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Oil Interests as Securities: The Enumerated vs. the General Definition Student Symposium - Interpreting the Statutory Definition of a Security: Some Pragmatic Considerations.

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OIL INTERESTS AS SECURITIES: THE ENUMERATED vs. THE GENERAL DEFINITION

The securities laws are being violated daily by persons who are unaware that the oil and gas interests in which they are dealing are securities.[114] The primary reason for such unintentional violations is the inadequacy of the state and federal securities laws which define a security by providing examples of specific interests that are per se securities and also by use of general definitions.[115] The purpose of enumerating various interests was to include by name or description many documents which had a well settled meaning and in which there was common trading for investment purposes.[116] Some interests, such as notes, bonds, and stocks, have a standardized meaning, and the terms alone were sufficient to identify them as securities. The multifarious types of oil rights which constitute securities, however, presented a unique problem to the draftsmen.[117] To include every oil right by name would have encumbered the security definition, but it was also evident that it was impossible to draft an enumerated definition broad enough to encompass every oil right which was a security. For example, a "fractional undivided interest in an oil, gas, or other mineral rights"[118] does not include within its meaning an entire oil lease,[119] which under certain circumstances is a security. If the entire lease is to be a security, it must come within the meaning of another term of the security definition. A second enumerated interest that has been used in an attempt to deal with oil and gas interests as securities but which is often of little value in determining whether a particular oil right is a security is a "certificate of interest in an oil, gas, or mining title or lease."[120] Unlike a "fractional undivided interest in an oil, gas, or other mineral rights," which describes an *interest*, a "certificate of interest" describes a *document* in which an interest is transferred. This enumerated interest provides no guidance in determining whether the oil interest which is transferred in the instrument is a security. For example, every mineral deed is a "certificate of interest" but not every oil interest transferred in the deed is a security. To determine whether the oil inter-

114. Meer, *The Securities Laws and Oil and Gas Financing*, 20 TEX. B.J. 211, 212 (1957).

115. *E.g.*, Securities Act of 1933, 15 U.S.C. § 77b(1) (1970); *see* SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943).

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

117. *Id.* at 352.

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

119. SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 352 (1943).

120. Corporate Securities Law, ch. 384, § 1, stats. 1919, *as amended*, CAL. CORP. CODE § 25019 (Deering Supp. 1973).

est which is conveyed is a security, a more searching inquiry beyond the form of the document is required.[121]

Several courts have failed to recognize the fact that the enumerated oil interest in the definition of a security was never intended to encompass every oil security, thereby erroneously concluding that unless the oil right in question is specifically enumerated, then no security is involved. The fact overlooked in these decisions is that if the enumerated interest is inapplicable, the oil right under consideration may nevertheless be a security within the meaning of the general definitions. Underlying the decisions of the courts that follow this narrow approach is the doctrine of "*ejusdem generis.*" This convenient maxim of statutory construction which constricts the general terms to those specifically set out in the security definition was summarily rejected in *SEC v. C.M. Joiner Leasing Corp.*[122] In this landmark decision, the Supreme Court held that oil interests which did not fit the specific designations were nevertheless not precluded from answering to the general descriptions of "investment contract" or "any interest or instrument commonly known as a security."[123]

In the line of cases which follows the liberal approach taken in *Joiner,* the courts have consistently applied the term "investment contract" and disregarded the phrase "any interest or instrument commonly known as a security." The reason for this preference is derived from the precedent set in *SEC v. W.J. Howey Co.*,[124] wherein an "investment contract" was given a definitive meaning, and a "common security" was virtually ignored. The Court in *Howey* defined an "investment contract" as a "scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of others."[125] There is a striking similarity between this definition and that of a "common security," which has been defined as "an investment of money with the expectation of profit through the efforts of others."[126] Professor Joseph Long describes the *Howey* test of an "investment contract" as the result of a "crazy-quilt development,"[127] in which the definition of a "common security" was inadvertantly merged with the definition of an "investment contract."[128] The *Howey* test of an investment contract in effect merely expanded the definition of a common

121. SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 355 (1943).

122. 320 U.S. 344, 351 n.8 (1943). For a critical look at the *ejusdem generis* doctrine see Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?* 18 CASE W. RES. L. REV. 367, 405-06 (1967).

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

124. 328 U.S. 293 (1946).

125. *Id.* at 299.

126. SEC v. Universal Serv. Ass'n, 106 F.2d 232, 237 (7th Cir.), *cert. denied,* 308 U.S. 622 (1939).

127. Long, *An Attempt to Return "Investment Contracts" To The Mainstream of Securities Regulations,* 24 OKLA. L. REV. 135, 139 (1971).

