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APPLYING SECURITIES REGULATIONS TO SALES OF CLUB MEMBERSHIPS

The term "association" ordinarily suggests a collection of individuals bound together as a unit for the achievement of a particular purpose or pursuit.²⁷⁰ In many investment associations, the purpose of realizing financial gain is achieved through the investment of members' money under circumstances which may amount to the sale of a security by the association. This segment of the symposium will examine the various types of associations in which memberships have been sold and will discuss why the sale has been held to lie either within or without the ambit of the federal and state securities acts. The first part of this discussion is a brief synopsis of prior case law concerning membership in associations entered into for the specific purpose of securing future financial profits solely from the efforts of a third party or promoter. The second section will analyze investment club membership agreements and the unique problem they pose for security classification purposes in light of the standard definition of an investment contract announced by the Supreme Court in *SEC v. W.J. Howey Co.*²⁷¹ The final section will examine membership in associations where the member has no rights in either the income or assets of the association with emphasis on the expansion of the term security under the "risk capital approach" promulgated in the landmark case of *Silver Hills Country Club v. Sobieski*.²⁷²

MEMBERSHIP IN AN ASSOCIATION FOR THE SPECIFIC PURPOSE OF SECURING A FUTURE FINANCIAL PROFIT

The history of securities litigation contains a significant number of cases where promoters solicited membership in profit-oriented associations to secure capital either to finance a speculative venture or simply to reap a quick profit by preying upon a gullible public eager to invest its earnings.²⁷³ The

270. *People v. Brander*, 91 N.E. 59, 60 (Ill. 1910).

271. 328 U.S. 293 (1946).

272. 13 Cal. Rptr. 186 (1961).

273. Schemes involving the solicitation of memberships for the purpose of securing capital are typified by the following cases: *Davenport v. United States*, 260 F.2d 591 (9th Cir. 1958), *cert. denied*, 359 U.S. 909 (1959) (membership in a plywood cooperative); *SEC v. Universal Serv. Ass'n*, 106 F.2d 232 (7th Cir. 1939), *cert. denied*, 308 U.S. 622 (1940); *United States v. Monjar*, 47 F. Supp. 421 (D.C. Del. 1942), *cert. denied*, 325 U.S. 859 (1945); *United States v. Davis*, 40 F. Supp. 246 (N.D. Ill. 1941) (membership in a cooperative association); *People v. Syde*, 235 P.2d 601 (Cal. 1951) (membership in a theatrical production company); *Grobby v. State*, 143 N.E. 126 (Ohio 1924); *State v. American Campground, Inc.*, 3 CCH BLUE SKY L. REP. ¶ 71,064, at

rationale underlying the solicitation of memberships was the avoidance of onerous registration requirements and the stringent anti-fraud provisions imposed by state and federal securities laws for the issuance or resale of a recognized security, such as stocks and bonds.²⁷⁴ By substituting the term "member" for stock or bondholder, promoters sought to elude the scope of security regulations since the terms "membership contract" and "receipt" are rarely included within the definition of a security.²⁷⁵ A literal interpretation of the definition by the courts would then preclude state or federal regulation of such schemes.²⁷⁶ Fortunately, the judiciary has not adopted a strict or literal approach when interpreting the securities enactments. To effectuate the legislative mandate, the remedial provisions of the acts have been construed liberally by the courts to afford the investor adequate protection.²⁷⁷

Two cases characteristic of attempts by a promoter to avoid the grasp of security regulation through the solicitation of membership subscriptions

67,319 (Ore. Ct. App. December 15, 1972) (membership in a recreational campsite development). See also 1 L. LOSS, SECURITIES REGULATION 495-96 (2d ed. 1961); Annot., 87 A.L.R.2d 1140 (1963).

274. See, e.g., *United States v. Davis*, 40 F. Supp. 246 (N.D. Ill. 1941) (defendants attempted to avoid registration requirements by issuing a membership certificate which recited in substance that the named individual became a member of a cooperative association entitled to *participate and share* in the distribution of profits); *Groby v. State*, 143 N.E. 126, 127 (Ohio 1924) (an attempt to avoid security registration involved the issuance of membership receipts indicating that the member would *share pro rata* in all earnings and profits of a syndicate which was formed to finance a speculative business venture).

