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Defining a "Security" After the 
*Forman* Decision

JOHN DEACON* AND JAMES D. PRENDERGAST**

With the 1975 decision of *United Housing Foundation, Inc. v. Forman*,¹ the United States Supreme Court coalesced twenty-nine years of judicial decisions prescribing methodology for defining a security for the purposes of federal law. In enunciating the criteria to be used in defining a security, the Supreme Court reaffirmed the factors set forth in *SEC v. W.J. Howey Co.*² namely, (1) an investment of money, (2) in a common enterprise, and (3) the expectation of profits from the entrepreneurial efforts of others. Moreover, in determining the existence of the foregoing elements requisite to finding a security, courts are to be guided by an "economic realities" standard; that is, form is always to be discarded and the court is to look to the substance of the transaction when deciding the applicability of the federal securities laws. To this end, the *Forman* decision rejects any literal test for determining what is

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2. 328 U.S. 293 (1946).
a security and, furthermore, announces a test that is to be universally applicable to defining securities.

The Ninth Circuit Court of Appeals, however, in the recent case of United California Bank v. THC Financial Corp., considered Forman's combination of the "economic realities" standard with the required expectation of profits from the entrepreneurial efforts of others as that Circuit's "risk capital" test. In footnote 9 of the THC opinion, the court stated that the "risk capital" standard was first employed by the California Supreme Court in Silver Hills Country Club v. Sobieski. Thus, the Ninth Circuit Court of Appeals assumes that the "risk capital" test announced by the California Supreme Court in Sobieski survives the Forman decision and, consequently, remains a viable standard by which the applicability of the federal securities laws may be determined.

The Sobieski formulation compels the finding of a security if there is any expectation of valuable benefit to the provider of risk capital. Forman, however, requires profit in a traditional sense as "capital appreciation resulting from the development of the initial investment . . . or a participation in earnings resulting from the use of investors' funds . . . ." Thus, Forman and Sobieski are distinguishable on the basis of risk and on the basis of profit expectation.

It is the contention of the authors that Forman should not be viewed as a federal "risk capital" test, but rather as a "venture capital" test. This subtle distinction between "risk capital" and "venture capital" leads to a better understanding of the trend in judicial decisions regarding securities and, further, demonstrates that while the Sobieski formulation of "risk of loss" may be of some evidentiary value, Sobieski is not incorporated in what may be termed the "Howey/Forman" test. In order to explain more clearly the distinction between the Howey/Forman test and Sobieski, however, it will be beneficial to trace briefly the historical background of judicial decisions preceding the Forman decision.

HISTORICAL BACKGROUND

Prior to 1933, securities regulation was the exclusive province of the states. As a result, Congress borrowed freely from the states' "Blue Sky" laws in defining the term "security" for the purpose of the Securi-

3. 557 F.2d 1351 (9th Cir. 1977).
4. Id. at 1358; see Great Western Bank and Trust v. Kotz, 532 F.2d 1252 (9th Cir. 1976).
6. Id. at 815, 361 P.2d at 908, 13 Cal. Rptr. at 188.
7. 421 U.S. at 852.
ties Act of 1933. In addition, both the Securities Act of 1933 (hereinafter referred to as the Securities Act) and the Securities Exchange Act of 1934 (hereinafter referred to as the Securities Exchange Act) define security "in sufficiently broad and general terms so as to include within the definition the many types of instruments that in our commercial world fall within the ordinary scope of securities." The "broad and general" terms used by Congress did little more than express the intent that transactions in "securities," whatever that nebulous term may mean, were to be regulated. It was left to the courts, therefore, to define more clearly what constituted a security.

Ten years after the promulgation of the Securities Act, the Supreme Court in SEC v. C.M. Joiner Leasing Corp. issued its first opinion on the interpretation of this definitional language. The case involved a program to sell oil leases, accompanied by representations that the defendants would drill a test well that would prove the productivity of the vendees' acreage. In response to defendants' arguments that this was merely an offer of "naked leasehold rights," Mr. Justice Jackson observed:

The drilling of this well was not an unconnected or uncontrolled phenomenon to which salesmen pointed merely to show the possibilities of the offered leases. The exploration enterprise was woven into these leaseholds, in both an economic and a legal sense; the undertaking to drill a well runs through the whole transaction as the thread on which everybody's beads were strung.

Mr. Justice Jackson emphasized the underlying purpose of the Securities Act:

It is clear that an economic interest in this well-drilling undertaking was what brought into being the instruments that defendants were selling and gave to the instruments most of their value and all


10. H.R. Rep. No. 85, 73d Cong., 1st Sess. 11 (1933), provides:

When used in this subchapter, unless the context otherwise requires—

(1) The term 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, fractional undivided interest in oil, gas or other mineral rights, 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.


11. 320 U.S. 344 (1943).

