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## Notes

### **Horse Syndicates as Securities Under Blue Sky Laws**

by

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# Notes

## Horse Syndicates as Securities Under Blue Sky Laws

### INTRODUCTION

Currently, all fifty states and the District of Columbia have some form of securities laws, each basically paralleling the federal securities acts of 1933<sup>1</sup> and 1934.<sup>2</sup> Although the merits of these state "blue sky laws"<sup>3</sup> are constantly debated,<sup>4</sup> neither critics nor proponents can realistically deny the increased complexity in business deals attributable to these laws.<sup>5</sup> Basically, an

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<sup>1</sup> 15 U.S.C. § 77a-77bbbb (1976 & Supp. 1980).

<sup>2</sup> *Id.* § 78a-78kk (1976 & Supp. 1980).

<sup>3</sup> Although the origin of this term of endearment is uncertain, Professors Loss and Cowett, among others, cite the following historical passage:

The State of Kansas, most wonderfully prolific and rich in farming products, has a large proportion of agriculturists not versed in ordinary business methods. The State was the hunting ground of promoters and fraudulent enterprises; in fact their frauds became so barefaced that it was stated that they would sell building lots in the blue sky in fee simple. Metonymically they became known as blue sky merchants, and the legislation intended to prevent their frauds was called Blue Sky Law.

Mulvey, *Blue Sky Law*, 36 CAN. L.T. 37 (1916).

<sup>4</sup> For arguments generally favorable to blue sky laws, see Brainin and Davis, *State Regulation of the Sale of Securities: Some Comments*, 14 BUS. LAW. 456 (1958-59); Cowett, *Federal-State Relationships in Securities Regulation*, 28 GEO. WASH. L. REV. 287 (1959-60); Warren, *Reflections on Dual Regulation of Securities*, 25 B.C.L. REV. 495 (1983-84); Wright, *Correlation of State Blue Sky Laws and the Federal Securities Acts*, 26 CORNELL L.Q. 258 (1941). For arguments critical of blue sky laws, see Armstrong, *The Blue Sky Laws*, 44 VA. L. REV. 713 (1958); Bloomenthal, *Blue Sky Regulation and the Theory of Overkill*, 15 WAYNE L. REV. 1447 (1968-69); Hill, *Some Comments on the Uniform Securities Act*, 55 NW. L. REV. 661 (1961); Millonzi, *Concurrent Regulation of Interstate Securities Issues: The Need for Congressional Reappraisal*, 49 VA. L. REV. 1483 (1963); Mofsky, *Blue Sky Restrictions on New Business Promotions*, 1969 DUKE L.J. 273 (1969); Smith, *State "Blue Sky" Laws and the Federal Securities Acts*, 34 MICH. L. REV. 1135 (1936).

<sup>5</sup> "The 'blue sky' laws had come to have a special meaning—a meaning full of complexities, surprises, unsuspected liabilities for transactions normal

attorney involved with the sale of securities must examine the blue sky laws of *each* state in which the security will be offered to ascertain the state's pertinent registration requirements. If a security is to be offered in thirty-two states, for example, thirty-three separate analyses must be completed, because compliance with federal laws is also required.<sup>6</sup> Of course, these registration requirements will not even be reviewed until the attorney concludes that the particular investment to be sold constitutes a "security."<sup>7</sup> This determination alone involves a separate analysis of all applicable state and federal laws.

This Note examines the effects of state blue sky laws on the use of syndicates in the horse industry. Specifically, the definitions of a security are explored to determine whether horse syndicates constitute securities under blue sky laws. Because few state courts have actually examined horse syndicates, this Note attempts to provide guidance concerning state securities definitions by examining the federal interpretive influence on state decisions in the past. Federal securities law and the status of horse syndicates under that law are also analyzed. First, how-

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and usual—in short, a crazy quilt of state regulations no longer significant or meaningful in purpose, and usually stultifying in effect, or just plain useless.”

Armstrong, *supra* note 4, at 714-15.

Obviously, some of this confusion is attributable to the emergence of federal securities laws and their expansion into fields previously occupied solely by blue sky laws. This conflict resulted in, and continues to fuel, arguments concerning preemption of state securities law by the federal laws. See generally Brainin & Davis, *supra* note 4, at 457; Millonzi, *supra* note 4, at 1494-99; Warren, *supra* note 4, at 498-538; Wright, *supra* note 4, at 260-83.

<sup>6</sup> A 32-state offering is not unrealistic for syndicates in the horse industry. Due to recent capital deficiencies, the use of public offerings and large partnerships in the industry has proliferated. It is no longer unusual to encounter as many as one thousand investors in a single financial scheme. See Heckmerman, *Taking Stock of Shares*, THE BLOOD HORSE, at 256 (Jan. 14, 1984). Although syndicates typically involve a much smaller group of investors, preparing such agreements may be quite burdensome. In 1958, Loss and Cowett wrote the following concerning this laborious process of preparing blue sky memoranda:

To begin with, the process . . . contemplates at least four weeks' time from the date that [a] preliminary blue sky memorandum has been prepared. Frequently that much time is not available to the blue sky attorney. And even if the overall time pressures are not great, there may be time pressures in a particular state.

Loss & COWETT, BLUE SKY LAW 122 (1958).

<sup>7</sup> See 15 U.S.C. § 77b(1) for the federal definition of security.

ever, the basics of breeding and racing syndicates are discussed.

## I. THE BASICS OF SYNDICATION IN THE HORSE INDUSTRY

### A. *The Stallion Syndicate*

Stallion syndicates<sup>8</sup> are designed primarily to alleviate costs, risks and responsibilities for interested investors. Although investors in major stallion syndicates are often experienced breeders, syndicate managers must be employed because each investor owns only a "fractional interest"<sup>9</sup> in the stallion. This interest usually entitles each owner to breed one mare to the stallion per year, although it also obligates the investor to pay a portion of the stallion's maintenance expenses. A syndicate manager must monitor breeding activity and ensure that the stallion receives proper care.<sup>10</sup> As illustrated below,<sup>11</sup> the syndicate manager's "efforts" (if he or she is also the syndicate promoter) are critical in determining whether the agreement constitutes a security. If the manager is assigned extensive responsibilities, which he often is,<sup>12</sup> then the potential for security status is increased.

### B. *The Racing Syndicate*

While the structure of a racing syndicate<sup>13</sup> resembles that of a breeding syndicate,<sup>14</sup> the purposes differ. Investors in the racing syndicate are concerned primarily with track performance,

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<sup>8</sup> For a more detailed discussion of stallion syndicates, see Campbell, *Stallion Syndicates as Securities*, 70 KY. L.J. 1131 (1981-82). See also Note, *Equine Syndication: A Legal Overview*, 62 KY. L.J. 1038 (1973-74).

<sup>9</sup> The term fractional interest is preferable to the word shares, because the United States Supreme Court has indicated that even the characterization of such agreements may affect the determination of whether a security exists. See Campbell, *supra* note 8, at 1132 n.4 (citing *United Housing Found., Inc. v. Forman*, 421 U.S. 837, 850-51 (1975)).

<sup>10</sup> Campbell, *supra* note 8, at 1132-33.

<sup>11</sup> See notes 26-32 *infra* and accompanying text.

<sup>12</sup> The manager is also sometimes responsible for promoting the stallion, providing insurance and assisting investors who wish to sell breeding rights. See *id.*

<sup>13</sup> For a more detailed discussion of racing syndicates, see Campbell, *Racing Syndicates as Securities*, 74 KY. L.J. 691 (1985-86).

<sup>14</sup> "Each involves the joint ownership of a horse with a contract, the syndicate agreement, that governs the rights and obligations of the joint owners ('co-owners')." *Id.* at 692.

rather than breeding performance. This inherent distinction generally requires that the racing syndicate manager be delegated greater duties than a breeding syndicate manager. Many of the decisions impacting on the racing performance of a horse must be made quickly and regularly, so that involvement of the co-owners would be impractical.<sup>15</sup> Individual investors in breeding syndicates, on the other hand, typically have absolute control over the critical investment performance decision: which mare to breed to which stallion.