128. *Id.* at 146-159.

security by adding the elements "common enterprise" and "solely from the efforts of others." Although the *Howey* decision would seem to be expanding the scope of the general definition of a security, there has been a tendency of the courts to apply the test mechanically, requiring that each technical element be satisfied.[129]

The courts have not taken uniform approaches in determining whether a particular interest is a security. However, despite this lack of uniformity, four distinct points of view can be delineated. In the first approach, the courts follow a strict view, holding that unless the oil right in question is enumerated in the definition of a security, then no security is involved. A more flexible outlook is reflected in those decisions where an oil right which is not within the meaning of the enumerated interest may nevertheless be deemed to be a security within the general terms. In the third line of cases, the question presented is whether the oil right is a "certificate of interest in an oil, gas, or mining lease." Because this enumerated interest merely describes the form of the document, the courts have resorted to the general terms, usually the "common security," to ascertain whether the interest which is transferred is a security. A fourth approach can be identified in court decisions which do not even consider whether the enumerated interest may be applicable, but directly apply the term "investment contract."

APPROACHES TAKEN IN DECIDING WHETHER AN OIL RIGHT IS A SECURITY

The Strict View

The basic rule of law which can be extracted from the cases following the strict view as to whether a particular interest is a security is that an oil right cannot be considered a security unless it is within the meaning of the enumerated oil interest under the definition of a security. The inadequacy of this rigid rule can be illustrated by examining two cases that reached contrary results in deciding the question of whether an oil lease was a security within the meaning of a specific definition.

1. Oil Leases in General. In *Kadane v. Clark*[130] the question of whether an unlicensed lease broker could recover commissions earned in selling oil leases turned on whether an oil lease was a "certificate or any instrument representing any interest in or under an oil, gas, or mining lease, fee or title."[131] The court held that the leases were specifically within the enumerated definition.[132] It should be noted, however, that this enumerated

129. *See* discussion concerning strict application of *Howey* test at 136-41 *supra*; Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulations*, 24 OKLA. L. REV. 135, 139 (1971).

130. 135 Tex. 496, 143 S.W.2d 197 (1940).

131. TEX. REV. CIV. STAT. ANN. art. 581-1 (1964).

132. Kadane v. Clark, 135 Tex. 496, 500, 143 S.W.2d 197, 199 (1940); *accord*,

interest merely describes the form of the document in which an oil security can be transferred, and therefore does not provide a test for ascertaining whether the oil interest conveyed is a security. Not every sale of an entire oil lease involves the transfer of a security,[133] but the approach taken by the court foreclosed any inquiry into the nature of the lease sales.[134] This inquiry could have been accomplished by applying the "common security" test, *i.e.*, if the lease agreements contemplated that the transferee was to rely on the efforts of others to produce a profit, then the leases would be considered as securities. The limited approach taken in *Kadane* was also taken in *State v. Allen*,[135] but with contrary results. In *Allen*, certain sellers offered oil leases in New Mexico to buyers in North Carolina. The court held that oil leases were not within the meaning of a "certificate of interest in an oil, gas, or mining lease," and whether the definition of a security should be amended to include sales or assignments of oil, gas, or mining leases was for the legislature to decide.[136] This conclusion, although contrary to *Kadane*, is equally unacceptable. Under this view, many lease agreements which would satisfy the test of an "investment contract" or a "common security" will escape the reach of the Act.

2. Working Interests in Leases. This narrow view of requiring the interest in question to specifically come within one of the enumerated interests is also evident in cases considering whether an undivided share of the working interest in a lease is a "certificate of interest in an oil, gas, or mining lease, royalty or title." The working interest is the lessee's interest in the lease (usually 7/8).[137] If the lessee is in need of financing, shares of the working interest are sold to investors, who in turn contribute a pro-rata share of the drilling costs, and are entitled to share in the profits. In *Smith v. Wedding*,[138] a seller actively engaged in speculative oil ventures sold undi-

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Lack v. Borsun, 44 F. Supp. 47, 49 (W.D. La. 1942); Mecom v. Hamblen, 155 Tex. 494, 500, 289 S.W.2d 555, 557 (1956); Muse v. State, 137 Tex. Crim. 622, 625, 132 S.W.2d 596, 597 (1939); Atwood v. State, 135 Tex. Crim. 543, 547, 121 S.W.2d 353, 360 (1938); Flournoy v. Ghallagher, 189 S.W.2d 108, 110 (Tex. Civ. App.—Eastland 1945, no writ). The Act does not protect sellers of leases against buyers, and is therefore inapplicable to the purchase of a lease. Herren v. Hollingsworth, 140 Tex. 263, 270, 167 S.W.2d 735, 738 (1943); Fowler v. Hults, 138 Tex. 636, 644, 161 S.W.2d 478, 481 (1942).