275. See Securities Act of 1933, 15 U.S.C. § 77b(1) (1970); Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(10) (1970); Uniform Securities Act § 401l, 1 CCH BLUE SKY L. REP. ¶ 4931, at 727 (1958).

276. A literal interpretation of a statute is synonymous with the "plain meaning" principle of statutory interpretation. This principle advocates that only the meaning derived from a literal reading of a statute shall be considered if the statute is clear and unambiguous on its face. See Frankfurter, *Some Reflections on the Reading of statutes*, 47 COLUM. L. REV. 527, 536 (1947); Note, *The Plain Meaning Rule in the Reflection of Current Trends and Proclivities*, 26 TEMP. L.Q. 174 (1952).

277. See *Tcherepnin v. Knight*, 389 U.S. 332 (1967), wherein Justice Brennan stated:

[W]e are guided by the familiar canon of statutory construction that remedial legislation should be construed broadly to effectuate its purposes. The Securities Exchange Act quite clearly falls into the category of remedial legislation. One of its central purposes is to protect investors through the requirement of full disclosure by issuers of securities

Id. at 336; *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943); *accord*, *SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476, 480-81 (9th Cir.), *cert. denied*, — U.S. —, 94 S. Ct. 117, 38 L. Ed. 2d 53 (1973); *Llanos v. United States*, 206 F.2d 852, 854 (9th Cir. 1953), *cert. denied*, 346 U.S. 923 (1954); *SEC v. Crude Oil Corp. of America*, 93 F.2d 844, 846-47 (7th Cir. 1937); *MacAndrews & Forbes Co. v. American Barmag Corp.*, 339 F. Supp. 1401, 1406 (D.S.C. 1972); *Anderson v. Francis I. du Pont & Co.*, 291 F. Supp. 705, 707 (D. Minn. 1968); *United States v. Attaway*, 211 F. Supp. 682, 685 (W.D. La. 1962); *State Comm'r of Sec. v. Hawaii Mkt. Center, Inc.*, 485 P.2d 105, 108-09 (Hawaii 1971); *State v. Lorentz*, 22 N.W.2d 313, 314 (Minn. 1946); *Groby v. State*, 143 N.E. 126, 128 (Ohio 1924).

in profit-oriented ventures are *Groby v. State*²⁷⁸ and *SEC v. Universal Service Association*.²⁷⁹ In *Groby*, the petitioner was convicted under the Ohio "Blue Sky Laws"²⁸⁰ for the sale of a \$200 membership subscription which purported to evidence a receipt in the assets of the "Citizens Syndicate." The scheme involved selling memberships to obtain capital which was to be employed by the Citizens Syndicate to finance an "Underwriters Association" that would in turn organize the Independent Shale Oil Company. The membership receipt entitled the named subscriber to share pro rata in all earnings and profits accruing to the "Citizens Syndicate." The Ohio Supreme Court affirmed the petitioner's conviction for selling unlicensed securities, emphasizing that the state Blue Sky Laws were enacted for the purpose of safeguarding investors against the sale of securities in "schemes purely speculative in character, and to protect the public from swindling peddlers of worthless stocks in mere paper corporations."²⁸¹ Seeking to fulfill this purpose, the court refused to limit the reach of the securities act to the regulation of corporate stock alone. Their reasoning was that the unfettered perpetration of schemes such as this would constitute a travesty of securities regulation, inconsistent with the spirit of the state Blue Sky Laws.²⁸² Therefore, the court concluded, the solicitation of a membership receipt which indicated a subscriber's right to share pro rata in the profits of an unincorporated syndicate at some future date was clearly within the scope of the Ohio Securities Act.²⁸³

A second case, *SEC v. Universal Service Association*,²⁸⁴ determined the true nature of the membership agreement in issue by considering substance over form. The defendants in *Universal* had conducted an intensive advertising and soliciting campaign promoting the concept of "plenocracy."²⁸⁵ A contributor, by simply signing a membership application and agreeing to donate one dollar per month for a 5-year period to the "Universal Order of Plenocrats" would be entitled to receive future financial profits either in the form of real property or income. The Securities and Exchange Com-

278. 143 N.E. 126 (Ohio 1924).

