 171 S.E.2d 620, 623 (Ga. 1969).

61. *Id.* at 623-24. The court stated that it would not adhere to the definition with such strictness that mere token participation by the investor would prevent the contract from being classified as a security. *Id.* at 623.

62. Gallion v. Alabama Mkt. Centers, Inc., 213 So. 2d 841, 845 (Ala. 1968). As stated before, the states are not pre-empted from regulating offers of securities made within their borders. They may impose standards entirely different from those applied by the SEC. See 15 U.S.C. § 77(r) (1970). But, since most of the state statutes have definitions of a security almost identical to that set out in the *United States Code* and further, since most states have not yet adopted specific formulas by which to determine if a security indeed exists, the states courts rely heavily on *Howey* and other federal precedent as well as on state decisions. Hawaii has, however, adopted its own formula for determining the existence of an investment contract. *See* State Comm'r of Sec. v. Hawaii Mkt. Center, Inc., 485 P.2d 105, 109 (Hawaii 1971).

Generally, state courts were careful to avoid rigid definitions of the term, security, recognizing that delineation would invite circumspection by ingenious promoters. State v. Gopher Tire & Rubber Co., 177 N.W. 937, 938 (Minn. 1920); Stevens v. Liberty Packing Corp., 161 A. 193, 195 (N.J. Ch. 1932); State v. Whiteaker, 247 P. 1077, 1079 (Ore. 1926).

63. Gallion v. Alabama Mkt. Centers, Inc., 213 So. 2d 841, 846 (Ala. 1968).

64. 199 N.E.2d 120 (Ohio Ct. App. 1964).

65. *Id.* at 125.

resulted from the personal efforts of the party receiving the return.[66]

The courts in *Fortson, Gallion*, and *Emery*, among others, have refused to find the existence of an investment contract simply because the profits were not to be made solely through the efforts of others as *Howey* strictly required.[67] One authority has remarked that "[t]hese courts have failed to distinguish between labor performed as a prerequisite to entitlement to receive the return on the investment (a partial investment by labor rather than money) and labor *performed in the generation of the actual return to be paid*."[68] In the founder-member cases, the labor of passing out the cards is a part of the investors' investment, and totally unrelated to the generation of the fund from which he is to be paid, since that aspect is exclusively in the hands of the cardholders and the company personnel who sell to them.[69] Courts faced with such facts have frequently quoted the flexible pronouncements of *Howey* while applying the test with blind disregard of their full meaning. In neglecting to conform to the intent of the *Howey* decision, these courts have held that mere physical or managerial participation by the investor, in the creation of a fund from which he is to receive payments for the use of his capital, removes the transaction from the investment contract category and thus from a security classification.[70] The fact that an indiviudal incidentally performs labor which helps to generate the fund from which payments of his capital are made should not be controlling but merely incidental.[71] Courts should not create fixed and arbitrary definitions of investment contracts, nor should they class the *Howey* test as rigidly unyielding. The term "solely" should not be interpreted as a strict, literal limitation on the definition of an investment contract but should be construed realistically, in light of the expressed intent of *Howey*, so as to include within the definition those schemes which involve in substance, if not in form, securities.[72] As one court succinctly pointed out: "It is by no means clear that the Supreme Court intended its three-pronged definition of an investment contract to be a litmus test which must be ap-

66. *Id.* at 125.

67. A case involving a referral sales situation similar to *Emery* is Pennsylvania Sec. Comm'n v. Consumers Research Consultants, Inc., 199 A.2d 428 (Pa. 1964). The court "reluctantly" held that the defendant's activities were not subject to securities regulation because the investor "is not promised a share in the profits of the seller but is given a *specific fee, regardless of profits, for his individual promotional efforts.*" *Id.* at 429 (court's emphasis).

68. Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135, 162 (1971) (author's emphasis).

69. *Id.* at 162.

70. *Id.* at 147.

71. *Id.* at 154-55. Professor Long in his article is not arguing this point but instead is criticizing the *Howey* test, not the courts, for its failure to cope with these novel situations.

72. Securities Act Release No. 5347 (January 4, 1973). The Securities Exchange Commission has expressed its intention to construe "solely" liberally.

