Mississippi College Law Review

Volume 11
Issue 1 *Vol. 11 Iss. 1*

Article 8

1991

What is a Common Enterprise - A Question of Legislative Intent

Stephen M. Maloney

WHAT IS A COMMON ENTERPRISE? A QUESTION OF LEGISLATIVE INTENT

I. INTRODUCTION

The term "investment contract" was first defined by the United States Supreme Court in *SEC v. W.J. Howey Co.*[1] The application of this definition has been the subject of extensive litigation. *Howey* articulated a three part test to define an "investment contract": (1) an investment of money, (2) in a common enterprise, (3) with profits dependent solely upon the efforts of a third party.[2] The circuit courts have not agreed on the application of the "common enterprise" element of the *Howey* test, and the Supreme Court has failed to resolve the conflict. This comment will address the scope of the federal securities laws and more particularly the term "investment contract" which is part of the broad definition of a "security." The comment will also discuss each circuit court's interpretation of the *Howey* test along with policy considerations of each court and will suggest a uniform approach which should be adopted by the Supreme Court to resolve the conflict.

The relationship between a promoter and an investor presents lawmakers with some very difficult problems. Lawmakers must decide what degree of protection, if any, should be given to the investor. Traditionally, the investors were thought to be protected by the fact that the transactions were at arm's length and both parties had equal bargaining power. However, without some type of regulation, the investor cannot make an informed decision because he lacks access to the information in the possession of the promoter. This scenario has provided a great temptation for fraud and deception and, consequently a need for government regulation. As a result of the 1929 Stock Market Crash, Congress adopted the Securities Act of 1933 and the Securities Act of 1934 to eliminate abuse of the financial market system.[3] The two Acts were designed to promote disclosure of material information and protect the public from purchasing worthless securities because of nondisclosure or misrepresentation.[4]

---

1. 328 U.S. 293 (1946). *See infra* notes 8-21 and accompanying text.

2. *Id.* at 298-99.

3. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976) (citing H.R. REP. No. 85, 73d Cong., 1st Sess. 1-5 (1933)).

4. Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 756 F.2d 230, 237 (2d Cir. 1985).

II. SUPREME COURT INTERPRETATION

The scope of the federal securities laws is limited by the definition of a "security."[5] Although the exact wording of the two Acts is somewhat different, the Supreme Court has consistently held that the definitions are essentially the same and should be treated as such.[6] The definitions of "security" are very broad and allow courts the flexibility "to meet the countless and variable schemes devised by those who seek use of money of others on the promise of profits."[7]

As noted above, the Supreme Court had not defined the term "investment contract" until its holding in *SEC v. W.J. Howey Co.*[8] In *Howey,* the SEC brought an action against the W.J. Howey Company to enjoin the sale of unregistered securities.[9] The central issue in *Howey* was whether the interests offered by Howey constituted an "investment contract" under section 2(1) of the 1933 Act.[10]

The Howey case involved a Florida citrus grove owned by the W.J. Howey Company.[11] The Howey Company would plant approximately 500 acres annually,

---

5. Section 2(1) of the 1933 Act states:

> 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, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, 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.

15 U.S.C. § 77(b)(1) (1982) (emphasis added).

Section 3(a)(10) of the 1934 Act states:

> The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, *investment contract,* voting-trust certificate, certificate of deposit, for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, or any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

15 U.S.C. § 78(a)(10) (1982) (emphasis added).

6. Marine Bank v. Weaver, 455 U.S. 551, 555 n.3 (1982). *See also* Tcherepnin v. Knight, 389 U.S. 332, 342 (1967).

7. SEC v. W.J. Howey Co., 328 U.S. 293, 299 (1946). Congress "sought to define 'the term "security" in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security.' " United Housing Found. v. Forman, 421 U.S. 837, 847-48 (1975) (quoting H.R. REP. No. 85, 73d Cong., 1st Sess. 11 (1933)).

8. 328 U.S. 293 (1946). The Court first used the term "investment contract" in SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943). While the Court employed this term to describe transactions at issue, no definition of "investment contract" was articulated.

