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Investment Contracts Under Federal and State Law

IN OHIO, a security is defined as "any certificate or instrument which represents title to or interest in, or is secured by any lien or charge upon, the capital, assets, profits, property, or credit of any person."¹ It includes, *inter alia*, shares of stocks, all forms of commercial paper, evidences of indebtedness, any instrument evidencing a promise or an agreement to pay money, and *any investment contract*.² As with all state securities acts, the Ohio Securities Act is to be liberally construed in order to achieve the purposes of its enactment: regulation of the issuance and sale of securities and prevention of the perpetration of fraud.³ The term "security" is defined in very general terms in the Ohio Act. In drafting the definition section, the committee emphasized that it believed this section to include virtually every form of security familiar to the financial world.⁴ The committee also believed that a very general definition would render determinations of the status of new instruments far less onerous.⁵

While the definition of security is broad and far-reaching, a number of problems have arisen in construing it. This Note will examine several unique situations which have arisen concerning "investment contracts." First, however, it is essential to consider the leading cases and tests which have developed under the federal securities acts⁶ in determining whether a particular instrument or agreement is an investment contract and therefore a security. Second, it will then be possible to examine certain Ohio and other state cases which have presented unique problems under the investment contract concept.

¹ OHIO REV. CODE § 1707.01(B).

² *Ibid.* (Emphasis added.)

³ 48 OHIO JUR. 2D *Securities Regulation* § 2 (1966); *Sellers v. State*, 18 Ohio L. Abs. 328 (Ct. App. 1934).

⁴ Report of the Ohio Bar Association Committee on Corporate Law and Committee on Blue Sky Law, 1 OHIO BAR No. 42, 1, 7-8 (Jan. 15, 1929), cited in Boesel, *Analysis of the Ohio Securities Act*, 5 W. RES. L. REV. 352, 354 (1954).

⁵ *Ibid.*

⁶ Securities Act of 1933, 48 Stat. 74, as amended, 15 U.S.C. §§ 77a-77aa (1964).

I. THE FEDERAL DEVELOPMENTS

A. *The Leading Cases*

The Securities Act of 1933,⁷ like the Ohio Act, defines the term "security" to include investment contracts. Certain definite tests have arisen under the Federal Act in construing "investment contracts." It is important to examine the cases developing these tests.

In *SEC v. Joiner Leasing Corp.*,⁸ the United States Supreme Court issued its first important opinion concerning investment contracts.⁹ There, the court found that certain assignments of oil and gas leasehold interests in tracts of real estate leased to the defendant Joiner, together with an agreement by the defendant to drill test wells on the land retained by it, constituted "securities."

The defendant had emphasized the character of the purchase as an investment and as participation in an enterprise in its advertising materials.¹⁰ Thus, defendant stated that the proposition was being made only to business people "who are interested in making an investment where they have a good chance for splendid returns on the investment."¹¹ The court found that the defendant was not offering naked leasehold rights.¹² If the corporation's offer had not included the inducement of the promised exploration well, the situation would have been entirely different.¹³ In that case, the purchasers would have had to exploit their interests themselves and to determine the productivity or non-productivity of their land. This would have involved time and expense to the purchasers. On the contrary, however, defendant corporation was offering the purchasers an opportunity to share in any results of exploration by defendant, with little time or expense. The drilling of the well by defendant was inherently interwoven into the leaseholds and "runs through the entire transaction as the thread on which everybody's beads were strung."¹⁴ Indeed, acceptance of the offer by the pur-

⁷ Securities Act of 1933, § 2(1), 48 Stat. 74, as amended, 15 U.S.C. § 77b(1) (1964).

⁸ 320 U.S. 344 (1943).

⁹ Pasquesi, *The Expanding "Securities" Concept*, 49 ILL. B.J. 728, 729 (1961).

¹⁰ 320 U.S. 344, 346 (1943).

¹¹ *Id.* at 346-47 n.3.

¹² *Id.* at 348.

¹³ *Ibid.*

¹⁴ *Ibid.*

chaser resulted in a contract in which payments depended upon completion of the well. Therefore, this was an investment contract in which both a lease and a development project were involved.¹⁵

The Court emphasized that it is not the nature of the assets behind a particular instrument which is the test of whether it is a security. Rather, it is "*what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect.*"¹⁶ Further, in this type of case, since the promoter holds out his offerings as being of a certain nature, they will be judged as if actually of that nature. Thus, assignments of oil leases are "investment contracts" or "securities" within the purview of the Securities Act of 1933, and sellers of these interests must conform to the requirements of the Act. The majority of state courts have adhered to as liberal an interpretation of state securities acts.¹⁷

In the *Joiner* case, the Supreme Court significantly committed itself to a liberal construction of the definition of security. In doing so, it rejected defendant's "*expressio unius est exclusio alterius*" argument that sales of leasehold subdivisions by acre do not constitute securities, since the Securities Act expressly includes sales of leasehold subdivisions by undivided shares.¹⁸ The Court stated that such rules and canons of construction aid in ascertaining legislative intent, but are subordinate to the precept that the courts will interpret an act so as to effectuate its dominant purpose and the legislative policy behind it.