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plied literally and strictly."[73] It should be evident that the very purpose of the securities statutes are violated by courts holding the *Howey* test applicable only to familiar and conventional transactions and not capable of adaptation to novel and irregular schemes covered by both the intent and phraseology of the statutes.[74] This rigid outlook has resulted in a reluctance on the part of many courts to abandon a fixed defintion when there is an obvious need for an expandable perspective in order to protect the public against the numerous and novel schemes which incessantly arise.

Rejection of the Howey Test

Because of the failure of the strict approach to adequately cope with the burgeoning growth of questionable financing schemes, a few courts have decided that the *Howey* test must be rejected and replaced with a new more all-encompassing formula. The seminal case representing this approach was the California Supreme Court decision of *Silver Hills Country Club v. Sobieski.*[75] In deciding that the sale of memberships to a proposed country club, though not entered into with the expectation of profits,[76] was the sale of securities, the court enunciated what has been termed the "risk capital" concept.[77] This approach recognizes that the subjection of an investor's money to the risks of an enterprise over which he exercises no managerial control is the basic economic reality of a security transaction. Two significant developments arose from this case: first, the "profit" motive was de-

73. SEC v. Glenn W. Turner Enterprises, Inc., 348 F. Supp. 766, 774 (D. Ore. 1972), *aff'd*, 474 F.2d 476 (9th Cir.), *cert. denied*, —U.S.—, 94 S. Ct. 117, 38 L. Ed. 2d 53 (1973).

74. *Id.* at 771.

75. 13 Cal. Rptr. 186 (1961). The defendants purchased a 22-acre ranch and intended to place a country club on the property. Various improvements were made, such as installing a swimming pool, steam room, and golf course, which were financed by the sale of memberships from $150 to $450. The investors had the right to use the facilities but no rights to the income or assets of the club.

76. Until *Silver Hills*, with the exception of Davenport v. United States, 260 F.2d 591 (9th Cir. 1958), every state and federal case which considered whether a membership or interest in property constituted a security, found either an expectation of a profit to the investor, or evidence of indebtedness.

77. It has been maintained that the risk capital concept had its origin much earlier than the *Silver Hills* case. *See* Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation,* 24 OKLA. L. REV. 135, 169 (1971) wherein it is stated that both the State v. Gopher Tire & Rubber Co., 177 N.W. 937 (Minn. 1920) and Brownie Oil Co. v. Railroad Comm'n, 240 N.W. 827 (Wis. 1932) decisions contained language indicative of the risk capital approach. Further, the court in the *Silver Hills* case never clearly defined risk capital. For Justice Traynor's general statement as to the meaning of the term risk capital see Silver Hills Country Club v. Sobieski, 13 Cal. Rptr. 186, 188-89 (1961). Basically, the risk capital concept requires any scheme to be viewed as composing two parts. For example, the franchised business operated by the franchisee and the franchisor's business of supplying the franchisee are separate ventures and the venture the franchisee participates in is not the same venture for which he supplies risk capital.

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emphasized as a controlling factor in determining whether or not a security was involved; and second, the risk capital concept emerged as a prominent element for ascertaining the existence of an investment contract. Generally stated, the risk capital approach rejects the argument that an interest in the assets or profits of the venture is the proper test, concluding the best indicator is whether the investor is led to expect the accrual of some benefit from the outlay of capital to be used in developing an enterprise.[78] This benefit need be neither tangible, material, nor in the form of money. *Silver Hills* thus extended the reach of securities laws to transactions where no profits or material benefits could be realized.

Notwithstanding this development, expectation of profits has clearly not been eliminated as a factor in considering the existence of a security. The advantage of the risk capital approach is that courts may look to the degree of risk to the investor even where the motive for investment is not profit. If it is determined that the investor is indeed risking capital on a questionable scheme, the risk capital analysis may be applied to further the intent of the securities laws in protecting the investor. In *Silver Hills* the court conluded that the objective of the California securities laws was "to afford those who risk their capital at least a fair chance of realizing their objectives in legitimate ventures whether or not they expect a return on their capital *in one form or another*."[79] Certainly the intent of the securities laws was effectuated by this court's expansionist outlook.