9. 328 U.S. at 294.

10. *Id.* at 297.

11. *Id.* at 295.

offering about half of the groves to the public.[12] The prospective investors were offered both a land sales contract and a service contract.[13] The service contracts were purchased by eighty-five percent of the investors.[14] The investors who purchased the service contracts retained no right of entry to market their produce without the consent of the company.[15] All produce was pooled with individual profits based upon an allocation of crop volume determined on each tract at the time of the picking.[16] After the sale of the fruit, the profits were divided among the landowners on a pro rata basis.[17]

Recognizing that "investment contract" was not defined within the Securities Act, the Court looked to state "blue sky" laws to ascertain the meaning of the term.[18] The Court determined that "investment contract" had been uniformly defined by state courts as an investment of "money in a common enterprise with the expectation that the investors would earn a profit solely through the efforts of the promoter or of some one [sic] other than themselves."[19] In *Howey,* the Court concluded that all three elements of the test were present: (1) there was an investment of money; (2) there was a common enterprise because the Howey Company was dependent upon capital provided by all of the investors;[20] and (3) profits were to be obtained solely from the efforts of others.[21]

The Supreme Court in *Tcherepnin v. Knight*[22] recognized the "common enterprise" element of the *Howey* test.[23] The plaintiffs in *Tcherepnin* were a number of individuals who held withdrawable shares in an Illinois corporation.[24] The plaintiffs would only receive a return on their investments if the corporation made a profit.[25] No interest rate was set on the investment, and the return was based solely upon the success of the corporation.[26] In *Tcherepnin* the Court held that the plaintiffs' participation in a money-lending operation satisfied the element of "common enterprise" because their profits were dependent upon the management of the money-lending operation.[27]

The circuit courts disagree regarding the proper test for determining whether a common enterprise exists. The Third, Sixth, and Seventh Circuits have adopted a

---

12. *Id.*
13. *Id.*
14. *Id.*
15. *Id.* at 296.
16. *Id.*
17. *Id.*
18. *Id.* at 298.
19. *Id.*
20. *Id.* at 300.
21. *Id.*
22. 389 U.S. 332 (1967).
23. *Id.* at 338.
24. *Id.* at 339.
25. *Id.*
26. *Id.*
27. *Id.* at 338.

very narrow "horizontal commonality" test.[28] Under this narrow test there must be multiple investors and pooling of funds.[29] The Fifth, Eighth, Tenth, and Eleventh Circuits have adopted a much broader "vertical commonality" test. Vertical commonality only requires a relationship between the investor and the promoter whereby the investor's profits are totally dependent upon the expertise of the promoter.[30] There is no need for multiple investors.[31] Vertical commonality can best be illustrated by a one-on-one relationship between the investor and the promoter.[32] The Ninth Circuit has adopted a strict vertical commonality test requiring the investor's and promoter's success or failure to be mutually dependent.[33]

III. HORIZONTAL COMMONALITY

Horizontal commonality involves a commonality between the investors themselves.[34] The relationship between the multiple investors is critical. The circuits adopting horizontal commonality are much more concerned with the relationship between the multiple investors than with the relationship between the investors and the promoters.

The "common enterprise" issue has surfaced in many cases involving commodity trading accounts. In the Third Circuit case of *Salcer v. Merrill Lynch, Pierce, Fenner & Smith,*[35] the plaintiff argued that the manner in which his commodity trading account was handled constituted an investment contract within the definition of "security."[36] The court held that a commodity account did not meet the "common enterprise" element of the *Howey* test.[37] The court strictly construed the *Howey* definition and held that the investment was not part of "a pooled group of funds and thus does not meet the second part of the *Howey* test."[38] In *Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*[39] the Sixth Circuit adopted the horizontal commonality test thus specifically rejecting the vertical commonality ap-

---

28. Note, *Are Discretionary Commodity Trading Accounts Investment Contracts? The Supreme Court Must Decide,* 35 CATH. U.L. REV. 635, 640 (1986) (authored by John Letteri).