## II. INTERPRETATION OF FEDERAL SECURITIES LAW

### A. *The Howey Test*

Although recent cases have modified its holding, *S.E.C. v. W.J. Howey Co.*<sup>16</sup> is the preeminent decision defining a security. The Court held in *Howey* that an "investment contract" and, therefore a security, exists when "a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or third party."<sup>17</sup> The *Howey* test is commonly reduced to four elements: 1) an investment of money, 2) a common enterprise in which the money is invested, 3) an expectation of profits, and 4) such expectation of profits to be derived solely from the efforts of the promoter or third party.<sup>18</sup>

### B. *The Status of Howey at the Federal Level*

Due to a great deal of criticism, subsequent decisions have softened the fourth component of the *Howey* test. *S.E.C. v.*

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[A]rrangement must be made regarding the control and supervision of the horse's racing career. For practical reasons, it is difficult to involve all the co-owners in the day-to-day decisions of a racing career. Decisions concerning jockeys, racing schedules and veterinary care, for examples, must be made expeditiously, and as a result, the syndicate agreement usually delegates responsibility for the care of the horse and the supervision of the racing career to the syndicate manager or to some other person or small group. The delegation is typically broad, usually giving the syndicate manager essentially unfettered control over the racing of the horse.

*Id.* at 692-93.

<sup>16</sup> 328 U.S. 293 (1946).

<sup>17</sup> *Id.* at 298-99.

<sup>18</sup> See, e.g., Campbell, *supra* note 8, at 1136-37.

*Koscot Interplanetary, Inc.*<sup>19</sup> is the case most often cited as the impetus for judicial variation from *Howey*. In *Koscot*, each participant, after paying a fee, was allowed to earn commissions by encouraging others to become representatives of *Koscot*. The original investor was entitled to a portion of the fee that each new participant paid.<sup>20</sup> Because each original investor played a significant role in the generation of profits, the Fifth Circuit Court of Appeals realized that application of a strict *Howey* standard would preclude its classifying of the transaction as a security.<sup>21</sup> The court therefore modified at least the terminology of the crucial fourth element: "The critical inquiry is '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.'"<sup>22</sup>

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<sup>19</sup> 497 F.2d 473 (5th Cir. 1974).

<sup>20</sup> *Id.* at 475-76. *Koscot* illustrates the operation of what is commonly referred to as a "pyramiding scheme." The Fifth Circuit Court of Appeals, using its expanded *Howey* test, concluded that the transaction constituted a security. As the discussion in this Note of state court decisions employing risk capital analysis explains, the same conclusion is reached almost universally. These state courts profess to use a test unlike the one used in *Koscot*, yet reach the same result, revealing the actual similarities of the two tests.

<sup>21</sup> The district court had relied upon the "solely" language of *Howey* in concluding that the *Koscot* scheme did not constitute an investment contract. *Id.* at 477.

<sup>22</sup> *Id.* at 483.

The critical language quoted in *Koscot* was taken from a 1973 case decided by the Ninth Circuit Court of Appeals. In *S.E.C. v. Glenn W. Turner Enter.*, 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973), investors contributed various sums of money in exchange for the right to attend classes aimed at improving self-motivation and sales ability. In addition, those investing in certain programs were allowed to sell the course, which included tapes, records and other materials, to others. *Id.* at 478. A sale of the course resulted in a commission for the investor. *Id.* at 479. In adopting the "undeniably significant" test set out in *Koscot*, the court stated:

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 requirements 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.

*Id.* at 483.

The Ninth Circuit, by analogy, made a persuasive argument that the "new" test was in accord with the Supreme Court's intention in *Howey*. See *id.* at 482. "Let us assume," the court hypothesized, "that in *Howey* . . . the sales and service agreement had provided that the buyer was to buy and plant the citrus trees." *Id.* at 482-83. In

The federal courts apparently have accepted this expanded interpretation of *Howey*.<sup>23</sup> In fact, the United States Supreme Court may have implicitly approved the expanded test in *United Housing Foundation v. Forman*,<sup>24</sup> in which the Court stated that the "economic realities underlying a transaction" are the critical considerations in analyzing alleged securities.<sup>25</sup>

It is within these parameters that syndicate organizers must operate. In structuring the duties of a syndicate manager/promoter, the attorney must remember that an over-delegation of duties will result in a security.

There is little case law interpreting horse syndicates under federal securities laws, although one recent district court case has addressed the issue. In *Kefalas v. Bonnie Brae Farms, Inc.*,<sup>26</sup> the court examined a syndicate agreement assigning the manager very few responsibilities. The agreement stated that the manager "would do no more than furnish a list of breeders who had inquired as to the availability of [breeding rights]."<sup>27</sup> While the court primarily based its decision on the fact that the syndicate

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*Howey*, the majority of the investors actually contracted with a Howey Company affiliate to have all of the work conducted by this "third party." As the Ninth Circuit pointed out, "[T]he essential nature of the scheme . . . would be the same," even though the investor was contributing some part of the services. *Id.* at 483. "He would still be buying, in exchange for money, trees and planting, a share in what he hoped would be the company's success in cultivating the trees and harvesting and marketing the crop." *Id.* Thus, the court concluded, the Supreme Court would have held under those facts that an investment contract existed. *Id.*

<sup>23</sup> See *Union Planters Nat'l Bank v. Commercial Credit Business Loans, Inc.*, 651 F.2d 1174, 1185 (6th Cir.), cert. denied, 454 U.S. 1124 (1981); *Noa v. Key Futures, Inc.*, 638 F.2d 77, 79 (9th Cir. 1980); *Cameron v. Outdoor Resorts of America, Inc.*, 608 F.2d 187, 193 (5th Cir. 1980); *Fargo Partners v. Dain Corp.*, 540 F.2d 912, 915 (8th Cir. 1976); *Lino v. City Investing Co.*, 487 F.2d 689, 692-93 (3d Cir. 1973).

This principle espoused in *Koscot* has been interpreted by some federal courts to require an inquiry as to whether the investor has contributed risk capital subject to the entrepreneurial or management efforts of others. See *Great Western Bank and Trust v. Kotz*, 532 F.2d 1252, 1256-58 (9th Cir. 1976). This should come as no surprise, because some contribution of capital is necessary to constitute the sale of an investment security. Furthermore, risk, in its most basic form, is an element of the *Howey* and *Koscot* tests: if the investor exerted a great deal of effort, the risk would not rest upon the efforts of a third party.

<sup>24</sup> 421 U.S. 837 (1975).

<sup>25</sup> *Id.* at 850-51.

<sup>26</sup> 630 F. Supp. 6 (E.D. Ky. 1985).

<sup>27</sup> *Id.* at 8.

lacked the common enterprise requirement of *Howey*,<sup>28</sup> the court also noted that the manager's efforts did not approach the threshold required by *Howey*'s fourth element.<sup>29</sup>

Fortunately, this decision appears to be consistent with the Security and Exchange Commission's (S.E.C.) position. "[T]he Commission has uniformly taken the position that a share in a *stallion* syndicate is not a security, provided the syndicate manager does no more than care for the horse and perform certain ministerial functions for the syndicate."<sup>30</sup>

The reaction to racing syndicates may be different, however, because of the greater duties generally delegated to the syndicate manager<sup>31</sup> and because of the other characteristics of typical racing syndicates.<sup>32</sup>

Against this general background, this Note examines pertinent blue sky decisions. Since few cases have interpreted syndicates, the following analysis proceeds on the premise that state courts following federal interpretations in the past will continue to do so. For example, assume that the high court of state "X" has in the past relied upon federal decisions when interpreting its blue sky law because of the similarities between state law and federal law. It is logical to further assume that the court will continue that practice when construing a syndicate agreement. As illustrated above, such a method would probably result in a

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<sup>28</sup> *Id.* See Campbell, *supra* note 13, at 696.

<sup>29</sup> 630 F. Supp. at 8. There was evidence that the managers offered to sell the plaintiff's right to other breeders. The court, however, granted the defendant's summary judgment despite this evidence. *Id.* at 9. Professor Campbell finds this conclusion promising:

Although *Kefalas* represents no major conceptual development in the definition of a security, it is a significant application of traditional *Howey* concepts, especially in light of the procedural setting of the case. The court's willingness to grant a defendant's motion for summary judgment, even in the face of plaintiffs' allegations concerning the syndicate manager's additional undertakings, indicates that one may be able to assign the syndicate manager duties and responsibilities beyond those presently sanctioned by the no-action letters of the Securities and Exchange Commission ("Commission"). More specifically, the case reflects at least one court's opinion that promises by a syndicate manager to sell nominations on behalf on the co-owners will not necessarily create a security. All of this should provide some comfort to persons who wish to expand the traditional responsibilities of the syndicate manager.