12. Id. at 348.
of their lure. The trading in these documents had all the evils inher- 
ent in the securities transactions which it was the aim of the Securi-
ties Act to end.13

In reversing the lower court, Mr. Justice Jackson refused to be bound 
by a specific formula in defining the term “investment contract.” 
Rather, he followed the lead of prior state and federal decisions and 
chose to place his holding on general policy grounds, suggesting a case-
by-case analysis.14

Three years after the Joiner decision, the Supreme Court decided the 
Howey case, which involved the sale of citrus acreage accompanied by 
an option to purchase service contracts that obligated an affiliated cor-
poration to cultivate and market the fruit. As in Joiner, it was imprac-
tical for the purchasers to participate in the development of their own 
land because of their lack of sophistication, absenteeism and the eco-
nomic difficulties of piecemeal farming. Mr. Justice Murphy, speaking 
for the majority, chose to isolate those elements which in his opinion 
were the distinguishing features of an investment contract. Noting that 
Congress had been influenced by the prior Blue Sky laws, Mr. Justice 
Murphy purported to rely upon state decisions to fashion a test that, he 
concluded, was consistent with the statutory aims:

[A]n investment contract for purposes of the Securities Act means 
a contract, transaction or scheme whereby [1] a person invests his 
money [2] in a common enterprise and [3] is led to expect profits 
solely from the efforts of the promoter or a third party, it being im-
material whether the shares in the enterprise are evidenced by formal 
certificates or by nominal interests in the physical assets employed 
by the enterprise.15

This sentence quickly became the three-part standard (or by splitting 
the third element into a profit expectation and a reliance factor, a four-
part standard) for judging whether a particular transaction involved an 
“investment contract.” Later decisions have rarely, if ever, construed 
the existence of an investment contract without considering, if not for-
ma ly relying upon, the Howey formula.

13. Id. at 349.
14. The test rather 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. In the 
enforcement of an act such as this it is not inappropriate that promoters’ offerings be judged as 
being what they were represented to be. Id. at 352-53. As the Supreme Court noted in Forman, 
the contrary may also be true:
[A] thing may be within the letter of the statute and yet not within the statute, because 
not within its spirit, nor within the intention of its makers.
421 U.S. at 849, citing Church of the Holy Trinity v. United States, 143 U.S. 457 (1892). See 
generally Church of the Holy Trinity v. United States, 143 U.S. 457 (1892).
15. 328 U.S. at 298-99; see Great Western Bank and Trust v. Kotz, 532 F.2d 1252, 1257 (9th 
Cir. 1976).
THE *FORMAN* DECISION

Twenty-nine years elapsed between the *Howey* and *Forman* decisions. During that period, the federal courts developed a number of levels of analysis to determine whether a transaction constituted a security. The simplest level is the "literal" test; that is, a transaction is a security because, on its face, it seems to fall under one of the elements of Section 2(1) of the Securities Act. When the courts find this test insufficient, they move to an "economic realities" analysis, another name for substance over form. Relying upon the intent of Congress that securities transactions are economic in character, this analysis seeks to determine whether those complex transactions which may come under the language of Section 2(1) of the Securities Act, fall within the regulatory purpose of the Securities Act. In certain contexts, such as promissory notes or commercial versus investment paper, the economic realities standard has been denominated the commercial/consumer-investment dichotomy by the courts.16 Alternatively, in evaluating investment contract securities under Section 2(1) of the Securities Act, the *Howey* test becomes the accepted methodology. Thus *Howey* was used to analyze investment contract securities; and the "economic realities" standard or the commercial/consumer-investment dichotomy was used to analyze other types of securities under Section 2(1) of the Securities Act.

The *Forman* decision reviewed all of these tests in the context of shares in a cooperative housing project. The case involved tenants of apartments owned by a nonprofit housing cooperative, who brought a class action against various defendants, including the corporation which had issued shares of stock entitling them to lease the apartments. The complaint alleged that the tenants were misled in their purchase of the shares by misrepresentation in the cooperative's information bulletin. On this basis they asserted claims for fraud under the Securities Act and the Securities Exchange Act. On certiorari, the Supreme Court held that the shares of stock purchased from the cooperative did not constitute "securities" within the purview of the federal securities laws.

The *Forman* decision is significant in that the Supreme Court combined under one definitional standard the analysis of both "investment contract" securities and other types of securities as defined in Section 2(1) of the Securities Act. In analyzing whether or not the stock in the cooperative constituted a security for the purposes of federal law, the Supreme Court stated that it perceived no distinction between an "in-

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16. 532 F.2d at 1257.
vestment contract” and an “instrument commonly known as a ‘security’” and that the Howey test “embodies the essential attributes that run through all of the Court’s decisions defining a security.” The Court went on to state that in either case, the basic test for distinguishing a security transaction from commercial dealings is “whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others.”

In deciding that the Howey test had universal application, the Supreme Court rejected the literal approach to analyzing transactions, and approved the “economic realities” test. As stated by the Court:

Because securities transactions are economic in character Congress intended the application of these statutes to turn on the economic realities underlying a transaction, not on the name appended thereto.

Therefore, if the Howey test fits an analysis of a given transaction, the Howey test is to be used. In the alternative, if a transaction does not fit the language of the first two elements of Howey, an “economic realities” standard is to be applied to determine whether the transaction is of the type Congress intended to bring within the purview of the Securities Acts. Yet the “economic realities” standard is only useful in analyzing those schemes that cannot be effectively analyzed under the concepts of investment and common enterprise. A security cannot be found under the “economic realities” standard absent a profit expectation in reliance upon the efforts of others, the third element of Howey that must be present. The Forman decision, however, provides several guideposts to be used to arrive at a better understanding of the Howey/Forman test.