29. *See, e.g.*, Salcer v. Merril Lynch, Pierce, Fenner & Smith, Inc., 682 F.2d 459 (3d Cir. 1982).

30. *See, e.g.*, SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 478-79 (5th Cir. 1974).

31. Union Planters Nat'l Bank v. Commercial Credit Business Loans, 651 F.2d 1174, 1183 (6th Cir. 1981); *see also* SEC v. Koscot Interplanetary, Inc., 497 F.2d 473 at 479.

32. 651 F.2d at 1183.

33. *See, e.g.*, Brodt v. Bache & Co., 595 F.2d 459 (9th Cir. 1978).

34. Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 622 F.2d 216, 221 (3d Cir. 1980).

35. 682 F.2d 459 (3d Cir. 1982).

36. *Id.*

37. *Id.* at 460 (citing Wasnowic v. Chicago Bd. of Trade, 352 F. Supp. 1066 (M.D. Pa. 1972), *aff'd without opinion,* 491 F.2d 752 (3d Cir. 1973), *cert. denied,* 416 U.S. 994 (1974)).

38. 682 F.2d at 460; *see also* 352 F. Supp. 1066, 1066-67 & n.2. The plaintiff alleged violations of the securities laws, and the defendant moved for a dismissal, contending that the transaction did not involve a security under the Securities Act of 1933 or the Securities Exchange Act of 1934. Defendants had originally moved to dismiss based on the contention that commodity futures contracts were under the exclusive jurisdiction of the Commodities Exchange Act of 1936 and therefore were not within the jurisdiction of the securities laws. The court determined that the common enterprise element of *Howey* was not met; therefore, the agreement was not considered an investment contract. *Wasnowic,* 352 F. Supp. at 1067 n.2.

39. 622 F.2d 216 (6th Cir. 1980), *cert. granted,* 451 U.S. 906 (1981), *aff'd,* 456 U.S. 353 (1982).

proach.[40] *Curran* also involved an investment in a discretionary commodity trading account.[41] The court acknowledged the debate between horizontal and vertical commonality.[42] Not surprisingly, the plaintiffs in *Curran* asserted that the "common enterprise" element was met by a one-on-one vertical relationship between the promoter and the investor.[43] The court rejected this vertical approach adopted by the Fifth Circuit and instead adopted the more restrictive horizontal approach.[44] The court held that the "common enterprise" element of *Howey* can only be met when "there also exists between discretionary account customers themselves some relationship which ties the fortunes of each investor to the success of the overall venture."[45]

The court in *Deckebach v. La Vida Charters, Inc.*[46] held that a purchase agreement along with a management contract did not meet the horizontal test.[47] The plaintiff in *Deckebach* purchased a boat and also entered into an agreement with the promoter whereby the promoter would manage the boat and charter it.[48] Although there were several similar investments taken by the promoters, the court held that they did not meet the horizontal test because the investments were independent and therefore were not "pooled."[49]

In the case of *SEC v. Professional Associates*,[50] the promoter sent out a promotional brochure to potential investors stating that individuals do not have the purchasing power to move enough money to "maximize" their profit margin.[51] The court held that the brochure was enough evidence to meet the horizontal commonality test which is applied by the Sixth Circuit.[52]

The leading case in the Seventh Circuit is *Milnarik v. M-S Commodities, Inc.*[53] In *Milnarik*, the investors brought suit to rescind their discretionary trading account in commodity futures.[54] Although the court acknowledged that the term "security" should be interpreted broadly, it still adopted the more restrictive horizontal view of the common enterprise test. The court held that the discretionary

---

40. *Id.* at 222.

41. *Id.* at 217. "Plaintiffs allege[d] that Merrill Lynch fraudulently misrepresented how the account would be handled with respect to other accounts in the same program." *Id.* at 220.

42. *Id.* at 221.

43. *Id.*

44. *Id.* at 223-24.