A recent case involving the typical founder-member contract arrangement which adopted the risk capital approach for defining an investment contract is *State Commissioner of Securities v. Hawaii Market Center, Inc.*[80] While concluding that the agreement was an investment contract, the Hawaii Supreme Court flatly declared that the *Howey* test was too mechanical for viable investor protection. The court believed the weakness of the *Howey* test was that it led courts to analyze investment projects mechanically, based on investor participation as narrowly viewed, and stated that judges had become

> entrapped in polemics over the meaning of the word 'solely' and fail to consider the more fundamental question whether the statutory policy of affording broad protection to investors should be applied even to those situations where an investor is not inactive, but participates to a limited degree in the operation of the business.[81]

The reasoning of the Hawaii court is consistent with the risk capital concept

78. Silver Hills Country Club v. Sobieski, 13 Cal. Rptr. 186, 188 (Cal. 1961).

79. *Id.* at 188-89 (emphasis added).

80. 485 P.2d 105 (Hawaii 1971).

81. *Id.* at 108. The Hawaii Circuit Court preferred to substitute the word "substantially" in place of the word "solely" as used in the *Howey* test. State Comm'r of Sec. v. Hawaii Mkt. Center, Inc., [1961-1971 Transfer Binder] CCH BLUE SKY L. REP. ¶ 70,880, at 67,007 (Hawaii Cir. Ct. October 21, 1970).

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and with the definition of an investment contract as offered by Professor Coffey. The new *Hawaii* test provided the broad coverage necessary to protect the public from novel as well as conventional financing schemes while focusing attention on the economic realities of security transactions.[82] Further, the court rejected the argument that there was no security involved because the founder-members received a fixed fee for their efforts rather than a share of the profits and stated that "[t]he reference point should be the offeree's expectations, not the balance sheet of the offeror corporation."[83] The court concluded it was immaterial that the investor participated in a minor way in the operation of the enterprise since the "quality" of the participation was the focal point. Thus, in order to negate the finding of a security the offeree must have real and practical control over the managerial decisions of the enterprise.[84]

The Hawaii Supreme Court has adopted a new test which eliminates some of the problems inherent in a strict application of the *Howey* formula. This test not only rejects the "common enterprise" loophole in favor of a more flexible "enterprise" approach, but it also removes any ambiguity surrounding the term "profits." This rationale seems to reject *both* the strict and the flexible viewpoint associated with the word "solely" and perceives the real issue to be the *quality*, rather than the *quantity*, of the investors' participation.[85]

This approach, while making effective use of the concept of risk capital, has yet to be widely acknowledged. Presumably this may be so because federal courts are constrained to conform to *Howey* and state courts are reluctant to bid farewell to so firmly entrenched a test until a more effective approach has been clearly identified. It is obvious that the risk capital concept is indispensable in view of the increased efforts by ingenious promoters to circumvent securities laws. The next line of cases and the suggested solution to this dilemma reveal that time-entrenched precedent need not be repudiated in order to endorse the viable, innovative risk capital concept. A number of recent court decisions discloses that the risk capital approach may be incorporated into the expansible sphere of *Howey* for the

82. State Comm'r of Sec. v. Hawaii Mkt. Center, Inc., 485 P.2d 105, 109 (Hawaii 1971). *See* Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?* 18 CASE W. RES. L. REV. 367, 376-77 (1967). The test enunciated by Professor Coffey is for a security rather than solely for investment contracts.

83. State Comm'r of Sec. v. Hawaii Mkt. Center, Inc., 485 P.2d 105, 110 (Hawaii 1971).

84. *Id.* at 111.

85. Note, 51 TEXAS L. REV. 788, 797 (1973). This clarification of the investor participation concept by showing that the investor must not only participate managerially within the enterprise but must also have a requisite degree of control over the major transactions of the enterprise, should prevent a purely mechanical application of the investor-participation concept.

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benefit of the unwary investor and in furtherance of the legislative intent underlying the securities laws.

Liberal Approach to Howey

A third line of cases adopts a middle-of-the-road approach located somewhere between the strict *Howey* application and the departure called for in the *Hawaii* decision.[86] These opinions demonstrate that the courts were cognizant of the expandable nature of *Howey* and properly perceived that *Howey* was composed of expressed flexibility as well as a formulary guideline. It was obvious that administration of a restrictive, static test would defeat the purposes of the securities laws by leading to unrealistic conclusions. These courts therefore relied on *Howey* as an elastic guideline worthy of consideration due to its spirit rather than its letter.