In *SEC v. Howey Co.*,¹⁹ an offering of units of a citrus grove development coupled with a contract for cultivation of the property and for remitting the net proceeds to the investor were held to constitute an investment contract within the meaning of the Securities Act of 1933. In that case every prospective customer was informed that it was not possible to invest in a grove unless the service arrangements were included in the agreement and therefore was offered both a land sales contract and a service contract. The superiority of the defendant's service company was stressed, although the purchaser was not precluded from entering into agreements with other similar companies. The service contract gave the de-

¹⁵ *Id.* at 349.

¹⁶ *Id.* at 352-53. (Emphasis added.)

¹⁷ See, e.g., *Prohaska v. Hemmer-Miller Dev. Co.*, 256 Ill. App. 331 (1930); *Wagner v. Kelso*, 195 Iowa 959, 193 N.W. 1 (1923).

¹⁸ 320 U.S. 344, 350 (1943).

¹⁹ 328 U.S. 293 (1946).

fendant service company a leasehold interest plus exclusive possession of the land, generally for a ten year period without option of cancellation.²⁰ Under the service contract, the service company assumed full control of the cultivation of the groves and crops. The purchasers were largely non-residents of Florida and business people who lacked the expertise requisite to the adequate care and cultivation of citrus groves. They were attracted by the expectation of generous profits which, it was asserted, would amount to a ten per cent annual return over a ten-year period, and even to twenty per cent for one season.²¹

The Court initially pointed out that the definition of security contained within the 1933 Act encompasses the "commonly known documents traded for speculation or investment."²² However, it also encompasses instruments of a "more variable character,"²³ such as investment contracts. In the *Howey* case, the Court viewed the legal issue as a determination of whether the land sales contract, the warranty deed, and the service contract *together* constituted an investment contract under these particular circumstances.²⁴

In order to consider this issue effectively, the Court next examined the investment contract concept itself. Concluding that it was undefined by the 1933 Act or appropriate legislative material, the Court pointed out that the term was nevertheless utilized with some frequency in state blue sky laws prior to the adoption of the Federal Act. Although the term is also undefined in state blue sky laws, judicial interpretation by the states has resulted in construction of the statutes so as to protect the public as fully as possible.²⁵ Significantly, the Court emphasized that on the state level, "form was disregarded for substance and emphasis was placed upon economic reality."²⁶ Further, under state court decisions, a definition of investment contract became crystallized.²⁷ The *Howey* court then reasoned that the meaning attributed to the term "investment contract" by the states should be presumed to be identical with the meaning intended by Congress in the 1933 Act, especially since this

²⁰ *Id.* at 296.

²¹ *Ibid.*

²² *Id.* at 297.

²³ *Ibid.*

²⁴ *Ibid.*

²⁵ *Id.* at 298.

²⁶ *Ibid.*

²⁷ *Ibid.* See *State v. Gopher Tire & Rubber Co.*, 146 Minn. 52, 56, 177 N.W. 937, 938 (1920), cited in the *Howey* opinion at 298.

definition would be consistent with statutory goals. It was concluded that for purposes of the 1933 Act, an investment contract 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 promoters or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise.*"²⁸

This definition, the Court stated, was necessarily implied in the *Joiner* decision, and had previously been utilized by the federal courts.²⁹ It permits attainment of the statutory purpose of full and fair disclosure of any instrument which might be a security.

The proceedings involved in the *Howey* case clearly fell within the Court's definition of investment contract, since the respondent corporations were actually offering to the purchasers an opportunity to contribute money and to share in the profits of a business at least partially owned and operated by the respondents.³⁰ In order to achieve this purpose, a "common enterprise" managed by respondents or third parties was essential and was represented by the land sale contracts and warranty. The profit-seeking business there involved investment contracts in the form of land sales contracts, warranty deeds, and service contracts.³¹

Finally, the *Howey* court emphasized that a proposition need not be "speculative or promotional in character" in order to be found to constitute an investment contract.³² Nor need the interest sold have intrinsic value apart from the success of the business as a whole. The test "*whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others.*"³³ If this test is satisfied, the aforementioned factors are irrelevant.³⁴

Prior to evaluating the *Joiner* and *Howey* decisions, it would

²⁸ 328 U.S. 293, 298 (1946). (Emphasis added.)