279. 106 F.2d 232 (7th Cir.), *cert. denied*, 308 U.S. 622 (1939).

280. The popular term "Blue Sky" was explained in an early United States Supreme Court case, *Hall v. Griger Jones Co.*, 242 U.S. 539 (1917). When commenting on the evils to be remedied by the securities laws the Court stated:

The name that is given to the law indicates the evil at which it is aimed . . . "speculative schemes which have no more basis than so many feet of 'blue sky' "

Id. at 550.

281. *Groby v. State*, 143 N.E. 126, 128 (Ohio 1924).

282. *Id.* at 128.

283. *Id.* See also *Ross v. Couden*, 154 N.E. 527 (Ohio Ct. App. 1926).

284. 106 F.2d 232, 237 (7th Cir. 1939), *cert. denied*, 308 U.S. 622 (1940).

285. The defendants in their promotional literature described "plenocracy" as the science of creating abundance for all. *SEC v. Universal Serv. Ass'n*, 106 F.2d 232, 234 (7th Cir. 1939), *cert. denied*, 308 U.S. 622 (1940).

mission claimed the membership solicitation was a violation of the Securities Act of 1933 and requested an injunction against further distribution which was granted by the district court. The defendants sought to overturn the injunction by contending the membership contribution was a mere voluntary donation to a charitable use rather than an investment. The court rejected this contention, determining that the substance of the transaction involved a security because in reality the members were mere passive investors cajoled into subscribing by the lure of 30 percent profits per annum from agricultural operations conducted solely by the defendants.²⁸⁶

An examination of cases dealing with membership schemes similar to those presented by *Groby* and *Universal* yields identical results. Thus, the sale of a membership certificate which evidences the member's right to share in the profits of the "Stone Mountain Land Syndicate" was classified a security in *Ross v. Couden*.²⁸⁷ Similarly, the sale of cemetery plots in the "Clover Leaf Memorial Park" was brought within the purview of the Minnesota security statute in *State v. Lorentz*²⁸⁸ when the court concluded the plots were purchased by members primarily for investment rather than burial purposes.²⁸⁹ Finally, in *People v. Sowell*²⁹⁰ the court decided that even the sale of fractional interests by purported heirs in the "New Harlem Patentees Estates" was a transaction subject to regulation under the Michigan Blue Sky Law.²⁹¹

The solidarity of opinion expressed by the courts permits two inferences to be drawn concerning membership in associations entered into for future financial gain. First, the failure of state and federal legislators to include the term "membership contract" or "receipt" within the standard definition

286. *SEC v. Universal Serv. Ass'n*, 106 F.2d 232, 237 (7th Cir. 1939), *cert. denied*, 308 U.S. 622 (1940); *accord*, *United States v. Monjar*, 47 F. Supp. 421, 426-27 (D.C. Del. 1942), *cert. denied*, 325 U.S. 859 (1944) (loans made by Mantle Club members to the defendant were considered securities since the loans were made by the members for the purpose of securing future financial benefits through business concerns to be operated by the defendant). *See also* *Riegel v. Habenstro*, 30 A.2d 645 (Pa. Super. Ct. 1943).

The recognition of substance over form has been the basis of many recent decisions. *See Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967); *accord*, *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298 (1946); *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943); *Lino v. City Inv. Co.*, 487 F.2d 689, 693 (3d Cir. 1973); *Farrell v. United States*, 321 F.2d 409, 416 (9th Cir. 1963), *cert. denied*, 375 U.S. 992 (1964); *Anderson v. Francis I. du Pont & Co.*, 291 F. Supp. 705, 707 (D. Minn. 1968); *United States v. Attaway*, 211 F. Supp. 682, 685 (W.D. La. 1962); *SEC v. Bailey*, 41 F. Supp. 647, 650 (S.D. Fla. 1941); *SEC v. Timetrust, Inc.*, 28 F. Supp. 34, 38 (N.D. Cal. 1939); *People v. Davenport*, 91 P.2d 892, 894 (Cal. 1939); *People v. Yant*, 80 P.2d 506, 510-11 (Cal. Dist. Ct. App. 1938).