First, the Forman Court re-emphasized the opinion of Tcherepnin v. Knight which held: “[I]n searching for the meaning and scope of the word ‘security’ in the Act[s], form should be disregarded for substance and the emphasis should be on economic reality.” The Court, for example, reiterated the congressional purpose underlying the securities laws; that is, Congress intended the application of the securities laws “to turn on the economic realities underlying a transaction, and not on the name appended thereto.” Thus, the Forman Court rejected a lit-
eral analysis for determining whether a particular transaction is within the ambit of the federal securities laws.

The second and perhaps the major interpretive guide provided by the *Forman* Court was a definition of "profits" in the *Howey* test. In commenting on the *Howey* decision, the majority held, over the dissent of Mr. Justice White, that the touchstone of the definition of a security . . . is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others. By profits, the court has meant either capital appreciation resulting from the development of the initial investment, as in *Joiner* . . . (sale of oil leases conditioned upon promoters' agreement to drill exploratory well), or a participation in earnings resulting from the use of investors' funds, as in *Tcherepnin* . . . (dividends on the investment based on savings and loan association's profits). In such cases the investor is "attracted solely by the prospects of a return" on his investment. . . . By contrast, when a purchaser is motivated by a desire to use or consume the item purchased—"to occupy the land or to develop it themselves," as the *Howey* court put it,—. . . the securities laws do not apply.24

One of the findings of the lower court, in concluding that the factual context in *Forman* met the test of *Howey*, was that "an expectation of income" included the deductibility for tax purposes of the interest on the mortgage in the cooperative apartment. The Supreme Court, however, held that there is no basis in law for the view that the payment of interest, with its consequent deductibility for tax purposes, constitutes income or profits.25 The Court went on to state that "even if these tax deductions were considered profits, they would not be the type associated with a security investment since they do not result from the managerial efforts of others."26

Third, the *Forman* Court noted that the respondents urged it to abandon the element of profits in the definition of securities and to adopt the "risk capital" approach articulated by the Supreme Court of California in *Silver Hills Country Club v. Sobieski*.27 The Court did not reject, but declined to adopt, the test of *Sobieski*. The Court went on to

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of the enterprise system: the sale of securities to raise capital for profit-making purposes, the exchanges on which securities are traded, and the need for regulation to prevent fraud and to protect the interest of investors. Because securities transactions are economic in character, Congress intended the application of these statutes to turn on the economic realities underlying a transaction, and not on the name appended thereto.

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421 U.S. at 849.
24. *Id.* at 852-53 n.20 (citations omitted).
25. *Id.* at 855.
26. *Id.*
say that even if it were inclined to adopt a "risk capital" approach, it would not apply in the Forman case. Purchasers of apartments in Co-op City in fact took no risk in any significant sense. If the purchasers were dissatisfied with their apartments, apparently they had the right to recover their initial investment in full. The result was no risk of loss of initial investment.

In light of the United States Supreme Court's failure to reject expressly the "risk capital" test originated in the Sobieski decision, the Ninth Circuit Court of Appeals reasoned that the "risk capital" test remains a viable standard by which to determine the existence of a security. Therefore, in order to distinguish the Howey/Forman test from the "risk capital" test, it is necessary to examine the California Supreme Court's decision in the Sobieski case.

CALIFORNIA'S RISK CAPITAL TEST

The "risk capital" standard was first employed by the California Supreme Court in Sobieski.28 Sobieski involved the capitalization of a country club through advance payments by members to finance construction. The question before the California Supreme Court was whether the interest in the country club constituted a "security" under Section 25008 of the California Corporations Code. The Sobieski court held that Section 25008 defined a security broadly to protect the public against spurious schemes, however ingeniously devised, to attract risk capital. In order to effect this purpose, the courts in California look through form to substance.

Under Section 25008, a security is defined as, among other things, any beneficial interest entitled to property, profits, or earnings. The Sobieski court held that the purchaser of a membership in the country club had a contractual right to use the club facilities that could not be revoked except for his own misbehavior or failure to pay dues. Such an irrevocable right qualified as a beneficial interest entitled to property within the literal language of subsection (a) of Section 25008. The court went on to hold that the petitioners were soliciting risk capital to develop a business for profit. The purchaser's risk was not lessened

merely because the interest he purchased was labeled a membership. Only because he risks his capital along with other purchasers can there be any chance that the benefits of club membership will materialize.

The Sobieski court noted that the California definition of security extended even to transactions where capital is placed without expectation of any material benefit. Thus, from its exemption of the securities of certain nonprofit companies, Section 25102 of the Corporations Code specifically excepted “notes, bonds, debentures, or other evidence of indebtedness whether interest-bearing or not.” The court then concluded:

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

Although Sobieski did not directly consider the importance of the criteria of managerial efforts of others in analyzing whether the club membership constituted a security, it should be recognized that reliance on the efforts of others is presupposed under the Sobieski analysis. Nevertheless, Sobieski and Forman are at odds over the concept of profits. What Sobieski does stand for is that capital, subject to risk and invested with the expectation of “any” material benefit is sufficient to characterize a transaction as a security under California law. The benefit of membership in a club, that results in neither capital appreciation nor earnings derived from the use of investors' funds, does not result in a security under federal law.