²⁹ *Id.* at 299 & n.5. See discussion of federal cases in text accompanying notes 45-54 *infra*.

³⁰ 328 U.S. 293, 299 (1946).

³¹ *Id.* at 300.

³² *Id.* at 301.

³³ *Ibid.* (Emphasis added.)

³⁴ Justice Frankfurter dissented, urging that the essential issue in the case involved whether the contracts for the land and those involving management of the property constituted separate transactions or were inextricably interwoven. He asserted emphatically that the Supreme Court should not upset the "concurrent findings of two lower courts in the ascertainment of facts . . ." *Id.* at 301-02.

be helpful to examine a recent federal decision in this area. In *Los Angeles Trust Deed & Mortgage Exch. v. SEC*,³⁵ one of the issues involved was whether the appellants were selling securities under the 1933 Act. The SEC contended that the sale through a "Secured 10% Earnings Program" constituted more than a simple sale of second trust deeds or a mere interest in property. On the contrary, it contended that the transaction involved here constituted an investment contract, specifically within the purview of the 1933 Act.

LATD had purchased second trust deed notes at discounts of more than forty per cent and an implied guarantee of ten per cent return to the purchasers, with LATD receiving an average profit of twenty-five per cent. It claimed that the choice of trust deeds was solely within the control of the purchaser and that each purchaser had the right of rejection within five days and that the services offered were to accommodate the purchasers only and were not an integral part of the trust deeds. Thus, appellants reasoned that they did not fall within the ambit of the *Joiner* and *Howey* cases.

The court pointed to the *Joiner* and *Howey* cases as guides in determining whether a particular instrument or transaction involves an investment contract. After discussing the relevant facts and holdings of each case, it concluded that "*Howey* adds the test of *common enterprise* to the *Joiner* test of *results dependent on the efforts of one other than the purchaser*."³⁶

The court addressed itself to the question of whether the investor is led to "expect profits solely from the efforts of one or more defendants arising from a common enterprise."³⁷ In order to answer that question, the court looked to the number of factors which, together, it considered to be determinative. First, it pointed out that at least persons untrained in finance would probably conclude that appellants were offering more than a mere note secured by a second mortgage or a deed of trust on property. Further, many purchasers never saw the trust deed or the real property, as there was no physical delivery in most cases. Also, purchasers were urged to rely on appellant's knowledge and expertise and there was an "anticipated common effort."³⁸ The brochures published by appellants reinforced this impression. The court also stressed the occa-

³⁵ 285 F.2d 162 (9th Cir. 1960).

³⁶ *Id.* at 168.

³⁷ *Ibid.*

³⁸ *Ibid.*

sions when trust deeds were sold to investors' accounts and then repurchased by appellants, so that appellants could profit from the proposed accelerated payment of principal, which was not known to the purchaser. Nor was the purchaser given the profit on the payment before maturity, even though the appellants admitted this was done by mistake.³⁹ The court also considered representations made by appellants to prospective purchasers, as well as a memorandum which was "illuminating" as to their interest payments.⁴⁰

Having considered the aforementioned factors, the court concluded that the second trust deed notes involved in the case were investment contracts and therefore securities. It found a "common enterprise," in which both the appellants and the purchasers had an economic interest. Inextricably entwined with the economic success of the enterprise was LATD's ability to locate independently a quantity of discounted trust deeds and to perform its other obligations. Investors were given reason to rely on representations of the per cent earnings solely on the basis of LATD's acquiring the requisite trust deeds, collecting the loan and taking care of any necessary dealings concerning the loan, and if necessary repurchasing or arranging for repurchase. The court relied on the lower court's finding that there was "an implied guarantee against loss" here.⁴¹

Thus, "the terms of the offer, the plan of distribution, the economic inducements held out to the prospects, the results dependent on one other than the purchaser and the common enterprise,"⁴² considered *together*, rendered the second trust deed notes investment contracts and "securities" within the meaning of the Supreme Court's definition of those terms.

Upon careful examination of the *Joiner*, *Howey*, and *LATD* decisions, it becomes apparent that in each of these cases the investors were offered interests in real estate or interests secured by real estate. Each court pointed out that none of the interests, *alone*, could have constituted an investment contract and a security. However, coupled with the property interest in each case was a management or service arrangement, under which the seller or some other party was given the power essential to management of the business and to attainment of the promised return or profit.

In *Joiner*, the additional and fatal agreement was that relating to

³⁹ *Id.* at 169-70.

⁴⁰ *Id.* at 171.

⁴¹ *Id.* at 172.