133. Roe v. United States, 287 F.2d 435, 437 (5th Cir.), *cert. denied*, 368 U.S. 824 (1961).

134. In some cases, the name of the document itself, such as a stock, bond, or note, sufficiently identifies it as a security. In others, the inquiry must go outside the instrument. SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 355 (1943).

135. 5 S.E.2d 844 (N.C. 1939).

136. *Id.* at 846-47.

137. *See generally* 1 L. LOSS, SECURITIES REGULATIONS 469-70 (2d ed. 1961); H. WILLIAMS & C. MEYERS, OIL AND GAS LAW § 441.1, at 544 (1973); Bloomenthal, *SEC Aspects of Oil and Gas Financing*, 7 WYO. L.J. 49, 58 (1953).

138. 303 S.W.2d 322 (Ky. 1957).

vided fractional working interests in oil and gas leases to the investors. In considering whether the oil interests were within the enumerated interest, the court stated:

> It is a primary rule of statutory construction that the enumeration of particular things excludes the idea of something else not mentioned. A working interest is not mentioned specifically . . . . We conclude that a working interest was not intended by the legislature to be covered by the provisions of the statute.[139]

Although the court did not explicitly mention it, the doctrine of "ejusdem generis" was invoked. This "handy Latin aphorism"[140] was rejected in *SEC v. C.M. Joiner Leasing Corp.*,[141] wherein the Court refused to read out of the statute the general designations merely because more specific ones had been used to reach some kinds of interests.[142] In *Smith,* the court apparently failed to note the prior holding in *Joiner*, and therefore did not consider the application of the general terms.

Another mandate of the United States Supreme Court—that the form of the agreement is to be disregarded for the substance[143]—was ignored in *Hammer v. Sanders.*[144] In that case, the sellers used cleverly drafted letter agreements, in which both a share of the working interest and a development contract were included. The agreements provided that although a share of the working interest was transferred, the only payments presently due were for the development contract. The court concluded that because the only money presently due was for the development contract, the share of the working interest was transferred incidentally to the drilling contract.[145] Because agreements to exploit potential oil lands were not enumerated in the definition of a security, the court found that no security was sold.[146] As Judge Davis indicated in his dissenting opinion, the court failed to look through the form of the agreement and consider whether an investment contract was involved.[147] He argued that such a hypertechnical analysis would give rise to simple methods of circumventing the Act.[148]

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139. *Id.* at 323 (citations omitted).

140. Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?* 18 CASE W. RES. L. REV. 367, 405 (1967).

141. 320 U.S. 344 (1943).

142. *Id.* at 351.

143. SEC v. W.J. Howey Co., 328 U.S. 293, 298 (1946).

144. 134 N.E.2d 509 (Ill.), *cert. denied,* 352 U.S. 878 (1956).

145. *Id.* at 513.

146. *Id.* at 514.

147. *Id.* at 516 (dissenting opinion). Professor Sterling argues that *Hammer* is wrong in both reasoning and result. He contends the majority simply would not allow astute businessmen to reap the tax benefits of the successful wells and make the defendant pay for the failures. Sterling, *Impact of State and Federal Securities Acts on Everyday Oil and Gas Transactions,* EIGHTH ANNUAL OIL & GAS LAW & TAX. INST. 33, 59(1957).

148. 134 N.E.2d 509, 517 (1956) (dissenting opinion).

As can be seen, some confusion has arisen as to whether an undivided share of the working interest in a lease satisfies the enumerated oil interest in the definition of a security in the Securities Act of 1933, which refers to a "fractional undivided interest in oil, gas, or other mineral rights . . . ."[149] The weight of authority supports the conclusion that shares of the working interest in a lease are securities within the enumerated definition,[150] but there are cases which appear to hold to the contrary. The confusion may be attributed in part to a failure by some courts to separate the question of whether the seller is an "issuer" from the question of whether the interest transferred is a "security." An "issuer" of fractional interests in oil and gas is "the owner of any such right or of any interest in such right (whether whole or fractional) who creates fractional interests therein for the purpose of public offering."[151] An issuer of a security is subject to the registration requirements of the Act.[152]