In *Florida Discount Centers, Inc. v. Antinori*,[87] the court held a typical founder-member financing scheme to be a security. The defendant relied upon *Gallion*, the Alabama decision which held that this same marketing plan did not constitute a security because it depended upon the efforts of the investors. The Florida court refused to follow the *Gallion* reasoning, asserting that the scheme required security status for the reason given by Mr. Justice Murphy in *Howey*: "The statutory policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae."[88] In a more recent pronouncement, a Colorado district court

86. *Id.* at 798-99.

87. 226 So. 2d 693 (Fla. Dist. Ct. App. 1969), *aff'd*, 232 So. 2d 17 (Fla. 1970).

88. *Id.* at 695, *quoting* SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946). Florida often regulates these types of schemes under lottery statutes. *See* FLA. STAT. ANN. § 849.091 (Supp. 1973); Frye v. Taylor, 3 CCH BLUE SKY L. REP. ¶ 71,020 (Fla. Dist. Ct. March 9, 1972); Bond v. Koscot Interplanetary, Inc., 246 So. 2d 631 (Fla. Dist. Ct. App. 1971). There are a number of other successful methods of attacking the referral sales plan. For examples using fraud as a control device see Blachly v. United States, 380 F.2d 665 (5th Cir. 1967); Lundstrom v. Radio Corp. of America, 405 P.2d 339 (Utah 1965). The concept of public policy has also been used. *See, e.g.*, Twentieth Century Co. v. Quilling, 110 N.W. 174 (Wis. 1907); McNamara v. Gargett, 36 N.W. 218 (Mich. 1888). Texas controls certain referral sales schemes and multi-level distributorships through the Deceptive Trade Practices-Consumer Protection Act. TEX. BUS. & COMM. CODE ANN. § 17.46(b)(20) (Supp. 1974).

An earlier case evidencing a flexible view of the *Howey* formula concluded, under facts similar to *Howey*, that even though the investors had control over the citrus groves' possession and cultivating, such transactions were nevertheless investment contracts. The court looked beyond the face of the agreement to the essence of the transaction in concluding the offering was not for land but for a source of income. Blackwell v. Bentsen, 203 F.2d 690, 692-93 (5th Cir. 1953), *cert. dismissed per curiam*, 347 U.S. 925 (1954). For further examples of a type of flexible viewpoint adopted though not directly in the franchise, founder-member, or referral sales area see SEC v. Latta, 250 F. Supp. 170, 173 (N.D. Cal. 1965), *aff'd per curiam*, 356 F.2d 103 (9th Cir.), *cert. denied*, 384 U.S. 940 (1966) (holding contracts purporting to assign undivided distributive shares in a decedent's estate, in the event they were recovered, to be scurities). The decision seemed to indicate a brief renaissance of the risk factor.

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in *D.M.C. of Colorado, Inc. v. Stanley R. Hayes*,[89] held a founder-member plan to be a security while citing both the *Florida* and *Hawaii* decisions.[90] The court quoted the pertinent elastic propositions from *Howey*, maintaining that "[i]t is this Court's opinion that the guiding principle rather than a strict adherence to the rule of the *Howey* case should be paramount."[91] Further, the court stated that even assuming the Court in *Howey* intended for "solely from the efforts of others" to be taken literally, that test of "solely" is to be applied to *managerial* efforts in the common enterprise.[92] Since the investors in *Hayes* lacked such control, a security classification was necessitated. The court discerned the presently existing judicial trend as one leaning towards re-defining "investment contract" in terms of economic realities rather than upon a blind adherence to the *Howey* formulation.

Recently, a number of decisions have been rendered in suits concerning the Glenn W. Turner Enterprise of Dare to Be Great, Inc. At revival-type subscription meetings, promoters for Dare to Be Great sold a series of schemes that were characterized as self-improvement courses.[93] In a diversity action, a United States District Court of Oregon, in *Hurst v. Dare to Be Great, Inc.*,[94] concluded this scheme to be subject to registration requirements under Oregon law while expressing no opinion on the effect of federal law upon the plan.[95] Similarly, in *Murphy v. Dare to Be Great, Inc.*,[96] a District of Columbia court referred to a number of decisions which had

In Los Angeles Trust & Deed Mortgage Exch. v. SEC, 285 F.2d 162 (9th Cir. 1960), *cert. denied*, 366 U.S. 919 (1961) the court held that a finance plan involved more than a simple sale of second trust deeds and constituted an investment contract. The flexible intent of both *Joiner* and *Howey* was quoted and followed as "instructions." *Id.* at 168. *See also* State v. Bushard, 205 N.W. 370 (Minn. 1925) (an operator's agreement, involving the sale of a motorbus with the chance to share in the company's profits and receive stock was an investment contract); United States v. Herr, 338 F.2d 607, 609-10 (7th Cir. 1964), *cert. denied*, 382 U.S. 999 (1966).