⁴² *Ibid.*

the drilling of the oil well; in *Howey*, the service contract involving management of the land was considered an essential part of the transaction; in *LATD*, the expertise and knowledge of appellants was considered an integral part of the second trust deed notes transactions and sales. In *LATD*, as contrasted with *Joiner* and *Howey*, the "fatal" aspect of the transaction necessarily occurred before the notes were acquired, rather than afterward. However, additional factors were present in the *LATD* case. Thus, the consideration of the repurchasing, reinvesting, and servicing with appellants' selection of the trust deed notes resulted in reliance by the investors on the expertise of *LATD*, rather than on the intrinsic value of the notes.⁴³ All these factors, considered together, resulted in determination of the transactions as investment contracts.

Thus, it becomes apparent that in attempting to ascertain whether an investment contract is involved in a particular situation, the courts will carefully scrutinize all aspects of the relationship between the parties involved, with a particular eye to any services which may be offered to the investor. The *Howey* formula has been interpreted to apply to a great variety of transactions and schemes, both under state and federal statutes.⁴⁴ In fact, it has been asserted that the term "investment contract" has been adapted, by judicial interpretation, to include any anomalous instrument or situation which does not fall clearly within any other definitional category.⁴⁵

In a release, the SEC pointed out that where mortgages or trust deeds are involved, the chief criteria it will examine in determining whether an investment contract is involved are the following: investment selection, payment collection, installment terms, minimum rate of return guarantee, and reliance upon the vendor, as indicated by investment among other things.⁴⁶

B. *Other Federal Cases*

In devising its definition of investment contract, the United States Supreme Court, in the *Howey* case, cited a number of federal and state decisions which had followed the same definition prior

⁴³ See Pasquesi, *supra* note 9.

⁴⁴ 1 LOSS, SECURITIES REGULATION 469-511 (1961).

⁴⁵ See Pasquesi, *supra* note 9.

⁴⁶ SEC Securities Act Release No. 3892 (Jan. 1958), Litigation Release No. 1876 (Jan. 1961). See Pasquesi, *supra* note 9, at 732.

to *Howey*.⁴⁷ Without discussing all these cases in detail, it is helpful to mention one or two key decisions.

In *Atherton v. United States*,⁴⁸ the defendants conceded their involvement in a scheme to defraud others through the sale of partial assignments of oil and gas leases and undivided interests in a drill site. The government alleged that the sale of assignments of these oil and gases leases constituted the sale of a security as defined under the 1933 Act. The defendants denied that the leases constituted securities. The court pointed out that the purchasers were entirely dependent upon the efforts of the promoters to make their investments profitable. The land leased to each purchaser was not itself susceptible to economic development, nor did the purchasers intend to exploit the land independently. The leases were sold, as in the *Joiner* case, on the representation that a drill would be put into operation in order to prove the productivity of the entire area under lease. Further, once the well was completed, the entire area would be sold in one unit, and each purchaser of an assignment would receive a proportionate share of the purchase price. The court held that it was clear that an investment contract was involved here, stressing that the federal courts had uniformly held that when the investor looks to the promoter to determine the success of the investment, an investment contract and a security are involved.⁴⁹

In *Penfield Co. v. SEC*,⁵⁰ the court adopted the *Atherton* concept of investment contract as encompassing agreements where there is complete reliance by the purchasers on the promoters to make their investment profitable.⁵¹ In *Penfield*, bottling contracts received in exchange for whiskey warehouse receipts which contained agreements that whiskey represented by the receipts would be bottled and sold without any separate holding of the whiskey for the contracting parties and would be sold by them were considered to be investment contracts.

Thus, the federal cases prior to *Howey* had developed the definition of investment contract espoused by the Supreme Court. Recent federal cases follow the same pattern, naturally adhering to the

⁴⁷ See *State v. Gopher Tire & Rubber Co.*, 146 Minn. 52, 56, 177 N.W. 937-38 (1920), and cases cited in *SEC v. Howey Co.*, 328 U.S. 293, 299 n.5 (1946).

⁴⁸ 128 F.2d 463 (9th Cir. 1942).

⁴⁹ *Ibid.*

⁵⁰ 143 F.2d 746 (9th Cir. 1944).

⁵¹ *Id.* at 750.