287. 154 N.E. 527 (Ohio Ct. App. 1926).

288. 22 N.W.2d 313 (Minn. 1946).

289. *Id.* at 315-16.

290. 271 N.W. 751 (Mich. 1937).

291. *Id.* at 753.

of a security has had little effect upon the willingness of the courts to classify these agreements as security transactions. In their quest to afford the investor adequate protection, the courts have consistently brought the membership agreements in question within the definition of a security by determining that the substance of the agreement prevailed regardless of the fact that they were faced with a designated beneficial interest in title to property,²⁹² an investment contract,²⁹³ a profit sharing agreement²⁹⁴ or simply an evidence of indebtedness.²⁹⁵ In examining the substance of a membership in an association, the courts have identified the elements that will ordinarily cause the transaction to be regarded as a security: the investment of the member's contribution to finance a speculative venture with the expectation of future profits solely by the efforts of a third party or a promoter.²⁹⁶

INVESTMENT CLUBS

An investment club is an association comprised of various persons who meet periodically to pool and invest their funds. The funds of the club are normally channeled into securities or other property of the members' own selection.²⁹⁷ The increasing popularity of investment clubs since 1945, and especially within the last decade, has resulted from their recognition as a vital factor within the American securities market.²⁹⁸ There are two major reasons for the increasing popularity of investment clubs. First, the clubs enable small investors to diversify their capital holdings and at the same time retain a greater degree of control than that afforded by other investments, such as mutual funds. Secondly, through group discussion and analysis, the members are able to develop a keener understanding of the problems and potentials of the enterprises in which they invest.²⁹⁹

Although there are myriad legal issues surrounding the operation of an investment club,³⁰⁰ this discussion will focus upon one specific question:

292. See, e.g., *People v. Sowall*, 271 N.W. 751, 752 (Mich. 1937); *Groby v. State*, 143 N.E. 126, 127-28 (Ohio 1924).

293. See, e.g., *State v. Lorentz*, 22 N.W.2d 313, 316 (Minn. 1946).

294. See, e.g., *United States v. Davis*, 40 F. Supp. 246 (N.D. Ill. 1941).

295. See, e.g., *In re Waldstein*, 291 N.Y.S. 697, 701 (Sup. Ct. 1936).

296. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946); accord, *SEC v. Universal Serv. Ass'n*, 106 F.2d 232, 237-38 (7th Cir.), cert. denied, 308 U.S. 622 (1939); *United States v. Monjar*, 47 F. Supp. 421, 427 (D.C. Del. 1942), cert. denied, 325 U.S. 859 (1944); *State v. Lorentz*, 22 N.W.2d 313, 314-15 (Minn. 1946).

297. Symposium, *Legal Problems Created by the Formation and Operation of Investment Clubs*, 106 U. PA. L. REV. 832, 833 (1958).

298. 1 L. LOSS, *SECURITIES REGULATION* 495 (2d ed. 1961); see Symposium, *Legal Problems Created by the Formation and Operation of Investment Clubs*, 106 U. PA. L. REV. 832, 833 (1958).

299. Symposium, *Legal Problems Created by the Formation and Operation of Investment Clubs*, 106 U. PA. L. REV. 832, 834 (1958).

300. See generally Symposium, *Legal Problems Created by the Formation of Investment Clubs*, 106 U. PA. L. REV. 832 (1958).

whether membership in an investment club constitutes a security. Due to the paucity of case law on this question, a specific answer, if any, must be gleaned from the opinions of leading commentators in the securities field and from judicial pronouncements in the related area of investment contracts.