The requirement of risk as a necessary element of Sobieski was made extremely clear in the California Court of Appeal case of Hamilton Jewelers v. Department of Corporations. In this case, the Court of Appeal rejected the contention of the California Department of Corporations that an advertisement offering certain unmounted diamonds together with a guarantee of return of the purchase price with interest at any time the customer might elect within three years of his purchase, constituted the offer of a security within the meaning of the California statute, in the form of an “evidence of indebtedness” or “investment contract.” The Court of Appeal pointed out that the “risk capital” approach is followed in California in ascertaining whether a transaction involves a security within the meaning of the California Corporate Securities Law. Relying on the trial court's finding of the fair market

29. 55 Cal. 2d at 815, 361 P.2d at 908-09, 13 Cal. Rptr. at 188-89 (emphasis added).
30. Id.
value of the gems if sold without the full refund-plus interest warranty, the Court of Appeal held that the customer, being adequately secured, would have placed no "risk capital" with the seller of the diamonds. Therefore, the transaction would not come within the regulatory purpose of the California statutes, even though the advertised interest might ultimately be paid.

The Hamilton Jewelers case is probably a misstatement of California law, because the "risk capital" theory of Sobieski is not the only test utilized in California in determining whether a transaction involves the offer or sale of a security. California has adopted the Howey test in determining whether an "investment contract" security is present under the California definition of a security. It is arguable that under Howey, the Hamilton Jewelers repurchase program would have constituted an investment contract security. Nevertheless, the Hamilton Jewelers case is useful in demonstrating that "risk of loss" is necessary to the finding of a security under Sobieski. The "risk capital" test is a distinct test from the Howey/Forman test and will find a security in those cases where there is risk to the provider of capital even though the provider of capital may not be investing in a common enterprise, or the provider of capital is not seeking profits as defined in Forman from the efforts of others.

Therefore, Howey and Sobieski might be considered complementary decisions. Where there is risk of loss coupled with the expectation of profit as required by Forman, both tests reach the same results. Where the investment involves no risk to the investor, Sobieski will not find a security, but the lack of a risk of loss will not preclude a securities determination under Howey/Forman. Where the investment return takes the form of a valuable but nonmaterial benefit, the substance of the scheme determines if it violates the criteria of Sobieski. The absence of a traditional profit motivation, however, will preclude a securities conclusion under the Howey/Forman test. Further, where the scheme contains none of the characteristics of investment return, for example in the case of retail trading stamps, neither case law nor policy considerations will sustain a securities theory under either Howey/Forman or Sobieski.

Sobieski, however, does not stand for the proposition that an unqualified expectation of a valuable benefit alone is sufficient to constitute an investment contract and thereby to completely circumvent the profit element of Howey. The reason that such an analysis must fail is easily seen when Howey, absent the profit element, is extended to its logical

conclusion. Whenever a customer of an enterprise is promised some future performance, the fulfillment of that promise necessarily rests upon the willingness and capability of the promisor to perform. If the valuable benefit concept were adopted indiscriminately, it would be tantamount to extending the securities acts to virtually every executory contract. Importantly, Sobieski did not involve every risk contingency found in executory contracts, but was limited to risks attendant to venture capital offerings.

In conclusion, the major difference between Howey/Forman and Sobieski is that under the federal standard the expectation of profit is defined in the traditional sense of capital appreciation resulting from the development of the initial investment or a participation in earnings resulting from the use of investors’ funds. Sobieski goes beyond this definition to conclude that any valuable benefit in the context of a venture capital offering, such as membership in a country club, will result in a security under California law.

Further, as highlighted by the Hamilton Jewelers decision, Sobieski requires risk of loss to the provider of capital. The Howey/Forman test, on the other hand, does not require a risk of loss but rather an expectation of profits to be derived from the entrepreneurial efforts of others. If there is economic risk under Howey/Forman, it is the risk associated with denial of expected gain because control of the venture is in the hands of others. Although risk of loss is an important analytical element under the economic realities standard, it is not a necessary element to the Howey/Forman test. In most cases where the Howey/Forman test elicits the finding of a security, risk of loss will be present.

The inquiry under Howey/Forman is whether the provider of funds is expecting profits from the common enterprise and whether the venture is in the control of others. These factors are necessary to distinguish a venture capital transaction from a commercial transaction where the provider of funds is seeking a return on the money lent rather than profit expectation from the success of the enterprise. Therefore, the Howey/Forman test might be denominated a “venture capital” test rather than a “risk capital” test as stated in the THC case. Furthermore, an analysis of the elements of the Howey/Forman test reinforces the conclusion that Forman adopts a “venture capital” test for the purpose of federal law.

**Risk and Reliance Upon The Efforts of Others**

Although not discarding “risk of loss” as an analytical element, the
Howey/Forman test requires a finding of a profit expectation coupled with a reliance by the investor on the efforts of others, notwithstanding risk of loss. But risk of loss is not the only type of economic risk present in a securities transaction. The third element of Howey, adopted in Forman, analyzes risk as an opportunity cost to the investor. The investor, because he is relying on others for his profit realization, is providing funds to an enterprise in which he has no effective control over success or failure. The third element of Howey focuses on this investment without corresponding control. The risk to the investor enunciated in Forman is not risk of loss of his initial investment but the risk of denial of gain because control is exercised by others.