Howey test. In *United States v. Herr*,⁵² an Illinois corporation claimed to be selling distributor agreements, but gave every indication that those purchasing distributor agreements would remain inactive and could rely on the corporation to obtain profit. Relying on the *Howey* case, the court pointed out that there was a business for profit here, with actual management and control by the promoters, constituting an investment contract. Regardless of the statement in the agreement that the relation created was that of vendor and purchaser, it was not the intention of either party that the investors were to resell the merchandise involved. The investors were described as inactive and were given reason to believe that they could expect profit solely from the effort of others.⁵³

It is appropriate to mention here that the Uniform Securities Act⁵⁴ includes "investment contracts" in its definition of securities. The official comment to the definition section of the Act⁵⁵ states that this section is nearly identical to the definition section of the Securities Act of 1933. The drafters point out that the definition, and the concept of "investment contract" in particular, have been broadly construed by both state and federal courts.⁵⁶

II. STATE DEVELOPMENTS

A. Ohio

The first Ohio blue sky law was enacted in 1913.⁵⁷ It was replaced by the current law in 1929.⁵⁸ Ohio was one of the earliest states to enact a blue sky law, the legislative intent behind the act being to prevent fraud and misrepresentation in the sale of securities.⁵⁹ Basically, there are four types of securities acts.⁶⁰ Ohio's

⁵² 338 F.2d 607 (7th Cir. 1964).

⁵³ *Ibid.* See *SEC v. Crude Oil Corp.*, 93 F.2d 844, 848 (7th Cir. 1937); *SEC v. Bailey*, 41 F. Supp. 647 (S.D. Fla. 1941) both cited in *Howey*. See also *Lenneth v. Mendenhall*, 234 F. Supp. 59 (N.D. Ohio 1964).

⁵⁴ LOSS & COWETT, BLUE SKY LAW 332-52 (1958).

⁵⁵ Uniform Securities Act § 401 (I), in LOSS & COWETT, *op. cit. supra* note 54, at 350.

⁵⁶ *Ibid.*

⁵⁷ Nida, *The Ohio Division of Securities and the Ohio Securities Act*, 13 OHIO ST. L.J. 427, 428 (1952).

⁵⁸ OHIO SECURITIES ACT OF 1929, 113 Ohio Laws 216 (1929). See Nida, *supra* note 57, at 431-32.

⁵⁹ *Ibid.* Thus, in *Grobby v. State*, 109 Ohio St. 543, 143 N.E. 126 (1924), the court stated, concerning the Ohio Securities Act, that:

This legislation was enacted for the obvious purpose of guarding investors against fraudulent enterprises, to prevent sales of securities based only on schemes purely speculative in character and to protect the public from swin-

is essentially a "licensing and inspection" type, which regulates both securities and dealers. While this is the most prevalent type of blue sky law, the Ohio Act may be broader in scope than many acts of its general type.⁶¹

While the Ohio definition of a security is probably as liberal and all-inclusive as any other,⁶² several leading Ohio cases have failed to find investment contracts and securities when applying the *Howey* test. Thus, in two 1956 criminal cases, an Ohio Court of Appeals and the Ohio Supreme Court held that a bona fide sale of a cooperative apartment to be occupied by the buyer did not involve a security. Both courts found this to be the case, despite the fact that a corporation was to be organized in each case to issue shares pro rata as evidence of ownerships of units of the apartment.⁶³

In *State v. Silberberg*,⁶⁴ the court examined the contracts involved in order to determine whether securities were involved. The supreme court pointed out that courts have had some difficulty in determining what constitutes a security. Therefore, they have preferred not to utilize an all-inclusive definition and have chosen to "draw the lines of demarcation as the circumstances of each case present themselves."⁶⁵ However, in determining whether an interest is an investment contract or an interest in real estate, it is the individual control which the purchaser has over the property or venture in which he has acquired an interest that should be examined. Generally, if the purchaser is to partake of the gross proceeds or net profits of enterprises managed by those disposing of the interest, the instrument involved is held to be an investment contract.⁶⁶ On the other hand, if the purchaser of real property is to occupy the premises and conduct the enterprise with others, the instrument involved is generally not an investment contract or a security. In *Silberberg*, each contract contained a provision to the effect that when the corporation was organized, the purchaser would

dling peddlers of worthless stocks in mere paper corporations. It should be so administered as to fully meet the purpose of its enactment. *Id.* at 550, 143 N.E. at 128.

⁶⁰ Boesel, *Analysis of the Ohio Securities Act*, 5 W. RES. L. REV. 352 (1954).

⁶¹ *Id.* at 354.

⁶² See text accompanying notes 1-5 *supra*.

⁶³ *State v. Silberberg*, 166 Ohio St. 101, 139 N.E.2d 342 (1956); *State v. Hirsch*, 101 Ohio App. 425, 131 N.E.2d 419 (1956). See 1 LOSS, *op. cit. supra* note 44, at 492.

⁶⁴ 166 Ohio St. 101, 139 N.E.2d 342 (1956).

⁶⁵ *Id.* at 104, 139 N.E.2d at 344.