The determination of whether the seller is an "issuer" is not conclusive in deciding whether a security has been transferred,[153] because a non-issuer, although exempt from registration requirements, may be subject to liability under the anti-fraud provisions of the Acts[154] as a seller of a security.[155] In several recent cases this distinction was not noted. In *Creswell-Keith, Inc. v. Willingham*,[156] the transferor of an entire one-eighth share of the working interest in a lease contended that the Securities Act was intended to cover only those situations wherein a person creates fractional interests in oil and gas leases for the purposes of making a public offering, and does not apply where a person merely sells to another an entire undivided interest.[157] The court took an equivocal position:

> The Court is inclined to agree that the Act may not have been intended to apply to such sales, but [the statutory definition of a secu-

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

150. *Accord*, Nor-Tex Agencies v. Jones, 482 F.2d 1093, 1098 (5th Cir. 1973); Gilbert v. Nixon, 429 F.2d 348, 354 (10th Cir. 1970); SEC v. McBride, 143 F. Supp. 562, 563 (M.D. Tenn. 1956); Wall v. Wagner, 125 F. Supp. 854, 857 (D. Neb. 1954), *aff'd sub nom.* Whittaker v. Wall, 226 F.2d 868 (8th Cir. 1955).

151. Securities Act of 1933, 15 U.S.C. § 77b(4) (1970).

152. 15 U.S.C. § 77d(1) (1970) does not exempt an issuer from the registration requirements of the Act provided for in § 77e.

153. There can be a transfer of a "security" without an "issuer." 1 L. Loss, SECURITIES REGULATIONS 472 n.5 (2d ed. 1961).

154. Securities Act of 1933, 15 U.S.C. §§ 77l(2), 77q(a) (1970); Securities Exchange Act of 1934, 15 U.S.C. §§ 780(c)(1)-(2) (1970); Uniform Securities Act, §§ 101, 410(a)(2) 1 CCH BLUE SKY L. REP. ¶¶ 4902, 4940 (1973); SEC Rule 10b-5, 17 C.F.R. 240, 10b-5 (1972).

155. Crooker v. SEC, 161 F.2d 944, 947 (1st Cir. 1947); Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?* 18 CASE W. RES. L. REV. 367, 371 (1967).

156. 160 F. Supp. 735 (W.D. Ark. 1958), *rev'd on other grounds*, 264 F.2d 76 (8th Cir. 1959).

157. *Id.* at 739.

> rity] . . . in no uncertain terms provides that the term "security" includes any "fractional undivided interest in oil, gas, or other mineral rights," and such fractional interests are involved in this action.[158]

Because this was an action for rescission under the anti-fraud provisions of the Act, the court need not have even considered the defendant's contention. The court could have disposed of the seller's assertion by stating that it was only relevant to the question of whether the seller was an issuer under the provisions for registration, and had no bearing on whether the interest sold was a security.

In two recent cases the confusion was compounded. Not only were the "issuer" and "security" questions merged, but the courts attempted to determine whether an entire oil lease was a security within the meaning of a "fractional undivided interest in an oil, gas, or other mineral rights." In *Woodward v. Wright*,[159] the seller transferred the entire working interest (15/16) in an oil lease. It should be noted that the sale of an entire working interest is equivalent to the sale of the entire lease.[160] In considering whether a security was involved, the court discussed the application of the enumerated interest, and the definitions of an "issuer" and a "security" stating:

> Not every transaction involving the sale of a fractional undivided interest in oil, gas, or other mineral rights is ipso facto the sale of a "security" within the meaning of the Act.[161]

There are two problems with this statement. The first is the application of the enumerated interest to the sale of an entire lease. A 15/16 interest is in essence an entire oil lease except the 1/16 portion which was reserved to the lessor. Therefore, the court should not have considered whether an entire oil lease was a fractional undivided interest in an oil, gas or other mineral rights, but should have applied the general terms "investment contract" or "common security."[162] The second problem with the court's statement is that it is subject to two interpretations. If what is meant is that not every sale of a "fractional undivided interest" is subject to the registration requirements of the Act, then it is undoubtedly correct. But if interpreted to mean that not every "fractional undivided interest" is a security, then it is incorrect. This language cannot be read separately from the language regarding an "issuer:"

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158. *Id.* at 739.

159. 266 F.2d 108 (10th Cir. 1959).

160. In a recent case, the sale of a 7/8ths interest in the lease was equivalent to an entire lease. *See* Roe v. United States, 287 F.2d 435, 437 (5th Cir.), *cert. denied*, 368 U.S. 824 (1961).