Campbell, *supra* note 13, at 697-98.

<sup>30</sup> Campbell, *supra* note 8, at 1147 (emphasis added).

<sup>31</sup> See text accompanying note 15 *supra*.

<sup>32</sup> Campbell, *supra* note 13, at 703-06.



conclusion that breeding syndicates are not securities, although racing syndicates are. A critical assumption in this synopsis, however, is that the pertinent blue sky law parallels the federal law. That assumption is tested in section three of this Note.

### III. STATES ADOPTING THE FEDERAL STANDARD

Thirty-five states and the District of Columbia have adopted the Uniform Securities Act<sup>33</sup> since its promulgation in 1956.<sup>34</sup> The section of the Act crucial to this Note is section 401(1),<sup>35</sup>

<sup>33</sup> UNIF. SECURITIES ACT, 7B U.L.A. 576 (1985).

<sup>34</sup> ALA. CODE §§ 8-6-1 to 8-6-33 (1975); ALASKA STAT. § 45.55.010 et seq. (1980); ARK. STAT. ANN. §§ 67-1235 to 67-1263 (1980); COLO. REV. STAT. §§ 11-51-101 to 11-51-129 (1973); CONN. GEN. STAT. ANN. §§ 36-470 to 36-502 (West 1981); DEL. C. tit. 6 §§ 7301-28 (1974); D.C. CODE ANN. §§ 2-2601 to 2-2618 (1981); HAWAII REV. STAT. §§ 485-1 to 485-25 (1976); IDAHO CODE § 30-1401 et seq. (1980); IND. CODE ANN. §§ 23-2-1-1 to 23-2-1-24 (Burns 1984); IOWA CODE ANN. §§ 502.101-.614 (1949 & Supp. 1985); KAN. STAT. ANN. §§ 17-1252 to 17-1275 (1981); KY. REV. STAT. ANN. §§ 292.310-.550, 292.991 (Bobbs-Merrill 1981); MD. CORPS. & ASS'NS CODE ANN. §§ 11.101-.805 (1983); MASS. ANN. LAWS ch. 110A, §§ 101-417 (1985); MICH. COMP. LAWS ANN. §§ 451.501-.818 (1967); MINN. STAT. ANN. §§ 80A.01-.31 (West 1968); MISS. CODE ANN. §§ 75-71-101 to 75-71-735 (1973); MO. ANN. STAT. §§ 409.101-.418 (Vernon 1967); MONT. CODE ANN. §§ 30-10-101 to 30-10-308 (1985); NEB. REV. STAT. §§ 8-1101 to 8-1124 (1983); NEV. REV. STAT. §§ 90.010-.205 (1985); N.H. REV. STAT. ANN. §§ 421-B:1 to 421-B:34 (1983); N.J. STAT. ANN. §§ 49:3-47 to 49:3-76 (West 1970); N.M. STAT. ANN. §§ 58-13-1 to 58-13-46 (1978); N.C. GEN. STAT. §§ 78A-1 to 78A-65 (1985); OKLA. STAT. ANN. tit. 71 §§ 101-502 (West 1965); OR. REV. STAT. § 59.005 et seq. (1985); PA. STAT. ANN. §§ 1-101 to 1-704 (Purdon 1965); P.R. LAWS ANN. tit. 10 §§ 851-95 (1976); S.C. CODE ANN. §§ 35-1-10 to 35-1-1590 (Law. Co-op 1976); UTAH CODE ANN. §§ 61-1-1 to 61-1-30 (1953 & Supp. 1985); VA. CODE §§ 13.1-501 to 13.1-527.3 (1985); WASH. REV. CODE §§ 21.20.005 to 21.20.940 (1983); W. VA. CODE §§ 32-1-101 to 32-4-418 (1982); WIS. STAT. ANN. §§ 551.01-.69 (West 1969); WYO. STAT. §§ 17-4-101 to 17-4-129 (1977).

<sup>35</sup> "Security" means any note; stock; treasury stock; bond; debenture; evidence of indebtedness; certificate of interest or participation in any profit-sharing agreement; collateral-trust certificate; preorganization certificate or subscription; transferable share; investment contract; voting-trust certificate; certificate of deposit for a security; certificate of interest of participation in an oil, gas, or mining title or lease or in payments out of production under such a title or lease; or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for guarantee of, or warrant or right to subscribe to or purchase any of the foregoing. "Security" does not include any insurance or endowment policy or annuity contract under which an insurance company promises to pay [a fixed sum of] money either in a lump sum or periodically for life or for some other specified period.

UNIF. SECURITIES ACT § 401(1) (1985).

which includes the term "investment contract"—the definition that the *Howey* Court relied upon<sup>36</sup>—in the definition of a security.

Of those thirty-six jurisdictions adopting the Act, twenty-three have retained this definition without any significant changes.<sup>37</sup> Furthermore, five states<sup>38</sup> not adopting the Act have enacted a substantially identical definition. Therefore, twenty-eight states appear to be in the proper statutory position to rely upon federal case law when interpreting agreements, because those states' definition of a security is virtually identical to the pertinent federal provisions.<sup>39</sup>

Otherwise, so far as horse syndications are concerned, Ohio,<sup>40</sup> Pennsylvania<sup>41</sup> and Texas<sup>42</sup> contain perhaps the most dangerous provisions defining securities. In addition to the basic language contained in section 401(1) of the Uniform Securities Act, these states specifically address syndicates. For example, section 1707.01(B) of the Ohio Act includes "syndicate certificates" in the definition of a security.<sup>43</sup> *Groby v. State*,<sup>44</sup> an early case interpreting the term securities, determined that membership receipts in an oil syndicate were securities when profits and earnings were anticipated from the property of the syndicate.<sup>45</sup>

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<sup>36</sup> *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293, 298 (1946).

<sup>37</sup> ARK. STAT. ANN. § 67-1247(1); COLO. REV. STAT. § 11-51-102(12); CONN. GEN. STAT. ANN. § 36-471(m); D.C. CODE ANN. § 2-2601(12); HAWAII REV. STAT. § 485-1(12); IDAHO CODE § 36-1402(12); IND. CODE ANN. § 23-2-1-1(k); IOWA CODE ANN. § 502.102(12); KAN. STAT. ANN. § 17-1252(j); KY. REV. STAT. ANN. § 292.310(13); MD. CORPS. & ASS'NS. CODE ANN. § 11-102; MASS. ANN. LAWS ch. 110A § 401; MINN. STAT. ANN. § 80A.14(18); MONT. CODE ANN. § 30-10-103(12); NEB. REV. STAT. § 8-1101(12); N.H. REV. STAT. ANN. §421-B:2(xx); N.J. STAT. ANN. § 49:3-49(m); N.C. GEN. STAT. § 78A-2(11); OR. REV. STAT. § 59.015(14)(a), (b); S.C. CODE ANN. § 35-1-20(12); UTAH CODE ANN. § 61-1-13(12); VA. CODE § 13.1-501(j); W. VA. CODE § 32-4-401(l).

<sup>38</sup> The five states are Arizona, Florida, Illinois, Maine and South Dakota.

<sup>39</sup> See Securities Act of 1933, at § 2(1), 15 U.S.C. § 77b(1) (1981); Securities Exchange Act of 1934, at § 3(a), 15 U.S.C. § 78c(a)(10) (1981).

<sup>40</sup> OHIO REV. CODE ANN. § 1707.01(B) (1985).

<sup>41</sup> PA. STAT. ANN. tit. 70 § 102(5) (1972).

<sup>42</sup> TEX. REV. CIV. STAT. ANN. art. 581-4 (Vernon 1964).

<sup>43</sup> OHIO REV. CODE ANN. § 1707.01(B).

<sup>44</sup> 143 N.E. 126 (Ohio 1924).

<sup>45</sup> *Id.* at 127-28. Although this is a broad interpretation, a later case implies that at least some analysis of the investor's efforts in a syndicate agreement is required. See *State v. George*, 362 N.E.2d 1223, 1228 (Ohio Ct. App. 1975).