⁶⁶ *Ibid.*

transfer his interest in the property to the corporation and receive stock in it proportionate to the interest purchased. But this part of the contract was essential to the operation and management of the building as a whole, and thus the transaction did not fall within the purview of the Ohio Securities Act.⁶⁷ The intent of the contract here was clearly to provide the buyers with an interest in an apartment building for the purpose of occupying it as a home. Further, neither the evidence of the parties involved nor the contract itself revealed any plan to invest in a profit-sharing venture. The purchasers did what they alleged they would do; they took possession of and occupied the property described in the contracts.

In *Silberberg* the court stressed another aspect of an investment contract and a security. It stated that the purpose of investing in a security is in the hope of receiving income as a return on such investment. There was no indication of this in the instant case. The provisions in the contract in regard to the formation of a corporation were subsidiary and tangential to the acquisition of an interest in the apartment building. Since the purchasers here were actually buying real estate and not shares in a corporation, the transactions involved could not constitute investment contracts or securities.⁶⁸

In *State v. Hirsch*,⁶⁹ once again, the land contract involved acquisition of an undivided interest in an apartment building with the right to occupy it as a home. The vendor was required to deliver a warranty deed upon complete performance of the contract. The court held that the contract involved constituted the purchase of an interest in land and not in a security, despite the fact that shares of stock would be issued upon payment of the purchase price. Again, the purchasers were, according to the findings of the court, purchasing a dwelling rather than looking for an investment. And the securities were not being sold by the vendors for investment purposes. Since the land contracts here amounted to genuine purchases of interests in land, they did not fall within the ambit of the Ohio Securities Act. The court relied on the *Silberberg* decision.⁷⁰

Thus, in both *Silberberg* and *Hirsch*, the courts held that formation of a corporation was only incidental to operation of the building as a cooperative enterprise. Also, in neither case did the contracts require that the buyer subscribe to the stock or exchange his

⁶⁷ OHIO REV. CODE § 1707.01(B).

⁶⁸ 166 Ohio St. 101, 139 N.E.2d 342 (1956).

⁶⁹ 101 Ohio App. 425, 131 N.E.2d 419 (1956).

⁷⁰ *Id.* at 434, 131 N.E.2d at 424-25.

deed for corporate shares.⁷¹ According to Loss, it would have been more direct to state that substance governs rather than form, or in other words, that certain transactions which superficially appear to be real estate are actually securities, and certain transactions which appear to be securities are actually real estate.⁷² Nevertheless, the result in both cases appears to be reasonable and completely in line with the *Howey* test.

Other types of contracts also have been considered. In the last three years, a novel question has twice been raised in the Ohio courts: what is a customer referral agreement and is it a security?

In *Yoder v. So-Soft of Ohio*,⁷³ a contract between the parties involved the sale of an over-priced water softener, sold to plaintiffs. The primary motivation for the purchase was the profit to be derived from the provision in the contract allowing a payment to the purchaser-customer of 100 dollars for each purchaser referred to defendant who consummated a similar agreement with it. The Court of Common Pleas of Stark County held that the contract was null and void, as it constituted the sale of a security within the meaning of the Ohio Act for which defendant was not licensed. According to the court, So-Soft utilized the sale of a water softener as a "mere subterfuge" to induce plaintiffs to enter into the agreement, with the real motivation being the sale of an instrument representing the promise to pay money.⁷⁴

A later court of appeals case apparently overrules *Yoder*. In *Emery v. So-Soft of Ohio*,⁷⁵ plaintiffs sought to set aside a contract containing a "customer referral agreement." Once again, the terms of the contract provided that plaintiffs were to purchase a water softener from defendant So-Soft, which was to install it. So-Soft promised a guaranteed amount of money to the purchasers if they furnished the defendant with the names of persons who would consummate agreements for the purchase of the product as well as another sum of money for a list of twenty "qualified prospects." The court examined the key terms of the referral agreement. First, it looked at the term of the contract concerning the sale and terms of sale and installment of the water softener; next, the terms of payment for the referral aspect of the agreement itself; third, the

⁷¹ 1 LOSS, *op. cit. supra* note 44, at 492.

⁷² *Ibid.*

⁷³ 202 N.E.2d 329 (Ohio C.P. 1963).

⁷⁴ *Id.* at 331.

⁷⁵ 199 N.E.2d 120 (Ohio App. 1964).

fact that the contract specifically stated that the plaintiff would be acting as an independent contractor and would have to pay all relevant taxes. Plaintiffs contended that the referral agreement constituted a security and that, therefore, they had the right to rescind the sale upon tender of the security and to seek redress against the seller and anyone aiding him.