161. Woodward v. Wright, 266 F.2d 108, 112 (10th Cir. 1959).

162. In a recent case the sale of a 7/8ths interest in the lease was not considered a security within the enumerated interest. If the lease was to be a security it had to be within the general term investment contract. Roe v. United States, 287 F.2d 435, 437 (5th Cir.), *cert. denied*, 368 U.S. 824 (1961).

> [W]hen the definition of a "security" as it relates to fractional undivided interests in oil, gas, or other mineral rights, is considered in *pari materia with the definition of an issuer* of fractional interests in oil and gas as "the owner of any such right or of any interest in such right (whether whole or fractional) who creates fractional interests therein for the purpose of a public offering . . . . It follows, we think, that a fractional undivided interest in oil and gas *becomes a "security" when it is created out of the ownership of an interest* in oil and gas or other mineral rights for the purpose of sale or offering for sale.[163]

By considering the definition of a security in pari materia with the definition of an issuer the court in *Woodward* has merely added to the confusion as subsequent decisions illustrate. For example, the language of *Woodward* was cited in *Lynn v. Caraway*,[164] where an entire working interest in a lease (7/8) was sold:

> It therefore follows that not every transaction involving the sale of a fractional undivided interest in oil, gas, or other mineral rights is necessarily the sale of a "security" under the Act. It is only that interest which is created by subdivision of a portion of the owner's interest for the purpose of a public offering for sale which is reached by the Act. Thus if the seller transfers the whole of what he owns, there can be no creation of the interests by him, as "issuer," such as would be counted "securities" within the meaning of the Act.[165]

The correct interpretation of *Lynn* is that if the seller does not split-up the interest he owns, whether whole or fractional, but transfers the entire interest, then he is not an issuer and is exempt from the registration requirements. However, *Lynn* can also be cited for the proposition that if the seller owns a fractional interest in the lease (*e.g.*, 1/8), and transfers the entire interest without subdividing it, then no security is involved. This interpretation was supported in *SEC v. MacElvain*,[166] wherein the court cited *Lynn* as holding that "if one transfers outright an entire interest in an oil and gas lease, no sale of a 'security' is involved."[167] Insofar as this statement relates to the transfer of an entire fractional interest in the lease, it is incorrect. This right is a security within the enumerated interest of the security definition, regardless of whether the seller splits-up the fractional interest or sells it in its entirety.[168] The confusion in this area could be resolved if the "security" and "issuer" questions are considered separately.

The Broad View

In several decisions, the courts have expanded the scope of the inquiry

163. Woodward v. Wright, 266 F.2d 108, 112 (10th Cir. 1959) (emphasis added).
164. 252 F. Supp. 858 (W.D. La. 1966), *aff'd*, 379 F.2d 943 (5th Cir. 1967).
165. *Id.* at 861.
166. 299 F. Supp. 1352 (M.D. Ala.), *aff'd*, 417 F.2d 1134 (5th Cir. 1969), *cert. denied*, 397 U.S. 972 (1970).
167. *Id.* at 1353.
168. *See* cases cited note 150 *supra.*

beyond the applicability of the enumerated interest, and have considered whether the oil right in question is a security within the general terms. This view was originally adopted in the landmark case of *SEC v. C.M. Joiner Leasing Corp.*[169] There, the leaseholders offered assignments of small oil leases to nearly a thousand prospects, many of whom were induced to purchase the leases by the promises of the sellers that a test well would be drilled. The sellers urged that because the definition of a security mentions "fractional undivided interest in oil, gas, or other mineral rights," it excluded sales of entire oil leases. Although the enumerated interest was inapplicable, the Court refused to limit the inquiry to the applicability of the specific terms:

> We cannot read out of the statute these general descriptive designations merely because more specific ones have been used to reach some kinds of documents . . . .
>
> . . . We do not think the draftsmen thereby immunized other forms of contracts and offerings which are proved as matter of fact to answer to such descriptive terms as "investment contracts" and "securities."[170]

Because the entire agreement contemplated that the investors were not to rely on their own input to develop the leases, but were merely to share in the discovery values which might follow the exploration enterprise, the Court concluded that the instruments were within the meaning of "investment contracts" or "any interest or instrument commonly known as a 'security.' "[171]

In *Joiner* these general terms were not given a definitive meaning, but in a subsequent landmark decision, *SEC v. W.J. Howey Co.*,[172] an "investment contract" was given a rather technical meaning involving a scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.[173] Since the *Howey* decision, many courts which purport to adhere to the broad approach taken in *Joiner* in reality have taken a more rigid view. When the question presented is whether an oil right which is not within the enumerated interest comes within the general terms, these courts have not only applied the term "investment contract" to the exclusion of the other definitions, but have also applied the *Howey* test strictly.[174] One case which demonstrates the practice of excluding other general terms from consideration

169. 320 U.S. 344 (1943).