45. *Id.* at 224. The Court also stated: "[I]n our view the finding of a vertical common enterprise based solely on the relationship between promoter and investor is inconsistent with *Howey*." *Id.*

46. 867 F.2d 278 (6th Cir. 1989).

47. *Id.* at 283.

48. *Id.* at 279-80. The plaintiff's ultimate plan was to use the boat solely for personal purposes. *Id.* at 280.

49. *Id.* at 282-83. *See also* Hart v. Pulte Homes Corp., 735 F.2d 1001 (6th Cir. 1984) (holding that a sale-and-leaseback arrangement did not meet the requirement of horizontal commonality).

50. 731 F.2d 349 (6th Cir. 1984).

51. *Id.* at 354.

52. *Id.* The lower court held "that this language gave rise to an implication that investor's funds were to be pooled, a situation which would meet the common enterprise requirement." *Id.*

53. 457 F.2d 274 (7th Cir. 1972).

54. *Id.* at 275. The plaintiffs sought to rescind the contract and recover their deposit plus interest alleging violation of the registration requirements of the federal securities laws.

commodity investments were independent and that there was no commonality between the independent investors; therefore, the "common enterprise" element of *Howey* was not satisfied.[55] The court in *Milnarik* affirmed the holding of the lower court that a discretionary commodities account created nothing more than an agency-for-hire relationship rather than a sale of a portion of a larger enterprise.[56]

In *Stenger v. R.H. Love Galleries, Inc.*,[57] the Seventh Circuit reiterated its strict adherence to the "horizontal" test of common enterprise under which there must be a pooling of investments with investors receiving a pro rata portion of the profits.[58] The *Stenger* court held that even the test of vertical commonality would not be met because the fortunes of the investor and the promoter were not interwoven.[59] Horizontal commonality requires a much stronger relationship between investors.[60] "In fact, a finding of horizontal commonality requires a sharing or pooling of funds."[61]

IV. Rationale for Adopting Horizontal Commonality

Probably the strongest argument that can be made for the adoption of horizontal commonality is the fact that horizontal commonality best complies with the particular facts of the *Howey* case. It can be argued, however, that the facts of the *Howey* case would pass any of the standards that have been applied in the circuit courts. *Howey* involved a pooling of investors and a pooling of funds.[62] However, there is a question as to whether or not there was actual "pooling" in the *Howey* case.[63] Two commentators have concluded that since each individual owned a

---

55. *Id.* at 278 (quoting Milnarik v. M-S Commodities, Inc., 320 F. Supp. 1149, 1152 (N.D. Ill. 1970), *aff'd*, 457 F.2d 274 (7th Cir. 1972)).

56. Milnarik v. M-S Commodities, Inc., 457 F.2d 274, 277 (7th Cir. 1972) (quoting Milnarik v. M-S Commodities, Inc., 320 F. Supp. 1149, 1151 (N.D. Ill. 1970), *aff'd*, 457 F.2d 274 (7th Cir. 1972)).

57. 741 F.2d 144 (7th Cir. 1984). The plaintiff in this case purchased paintings from defendant along with a guaranteed repurchase allowance whereby he could return a painting within five years and have the full amount of the purchase credited toward the purchase of other paintings. This gave the investor the ability to invest in different paintings without the need for additional capital. *Id.* at 146. The plaintiff alleged that this scheme was a "security." *Id.*

58. *Id.* at 146.

59. *Id.* at 147.

60. Union Planters Nat'l Bank v. Commercial Credit, 651 F.2d 1174, 1183 (6th Cir. 1981). This case involved a loan participation agreement between the two parties, both financial institutions. *Id.* at 1175. The court held this agreement was not a security. *Id.* at 1181.

61. *Id.* at 1183 (citing Hirk v. Agri-Research Council, Inc., 561 F.2d 96, 101 (7th Cir. 1977)).