The term "investment contract" is invariably included within the definition of a security under all state³⁰¹ and federal³⁰² security acts. The definition of the term investment contract was originally set out in *State v. Gopher Tire & Rubber Co.*³⁰³ and later canonized by the Supreme Court in *SEC v. W. J. Howay Co.*³⁰⁴ when Justice Murphy proclaimed:

[A]n investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party³⁰⁵

Reduced to its essentials, the *Howey* definition of an investment contract contains three basic criteria: 1) the investment of money; 2) investment in a common enterprise; and 3) the expectation of profits *solely* through the efforts of others.³⁰⁶ Applying this definition to the organizational structure of an investment club, it is clear that the first two criteria are present: the members invest their funds in an enterprise in which the fortune of each member's investment is interwoven with and completely dependent upon the success of the club itself. The only criterion within the *Howey* definition which does not necessarily coincide with the organizational structure of an investment club is the requirement that the profits expected by the investor result solely from the efforts of others. The reason for this variance is that investment club members are not totally passive toward the investment as were the members of the associations examined in *Groby* and *Universal*, since membership in an investment club presupposes active participation by the members concerning the investment of club funds.³⁰⁷ A literal interpretation of "the solely through the efforts of another" requirement in *Howey* would then preclude the classification of investment club membership as a security.

Although there are no cases involving investment clubs which specifically address the question of investor participation, there is support for the proposition that active participation by the investor will preclude classification

301. *E.g.*, MD. CODE ANN. art. 32a, § 25(l) (1971).

302. *E.g.*, 15 U.S.C. § 77b(1) (1970); 15 U.S.C. § 78c(a)(10) (1970).

303. 177 N.W. 937, 938 (Minn. 1920).

304. 328 U.S. 293 (1946).

305. *Id.* at 298-99.

306. *See* Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135, 142 (1971).

307. Symposium, *Legal Problems Created by the Formation and Operation of Investment Clubs*, 106 U. PA. L. REV. 832, 838 (1958).

as a security in cases dealing with other types of memberships. In *People v. Syde*,³⁰⁸ the defendants were charge with conspiracy to violate the California Securities Laws for entering into contractual agreements with parents, directed at realizing a return of investment in their children's talent in the entertainment field. The agreement stated that the defendants would provide training in drama for the children of investing parents and stipulated that the children agreed to devote their full efforts to the production of commercial films. In the event the films were sold or distributed, 60 percent of the gross receipts would be disbursed equally among the case members. After examining the substance of the transaction, the court concluded the agreements in question constituted personal service contracts for compensation and not investment contracts because the profits to be derived from the successful completion of the films required active participation by the children as cast members.³⁰⁹ This activity by the children, then, barred the application of the California Corporate Securities Laws since the statutes were "not intended to afford supervision and regulation of instruments which constitute agreements with persons who expect to reap a profit from their own services or other *active participation* in a business venture."³¹⁰

One of the unique features which distinguishes a security from other forms of investment is the loss of control by the investor over his investment.³¹¹ The usual meaning attributed to the word "control" is the authority to direct, manage or regulate.³¹² Thus it is possible for the investor to actively *participate* in the enterprise and still have his investment solely *controlled* by a third party when the third party exercises actual or direct control over the managerial decisions of the enterprise.³¹³ This very concept of participation without the ability to control was present in *Syde* because even though the children actively participated in the enterprise, management over the production, distribution and marketing of the films rested exclusively under the control of the defendants.³¹⁴ The reluctance of the court to recognize this reality, however, accounts for its conclusion that active participation of a non-managerial nature is sufficient to prevent the imposition of security regulation.

308. 235 P.2d 601 (Cal. 1951).

309. *Id.* at 603.

310. *Id.* at 603 (emphasis added); see *Gallion v. Alabama Mkt. Centers, Inc.*, 213 So. 2d 841, 845 (Ala. 1968); *Georgia Mkt. Centers, Inc. v. Fortson*, 171 S.E.2d 620, 624 (Ga. 1969); *Carlton Brown v. Computer Credit Sys., Inc.*, 3 CCH BLUE SKY L. REP. ¶ 71,061, at 67,302 (Ga. Ct. App. March 7, 1973).

311. Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135, 170 (1971).

312. WEBSTER'S THIRD INTERNATIONAL DICTIONARY 496 (3d ed. 1960).

313. Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?* 18 CASE W. RES. L. REV. 367, 396-98 (1967).

314. *People v. Syde*, 235 P.2d 601, 603 (Cal. 1951).