The *Emery* court traced the definition of a security and of an investment contract from the Ohio Revised Code definition to the *Silberberg* case, and including the *Howey* test.⁷⁶ It adopted the *Silberberg* test, looking to the individual control which the purchaser has over the property or transaction in which he acquired the interest. Perhaps of greater interest are the two other cases relied on by the court. First, it pointed to the case of *People v. Syde*,⁷⁷ a California case, in which the defendant corporation, a producer and seller of dramatic exhibitions for the different media, entered into service contracts with "artists" to provide for their training in dramatics. The consideration was a stated fee plus services of the artist for participation in dramatic exhibitions, plus a share in potential profits to be realized therefrom. The California Code definition of security included "investment contract." According to the *Syde* court, whether an instrument is a security must depend on the circumstances of each case. However, the court stressed the distinction between an interest in a profit-sharing agreement or in profits and earnings and an agreement of active participation in an enterprise, even with the expectation of some material return. The California law was not intended to supervise or regulate instruments which essentially involve agreements with persons expecting a return from their own services or their own participation in an enterprise, and such an instrument does not constitute an investment contract or a security. Such an instrument is clearly distinguishable from one in which a party, for consideration, purchases a right to share in the profits or proceeds of a business which is to be conducted by others.⁷⁸

The second case examined by the *Emery* court was that of *Pennsylvania SEC v. Consumers Research Consultants, Inc.*,⁷⁹ in which agreements for the sale of vacuum cleaners, according to which the purchaser would be paid a commission for each new purchaser re-

⁷⁶ *Id.* at 123.

⁷⁷ 235 P.2d 601 (Cal. App. 1951).

⁷⁸ *Id.* at 603.

⁷⁹ CCH BLUE SKY L. REP. § 70640 (Pa. Sup. Ct. 1964).

ferred to the seller, were held not to constitute securities. The court reasoned that the advertising agent was not promised a share of defendant's profits and was only to be paid a specific fee for his own "individual promotional efforts."⁸⁰

From these two cases, the *Emery* court deduced that:

[T]o establish [that] an instrument or certificate is a security, it must be shown that such instrument or certificate represents an investment in a designated portion of the assets and capital of a concern with the hope of receiving a profit *solely through the efforts of persons other than the investor*.⁸¹

Conversely the court stated that the mere representation by an instrument of a purchaser's right to reap a profit from his own services, where profit is guaranteed upon performance of such services and no interest in the capital or assets of the seller is evidenced, does not constitute a security.⁸²

Applying these concepts of investment contracts and securities, the *Emery* court reasoned that the referral agreement in the instant case could hardly be said to constitute an instrument "representing title to or interest in the capital, assets, profits, property or credit of So-Soft."⁸³ While the contract promised to pay money, so do many salesmen's commission and employment contracts. There was to be no acquisition of an interest in the profits or capital, assets, or property of So-Soft stemming from the referral agreement. In fact, here there was "merely an offer for a unilateral contract" by defendant So-Soft, agreeing to pay plaintiffs a sum of money if plaintiffs performed certain acts. A security would involve complete reliance for anticipated profit by the purchaser on the efforts of the promoter; the referral agreement here depended solely for its effect on the efforts of the purchaser alone.⁸⁴

It is submitted here that no other result could rationally have been reached by the *Emery* court. Accepting the Supreme Court, federal, and state tests of the investment contract concept, it becomes apparent that the customer referral agreement did not fall within the criteria established by the tests of *Joiner*, *Howey*, and other cases. Nor did it fall within Ohio judicial holdings. Clearly, the only profit to be derived from the referral agreement would be that obtained exclusively by the efforts of the purchaser in seeking

⁸⁰ *Ibid.*

⁸¹ 199 N.E.2d 120, 124 (Ohio App. 1964).

⁸² *Ibid.*

⁸³ *Ibid.*

⁸⁴ *Id.* at 125.

"qualified prospects" or persons willing to consummate a contract of sale with the defendant for its product. Unlike the situations in *Joiner* and *Howey*, no effort, service, or operation by the defendant corporation was essential to the realization of profit, and the purchaser was not relying exclusively — or to any degree — on the efforts, skill, or management by the defendant.

Although the purpose of the Ohio Securities Act, like other state blue sky laws, is — at least in part — the prevention of the perpetration of fraud or misrepresentation, and although the entire transaction in the *Emery* case appeared tainted with fraud or with some degree of deceit, it must be remembered that the Ohio Act is designed to encompass the field of *securities* alone. And, while the definition of security in Ohio is extremely broad, it does have definite limits. Were the court to have avoided the agreement in the *Emery* case as a "security" not registered or licensed for sale, it would necessarily have forced itself into the position of avoiding many other routine business contracts on that basis. Surely the Securities Act was not designed to be a general statute to protect against fraud. It was geared to a specialized area. If the plaintiffs in the *Emery* case had any remedy — and the court implied that perhaps they did not⁸⁵ — then that remedy should have been sought in a statute concerned with rescission for fraud of an ordinary contract.