62. SEC v. Howey, 328 U.S. 293, 300 (1946).

63. *See, e.g.*, Gordon, *Common Enterprise and Multiple Investors: A Contractual Theory for Defining Investment Contracts and Notes*, 1988 COLUM. BUS. L. REV. 635, 645.

separate tract of land there was actually no "pooling" in *Howey*, and, therefore, the *Howey* case does not pass the horizontal commonality test.[64]

The circuits adopting horizontal commonality argue that a finding of common enterprise based solely on a one-to-one relationship between investor and promoter would "effectively excise[] the common enterprise requirement of *Howey*."[65] The new test would simply require (1) the investment of money with (2) expectation of profits produced solely from the efforts of others.[66] The court in *Berman v. Bache, Halsey, Stuart, Shields, Inc.*[67] stated that, although the phrase "common enterprise" had never been defined by the Supreme Court, it is not intimated that the phrase is "somehow redundant of other elements of the definition of a security."[68] The vertical commonality requirement will almost always be met if the "solely from the profits of others"[69] requirement is met. The circuits adopting commonality must answer the question: If the common enterprise element is to be interpreted so broadly, then why is it even part of the test?

The circuit courts adopting the horizontal scheme also point to the fact that the investors in the *Howey* case could not have earned a profit if they had not been pooling with the other investors.[70] However, when the lots were added together with the lots of other investors in a common venture, the investors were able to make a profit.[71] This important factor seems to indicate that the common enterprise element of the *Howey* case required pooling, and this is the interpretation followed by the circuits adopting horizontal commonality.

V. VERTICAL COMMONALITY

The circuit courts adopting vertical commonality take a much broader approach to the common enterprise element of the *Howey* test. The Fifth Circuit in *SEC v. Koscot Interplanetary, Inc.*[72] adopted such an analysis, requiring only that

---

64. *Id.* at 645; *see also* Bennett, *How Common is a "Common Enterprise"?, 1974* ARIZ. ST. L.J. 339, 349.

> "Pooling" has been interpreted to refer to an arrangement whereby the account constitutes a single unit of a larger investment enterprise on which units are sold to different investors and the profitability of each unit depends on the profitability of the enterprise as a whole . . . . Thus, an example of horizontal commonality involving brokerage account [sic] would be a "commodity pool," in which investors' funds are placed in a single account and transactions are executed on behalf of the entire account rather than being attributed to any particular subsidiary account. The profit or loss shown by the account as a whole is ultimately allocated to each investor according to the relative size of his or her contribution to the fund. Each investor's rate of return is thus *entirely* a function of the rate of return shown by the entire account.

Gordon, *Common Enterprise and Multiple Investors: A Contractual Theory for Defining Investment Contracts and Notes*, 1988 COLUM. BUS. L. REV. 635, 645 n.72 (quoting Savino v. E.F. Hutton & Co., 507 F. Supp. 1225, 1236 (S.D.N.Y. 1981) (emphasis added) (citations omitted)).

65. Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 622 F.2d 216, 224 (6th Cir. 1980) (citing Berman v. Bache, Halsey, Stuart, Shields, Inc., 467 F. Supp. 311, 315-16 (S.D. Ohio 1979)).

66. *Id.*

67. 467 F. Supp. 311 (S.D. Ohio 1979).

68. *Id.* at 319.

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

70. Note, *Are Discretionary Commodity Trading Accounts Investment Contracts? The Supreme Court Must Decide*, 35 CATH. U.L. REV. 635, 657 (1986) (authored by John Letteri).

71. *Id.*

72. 497 F.2d 473, 479 (5th Cir. 1974).

the investors' success be dependent solely upon the efforts of the promoter.[73] The *Koscot* case involved a pyramid scheme in which investors received varying discounts on cosmetics depending on the amount of their original investment.[74] The court in *Koscot* held that the fact that the success of one investor is independent of other investors is not decisive;[75] rather, the commonality requirement is met when the fortunes of all investors are totally dependent upon Koscot's ability to recruit prospects and consummate sales.[76] As the *Koscot* court pointed out, the *Howey* Court referred to common enterprise in terms of commonality between the promoters as opposed to commonality between investors.[77] The court stated: "A common enterprise managed by respondents or third parties with adequate personnel and equipment is therefore essential if the investors are to achieve their paramount aim of a return on their investments."[78] This language creates a strong argument that the common enterprise element of the *Howey* test refers to commonality between promoters and not investors.