Taking a position opposite that in *Syde*, courts in other recent cases encountering non-managerial participation by the investor have tended to reject the "solely" test of *Howey*.³¹⁵ Relying upon the remedial goals of the Securities Acts, these cases indicate that the judiciary should focus upon the *quality* of the investor's participation.³¹⁶ Under this approach, mere physical participation by the investor in the enterprise is insufficient to remove the transaction from the scope of securities regulation. Rather, the investor by his participation must exert *joint control* over the managerial decisions of the enterprise before the membership agreement will be held not to constitute a security, for it is this control which provides the investor with adequate safeguards of his investment and thereby obviates the need for state and federal intervention.³¹⁷

Protection of the investor is the touchstone of security regulation.³¹⁸ Logically this protection should not be withdrawn simply because the investor performs some type of non-managerial activity in the investment enterprise. Based upon this premise, the joint-control theory seems the preferable course to follow in determining when membership in an investment club is a security.

To gauge the extent of "joint control" exerted by the members in an investment club, the operation of each club must be evaluated on an individual basis.³¹⁹ To facilitate this evaluation, the following inquiries have been suggested as helpful guidelines: (1) Is the distribution of club profits withheld until dissolution of the club through a policy of automatic reinvestment? (2) Is the membership large in number?³²⁰ (3) Do the members

315. See *SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476, 482-83 (9th Cir.), *cert. denied*, — U.S. —, 94 S. Ct. 117, 38 L. Ed. 2d 53 (1973); *D.M.C., Inc. v. Stanley R. Hayes*, [1961-1971 Transfer Binder] CCH BLUE SKY L. REP. ¶ 70,897, at 67,039 (Colo. Dist. Ct. February 26, 1971); *State Comm'r of Sec. v. Hawaii Mkt. Center, Inc.*, 485 P.2d 105, 108-09 (Hawaii 1971).

316. *E.g.*, *State Comm'r of Sec. v. Hawaii Mkt. Center, Inc.*, 485 P.2d 105, 111 (Hawaii 1971).

317. *Id.* at 111; *accord*, *SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476, 482 (9th Cir.), *cert. denied*, — U.S. —, 94 S. Ct. 117, 38 L. Ed. 2d 53 (1973); *D.M.C., Inc. v. Stanley R. Hayes*, [1961-1971 Transfer Binder] CCH BLUE SKY L. REP. ¶ 70,897, at 67,042 (Colo. Dist. Ct., February 26, 1971). See also Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?* 18 CASE W. RES. L. REV. 367, 396-98 (1967); Goodwin, *Franchising in the Economy: The Franchise Agreement as a Security Under Securities Acts, Including 10b-5 Considerations*, 24 BUS. LAW. 1311, 1318-19 (1969); Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135, 170-73 (1971).

318. *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967).

319. Symposium, *Legal Problems Created by the Formation and Operation of Investment Clubs*, 106 U. PA. L. REV. 832, 838 (1958).

320. For example, the Director of the Wisconsin Department of Securities has stated that any investment club having more than 15 members must be registered under the Wisconsin Securities Law. Statement of Director, Wis. Dept. of Securities, [1954-1961 Transfer Binder] CCH BLUE SKY L. REP. ¶ 70,248, at 65,425 (October 1954).

rely upon the judgment of a single individual or a few select members to determine the investment of club funds? (4) Are the members permitted to purchase unequal fractions of the club's assets? (5) Is there a liberal policy toward admitting new members? (6) Is a concentration of a majority of the club's assets in the hands of a few members? (7) Is the club's portfolio reviewed only infrequently?³²¹

The application of the above inquiries to the method of operation employed by the investment club will aid in determining whether membership in such a club constitutes a security. If a majority of the above inquiries are answered in the affirmative, then membership in the club would probably constitute a security. The basis for this conclusion is that a high percentage of affirmative answers indicates an acute deficiency of joint control exerted by the members over their investment funds. Conversely, if the inquiries reveal a significant level of joint control, the membership should not be subjected to regulation.³²²

MEMBERSHIPS ENTERED INTO FOR NON-PROFIT PURPOSES

A review of prior cases indicates few instances where the membership interest in issue denied the member a right to share in either the income or assets of the association. This scarcity of decisions should not be attributed, however, to a consensus of opinion among the judiciary concerning the security status of such memberships, for there is a considerable divergence of opinion between those cases decided prior to *Silver Hills Country Club v. Sobieski*³²³ and those appearing afterwards.