89. [1961-1971 Transfer Binder] CCH BLUE SKY L. REP. ¶ 70,897, at 67,039 (Dist. Ct. Colo. February 26, 1971).

90. *Id.* at 67,042. The Hawaii reference is to the circuit court decision which delineated the "substantially through the efforts of others" test that this court adopts.

91. *Id.* at 67,042.

92. *Id.* at 67,042.

93. There are both the "old" and "new" Dare to be Great schemes but this is of little consequence here.

94. 3 CCH BLUE SKY L. REP. ¶ 71,012 (D. Ore. December 23, 1971), *aff'd in part*, 474 F.2d 483 (9th Cir. 1973). *See* Venture Investment Co., Inc. v. Schaefer, 3 CCH BLUE SKY L. REP. ¶ 71,031 at 67,234 (D. Colo. June 16, 1972).

95. Hurst v. Dare to be Great, Inc., 3 CCH BLUE SKY L. REP. ¶ 71,012, at 67,165 (D. Ore. December 23, 1971), *aff'd in part*, 474 F.2d 483 (9th Cir. 1973). In Idaho v. Glenn W. Turner Enterprises, Inc., 3 CCH BLUE SKY L. REP. ¶ 71,023 at 67,201 (Dist. Ct. Idaho March 29, 1972) the court states that in order for the Oregon federal court to reach this decision, it must have applied the "risk capital" test. *See also* Frye v. Taylor, 3 CCH BLUE SKY L. REP. ¶ 71,020 (Fla. Dist. Ct. App. March 9, 1972).

96. 3 CCH BLUE SKY L. REP. ¶ 71,053, at 67,276 (D.C. Super. Ct. September 20, 1972).

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considered this enterprise, subsequently holding the scheme to constitute an investment contract. The court, in reflecting upon the *Howey* position, concluded that its definition was intended to be flexible and adaptable to schemes devised by those who seek the use of the money of others on the promise of profits:

> [T]his Court construes the words "his money" in said definition to mean "anything of value or any consideration, including any benefit to the promisor or detriment to the promisee." Such a construction does no more than effectuate the intent of the *Howey* Court by adapting its investment contract definition to a much more sophisticated scheme, *without at all changing its meaning.*[97]

Thus, this court certainly understood that the *Howey* test was intended to be more than merely the sum of its parts.

In 1973, in *SEC v. Glenn W. Turner Enterprises, Inc.*,[98] the Court of Appeals for the Ninth Circuit relied on the expansive dicta in *Howey* and decided that the sale of these self-improvement courses constituted the sale of securities within the meaning of the federal securities laws.[99] Realizing that both the Securities Act of 1933 and Securities Exchange Act of 1934 are remedial in nature, the court followed the canon of legislative construction which required them to be broadly interpreted. The *Joiner-Howey-Tcherepnin* liberal philosophies were cited and the court then approached its application of the security defintion "with these admonitions in mind."[100] The word "solely" presented the only difficulty in *Turner*; all of the *Howey* elements of an investment contract were present except that the profits were not to come solely from the efforts of others.. Nevertheless, the court stated:

> We hold, however, that in light of the remedial nature of the legislation, the statutory policy of affording broad protection to the public, and the Supreme Court's admonitions that the definition of securities should be a flexible one, the word "solely" should not be read as a strict or literal limitation on the definition of an investment contract, but rather must be construed realistically, so as to include within the definition those schemes which involve in substance, if not form, securities.[101]

In viewing the *Howey* decision in this perspective, the court realized that adherence to a strict interpretation of *Howey* would result in a mechanical

97. *Id.* at 67,282 (emphasis added). The court earlier stated that it did not find it necessary to expand the *Howey* definition to the extent done in the Oregon and Ohio cases but it still found the existence of an investment contract under the *Howey* rationale. *Id.* at 67,281.

98. 474 F.2d 476 (9th Cir.), *cert. denied,* —U.S.—, 94 S. Ct. 117, 38 L. Ed. 2d 53 (1973).