Given a profit expectation as defined by the Supreme Court, if the managerial decisions leading to the success of the venture are the prerogative of the investor or the success of the venture is not dependent on managerial effort even if the venture entails risk of loss, the Howey/Forman test will conclude that a security is not present. If the significant managerial efforts that determine the success of the venture are substantially in the hands of a third party or the promoter and there is a profit expectation, then the Howey/Forman test will find a security present. This conclusion will stand even if there is no “risk of loss” to the investor, e.g., a guaranteed repurchase by the promoter, for the analysis turns not on risk but on whether there is a profit expectation from the efforts of others.33

It is the emphasis on “profit” expectation from the efforts of others, without a requirement of risk of loss, that is the basis of the Howey/Forman test and which permits the economic realities standard to distinguish between commercial and investment transactions. A short term loan to a risky borrower is normally not a security. Although Section 2(1) of the Securities Act includes “note” as a security, the prefatory language limits application to the “context” of the transaction. Although a short term risky loan arguably involves, under a broad definition, an investment of money in a common enterprise with a profit expectation, the profit expectation is normally not the type of expectation interest that Howey meant to include. This is the key to the commercial/investment dichotomy.

The distinction between risk capital and venture capital is found in


34. This illustration assumes that vertical commonality is equivalent to common enterprise. The federal courts are divided on this point. For a discussion of horizontal and vertical commonality as it relates to common enterprise, see generally Brodt v. Bache & Co., Inc., 595 F.2d 459 (9th Cir. 1978); Troyer v. Karcagi, [1978] FED. SEC. L. REP. (CCH) ¶96,929 (S.D.N.Y.).
the difference between the simple risk of loss of money lent and the risk associated with the contribution of capital to a venture. Risk in the commercial context can be a function of innumerable criteria, from general market conditions to collateral base, financial ability to repay, and interest rates. Risk in a venture capital context is the risk of investment in an enterprise with return dependent on the success of the enterprise, normally over the long run. The success of the enterprise in this context is most often a function of the entrepreneurial efforts of the promoter or a third party.

The reality of the marketplace is that nearly all businesses ultimately finance themselves by obtaining public funds through the sale of goods or services. Whenever some future performance is promised a customer of an enterprise, there is a commercial risk that the promisor will not perform or that the intervening insolvency of the promisor will prevent or delay performance. These types of "normal" commercial risks, without more, do not shift the principal risk of the enterprise to the customer. Nevertheless, every lender of money is, in one sense, an investor since he places his money at risk in anticipation of a profit in the form of interest.

Within the commercial/consumer-investment dichotomy the extremes are conceptually definable: buying shares of common stock of a publicly held corporation, where the impetus for the transaction derives from the person with the money, is clearly an investment; borrowing money from a bank to finance the purchase of an automobile, where the impetus for the transaction comes from the person who needs the money, is a loan. In between is a vast gray area which has been, and must be in the future, subject to a case-by-case analysis.

For example, if an undercapitalized entity should impose itself in the midst of an investment risk which emanates from the marketplace, risk, both of loss and to expectation interest, may be fundamentally altered. No longer will the risk to the investor be subject only to the marketplace; rather, the investor's risk will now be contingent upon the changing fortunes of his middleman, much as if he had purchased common stock. The investor will be looking to the middleman for the realization of his profit expectation interest. Utilizing this type of risk analysis, the purpose of the scheme is to obtain venture capital and shift the risk to the investor. The investor becomes a passive financer of the enterprise and should be entitled to the protection of the securities laws.

The analysis focuses on risk associated with success or failure of the venture; not the risk of loss of initial investment, but risk, in the sense of opportunity cost, of not achieving the profit expectation because con-
control of the venture is in the hands of others. The investor, who is providing funds to an enterprise expecting profits from the efforts of the promoter of the enterprise or a third party, is bearing the risk of not achieving his profit expectation because he does not have control over the venture. Analytically, risk of denial of gain equates to a profit expectation without the effective control over the venture to be responsible for the profit realization.

Yet, risk to expectation interest is not a major analytical element in evaluating a transaction as a security under the Howey/Forman test. Rather, risk to expectation interest is a result or forced conclusion from an analysis that turns upon who is to perform those efforts that may lead to the success or failure of the venture. For example, in the promissory note context, the analysis again turns on whether the lender is providing funds to a venture and seeking a return from the efforts of others. If so, the transaction is an investment.

A number of Supreme Court cases, however, have been based on the issue of risk of loss. These decisions are prior to Forman. One need only look to the Joiner decision to recognize that the case turned not so much on the promoter's representations of profit as on the economic reality that the risk of loss had been placed on the shoulders of the investor.35

Similarly, the Supreme Court's concern in SEC v. Variable Life Insurance Co. of America36 and SEC v. United Benefit Life Insurance Co.37 is clearly directed at the insurer's attempt to shift all or a substantial portion of the risk of loss in a variable annuity transaction to the investor.