A representative case involving the refusal to classify a membership agreement as a security when the agreement entitled the member only to purchase goods at a stipulated discount is *Creasy Corp. v. Enz Bros. Co.*³²⁴

321. These criteria were set out in Symposium, *Legal Problems Created by the Formation and Operation of Investment Clubs*, 106 U. PA. L. REV. 832, 837-42 (1958).

322. See *Polikoff v. Levy*, 204 N.E.2d 807, 809 (Ill. Ct. App. 1965), cert. denied, 382 U.S. 903 (1965). See also Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135 (1971), where a similar conclusion regarding the control factor was stressed:

In terms of segregating securities from other forms of investment [the control] factor is most critical. Other forms of investments have one or more of the characteristics outlined above, but securities are unique in that the investor loses all control over his investment. This unique arrangement was one of the prime factors leading to the enactment of securities regulation. *If the investor is going to be asked to turn funds over to another and have no direct control in the policy decisions concerning its use*, then he ought to have complete information about the individual and the scheme the latter is going to conduct. Without this information the investor cannot make an intelligent decision concerning the trustworthiness of the promoter or the soundness of the venture. On the other hand, *if he has a direct voice in the management and control of the enterprise* he is in a position to protect his investment.

Id. at 171 (emphasis added).

323. 13 Cal. Rptr. 186 (1961).

324. 187 N.W. 666 (Wis. 1922).

The action in this case was instituted by the Creasy Corporation for the recovery of goods purchased. The Enz Brothers Company counterclaimed for a return of its membership fee, contending the corporation had not obtained a security permit prior to selling the memberships; hence the sale was void and the corporation required to remit the purchase price. In rejecting this contention, the court expressed the view that the Wisconsin "Blue Sky Laws" were enacted to protect investors from the sale of worthless money obligations which entitle the investor to share in either the capital or profits of the company. Therefore, the "Blue Sky Laws" would not be applied to personal service contracts which merely offer the member a discount.³²⁵

The question of whether the sale of memberships in a country club constitutes a security was presented for the first time in *Hacker v. Goldberg*.³²⁶ The court in *Hacker* relied upon the "plain meaning" of the Illinois Security Act and answered the question in the negative by stating:

We think the Act intended to prohibit the sale unless its provisions were complied with, of securities from which income or profit was expected to derive, and not for an interest in a club from which no financial profit or income could be derived under the charter.³²⁷

Taken in conjunction, the decisions in *Creasy* and *Hacker* represent the viewpoint that the sale of a membership will not constitute a security unless the membership agreement entitles the member to share in the profits or assets of the association.

A clear departure from the "profit motive criterion," however, occurred in the landmark case of *Silver Hills Country Club v. Sobieski*.³²⁸ The question in *Silver Hills* also involved the sale of memberships in a country club. In June 1959, the defendants entered into a partnership to organize the Silver Hills Country Club. The capital needed to finance the venture was raised by the sale of club memberships entitling a member and his immediate family to the use of the facilities of the club. The application specifically stated, however, that a member had no right in either the *income or assets of the club*. The California Commissioner of Corporations concluded that the memberships were securities and issued a "Desist and Refrain Order" directing the defendants to stop the sale of memberships until a permit was obtained. A divided court upheld the commissioner's contention that the memberships were securities. Justice Traynor, speaking for the majority, concluded:

325. *Id.* at 667; *accord*, *Lewis v. Creasy Crop.*, 248 S.W. 1046, 1048-49 (Ky. 1923).

326. 263 Ill. App. Rep. 73 (Super. Ct. 1931).

327. *Id.* at 76-77 (citations omitted); *Prohaska v. Hemmer-Miller Dev. Co.*, 256 Ill. App. Rep. 331, 339-40 (Super. Ct. 1930).

328. 13 Cal. Rptr. 186 (1961). *Silver Hills* has aroused much discussion within the California legal community. Additional analysis of this case can be found at: *Sobieski, Securities Regulation in California: Recent Developments*, 11 U.C.L.A.L. REV. 1, 5-7 (1963); Note, 50 CALIF. L. REV. 156 (1962); Note, 14 HASTINGS L.J. 181 (1962).