99. *Id.* at 483. The court does not mention Chapman v. Rudd Paint & Varnish Co., 409 F.2d 635 (9th Cir. 1969) which adopted a strict application of the *Howey* test.

100. SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476, 481 (9th Cir.), *cert. denied,* —U.S.—, 94 S. Ct. 117, 38 L. Ed. 2d 53 (1973).

101. *Id.* at 482.

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and unduly restrictive view of investment contracts. The court accepted a more realistic "efforts" test based upon "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."[102] In concluding, the court announced:

> Our holding in this case represents no major attempt to redefine the essential nature of a security. Nor does our holding represent any real departure from the Supreme Court's definition of an investment contract as set out in *Howey*. We hold only that the requirement that profits come "solely" from the efforts of others would, in circumstances such as these, lead to unrealistic results if applied dogmatically, and that a more flexible approach is appropriate.[103]

Other courts have similarly recognized that any strict definitional format applicable to investment contracts may lead to restrictive, technical tests which may defeat the legislative intent behind both federal and state securities laws. Thus, an outgrowth of this more adaptable rationale has recently appeared. It may be termed the "flexible composite" approach. *Idaho v. Glenn Turner Enterprises, Inc.*,[104] is a representative example of court adoption of the "flexible composite" approach. The court was cognizant of the fact that in the interest of investor protection, the *Howey* test should not be applied as an "exclusive" test because strict administration only provided the unscrupulous with both loopholes and an invitation to defraud. The risk capital concept was embraced as a needed supplement to the *Howey* formula.[105] Further, the court recognized problems inherent in the *Hawaii* test which flatly rejected the *Howey* formula, pointing out that since the *Hawaii* test applied merely to "initial" capital, existing but unproven businesses might remain outside the scope of the *Hawaii* test. The defective feature of any strict test is therefore readily apparent: the inflexibility inherently present in any static formula. As a result, the court asserted that while the *Howey* test may not be exclusive, neither may be the *Hawaii* test. The suggested solution was the combining of the *Howey* for-

102. *Id.* at 482. The court added to the *Howey* fact situation the facts necessary to make it analogous to the principal case and stated they could not believe the Supreme Court would not have held such a scheme to be an investment contract. *Id.* at 483. The Third Circuit is in accord with the *Turner* rationale. *See* Lino v. City Investing Co., 487 F.2d 689, 692 (3d Cir. 1973).

103. SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476, 483 (9th Cir.), *cert. denied*, —U.S.—, 94 S. Ct. 117, 38 L. Ed. 2d 53 (1973). It has been argued that *Turner* may possibly stretch the *Howey* formula too far in its new "efforts" application. *See* Note, 51 TEXAS L. REV. 788, 800 (1973). In Mitzner v. Cardet Int'l, Inc., 358 F. Supp. 1262, 1268 (N.D. Ill. 1973) the court expressly accepted the *Turner* test and applied it appropriately to a franchise situation in finding the existence of an investment contract.

104. 3 CCH BLUE SKY L. REP. ¶ 71,023, at 67,200 (Dist. Ct. Idaho March 29, 1972).

105. *Id.* at 67,202.

mula and the *Silver Hills* risk capital concept in order to most fully protect the unsophisticated investor.[106]

Perhaps the source of this "flexible composite" approach was *Healy* v. *Consumer Business System, Inc.*,[107] wherein an Oregon appellate court held the *Howey* test and the risk capital concept were *alternative formulas* to be employed in discovering whether an investment contract existed.[108] The facts disclosed a franchising scheme under which if the franchisee did nothing, he would make no profits, thereby removing this plan from the scope of *Howey* if it were literally applied. The court discussed the risk capital concept, prior Oregon precedent,[109] and California attorney general opinions[110] in concluding "that the *Howey* test is not exclusive and that the 'risk capital' test is also to be used in determining whether a particular financial activity constitutes an offer of an 'investment contract' . . . ."[111] Upon application of the risk capital theory, the court found the franchisor to be dependent upon the investor for a substantial proportion of the initial capital needed to launch the enterprise and thus, detected the existence of an investment contract.[112]

It is submitted that this recently developed viewpoint, represented to be the "flexible composite" approach and an extension of the philosophy pronounced in the "flexible" line of decisions, is the proper and indispensable rationale to be used in analyzing investment contracts particularly, but not solely, with reference to franchises, founder-member contracts and referral sales agreements.[113]

Numerous recent court pronouncements reveal a trend towards recognition that the *intent* of the *Howey* decision composes a vital part of the precedental value of that case. This realization has simultaneously resulted in

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106. *Id.* at 67,202.