Other statutes that cause the greatest confusion are those based upon the risk capital test, discussed in section four of this Note.<sup>46</sup> Statutes in Alaska,<sup>47</sup> Georgia,<sup>48</sup> Michigan,<sup>49</sup> North Dakota,<sup>50</sup> Oklahoma<sup>51</sup> and Washington<sup>52</sup> specifically include risk capital language. Although the Hawaii and California courts<sup>53</sup> use the risk capital test in defining a security, neither state statutorily embraces the language of the test.<sup>54</sup>

Of the twenty-eight jurisdictions adopting the Act's definition of security, courts in twenty-four jurisdictions have used the general federal guidelines when interpreting the definition of investment contract or security under blue sky laws.<sup>55</sup> This should

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<sup>46</sup> See notes 81-128 *infra* and accompanying text.

<sup>47</sup> ALASKA STAT. § 45.55130(12).

<sup>48</sup> GA. CODE ANN. § 10-5-2(16) (1982).

<sup>49</sup> MICH. COMP. LAWS ANN. § 451.801(l).

<sup>50</sup> N.D. CENT. CODE § 10-04-02(12) (1985).

<sup>51</sup> OKLA. STAT. tit. 71 § 2(20).

<sup>52</sup> WASH. REV. CODE § 21.20.005(12).

<sup>53</sup> See notes 94-128 *infra* and accompanying text.

<sup>54</sup> CAL. CORP. CODE § 25019 (West 1977); HAWAII REV. STAT. § 485-1(12) (1968).

<sup>55</sup> The states closely following federal law include:

Alabama: See *Burke v. State*, 385 So. 2d 648 (Ala. 1980) (citing *S.E.C. v. Koscot Interplanetary, Inc.*, 497 F.2d 473 (5th Cir. 1974) and *S.E.C. v. Glenn W. Turner Enter.*, 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973)). See also *Buffo v. State*, 415 So. 2d 1158, 1162 (Ala. 1982) ("[F]ederal cases should be reviewed to aid in the proper interpretation of the corresponding sections of Alabama statutory law inasmuch as the sections are virtually identical."); *Gallion v. Alabama Mkt. Centers, Inc.*, 213 So. 2d 841 (Ala. 1968) (adopting strict *Howey* standard), *modified*, *Burke v. State*, 385 So.2d 648 (Ala. 1980) (stating that investment contract shall be more broadly construed than in *Gallion*).

Alaska: See *American Gold and Diamond Corp. v. Kirkpatrick*, 678 P.2d 1343 (Alaska 1984) (In determining whether "investment contracts" exist, *substance* and *economic reality* prevail over form). See also *Wheeler v. State*, 659 P.2d 1241 (Alaska 1983) (reliance by investors on corporation's efforts was critical to finding of investment contract); *Hentzner v. State*, 613 P.2d 821 (Alaska 1980) (gold mining scheme constitutes investment contract under *Howey*).

Arizona: See *Rose v. Dobras*, 624 P.2d 887 (Ariz. Ct. App. 1981) (lease of land and sale of orchard trees accompanied by management contract constitutes a security under *Glenn W. Turner* even though buyers had right to cancel management agreement).

Colorado: See *People v. Milne*, 690 P.2d 829 (Colo. 1984) (investment notes sold by consumer finance corporation constitute "investment contracts" under *Howey*); *Lowery v. Ford Hill Inv. Co.*, 556 P.2d 1201 (Colo. 1976) (condominium investment agreement containing mandatory exclusive management and rental agreement constitutes investment contract under *Howey*). See also *Sauer v. Hays*, 539 P.2d 1343 (Colo. Ct. App. 1975) (sale of corporation's "distributorships" constitutes "investment contract")

under "undeniably significant" test of *Glenn W. Turner*).

Connecticut: *See State v. Bull Inv. Group, Inc.*, 351 A.2d 879 (Conn. 1974) (pyramiding scheme under which purchaser earned commission for selling advertisements in corporate booklet deemed a security under *Glenn W. Turner*). *See also State v. Kreminski*, 422 A.2d 294 (Conn. 1979) (defendant convicted for selling short-term notes of financial services corporation because they constituted unregistered securities under federal standards).

Florida: *See notes 61-66 infra* and accompanying text.

Illinois: *See notes 67-78 infra* and accompanying text.

Kansas: *See State v. Colby*, 646 P.2d 1071 (Kan. 1982) (agreement under which corporation, after receiving initial investment, supplied distributor/purchaser with auto parts for resale to public is not a security under fairly strict *Howey/Forman* test); *State v. Hodge*, 460 P.2d 596 (Kan. 1969) (agreement under which defendant gave note for twice the amount received from investor is a security under federal standards).

Kentucky: *Scholarship Counselors, Inc. v. Waddle*, 507 S.W.2d 138 (Ky. App. 1974) (sale for \$175.00 of an interest is a "scholarship fund" held to be a security under flexible *Howey* test). *See also Securities Administrator v. College Assistance Plan (GVAM) Inc.*, 700 F.2d 548 (9th Cir. Ct. App. 1983) (citing *Waddle* for support of application of flexible *Howey* test to scholarship program).

Louisiana: *Ek v. Nationwide Candy Div., Ltd.*, 403 So. 2d 780 (La. Ct. App. 1981) (investment in vending machines is an investment contract under *Koscot* "essential managerial efforts" test even though plaintiff agreed to maintain the machines and keep the business records).

Massachusetts: *Valley Stream Teachers v. Comm'r. of Banks*, 384 N.E.2d 200 (Mass. 1978) (lending agreements not securities under *Howey* and *Great Western Bank & Trust v. Kotz*, 532 F.2d 1252 (9th Cir. 1976)).

Michigan: *Dept. of Commerce v. DeBeers Diamond Inv.*, 280 N.W.2d 547 (Mich. Ct. App. 1979) (sale of diamonds by defendant is not an investment contract under *Howey* even though defendant guaranteed to repurchase any diamond sold to investors at same price at which diamonds were selling on repurchase date). *See also People v. Dempster*, 242 N.W.2d 381, 381 (Mich. 1976) ("The Uniform Securities Act carries within itself the statement of its purpose, i.e. to 'make uniform the law of those states which enact it and to coordinate the interpretation and administration of this act with the related federal regulation.'"). *But see M.C.L.A. § 451.801(1)* (1979) (addition of risk capital language to definition of security in state securities law).

Missouri: *Garbo v. Hilleary Franchise Sys.*, 479 S.W.2d 491 (Mo. Ct. App. 1972) (investment in limited partnership in which general partner was to manage restaurant is an investment contract under strict *Howey* standard). *See also Carney v. Hanson Oil Co.*, 690 S.W.2d 404 (Mo. 1985) (state securities laws not preempted by federal regulations).

Montana: *State v. Duncan*, 593 P.2d 1026 (Mont. 1979) (investment is a security under *Glenn W. Turner* where purchasers were sold materials to construct packages for resale to defendant).

New Hampshire: *See State v. Haneault*, 431 A.2d 142 (N.H. 1981) (implying that a "circle-of-gold" chain letter constitutes a security under *Howey* even though the express language of the state statute constrained the court from so holding).

New Jersey: *AMR Realty Co. v. State*, 373 A.2d 1002 (N.J. Super. Ct. App. Div. 1977) (using *Howey* to illustrate that housing cooperative shares entitling purchaser only

comfort promoters of, and investors in, horse syndicates, at

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to lease of apartment did not constitute a security).

New Mexico: *State v. Sheets*, 610 P.2d 760 (N.M. Ct. App. 1980) (recognizing *Howey* as appropriate test for an investment contract).

New York: *See Gardner v. Lefkowitz*, 412 N.Y.S.2d 740 (Sup. Ct. 1978) (sale of diamonds for investment purposes is an investment contract under *Howey*).

North Dakota: *See State v. Gates*, 325 N.W.2d 166 (N.D. 1982) (loan commitments are securities under guidance of federal cases); *State v. Goetz*, 312 N.W.2d 1 (N.D. 1981), *cert. denied*, 455 U.S. 924 (1982) (using federal cases in determining that no evil intent is required to show willful violation of state securities law).