170. *Id.* at 351-52.

171. *Id.* at 351; *accord*, Price v. United States, 200 F.2d 652, 654 (5th Cir. 1953); Mansfield v. United States, 155 F.2d 952, 54-55 (5th Cir.), *cert. denied sub nom.* Browne v. United States, 329 U.S. 792 (1946).

172. 328 U.S. 293 (1946).

173. *Id.* at 299.

174. *E.g.*, Roe v. United States, 287 F.2d 435, 439-40 (5th Cir.), *cert. denied*, 368 U.S. 824 (1961); Darwin v. Jess Hickey Oil Corp., 153 F. Supp. 667, 671-72 (N.D. Tex. 1957).

is *Roe v. United States.*[175] In that case a mail campaign was conducted to sell to large numbers of persons oil leases on small tracts of land in Texas and Utah. The offerings described in the letters promised great wealth to the investors. The court phrases the issue as follows:

> There was not, therefore, any sale, offer of sale, or delivery of a "fractional undivided interest in oil, gas, or other mineral rights" . . . . Nor did such oil leases fit within any other specifically itemized interests. If they are to come within the term "security" they must do so as an "investment contract."[176]

The court thereupon held that because the prospective purchaser was offered a chance to reap great rewards solely because of the activities of others, the instruments were "investment contracts."[177] In *Roe*, the general terms "certificate of interest or participation in a profit sharing agreement" and "any interest or instrument commonly known as a security" were disregarded in accordance with *Howey*, where these general terms were also ignored.

In a recent case a court has not only restricted the question to the application of the term "investment contract," but also has applied the *Howey* test narrowly. In *Darwin v. Jess Hickey Oil Corp.*,[178] oil leases to land in Utah were sold to Texas residents, but there was no evidence that the sellers made any representations that a test well would be drilled, or any other promises which would have induced the purchasers to buy. It appeared the investors merely hoped that the leases would appreciate in value and could later be re-sold at a profit. In considering whether the oil leases were investment contracts, the court discussed the *Howey* test and emphasized its elements of "common enterprise" and "reliance upon the sole efforts of the promoter."[179] These elements, however, were not found to exist because

> the investors had absolute dominion and control over the property acquired, and because there were no elements of a *common enterprise* in the transaction it is reasonable to conclude that the lease assignments in the instant case were not "investment securities" . . . .[180]

The difficulty with *Darwin* is not in the result, because the leases would not have been considered securities within the less-rigid common security test—an investment of money with the expectation of profit through the efforts of others. The investors in *Darwin* did not rely on others to produce profits. The error is in the method. By applying the *Howey* test mechanically, requiring that each technical element be satisfied, the court has liter-

175. 287 F.2d 435 (5th Cir.), *cert. denied*, 368 U.S. 824 (1961).
176. *Id.* at 437.
177. *Id.* at 439-40.
178. 153 F. Supp. 667 (N.D. Tex. 1957).
179. *Id.* at 671.
180. *Id.* at 672 (court's emphasis).

ally invited ingenious promoters to devise oil securities which will circumvent one of these elements, thereby escaping the reach of the Securities Acts.

Certificates of Interest

When the enumerated interest merely describes the form of the instrument, the courts have resorted to the general terms for proper guidance in determining whether the oil interest which is transferred is a security. A "certificate of interest in an oil, gas, or mining lease" does describe the document in which an oil security is transferred, but it fails to provide the court with an adequate standard by which to distinguish which "certificates of interest" are securities. This difficulty was effectively pointed out in *Moore v. Stella*,[181] where the issue raised was whether mineral deeds, in which fractional tracts of prospective oil lands were conveyed, were securities:

> Section 2(a)7 of the Act includes in the definition of the word "security" "any . . . certificate of interest in an oil, gas or mining title or lease," and the decisive question is whether the deeds issued to plaintiff fall within that definition. A deed to mineral rights may or may not be a security. The determination of its true character requires an inquiry which goes beyond the mere name of the instrument or the nature of the interest conveyed.
>
> In deciding whether a given instrument is a security the courts have invariably looked through mere form to substance.[182]

A "certificate of interest" differs from a "fractional undivided interest" because the former describes only the document, and not the interest which is transferred in the instrument. Since a "certificate of interest" was applicable to every transaction in which an oil right was being conveyed, the court in *Moore* had to rely on the general definitions to distinguish those instruments in which an oil security was transferred. In formulating its own test, the court stated:

> The question . . . which is determinative . . . was whether . . . the scheme under which the deeds were given contemplated and involved investment by the purchasers in an enterprise or venture conducted by others for earnings and profits . . . .[183]

Without explicitly referring to it as such, the court applied the common security test. In considering whether the deeds were securities, it was necessary to inquire into the mutual purposes and expectations of the parties,[184] and the common security test provided the court with a meaningful formula for ascertaining their intentions. The court concluded that it was highly improbable that the investors intended to develop the small parcels themselves,

181. 127 P.2d 300 (Cal. Dist. Ct. App. 1942).
182. *Id.* at 303.
183. *Id.* at 302.
184. *Id.* at 303.

because the tracts were not of sufficient size to justify expensive exploratory drilling. Therefore, it could be inferred that all of the buyers intended to lease their mineral lands back to the sellers, who would, in turn develop the minerals for the investors.[185] It is interesting to consider the wording of the court's conclusion: "We are of the opinion that the . . . mineral deeds were "certificates of interest" in an oil, gas or mining title and were therefore 'securites' . . . ."[186] This wording gives rise to a deceptive conclusion because it implies that the enumerated interest was the guiding test. A clearer version of the holding in *Moore* is that the transaction involved the sale of a security, because the mineral deeds were "certificates of interest" which satisfied the common security definition.

This approach has been uniformly followed by the California courts.[187] In one recent case, *Oil Lease Service, Inc. v. Stephenson*,[188] the test laid down in *Moore* was followed, but the court also applied other general terms. In *Stephenson* the seller offered to use his skill and knowledge in selecting government leases for the investors. He also assured the buyers that the leases selected would be favorable for oil development, and that when oil was discovered, the investors would be able to re-assign the leases at a large profit. In determining whether the transaction involved the transfer of a security, the court applied the "common security" test:

> It is settled law that any deed, certificate of interest or like instrument of conveyance or assignment falls within the act only when it appears directly or inferentially that the buyer contemplates receipt of profits from activites of other persons . . . .[189]

Applying this test, the court found that the investors' profits did not depend on their own efforts, but entirely on the efforts of others—first, on the seller to select favorable leases and, second, on an oil company to drill and discover oil on that land.[190] In its conclusion, the court not only applied the common security test to bring the instruments within the enumerated interest, but also held that the interests were within other terms of the security definition:

> [W]e have used this test to determine the true character of the instruments . . . and looking through their legal form we find, in reality,

185. *Id.* at 303.
186. *Id.* at 303.
187. The basic test is whether the investor receives a right to share in the profits or the proceeds of a business enterprise or venture to be conducted by others. People v. Sidwell, 162 P.2d 913, 916 (Cal. 1945); Austin v. Hallmark Oil Co., 134 P.2d 777, 782 (Cal. 1943); Domestic & Foreign Petro. Co. v. Long, 51 P.2d 73, 77 (Cal. 1935); Oil Lease Serv., Inc. v. Stephenson, 327 P.2d 628, 633 (Cal. Dist. Ct. App. 1958); Ogier v. Pacific Oil & Gas Dev.Corp., 282 P.2d 574, 578 (Cal. Dist. Ct. App. 1955); People v. Chait, 159 P.2d 445, 455 (Cal. Dist. Ct. App. 1945); People v. Rubens, 54 P.2d 98, 100 (Cal. Dist. Ct. App. 1936).
188. 327 P.2d 628 (Cal. Dist. Ct. App. 1958).
189. *Id.* at 633.
190. *Id.* at 633.

> certificates of interest in oil leases and assignments thereof, investment contracts and collateral trust certificates . . . .[191]

The application of the *Moore-Stephenson* approach is preferable when the enumerated interest in the definition of a security merely describes the form of the document. Without having to struggle with the meaning to be afforded the enumerated interest,[192] a court, by applying the common security test, can focus on the essential element of a security—the mutual expectation of the parties that the investor is to rely on others to produce a profit or other value.