B. Other Jurisdictions

Finally, it is important to look briefly at several cases which arose in Illinois and California, two states in which a relatively large amount of litigation has occurred in this field.

In *Hammer v. Sanders*,⁸⁶ the defendants were partners in an oil drilling firm and sold fractional interests in their oil leases to the purchasers. The sales were consummated by means of "letter agreements," according to which the purchasers were assigned an undivided working interest in the oil and gas leases for a specific sum, and the defendants agreed to commence drilling a well, with purchasers to pay a proportionate part of the monthly operating expense in the event of a producing well. Claiming that this transaction constituted a security under the Illinois Securities Act of 1919,⁸⁷ the purchaser sought to rescind the sale and recover the considera-

⁸⁵ *Ibid.*

⁸⁶ 8 Ill. 2d 414, 134 N.E.2d 509, *cert. denied*, 352 U.S. 878 (1956).

⁸⁷ ILL. SECURITIES LAW OF 1919, ILL. Laws 351 (now ILL. SECURITIES LAW OF 1953 §§ 137.1-19).

tion paid. The trial court found the interests to constitute securities, but the court of appeals and the supreme court reversed. The Illinois Supreme Court reasoned that the real purpose of the letter agreements was apportionment of capital for development between the parties as co-owners, and that the transfer of the working interest to the plaintiffs was only individual and subsidiary to this essential purpose.

In a more recent Illinois case, *Polikoff v. Levy*,⁸⁸ plaintiff entered into an agreement with defendants to buy shares of units in a motel being built by defendants. Plaintiff invested a certain amount of money in the venture and claimed that the sale of units was the avoidable sale of unregistered securities. The defendant contended that plaintiff entered into a joint venture with the defendant and others to construct a motel and conduct a motel business, which is not within the purview of the securities laws. The court, looking to the substance of the transaction and the relation between the parties, stated that these elements control over the form of the instrument, as stressed in the *Joiner* and *Howey* cases. Emphasizing that the Illinois and federal courts have defined investment contract and security as dependent on profits arising solely from the efforts of others, the court pointed out the rationale behind excluding transactions on which the profits do not come solely from the efforts of others:

In such situations, the member of the enterprise pools his money with that of others in the group; he has an equal right of control over the project and the opportunity and right to know what is going on. Because of this, the protection of the full disclosure offered by registration is not needed as it is in cases involving a non-participating investor.⁸⁹

In the instant case, there was a joint venture to buy and improve real estate — *i.e.*, an association of persons engaged in an enterprise for profit, with a community of interest in purpose and an expectation of profit and the sharing of the profit. Since the court found a true joint venture here, the transaction did not fall within the provisions of the securities acts.⁹⁰

California has broadly interpreted its definition of security, which also includes investment contracts.⁹¹ Traditionally, Califor-

⁸⁸ 55 Ill. App. 2d 229, 254 N.E.2d 807 (1965).

⁸⁹ *Id.* at 231, 254 N.E.2d at 809.

⁹⁰ *Ibid.*

⁹¹ CAL. CORP. CODE § 25008.

nia courts have tended to construe the term liberally and have adhered to the concepts espoused in the Supreme Court cases. In *Moore v. Stella*,⁹² a California appellate court stressed the necessity of disregarding mere form for substance. Thus, in that case it examined certain transactions to determine whether they were true transfers of interest in real estate to be held or sold by the grantees without participation with others in a profit-sharing venture, or whether, though they were actually conveyances of definite interests in real property, they were also intended to transfer rights to participate in earnings or profits. It pointed out that this was a question of fact to be determined by the trial court. The appellate court stated that the state's policy demanded that all schemes be subject to regulation for investment, in spite of any procedures employed which are designed to make profits depend on the management and control of others.⁹³

III. CONCLUSION

A careful examination of the investment contract aspect of securities reveals, in general, a trend toward expansion of that concept. It has been held by state and federal courts to include instruments and transactions which cannot readily be classified according to any other definition of security. The primary test in determining whether a particular transaction constitutes such an investment contract is whether the profit to be derived from an enterprise depends solely on the efforts of the promoter-vendor or on the efforts of others than the investor. While this test has been broadly construed so as to apply to questionable fact situations, in Ohio, at least, it has *not* been construed so as to bring all transactions within its purview. The customer referral agreement situation exemplifies this fact.

LESLIE J. CROCKER

⁹² 127 P.2d 300 (Cal. App. 1942).

⁹³ *Id.* at 306.