Pennsylvania: *A.B.A. Auto Lease Corp. v. Adam Indus.*, 387 F. Supp. 531, 534 n.6 (E.D. Pa. 1975) (Section 1.2.201 of the Pennsylvania Securities Commission Rules adopts a "significant managerial efforts" test.).

South Carolina: *O'Quinn v. Beach Assoc.*, 249 S.E.2d 734 (S.C. 1978) (no investment contract exists where condominium manager merely offers rental services to purchaser whose efforts were therefore greater than "nominal or insignificant").

Texas: *See Sears v. Commercial Trading Corp.*, 560 S.W.2d 637 (Tex. 1977) (commodity options are securities under "undeniably significant" test of *Glenn W. Turner*); *Mayfield v. Troutman*, 613 S.W.2d 339 (Tex. Civ. App. 1981) (limited partnership with general partner performing managerial duties is an investment contract under *Howey* and its progeny); *Wilson v. Lee*, 601 S.W.2d 483 (Tex. Civ. App. 1980) (joint venture interests in raw land held solely for appreciation profit are not securities under *Howey* and progeny); *McConathy v. Dal Mac Commercial Real Estate, Inc.*, 545 S.W.2d 871 (Tex. Civ. App. 1976) (joint venture interests in raw land held solely for appreciation profit are not securities under *Howey* and progeny); *Star Supply Co. v. Jones*, 665 S.W.2d 194 (Tex. Ct. App. 1984) (transfer of company stock merely indicating ownership of entire business is not a sale of securities under *Howey-Forman*); *Cross v. DFW South Entry Partnership*, 629 S.W.2d 860 (Tex. Ct. App. 1982) (sale of interest in unimproved land is not a security where promoter merely managed daily activities and purchaser retained ultimate control of investment and profits).

Utah: *Payable Accounting Corp. v. McKinley*, 667 P.2d 15 (Utah 1983) (investor contracts through which company generated capital to fund business of managing payrolls for other businesses are investment contracts under *Glenn W. Turner*).

Vermont: *Northern Terminals, Inc. v. Leno*, 392 A.2d 419 (Vt. 1978) (security cannot exist when plaintiffs' expectation of profits depended upon acquisition of new facilities rather than entrepreneurial or managerial efforts of others).

Washington: *See McClellan v. Sundholm*, 574 P.2d 371 (Wash. 1978) (investment contract exists under *Howey* when investor in silver bars expects to derive profit from seller's ability to wisely manage selection, purchase and resale activities). *See also Sauve v. K.C., Inc.*, 591 P.2d 1207 (Wash. 1979) (transaction involving loan of capital in return for promise of fixed interest payments and return of principal within three years is a security under federal standards), *reversing Sauve v. K.C., Inc.*, 577 P.2d 599 (1978) (in which court of appeals incorrectly applied risk capital test and found no security); *State v. Markham*, 697 P.2d 263, 269 n.6 (Wash. Ct. App. 1985) (affirming use of *Howey* while also noting addition of risk capital language to Washington securities law); *Christgard, Inc. v. Christensen*, 627 P.2d 136 (Wash. Ct. App. 1981) (sale of interest in sawmill is a security when investor depended on seller's knowledge, skills, managerial expertise and marketing experience).

Wyoming: *Gaudina v. Haberman*, 644 P.2d 159 (Wyo. 1982) (inter vivos trust managed for investors is a security under *Howey*).

least in breeding syndicates.<sup>56</sup> Although it is difficult to determine the amount of effort that the syndicate manager is allowed to exert before the syndicate is ruled a security, at least concrete guidelines are in place.

*Marshall v. Harris*,<sup>57</sup> decided in 1976 by the Oregon Supreme Court, illustrates a state court's use of federal guidelines. In *Marshall*, the defendants purchased from the plaintiffs a one-third interest in the track earnings of two thoroughbreds. In addition to the initial purchase price, the investor agreed to pay for training, feeding and other maintenance expenses. The promoter expressly retained the right of control over the care and activities of the horses. Within a matter of months, the investor terminated all payments, thus compelling the promoter to file a law suit.<sup>58</sup> The court had little trouble holding that the agreement constituted an investment contract under *Howey*.<sup>59</sup> Because the two horses had been shipped to California for training, it was impossible for the investor to have any control whatsoever.<sup>60</sup> In addition, the promoter contractually retained complete control of the horses.

A Florida court reached a similar result in *Brown v. Rairigh*.<sup>61</sup> In *Brown* the investor purchased a ten percent interest in five horses for \$11,675.00.<sup>62</sup> The investor was to receive ten percent of the horses' winnings, while the seller "was to retain custody and control of the horses and undertake all the work of training, caring for and racing them."<sup>63</sup> Although the court

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<sup>56</sup> See notes 26-32 *supra* and accompanying text.

<sup>57</sup> 555 P.2d 756 (Or. 1976).

<sup>58</sup> *Id.* at 758.

<sup>59</sup> Although the Oregon court applied federal standards in this case, Oregon is not categorized as having "adopted" those guidelines because of several other Oregon cases either considering or adopting risk capital analysis. See *Pratt v. Kross*, 555 P.2d 765 (Or. 1976) (risk capital test was noted as a viable option, but modified *Howey* test was applied in holding that a limited partnership interest is an investment contract); *Black v. Corp. Div.*, 634 P.2d 1383 (Or. Ct. App. 1981) (tax shelter investment scheme is a security under both *Howey* and risk capital tests); *State v. Consumer Business System, Inc.*, 482 P.2d 549 (Or. Ct. App. 1971) (franchise agreements are securities under risk capital test).

<sup>60</sup> 555 P.2d at 758.

<sup>61</sup> 363 So. 2d 590 (Fla. Dist. Ct. App. 1978).

<sup>62</sup> *Id.* at 591.

<sup>63</sup> *Id.*

concluded that no security existed because there was no common enterprise,<sup>64</sup> it noted that the efforts requirement of the *Howey* test had been satisfied because the investor was relying solely upon the efforts of the promoter.<sup>65</sup> This decision is not surprising, even though the contract gave the investor the privilege of selling his interest back to the promoter until the end of the year.<sup>66</sup>

A recent Illinois case provides a similar illustration of the effects of federal standards in the analysis of breeding syndicates. Although *Ronnett v. American Breeding Herds, Inc.*<sup>67</sup> involved what is commonly known as a "cattle-care contract," the principles, and the facts, greatly resembled a stallion syndicate.<sup>68</sup> In that case, the investor, Ronnett, was advised by defendant Shannon to invest in a cattle breeding operation offered by defendant American Breeding Herds (ABH). In 1972, Ronnett purchased thirty-six Charolais cows and a one-quarter interest in a Charolais bull for a total of \$113,000.00. Ronnett also agreed to pay \$80.00 per animal in quarterly maintenance fees.<sup>69</sup> The contract provided Ronnett with one breeding privilege for each cow but the selection of the sire was reserved exclusively to ABH. Although the contract entitled Ronnett to cancel the maintenance program upon ninety days notice and to sell the cattle publicly or privately, ABH retained "complete jurisdiction and control of the animals."<sup>70</sup> That authority included exclusive control over maintenance and feed for the animals and the choice of the animals' location. Ronnett received status reports on the animals' condition and personally inspected the herd and the facilities.<sup>71</sup>

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<sup>64</sup> The court held that, under *Howey*, there could be no common enterprise with only one investor. *Id.* at 593.

<sup>65</sup> *Id.* The court also noted that the term "solely" had been modified in federal cases. *Id.* at 592 n.3.

<sup>66</sup> *Id.* at 591.

<sup>67</sup> 464 N.E.2d 1201 (Ill. App. Ct. 1984).

<sup>68</sup> See notes 8-12 *supra* and accompanying text.

<sup>69</sup> 464 N.E.2d at 1202. As in many of these cases, the investor in *Ronnett* was totally unfamiliar with cattle breeding. In fact, he was a physician advised to invest for tax purposes.