After Forman, it can be argued that the variable annuity cases are sui generis and do not affect the general conclusion of this article that risk of loss is only a useful analytical tool in analyzing the commercial/investment nature of a transaction and not a prerequisite to the finding of a security. The Joiner decision may be viewed as emphasizing the use of risk of loss as an evidentiary consideration; that is, risk of loss of initial investment is useful in analyzing the economic realities of a transaction to determine whether the transaction is in the nature of an investment. If such is the case, the last element of Howey is then considered. The finding of risk of loss will normally lead to the conclusion

35. As Professor Coffey observed about the Joiner opinion:
The court's concern is clearly focused on the relationship between the success of the enterprise and the preservation or deterioration of the value which the buyer originally furnished in the alleged security transaction.


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that an investment transaction is present. Risk of loss is often present
in commercial transactions such as risky loans, and, therefore, the dis-
tinction is the expectation of profits in reliance on the efforts of another.
Absence of a risk of loss of initial investment, however, will not pre-
clude the finding of an investment contract security. Given the ele-
ments of Howey, primarily the expectation of profits in reliance on the
efforts of others, the federal test after Forman will find the presence of a
security even if there is no risk of loss of initial investment.

Moreover, an analysis of the "shifting of risk" without a correlative
analysis of who is responsible for those significant managerial efforts
that will determine the success or failure of the enterprise, will analyti-
cally equate with a "risk capital" theory rather than "venture capital,"
which is not federal law. Forman stressed the importance not only of
"profits" and the control of the capital markets as the primary purpose
of the Securities Acts, but also the expectation of those profits from the
entrepreneurial efforts of others. Forman stands for the proposition
that in the absence of the third element of Howey, with the first two
elements determined under the economic realities standard, the shifting
of business risk or risk of loss alone will not render a given transaction
a security.

APPLYING THE HOWEY/FORMAN TEST

A. Substance Over Form

The Supreme Court in Forman rejected a literal approach to analyz-
ing whether a transaction constituted a security. In the context of
"stock," the Court adopted the economic realities standard.38 This test
looks to "the economic realities underlying a transaction and not [to]
the name appended thereto."39

Applying this economic realities standard to the facts of Forman, the
Court found that none of the usual characteristics of stock were associ-
ated with the shares in the cooperative apartments. For example, the
shares carried no rights to dividends; they were nonnegotiable; the
shares could not be hypothecated; the instrument conferred no voting
rights proportioned to the number of shares owned and the shares
could not appreciate in value. The Supreme Court, therefore, con-

38. 421 U.S. at 849. However, in the recent case of Coffin v. Polishing Machines, Inc., 502
SEC. REG. & L. REP. (BNA) at A-13 (5th Cir. 1979), the court did not believe that participating in
the management of a closely held business, acquired through the purchase of common stock,
rather than awaiting profits derived "solely from the efforts of others" as required by Howey,
denied the purchasers of ordinary common stock the protections of the antifraud provisions of
federal law. Distinguishing Forman, Judge Butzner observed: "Having decided to deal in stock,
they brought their transaction under the federal securities laws."

cluded that the purchasers' intent was to obtain housing rather than to make an investment for profit.\textsuperscript{40}

The rejection of the literal test is most significant with regards to transactions falling under the language of Section 2(1) of the Securities Act. For example, in the case of promissory notes, many cases have employed a variant of Mr. Justice Frankfurter's "plain meaning" construction\textsuperscript{41} holding that when the statute read "'security' means any note . . ." it meant just that.\textsuperscript{42} Rejection of the literal test means that an instrument or document, such as a promissory note exceeding a nine-month term, is not to be deemed a security on its face. With this decision, the Supreme Court has indicated its view that the economic realities of the transaction must be considered by a court before reaching its conclusion.

B. Common Enterprise

After rejecting the literal test and concluding under the economic realities standard that the rights, preferences, privileges, and restrictions on the purchasers of apartments were not those of purchasers of common stock, the Supreme Court then considered whether the shares were "investment contracts" under the \textit{Howey} test.

Clearly, in the \textit{Forman} case the purchasers of apartments were investing money. This is seldom a meaningful debate in a securities analysis.\textsuperscript{43} As an analytical matter the first element of the \textit{Howey} test is

\begin{itemize}
  \item \textsuperscript{40} 421 U.S. at 852-53.
  \item \textsuperscript{41} See Frankfurter, \textit{Some Reflections on the Reading of Statutes}, 47 \textit{COLUM. L. REV.} 527 (1947).
  \item \textsuperscript{42} See, e.g., Rekant v. Desser, 425 F.2d 872, 878 (5th Cir. 1970); Movielab, Inc. v. Berkey Photo, Inc., 321 F. Supp. 806 (S.D.N.Y. 1970), aff'\texttextsuperscript{d} 452 F.2d 662 (2d Cir. 1971).
  \item \textsuperscript{43} A determination of what may constitute an "investment" for the purpose of the \textit{Howey} test was significant in the recent case of \textit{Teamsters v. Daniel}, 99 S. Ct. 790 (1979). In this case the Supreme Court held that, in the context of a noncontributory, compulsory pension plan, an employee sold his labor to obtain a livelihood, not to make an investment. In reaching this position, the Court reviewed its previous decisions which have recognized the presence of a "security," noting that in all such cases the person found to have been an investor chose to give up a specific, tangible, or definable consideration in return for a separable financial interest with the characteristics of a security. The Court did, however, note that a person's "investment," in order to meet the definition of an investment contract, need not take the form only of cash, but can also be other goods and services, citing \textit{Forman} at 852 n.16.
  