107. 482 P.2d 549 (Ore. Ct. App. 1971).

108. *Id.* at 554.

109. *See* Sperry & Hutchinson Co. v. Hudson, 226 P.2d 501 (Ore.1951). The Oregon Supreme Court stated that no hard and fast rule should be laid down for determining what is or is not a security because of the ability of ingenious promoters to circumvent such fixed definitions. *Id.* at 505. The court in *Healy* felt these statements indicated that the use of the *Howey* test should not foreclose the courts from using other methods of analysis when warranted.

110. For an analysis of the various kinds of franchise situations in which an investment contract would probably exist under the risk capital concept see 49 OPS. CAL. ATTY. GEN. 124 (1967).

111. Healy v. Consumer Busn. Sys., Inc., 482 P.2d 549, 554 (Ore. Ct. App. 1971).

112. *Id.* at 555-56.

113. Legislation, particularly in the franchise area may be beneficial. *See* Comment, *A Tempest in a Chicken Bucket: Some Reflections on Franchise Regulation in California*, 17 U.C.L.A. L. REV. 1101 (1970); Note, 24 VAND. L. REV. 638 (1971). Several states have attacked such promotions through lottery and consumer legislation protection. For a listing of both the federal and state protective devices see Note, 51 TEXAS L. REV. 778, 802 n.60 (1973).

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a more realistic application of the *Howey* standards in light of the need to protect the unwary from the ever-increasing questionable promotional schemes. It is suggested that the employment of any further technical tests in the investment contract area be discouraged. A new definitional format of any nature would only create further confusion, lead to unrealistic results, and stifle the legal creativity of the courts in an area of the law where flexibility is a prerequisite to sound decision making. Mechanical tests are inadequate to deal with the novel schemes that increasingly threaten the public as the results reached through a strict application of the *Howey* formula so firmly attest. Newly enunciated tests, though constructed by the powerful engineer of hindsight, may, by improper application or by mere passage of time, become "irrelevant formulae."

The "flexible composite" approach appears to resolve a significant number of the problems created by the *Howey* decision. Since the *Howey* test is so firmly entrenched in the investment contract analytical field, it seems unrealistic to propose that state courts unqualifiedly reject a decision so uniformly relied upon. Assuredly, strict application of the *Howey* test defeats the purpose of the securities laws, but just as surely, the radical approach advocating unconditional overthrow of the *Howey* test would necessitate that courts once again tread through a quagmire of confusion in order to deduce a guideline which could *presently* be as uniformly depended upon as is the *Howey* test. Thus, the "flexible composite" approach allows state courts the opportunity to retain a familiar guidepost while simultaneously permitting judicial expansion of the approach as both time and developments require.

The "flexible composite" outlook relative to the federal courts acknowledges the fact that though these courts are constrained to conform to *Howey*, they need not do so at the expense of investor protection. By consolidating the intent of *Howey* with essential concepts which originate through practical necessity, such as risk capital, the federal courts will merely be effectuating the expressed aim of *Howey* without doing any violence to that decision. Further, this pragmatic perspective eliminates the question of "judicial overreach" that has been expressed by a number of courts as restricting their ability to arrive at a just result while being consistent with the *Howey* mandates. This view may conceivably lead to the establishment of a widely recognized standard as to what is "commonly known nationally" as a security, while clarifying present uncertainties in the securities field through the delineation of elastic, general guidelines to be used in answering securities questions. Certainly the potential is considerable.

Legal developments over the past years have created a workable solution from the dichotomy presented by subsequent judicial application of *Howey*. Though the *Howey* test is to be employed as the fundamental point of departure in determining whether a scheme warrants security status, the "prof-

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itability", "solely," and "common enterprise" prongs of the test will be supplanted with more realistic indicators such as the risk capital concept. Thus, the "flexible composite" approach, while not eliminating *Howey* from the investment contract scene, would certainly help put an end to circumvention of the securities acts by even the most ultra-ingenious promoters and thereby finally effectuate the purposes of the securities laws.