<sup>70</sup> *Id.*

<sup>71</sup> *Id.*

In June, 1977, after investing approximately \$204,000.00 into the venture, Ronnett ordered the cattle sold and received in return a check for \$7,016.27. Subsequently, he sought rescission of the contract and a refund of invested funds.<sup>72</sup>

As the court noted, the principal issue was whether the transaction amounted to an investment contract subject to the federal and state securities laws.<sup>73</sup> After finding that a common enterprise existed due to a "vertical commonality,"<sup>74</sup> the court addressed the difficult efforts issue. Although the court acknowledged Ronnett's authority in first delegating maintenance duties to ABH and then in ordering the sale of the cattle, it determined that an investment contract did exist.<sup>75</sup> The control retained by Ronnett was insufficient to vitiate the true nature of the contract:

Ronnett was permitted to observe his herd, and he commented upon his satisfaction with the way things were going. Yet, he could not have participated in the . . . vital aspects of the operation in terms of its potential for success since they were within the sole control of ABH.<sup>76</sup>

It may be significant that the court reached this conclusion even though Ronnett had the right to order his cattle sold.<sup>77</sup> The court also emphasized that Ronnett had no expertise in breeding or selling cattle, even though he was an experienced investor.<sup>78</sup>

As indicated, state courts clearly adopting federal interpretations for security analysis have provided critical groundwork for parties interested in syndicate agreements. There are, however, three other categories of states in which the courts' positions are not as clear. One category contains states indicating in some manner—either by dictum or by implication—that they at least acknowledge federal interpretations;<sup>79</sup> another contains states

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<sup>72</sup> *Id.*

<sup>73</sup> *Id.* at 1203.

<sup>74</sup> *Id.* at 1204.

<sup>75</sup> *Id.* at 1206.

<sup>76</sup> *Id.*

<sup>77</sup> The investment agreement provided, however, that ABH would decide "when, how, where and for what price" the cattle would be sold. *Id.*

<sup>78</sup> *Id.*

<sup>79</sup> The following jurisdictions have accepted, at least directly or indirectly, general federal guidelines. District of Columbia: *See Price v. Griffin*, 359 A.2d 582 (D.C. 1976)



in which the courts have given no indication whatsoever of how they interpret blue sky laws;<sup>80</sup> and the final category, one that is analyzed in section four of this Note, contains states basically rejecting federal interpretations and applying instead some form of risk capital analysis. It is demonstrated that the application of the risk capital test is essentially identical to federal interpretations under *Koscot* and its progeny. Because these state courts apparently do not realize this similarity, however, they still pose something of a risk to potential investors.

#### IV. STATES ADOPTING THE RISK CAPITAL TEST

Six states statutorily include risk capital language in their definition of a security. In addition to those states, Hawaii and California courts have analyzed various schemes under the risk capital test.<sup>81</sup>

The Washington rendition of the risk capital test is perhaps the most simply stated, although its elements are virtually identical to the tests in Alaska, Michigan, North Dakota, and Oklahoma. The Washington statute provides that a security includes an "investment of money or other consideration in the risk capital of a venture with the expectation of some valuable benefit to the investor where the investor does not receive the right to exercise practical and actual control over the managerial decisions of the venture."<sup>82</sup> Michigan requires the contribution to

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(using federal cases to interpret District of Columbia's equivalent of federal Rule 10b-5). Indiana: *Wisconics Engineering, Inc. v. Fisher*, 466 N.E.2d 745 (Ind. Ct. App. 1984) (tacitly accepting trial court's use of *Forman* to interpret state's definition of security). Iowa: *Midwest Management Corp. v. Stephens*, 291 N.W.2d 896 (Iowa 1980) (generally relying on federal cases in discussing state blue sky law). North Carolina: *Commodities Int'l, Inc. v. Eure*, 207 S.E.2d 777, 780 (N.C. Ct. App. 1974) (stating that blue sky laws' similarity to 1933 Act "dictates our reliance on the decisions of the state and federal courts in interpreting them.").

South Dakota's courts have interpreted the state's blue sky law without explaining their rationale. *See, e.g., Hofer v. General Discount Corp.*, 192 N.W.2d 718 (S.D. 1971).

<sup>80</sup> These states are Delaware, Idaho, Kentucky, Maine, Maryland, Mississippi, Nebraska, Nevada, Oklahoma, Rhode Island, Tennessee, Virginia, West Virginia, and Wisconsin.

<sup>81</sup> *See* notes 46-54 *supra* and accompanying text.

<sup>82</sup> WASH. REV. CODE § 21.20.005(12) (1985).

be "capital, other than services,"<sup>83</sup> while Alaska, North Dakota and Oklahoma specifically include the "investment of money or money's worth including goods furnished [and]/or services performed in the risk capital of a venture. . . ."<sup>84</sup>

Whether state courts constrained by statutory risk capital language may still follow federal standards when interpreting state securities laws is questionable. If the pattern of blue sky interpretation and legislation in Georgia is any indication, the answer is "probably not." Section 10-5-2(16) of the Georgia Code currently provides that an investment contract and, therefore, a security, exists when an investment

holds out the possibility of return of risk capital even though the investor's efforts are necessary to receive such return if:

(A) Such return is dependent upon essential managerial or sales efforts of the issuer or its affiliates; and

(B) One of the inducements to invest is the promise of promotional or sales efforts of the issuer or its affiliates in the investor's behalf; and

(C) The investor shall thereby acquire the right to earn a commission or other compensation from sales of rights to sell goods, services, or other investment contracts of the issuer or its affiliates.<sup>85</sup>

This legislation, particularly section 10-5-2(16)(C), clearly resulted from criticism of the Georgia Supreme Court's decision in *Georgia Market Centers, Inc. v. Fortson*.<sup>86</sup> In *Georgia Market Centers*, investors (called Founder Distributors or Founder Supervisors) paid a stated sum in return for the right to participate in a marketing program.<sup>87</sup> Each investor was given a number of plastic purchase authority cards to distribute to his contacts; the cards entitled holders to shop at the Market Center. Each time a cardholder made a purchase, the investor received a commis-

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<sup>83</sup> MICH. COMP. LAWS ANN. § 451.801(l) (1967).

<sup>84</sup> ALASKA STAT. § 45.55.130(12) (1962); N.D. CENT. CODE § 10-04-02(12) (1985); OKLA. STAT. tit. 71 § 2(20) (1965).

<sup>85</sup> GA. CODE ANN. § 10-5-2(16) (1982).

<sup>86</sup> 171 S.E.2d 620 (Ga. 1969).

<sup>87</sup> *Id.* at 621-22.

sion based upon the size of his original investment.<sup>88</sup> The Georgia court, applying *Howey* while also emphasizing the economic realities of the transaction, held that no security existed.

No share is sold in the stock of the [Market Centers] corporations and there is no participation in the profits of the . . . corporations. While the efforts of the [Market Centers] are necessary in establishing the centers and selling the merchandise in order that there may be any return to the Founder [investor], no commission is earned by the Founder [investor] except from sales to customers obtained, directly or indirectly, by him.<sup>89</sup>

That language juxtaposed beside section 10-5-2(15)(C) clearly belies the legislative impetus for adopting the risk capital test in 1974. The test employed by the court appears overly restrictive when compared with modern federal standards. Nevertheless, the legislature's hyperactive attitude was unnecessary in light of federal decisions between the time *Georgia Market Centers* was decided in 1969 and section 10-5-2(16) was enacted in 1974. For example, *S.E.C. v. Glenn W. Turner*,<sup>90</sup> decided in 1973, interpreted such pyramiding schemes as constituting securities. Furthermore, the new legislation compelled the Georgia courts to consider risk capital in subsequent decisions.<sup>91</sup> Most courts have found their own way to the expanded federal standards without such legislative tampering.

The difficult aspect of analyzing risk capital states is determining exactly what risk capital analysis entails. Many authors have tried to explain the distinction between this test and the prominent federal standard,<sup>92</sup> although none of the arguments is particularly persuasive. This may be because the two tests are, in fact, identical. To state it indelicately, these courts generally find that capital is at risk when the promoter or third party retains control over the use of the capital—when he is responsible for the entrepreneurial or managerial efforts<sup>93</sup> and the investor exerts no effort.

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<sup>88</sup> *Id.* at 622.

<sup>89</sup> *Id.* at 623-24.

<sup>90</sup> 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

<sup>91</sup> See *Dunwoody Country Club of Atlanta v. Fortson*, 253 S.E.2d 700 (Ga. 1979).

<sup>92</sup> See, e.g., Coffey, *The Economic Realities of a "Security:" Is There a More Meaningful Formula?*, 18 W. RES. L. REV. 367 (1967).