The Fifth Circuit dealt with a discretionary commodity account in *SEC v. Continental Commodities Corp.*[79] The court reaffirmed its adherence to vertical commonality and held that the discretionary commodity account met the common enterprise element of the *Howey* test.[80] The court held that the investors were dependent upon the expertise of the promoter for the success of their investment and this factor was enough to satisfy vertical commonality.[81] The court in *Continental Commodities* noted that the language of *Koscot* "expressly rejects the proposition that the pro-rata sharing of profits is critical to a finding of commonality."[82] The critical test is whether the profits of the investor are totally dependent upon the expertise of the promoter.[83] The court went on to state that the fortuity of some investors should not vitiate the fact that the whole trading enterprise is dependent upon the investment counseling of the corporation.[84] This broad interpretation of the common enterprise element is consistent with the Fifth Circuit's equally broad interpretation of the "solely from the efforts of others" element of *Howey* in the case of *SEC v. Koscot Interplanetary, Inc.*[85]

The most recent Fifth Circuit case utilizing the vertical test for common enterprise is *Long v. Shultz Cattle Co.*[86] The plaintiffs in *Long* invested in a cattle feed-

---

73. *Id.*

74. *Id.* at 475. At the lowest level the salespersons received a 45% discount; for a $1,000 investment the supervisors received a 55% discount; and for $5,000 investors receive a 65% discount on Koscot products. *Id.*

75. *Id.* at 479.

76. *Id.*

77. *Id.* at 478.

78. *Id.* (quoting SEC v. Howey, 328 U.S. 293, 300 (1946)).

79. 497 F.2d 516 (5th Cir. 1974).

80. *Id.* at 522.

81. *Id.*

82. SEC v. Continental Commodities Corp., 497 F.2d 516, 522 (5th Cir. 1974).

83. *Id.*

84. *Id.*

85. *Id.*

86. 881 F.2d 129 (5th Cir. 1989).

ing program that required the purchase of cattle together with a feeding arrangement contract.[87] The plaintiffs claimed that this investment scheme constituted an "investment contract" and was, therefore, within the definition of a security thereby requiring compliance with the federal securities laws.[88] The court, in addressing the common enterprise element of the *Howey* test, stated: "[T]he critical inquiry is confined to whether the fortuity of the investments collectively is essentially dependent upon promoter expertise."[89] The court went on to say that "[w]hile our standard requires interdependence between the investors and the promoter, it does not define that interdependence narrowly in terms of shared profits or losses."[90] The interdependence may be demonstrated by a showing of complete reliance upon the expertise of the promoter even if the promoter's profits are not dependent on the investors' profits.[91] The court held that the investment involved in the *Long* case met the Fifth Circuit's broad interpretation of the common enterprise element of *Howey*.[92]

The Eighth Circuit addressed the commonality issue indirectly in the case of *Booth v. Peavey Co. Commodity Services*.[93] In *Booth* the court held that a private remedy for churning a commodity account exists within the Securities Act of 1934.[94] This decision has been interpreted as an adoption of vertical commonality.[95]

The Tenth Circuit in *McGill v. American Land & Exploration Co.*[96] rejected a rigid horizontal commonality standard and instead elected to adopt a broad interpretation of the *Howey* case.[97] *McGill* involved the plaintiff's investment in a joint venture for the development of a subdivision.[98] The court did not adopt the language of "vertical commonality"; however, it did specifically reject horizontal commonality. The court stated: "The lack of 'horizontal commonality' between McGill and any other investors cannot obscure the economic reality of the situation and the existence of a 'common enterprise' within the meaning of the *Howey* test."[99]

---

87. *Id.* at 130. The investors were able to use the investment as a tax shelter by utilizing the cash-method of accounting. This method allowed taxpayers to deduct feeding costs and defer income until the cattle were sold. *Id.* at 131.