Since the act does not make profit to the supplier of capital the test of what is a security, it seems all the more clear that its objective is to afford those who risk their capital at least a fair chance of realizing their objectives in legitimate ventures whether or not they expect a return on their capital in one form or another.³²⁹

The significance of *Silver Hills* was in the formulation of the "risk capital approach" as the standard to be applied when examining a membership agreement³³⁰ in regard to its classification as a security. An analysis of the opinion reveals that the sale of a membership will constitute a security whenever the substance of the agreement results in the following:

- 1) the member extends capital to the promoter of the enterprise,
- 2) the capital extended by the member is subject to the risks of the enterprise, and
- 3) the capital is contributed by the member in the belief that *some type of valuable benefit* will accrue to the member from its emment by the promoter.³³¹

By de-emphasizing the "profit motive" criterion of *Creasy* and *Hacker*, the risk capital approach expanded the definition of a security to include benefits of an intangible nature. Thus in *Silver Hills* the sale of country club memberships, which gave the investor no rights in either the income or assets of the enterprise but simply allowed the purchaser to use and enjoy the club's facilities, conferred a benefit sufficient to bring the membership within the ambit of securities regulation. The effect of the risk capital approach on a similar membership agreement, when profit to the investor was not the motivating factor, is reflected by a recent opinion of the California Attorney General.³³² In this opinion, the guidance of the attorney general was requested in the determination of whether the sale of memberships in air travel clubs constituted a security interest. The gist of the membership schemes involved had a common nucleus of facts. A company would purchase an aircraft capable of carrying a stated number of passengers. An air travel club would then be formed in which memberships were sold to recoup the cost of the purchase price. Membership in the club allowed a member and his family to travel on the club's plane to various parts of the United States and foreign lands at costs considerably below fares charged by public air carriers. Relying on the reasoning in *Silver Hills*, the Attorney General concluded that the members extended their capital to the promoters on the expectation they would provide safe air travel at reduced rates, an expected benefit that brought the sale of these memberships under the pro-

329. *Silver Hills Country Club v. Sobieski*, 13 Cal. Rptr. 186, 188-89 (1961).

330. Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135, 167-70 (1971).

331. *Silver Hills Country Club v. Sobieski*, 13 Cal. Rptr. 186, 188-89 (1961).

332. 67 OPS. ATT'Y GEN. 160, [1961-1971 Transfer Binder] CCH BLUE SKY L. REP. ¶ 70,750, at 66,647 (August 11, 1967).

tection of the California Corporate Securities Act.³³³

The air travel club membership is just one of many types of non-profit memberships available in the modern marketplace in which security regulation might properly be imposed through the "risk capital approach." Conceivably, the sale of memberships by promoters to finance the development of golf clubs, health clubs, tennis clubs and yacht clubs could be classified as transactions involving the sale of a security when the members invest their capital in an attempt to secure the benefits which those kinds of clubs offer to the public.

The mandate of the Supreme Court is clear: the definition of a security embodies a flexible 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 profit."³³⁴ To restrict this definition solely to tangible profits reflected by the promoters balance sheet is inconsistent with the remedial goals of the securities laws.³³⁵ Rather, the protective umbrella of the laws should be extended to safeguard the benefit which the investor expects. The fact that the benefit is intangible in nature should be of little consequence to the courts.

333. *Id.* at 66,649.

334. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 299 (1946); *accord*, *Tcherepnin v. Knight*, 389 U.S. 332, 338 (1967). A flexible definition of a security was also advocated by the Court in *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943), wherein Justice Jackson admonished:

However, the reach of the Act does not stop with the obvious or commonplace. Novel, uncommon or irregular devices, whatever they appear to be, are also reached if it be proved as 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.'"

Id. at 351.

335. *See Silver Hills Country Club v. Sobieski*, 13 Cal. Rptr. 186, 188-89 (1961); *accord*, *State Comm'r of Sec. v. Hawaii Mkt. Center, Inc.*, 485 P.2d 105, 110 (Hawaii 1971).