<sup>93</sup> See notes 19-25 *supra* and accompanying text.

This efforts analysis, if accepted in all fifty states, would provide the analytical framework presently found in the federal courts. Some criteria must be universally accepted so that syndicators and investors, without trepidation, can structure syndicate agreements. Such an agreement, if the syndicator wishes to avoid security classification, should carefully follow federal guidelines in limiting the syndicate manager's duties.

The case most often cited as the genesis of the risk capital test is *Silver Hills Country Club v. Sobeiski*.<sup>94</sup> It may be argued, however, that *State v. Gopher Tire & Rubber Co.*,<sup>95</sup> decided in 1920 by the Minnesota Supreme Court, actually provides the neck around which this albatross may be hung.

In *Gopher Tire*, a case involving the sale of certificates entitling purchasers to a commission on the sale of tires, the court stated:

No case has been called to our attention defining the term "investment contract." The placing of capital or laying out of money in a way intended to secure income or profits from its employment is an investment as the word is commonly used and understood. If the defendant issued and sold its certificates to purchasers who paid their money, justly expecting to receive an income or profits from the investment, it would seem that the statute should apply.<sup>96</sup>

The principal difference between this test and the *Howey* test is the absence of any concern by the Minnesota court over efforts.<sup>97</sup> In *Gopher Tire*, the purchased certificates "recite that defendant [promoter] has appointed the holder (purchaser) as one of his agents to assist by word of mouth and in other ways in the sale of tires and tubes which defendant will manufacture."<sup>98</sup> In return the agent received ten percent of the profit from tires and tubes sold at his location.<sup>99</sup> Thus, it is obvious that the agent's efforts were quite important in the production of his expected return.

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<sup>94</sup> 13 Cal. Rptr. 186 (Cal. 1961).

<sup>95</sup> 177 N.W. 937 (Minn. 1920).

<sup>96</sup> *Id.* at 938.

<sup>97</sup> For a discussion of *Howey* and other federal cases, see notes 16-25 *supra* and accompanying text.

<sup>98</sup> 177 N.W. at 937.

<sup>99</sup> *Id.*

In fact, the circumstances presented in *Gopher Tire* are similar to those in *S.E.C. v. Kosco*<sup>100</sup> and other federal cases responsible for expanding the *Howey* test. Those cases, however, employed an efforts analysis not developed in 1920 when *Gopher Tire* was decided. The Minnesota Supreme Court has employed *Howey*'s standard at least once since *Gopher Tire* was decided,<sup>101</sup> although the court has more recently pledged its allegiance to *Gopher Tire*.<sup>102</sup> Arkansas has adopted this same approach, expressly rejecting the federal interpretations<sup>103</sup> and any efforts analysis. This approach may be because the agreement under scrutiny in the Arkansas case required no efforts to be exerted by the investor.<sup>104</sup>

The lack of any effort analysis is also evident in the California Supreme Court's *Silver Hills* opinion. *Silver Hills* involved the sale of memberships in a country club developed by a group of businessmen. After making a downpayment on the buildings and land to be developed, the partners financed necessary improvements by selling "charter memberships" for \$150.00 each. Members were entitled to use the club's facilities, except the golf course for which special memberships were required. The memberships did not grant to the holder any rights in the income or assets of the club. After 110 of these charter memberships were sold, the state commissioner of corporations issued a desist and restrain order, having concluded that the memberships were unregistered securities under California's corporate securities act. The developers sought a writ of mandamus to compel the commissioner to vacate his order. The superior court granted the writ, and the Commissioner appealed to the California Supreme Court.<sup>105</sup>

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<sup>100</sup> 497 F.2d 473 (5th Cir. 1974). See notes 19-22 *supra* and accompanying text.

<sup>101</sup> See *State v. Investors Security Corp.*, 209 N.W.2d 405 (Minn. 1973).

<sup>102</sup> See *State v. Coin Wholesalers, Inc.*, 250 N.W.2d 583 (Minn. 1976) (sale of silver coin investments constitutes sale of investment contract).

<sup>103</sup> *Schultz v. Rector-Phillips-Morse, Inc.*, 552 S.W.2d 4 (Ark. 1977) (joint venture interests in apartment complex are securities under the *Gopher* approach).

<sup>104</sup> The court noted that "[t]he investors were strictly passive investors who were buying an interest in a tax shelter with apparently a long-term hope of realizing capital gains on their investments." *Id.* at 11.

<sup>105</sup> 13 Cal. Rptr. at 187.

The court's analysis focused primarily upon the rights granted to members under the membership application and the corporate by-laws. The court noted:

The purchaser of a membership in the present case has a contractual right to use the club facilities that cannot be revoked except for his own misbehavior or failure to pay dues. Such an irrevocable right qualifies *as a beneficial interest in title to property* within the literal language of subsection (a) of Section 25008.<sup>106</sup>

This emphasis on a beneficial interest in title to property allowed—or caused—the court to avoid the efforts issue. Furthermore, it facilitated the court's holding that such memberships were securities even though there was no expectation of any material benefits.<sup>107</sup> “[I]t seems . . . clear that [the Act's] 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.”<sup>108</sup>

The court's analysis exposes the infirmities created by the *Silver Hills* decision and its subsequent application. Because the court focused upon a beneficial interest in title to property, the efforts and profits analyses required in investment contract analysis are absent. The beneficial interest in property was created by mere investment of funds and required the investor to exert no efforts. Perhaps the court believed that the efforts issue was trivial. Although obscure at first, the distinction between an investment contract analysis and a beneficial interest in property

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<sup>106</sup> *Id.* at 188. When *Silver Hills* was decided, CAL. CORP. CODE § 25008 (West 1960) read as follows:

‘Security’ includes all of the following:

(a) Any stock, including treasury stock; any certificate of interest or participation; any certificate of interest in a profit sharing agreement, any certificate of interest in an oil, gas, or mining title or lease; any transferable share, investment contract, or beneficial interest in title to property, profits, or earnings.

(b) Any bond; any debenture; any collateral trust certificate; any note; any evidence of indebtedness, whether interest bearing or not.

(c) Any guarantee of a security.

(d) Any certificate of deposit for a security.

<sup>107</sup> 13 Cal. Rptr. at 187.

<sup>108</sup> *Id.* at 188-89.

analysis becomes critical when the effects of *Silver Hills* are recognized. The decision has been misapplied in the past, and the potential for future error remains because some courts continue to rely upon *Silver Hills* in analyzing investment contracts.

The use of "effort" analysis, although neglected by *Silver Hills*, was well-founded in California law. For example, in *Hollywood State Bank v. Wilde*,<sup>109</sup> decided in 1945, a district court of appeal held that securities-laws apply to the sale of chinchillas when the purchasers are led to believe that the sellers will "by their own efforts make the investments safe without the application of effort by the investors. . . ."<sup>110</sup>

California courts since *Silver Hills* have conducted an efforts analysis even though they purport to adopt the risk capital approach. In *Sarmento v. Arbax Packing Co.*,<sup>111</sup> decided four years after *Silver Hills*, Arbax was engaged in the business of packing and shipping cherry and grape crops.<sup>112</sup> In 1961, Arbax sold eighty acres of Tokay grapes to the plaintiff for \$25,000.00. The sales contract contained an agreement under which Arbax promised to care for the crop at its own expense until harvest. At harvest time, the plaintiffs/purchasers would harvest the crop at their expense. A second contract provided that Arbax would market the crop at its normal rate of commission. Before harvest, however, heavy rains damaged the crop, resulting in a loss to the purchasers of \$7,069.84. The purchasers filed suit against Arbax alleging that the transaction constituted an unregistered security.<sup>113</sup>

The court, citing *Silver Hills*, stated that the broad definition of a security in the California statutes "is designed to embrace speculative schemes to attract risk capital. . . ."<sup>114</sup> In a departure from *Silver Hills*, however, the court focused immediately upon the elements of control and effort exerted by the parties. The court concluded that this transaction did not constitute a security, because, the court emphasized, the purchasers had exercised

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<sup>109</sup> 160 P.2d 846 (Cal. Dist. Ct. App. 1945).

<sup>110</sup> *Id.* at 847.

<sup>111</sup> 41 Cal. Rptr. 869 (Cal. Dist. Ct. App. 1964).