  It should also be kept in mind that the term "investment" as used in the \textit{Howey} test, although infrequently discussed by the courts, is not the same as a speculative investment where there is substantial danger of loss of principal. This ties back to the discussion above as to whether risk in the context of the \textit{Howey/Forman} test is the risk associated with risk of loss of initial investment or whether, as is contended here, it is the risk associated with opportunity cost and the failure to achieve profit expectation in reliance upon the efforts of others. Investment in the context of the federal securities laws involves nothing more than the turnover of consideration for the expectation of gain. As stated in the case of \textit{SEC v. Wickham}:

  The placing of capital or laying out of money in a way intended to secure income or profit from its employment is an "investment" as that word is commonly used and understood.

\end{itemize}
presupposed.

The second element of the Howey test focuses on the nature of the investment venture, i.e., is the individual investor part of a “common enterprise.” As developed by the federal courts, a common enterprise need not be a common fund. The term denotes an interdependence of fortunes: a dependence by one party for his profits on the success of some other party in performing his part of the venture. The federal cases clearly show that a common enterprise is not dependent upon the interrelated success of all investors in the common enterprise. Rather, it will suffice for this element of the Howey test if an investor’s success is dependent upon the success of the promoter, as, in turn, is the success of all other investors.

An excellent discussion of the federal cases that have considered the question of common enterprise is contained in the recent decision of the Washington Supreme Court—McClelland v. Sundholm.45 The Sundholm court concluded that a common enterprise existed in the sale of silver bullion for investment purposes, and determined the sale to be a security under Washington State’s securities act.46 The Washington Supreme Court held, citing the federal precedents, that there was sufficient dependence to find a common enterprise.47 The investor expected to gain a profit from his investment only if the defendant-trading corporation wisely managed its own silver selection, purchase, and resale activities. The intended ongoing relationship between the purchaser and the trading company emphasized the existence of a common enterprise. Consequently, the market, and the reliance of all investors on the trading company thereby constituted a common enterprise.48

Other courts have held that “common enterprise” should be liberally construed to mean any type of concerted effort whereby the investors’ financial interests are “inextricably interwoven” with those of the promoter or third party.49 In other words, the element of commonality is vertical between buyer and seller—not horizontal—among investors similarly situated.50 As stated in the case of Jones v. International Inves-

45. 89 Wash. 2d 527, 574 P.2d 371 (1978).
46. Id. at 529, 579 P.2d at 373-74.
47. Id.
48. Id.
49. Los Angeles Trust Deed & Mortgage Exch. v. SEC, 285 F.2d 162 (9th Cir. 1961).
50. For an excellent discussion of common enterprise, see Continental Marketing Corp. v. SEC, 387 F.2d 466 (10th Cir. 1967).
51. The federal courts are, however, inconsistent as to other types of “common” transactions. (a) In Maheu v. Reynolds & Co., 282 F. Supp. 423 (S.D.N.Y. 1967), the court held that a discretionary commodities account, managed and supervised by defendants, constituted an investment
tors, Inc. East:

[I]t is well settled in this circuit that the fact that one investor's return is independent of that of other similar investors does not preclude satisfaction of the common enterprise element, if the fortunes of all the investors are, in the last analysis, dependent upon the efficacy of the promoter's efforts. Thus, it is not significant whether the profits of the enterprise will be pooled and distributed among all the investors and the promoter, but rather the emphasis should be on "the uniformity of the impact of the promoter's efforts" on the fate of all investors. 52

Upon review of the case authority, however, the "common enterprise" element of the Howey test has not been a significant factor in determining whether a transaction constitutes an investment contract. The courts have structured a priority analysis out of the Howey criteria: whether or not a transaction meets the Howey test will most often depend on the element of "profits from the efforts of another" and not on the issue of "common enterprise." Should a court hold that insufficient managerial efforts are to be performed by the purchaser who expects profits, confusion in the law as to the definition of "common enterprise" will not preclude a court from determining that a security exists.

contract, notwithstanding the fact that plaintiff's account was not pooled with that of other investors. Contrary is the case of Milnarik v. M-S Commodities, Inc., 457 F.2d 274 (7th Cir. 1972), cert. denied, 409 U.S. 887 (1972), which held, by opinion of Mr. Justice Stevens, that an individual who, for a fee, invests his client's money in a commodities market, was not selling a security within the meaning of the Securities Act. This court found that even though the defendant invested the money at his own discretion, the element of commonality necessary to constitute an investment contract was missing:

Although the complaint does allege that Nelson entered into similar discretionary arrangements with other customers, the success or failure of those other contracts had no direct impact on the profitability of plaintiff's contract. Nelson's various customers were represented by a common agent, but they were not "joint participants in the same investment enterprise."


(b) Another point on which the courts are divided is whether a common enterprise can exist between a promoter and one investor. In the case of Sunshine Kitchens v. Atlantic Corp., 403 F. Supp. 719 (1975), a purchaser of computers under an agreement whereby the seller would manage leasing arrangements brought suit charging the seller with violation of the securities laws. The court held that a common enterprise which will constitute a transaction a security within the securities laws does not exist where there is only one investor and one promoter. Id. at 721-22. The court held, citing Koscot and SEC v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974), that those courts dealt with schemes involving hundreds of investors. Those courts were not primarily interested in whether the money or profits were pooled. They were interested, however, and found to be a critical factor, "the uniformity of impact of the promoter's efforts."