Direct Application of the General Definitions

In the fourth line of cases, the general terms have been directly applied without any prior consideration of whether the oil interest enumerated in the security definition may be applicable. One reason for this approach is that the enumerated oil interest within the security definition has not been specifically defined, while the term "investment contract" has been given a very definitive meaning in *Howey*. Indicative of this preference for the term "investment contract" is *Meihsner v. Runyon*,[193] where the question presented was whether an undivided 1/64th interest in a 7/8th or working interest in a lease was a security:

> The sole question presented on this appeal is whether or not the instruments or interests are securities . . . . The applicable provisions of the Illinois Securities Law of 1919 are as follows:
>
> "The word 'securities' shall mean . . . any oil, gas or mining lease, royalty, or deed, and interest, units or shares in any such lease, royalty, or deed."[194]

The court, however, did not attempt to consider the applicability of this specific definition. Instead, the *Howey* test was cited as controlling the issue:

> In determining whether a particular instrument is a security within the meaning of the statute, we must look to the substance of the transaction and the relationship between the parties . . . .
>
> . . . .
>
> The test is whether the scheme involves an investment of money in a common enterprise with profits to be derived solely from the efforts of others.[195]

The court could have concluded that the fractional shares of the working interest were securities within the meaning of the definitional enumerated

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191. *Id.* at 635.
192. Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?* 18 CASE W. RES. L. REV. 367, 369 (1967).
193. 163 N.E.2d 236 (Ill. Ct. App. 1960).
194. *Id.* at 239.
195. *Id.* at 239-40.

interest as "units or shares in any such lease," instead of holding that the interests satisfied the *Howey* test.

The preference for the term "investment contract" was obvious in two recent cases wherein the enumerated interest was not even cited within the opinions. In *SEC v. MacElvain*,[196] the defendants offered to sell 1/16th interests in mining claims to mineral rights in submerged lands off the coast of California. The purpose of selling these interests was to raise money for an expensive court fight with the United States Department of the Interior which would decide whether the defendants had a superior right to the claims. The defendants made it clear in their offerings that the litigation would inure to the benefit of the investors. The court found that this promise created an expectation that profits would accrue from the efforts of a third party; therefore, the court held that the offerings were investment contracts.[197] The court did not attempt to decide whether the enumerated oil interest was applicable, but relied exclusively on "investment contract." In the recent decision of *Buie v. United States*,[198] a similar approach was taken. In that case, sellers bought up oil and gas leases at a reduced price and sold interests in them by falsely presenting that the leases had great potential for production. The court relied exclusively on the term "investment contract," without mentioning the enumerated interest, in determining that the transactions involved the transfer of a security because the leases depended for their value upon services to be performed exclusively by the sellers.[199]

The exclusive reliance on the term "investment contract" has caused the other terms of the security definition to become obscure. In a recent case, *Johns Hopkins University v. Hutton*,[200] the court relied on the "investment contract" test, but recognized the fact that other terms of the security definition were also applicable. In that case, the defendant stockbroker sold an oil production payment to Johns Hopkins University for $1.3 million. The sale of the oil payment entitling the investor to receive a fixed portion of the oil and gas produced was secured through the seller's guarantees that the transaction would be profitable. Relying on *Howey*, the court first held that the interest was an "investment contract,"[201] and in addition, that the enumerated interest and another general term were applicable:

> [T]he fact that the Hopkins production payment is an "investment contract" does not exclude the possibility that it may also be a "frac-

196. 299 F. Supp. 1352 (M.D. Ala.), *aff'd*, 417 F.2d 1134 (5th Cir. 1969), *cert. denied*, 397 U.S. 972 (1970).
197. *Id.* at 1353.
198. 420 F.2d 1207 (5th Cir.), *cert. denied*, 398 U.S. 932 (1969).
199. *Id.* at 1209.
200. 297 F. Supp. 1165 (D. Md. 1968), *modified on appeal*, 422 F.2d 1124 (4th Cir. 1970).
201. *Id.* at 1216.

> tional undivided interest in oil, gas or other mineral rights" or even a "profit sharing plan."[202]

It is interesting to compare this language to the cases which hold that an oil right cannot be considered a security unless it is within the meaning of enumerated interest. Clearly, the approach taken in *Johns Hopkins* is preferable because the general terms of the security definition provide the court with a more meaningful standard than does the enumerated interest in deciding whether a particular oil interest is a security.

The various approaches taken by the courts in deciding whether an oil right is a security is a result of the uncertainty surrounding the purposes and the definitions of the enumerated interests. These specific designations are not all inclusive, but were merely intended to serve as examples of those oil rights in which there was common trading for investment pruposes. The trend has been to rely on the general term "investment contract," principally because *Howey* firmly established its meaning. The *Howey* test of an investment contract is viable, however, only so long as it is flexibly applied. Unfortunately, the "investment contract" element of the securities definition has been the only general term to be given a definitive meaning, which accounts for the exclusive reliance on the definition by the courts. Perhaps an elucidation of the terms "certificate of interest or participation in any profit sharing agreement" and "any interest or instrument commonly known as a security" will afford the courts the additional guidance and flexibility required in order to give full effect to the purposes of the securities laws.

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202. *Id.* at 1216-17 (citations omitted).