<sup>112</sup> *Id.* at 869.

<sup>113</sup> *Id.* at 870.

<sup>114</sup> *Id.*

a considerable amount of control and had not depended on “the skill and managerial ability of Arbax” for their profit.<sup>115</sup> That statement provides the two elements missing from *Silver Hills*—control (or efforts) and profit. It also makes abundantly clear that the court, unwittingly or not, applied *Howey*. Risk capital rhetoric cannot obscure that conclusion.

In *People v. Witzerman*,<sup>116</sup> decided in 1972, another California court of appeal examined “cattle care contracts” under the state securities laws. The transaction involved an investment of \$500.00 or \$600.00 in return for a cow and a calf to be raised on the Saddle Butte Ranch. The proceeds from the annual sale of each calf crop were to be divided over a six-year period between the purchaser and the owner of the ranch.<sup>117</sup> The court had little trouble determining that the contracts were securities. In so holding, the court further exposed the interconnection between the risk capital and efforts analyses:

[T]he purchasers of the cattle care contracts were merely passive investors providing risk capital for the operation of the Saddle Butte Ranch in Oregon. They placed their cows and calves under the exclusive care and control of Forslund and they depended completely upon his skill and expertise in the production and marketing of their cattle for any return on their investment.<sup>118</sup>

Again, the critical elements of the *Howey* test are evident in the court’s opinion.<sup>119</sup>

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<sup>115</sup> *Id.* at 871. The facts in this case are similar to the facts in *Howey*; although in *Howey*, the investors exerted practically no efforts. It is therefore no surprise that the California Supreme Court reached the same conclusion as did the *Howey* Court.

<sup>116</sup> 105 Cal. Rptr. 284 (Cal. Ct. App. 1972).

<sup>117</sup> *Id.* at 287.

<sup>118</sup> *Id.* at 290. See notes 67-78 *supra* and accompanying text for a similar conclusion regarding cattle care contracts under federal standards.

<sup>119</sup> In response to the preceding discussion, one might argue either that the *Silver Hills* opinion implicitly addressed the efforts issue or that the conclusion was so self-evident in the facts that it did not require discussion. To advance such an argument, however, is to assert that the entire “dispute” between risk capital and the *Howey* progeny is nonexistent. Such an argument is easily controverted.

No better case exists to prove this point than *People v. Graham*, 210 Cal. Rptr. 318 (Cal. Ct. App. 1985), decided by the Court of Appeals for the Fourth District of California. Defendant Graham was convicted of selling an unqualified security to a



The Hawaii Supreme Court recognized the conceptual problem in the *Silver Hills* risk capital test and expressly added an efforts analysis. That court's risk capital test provides that an investment contract exists whenever:

- (1) An offeree furnishes initial value to an offeror, and
- (2) a portion of this initial value is subjected to the risks of the enterprise, and
- (3) the furnishing of the initial value is induced by the offeror's promises or representations which give rise to a reasonable understanding that a valuable benefit of some kind, over and above the initial value, will accrue to the offeree as a result of the operation of the enterprise, and
- (4) the offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise.<sup>120</sup>

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purchaser working undercover for the district attorney. The transaction involved, basically, the sale of an interest in a limited partnership formed to promote a fluke invention. *Id.* at 322.

The defendant urged the court to adopt the *Howey* test and to apply a strict interpretation of the "solely" requirement. Such an analysis might have benefitted the defendant because the partnership agreement anticipated that the investor would heavily promote the invention. *Id.* at 321. Such an analysis may also have shocked the state's attorney given the high degree of acceptance of the risk capital test in California. The defendant was not advancing a spurious defense, however, and cited a 1979 California case adopting federal standards. *Id.* at 327 (citing *People v. Park*, 151 Cal. Rptr. 146 (Cal. Ct. App. 1978)). Rather than arguing for a risk capital analysis, the state in response argued that the "solely" language of *Howey* should be rejected in favor of an "essential managerial efforts test." 210 Cal. Rptr. at 323.

The opinion states: "Both parties ignore the fact that the *Howey* test, whether modified or not, may well not be the means by which a 'security' is defined in California." *Id.* at 323. Although the opinion is somewhat confusing, it is clear that the court interpreted the interest to be a security because the efforts exerted by the investor were not "those essential managerial efforts which affect the failure or success of the enterprise." *Id.* at 325. By way of a footnote to this conclusion that the risk capital and *Howey* analyses merged, the court declared that it need not decide "whether the *Silver Hills* risk capital analysis is the exclusive definition of a security in California or whether the . . . tests are complementary and alternative." *Id.* at 325 n.12. The effects of *Silver Hills* are clear. Although the court reached the proper conclusion by applying the expanded *Howey* test, it was compelled to credit *Silver Hills* with an element it simply did not address—the efforts of the investor. This decision clearly illustrates the confusion still generated by *Silver Hills*.

<sup>120</sup> *State v. Hawaii Market Center*, 485 P.2d 105, 109 (Hawaii 1971).

The court stated in its development of the "new" test that the *Howey* test's narrow concept of investor participation had led courts to engage "in polemics over the meaning of the word 'solely.'" <sup>121</sup> Such entrapment results in a failure to consider whether investors who participate to a limited degree in the operation of the business should be protected. <sup>122</sup> As emphasized throughout this Note, however, that element of the *Howey* test has been modified and corresponds closely to the language in subsection four of the Hawaii test. <sup>123</sup> Furthermore, the modified risk capital test parallels the *Howey*-type analysis in that it avoids the myopic view taken by *Silver Hills*. By including the provision regarding efforts, the test illustrates that the *Silver Hills* court was engaged in polemics regarding risk capital, thereby ignoring the efforts issue. It should now be clear that the two tests are the same.

This conclusion is illustrated by the case that spawned the Hawaii risk capital test, *State v. Hawaii Market Centers, Inc.* <sup>124</sup> In that case, Hawaii Market Center (HMC) intended to open a retail store that would sell merchandise only to persons possessing purchase authorization cards. HMC raised initial capital and distributed the first memberships by recruiting "founder-members." For \$320.00, these founder-members were given a sewing machine or cookware set and an agreement with the corporation called a "Founder-Member Purchasing Contract Agreement." That agreement specified five ways the founder-members could earn commissions from the corporation; each related in some way to the distribution of membership cards or the induction of a new member into the corporation. <sup>125</sup>

Eventually, the state commissioner of securities filed suit against HMC, alleging that the memberships constituted securities. The trial court supported the commissioner, holding that the agreements were investment contracts. The Hawaii Supreme Court affirmed, using its new risk capital test. <sup>126</sup> The circum-

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<sup>121</sup> *Id.* at 108.

<sup>122</sup> *Id.*

<sup>123</sup> See notes 16-25 *supra* and accompanying text.

<sup>124</sup> 485 P.2d at 105.

<sup>125</sup> *Id.* at 107.

<sup>126</sup> *Id.*

stances recited above should create a sense of *deja vu* because the facts are virtually identical to those in *S.E.C. v. Koscot*<sup>127</sup> and *S.E.C. v. Glenn W. Turner*,<sup>128</sup> two of the principal cases in the development of the "new" federal standard. Applying the expanded *Howey* test, both of those courts held that such agreements were investment contracts. Those holdings support the theory that the federal standard and the "Hawaiian" risk capital test are identical.

#### CONCLUSION

This Note, while indicating which states interpret blue sky laws under federal guidelines, has also implicitly revealed at least one area of confusion created by a dual system of securities regulation. Though one set of states argues that it applies an analysis differing from the federal test, this Note argues that the tests are identical.

Whether or not the reader accepts that argument or appreciates the ramifications, it should at least be clear that the ambiguities fueling the argument are an unnecessary impediment to business transactions. Without a doubt, the threat of civil and/or criminal sanctions deters prospective investors from engaging in business transactions.

It should be realized that cooperation—either judicial or legislative—is needed in order to supply the uniformity between state and federal securities laws. Until this uniformity is obtained, inconsistent judicial decisions and unnecessary investor trepidation will continue.

*John Coleman Ayers*

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<sup>127</sup> 497 F.2d 473 (5th Cir. 1974). See notes 18-25 *supra* and accompanying text.

<sup>128</sup> 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973). See notes 18-25 *supra* and accompanying text.