Contrary to the holding in Sunshine is the case of Huberman v. Denny's Restaurants, Inc., 337 F. Supp. 1249 (N.D. Cal. 1972). In this case the purchase and sale of a restaurant property constituted the purchase and sale of a security if, as alleged, the lease package was put together by the lessee and vendor and offered as an investment to the purchaser where it was not intended that the purchaser participate in the operation of the franchise held by the lessee. And if rental, above monthly minimum, depended upon the volume of the restaurant's sales, so that there existed the elements of common enterprise and complete reliance by the purchaser upon the efforts of others for her profits.

On the other hand, should a court hold that the significant managerial efforts that determine the success or failure of the profit expectation interest are to be performed by the investor in an enterprise, then the court will rarely, if ever, address the question of common enterprise.

C. Led to Expect Profits Solely From the Efforts of the Promoter or A Third Party

The most important conclusion of the Court was that the third element of the Howey test was not met because the “shareholders” did not expect to realize profits from the entrepreneurial efforts of others.

For analytical purposes, it is best to split this third element of the Howey test into the profit expectation interest and the reliance on the efforts of another. As to the profit expectation interest, as discussed above, the Forman Court was quite clear in what Howey meant by profits. Profits are to be capital appreciation or participation in earnings resulting from the use of investors’ funds and not tax deductions or, by analogy, membership rights in a country club. It is this definition of profits that precludes adoption by the federal courts of Sobieski in its entirety for Sobieski does not require such a profit expectation but merely a risk-benefit analysis.

As to the realization of profits from the efforts of the promoter or a third party, although not specifically adopted in the Forman decision, an analysis of such efforts no longer hinges on the word “solely” contained in the original Howey formulation. The analysis is now based on whether the “essential” or “undeniably significant” efforts of persons other than the investor determine the success of the enterprise.53

Control over management seems to be the key. Neither a general partnership nor a joint venture interest has been held to be a security since effective management control is in the hands of the “investor.”54

Therefore, the third element of Howey becomes the major focus of the Howey/Forman test. Investment and common enterprise, although necessary elements, usually are not significant in analyzing a transaction and may not even be directly considered under the “economic realities” standard. It is profit expectation in reliance on others that now differentiates a security from other commercial or consumer transactions; and, after Forman, is applicable to all transactions, whether traditional investment contracts or other types of securities under Section 2(1) of the Securities Act. Finally, this third element of Howey directs the analysis to the risk of denial of profit expectation because

the investor does not effectively control the enterprise. The result is not a federal risk capital test but a venture capital test.

\textbf{Conclusion}

The \textit{Forman} decision, as perhaps the most significant decision defining securities for the purposes of federal law since \textit{Howey}, effectively tied together the various tests used by the federal courts since \textit{Howey} in defining securities. The “literal test” was rejected as too superficial and the “economic realities” standard approved. Beyond that, the \textit{Forman} decision integrated the third element of the \textit{Howey} formulation and the economic realities standard, which together constitute the \textit{Howey/Forman} test. Finally, the Supreme Court stated that this test should be applied to all types of investment transactions coming within the definition of a security in Section 2(1) of the Securities Act and not just “investment contracts.”

Perhaps this new \textit{Howey/Forman} test will provide some uniformity to the federal courts as they approach the myriad of schemes and programs that come before them. The test goes clearly to the substance of the transaction, analyzing the risk of the venture and whether the individual responsible for success or failure, given the risk, is the investor or the promoter. But the Court also drew limits to this analysis by defining profits and indicating its view of congressional intent behind the Securities Acts. The purview of federal securities laws is not as broad as \textit{Sobieski}, for there must be an expectation of profits, in terms of capital appreciation or a participation in earnings resulting from the use of investors’ funds, and not merely an expectation of a material benefit. Further, in addition to profits, the \textit{Forman} Court requires that the investor’s profit expectation be in reliance on the significant managerial efforts of the promoter or a third party. Conversely, the \textit{Howey/Forman} test is broader than \textit{Sobieski} because risk, in the sense of risk capital, although useful in determining whether a transaction is of an investment character rather than of a commercial character, is not determinative of the existence of a security.

It is our view that the Supreme Court in \textit{Forman} not only clarified the \textit{Howey} test to provide the courts a clear but flexible framework for analyzing transactions under the federal securities laws, but the Court also correctly limited the types of transactions that may now be brought under the purview of such laws. Any expectation of gain is insufficient because \textit{Forman} requires a profit expectation in a traditional economic sense. The name applied to a transaction is not dispositive. “Risk capital” is not federal law and the Court’s definition of “profits” highlights the distinction between “risk capital” of \textit{Sobieski} and “venture capital”
of the *Howey/Forman* test. The Supreme Court apparently understood that if judicial expansion of the scope of the federal securities laws was left unchecked, few business transactions would escape the label of an investment contract security. Clearly this was not the intent of the Congress when it enacted the Securities Act.