88. *Id.* at 130.

89. *Id.* at 140 (quoting SEC v. Continental Commodities Corp., 497 F.2d 516, 522 (5th Cir. 1974)).

90. *Id.* at 140-41.

91. *Id.*

92. *Id.* at 142. The court held that the investment in the cattle feeding program was a security. *Id.*

93. 430 F.2d 132 (8th Cir. 1970).

94. *Id.* at 133.

95. *See* Christensen Hatch Farms v. Peavey Co., 505 F. Supp. 903, 907 (Minn. 1981). The court in *Christensen* held that a discretionary commodities account was a security.

96. 776 F.2d 923 (10th Cir. 1985).

97. *Id.* at 925.

98. *Id.* at 924. The investors were to invest in the development of the subdivision but, unfortunately, there was a lack of development, and the company never became an active one. As a result the plaintiffs alleged material misrepresentations in violation of the securities laws. *Id.*

99. *Id.* at 926. *But see* Rother v. La Renovista Estates, Inc., 603 F. Supp. 533, 537 (W.D. Okla. 1984). In this case the court stated that the Western District of Oklahoma followed "horizontal commonality." *Id.* at 537.

The Eleventh Circuit in *Villeneuve v. Advanced Business Concepts Corp.*[100] also adopted the broad view of vertical commonality, citing the Fifth Circuit with approval.[101] *Villeneuve* involved an investment in the distribution of self-watering planters.[102] The court held that the investment scheme met the common enterprise element of *Howey.*[103] In *Taylor v. Bear Stearns & Co.*[104] the federal district court for the northern district of Georgia also approved vertical commonality in a case involving a discretionary commodity account.[105]

VI. Rationale for Adopting Vertical Commonality

The circuits adopting vertical commonality take the position that the common enterprise element of the *Howey* test should be interpreted broadly so as to ensure that the remedial intent of the securities laws is achieved. The *Howey* case repeatedly states that the securities laws should be interpreted broadly in order to meet their intended remedial purpose.[106]

The Court in *Howey* acknowledged that the definition of an "investment contract" should be construed to include many different types of instruments that may fall within the concept of a security.[107] The definition "embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."[108] A narrow reading such as that adopted by the horizontal commonality circuits would not be consistent with the intent of Congress or the Supreme Court in the *Howey* opinion.[109] The Supreme Court in *Tcherepnin v. Knight*[110] stated: "Finally, we are reminded that, in searching for the meaning and scope of the word 'security' in the Act, form should be disregarded for substance and the emphasis should be on economic reality."[111]

The Court in *Howey* recognized that the term "investment contract" had been adopted in many state "blue sky" laws, and, although the term was undefined, it was broadly construed to afford the public the greatest measure of protection.[112] An investment contract was considered to be any scheme for "the placing of capital

---

100. 698 F.2d 1121 (11th Cir. 1983), *reh'g granted,* 730 F.2d 1403 (11th Cir. 1984).

101. *Id.* at 1124 (citing SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 477 (5th Cir. 1974)).

102. *Id.* at 1122.

103. *Id.* at 1124. Although the court held that the scheme met the "common enterprise" element, it did not meet the "solely from the efforts of others" requirement; therefore it was held not to be a security. *Id.* at 1125.

104. 572 F. Supp. 667 (N.D. Ga. 1983).

105. *Id.* at 670-71. The court failed to grant defendant's motion for dismissal for lack of subject matter jurisdiction under the federal securities laws. *Id.* at 671-72.

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

107. 328 U.S. at 299.

108. *Id.*

109. *Id.*

110. 389 U.S. 332 (1967).

111. *Id.* at 336 (citing SEC v. W.J. Howey Co., 328 U.S. 293, 298 (1986)).

112. 328 U.S. at 298.

or laying out of money in a way intended to secure income or profit from its employment."[113]

The Securities Exchange Act was enacted as a form of remedial legislation.[114] The primary purpose of the Act is to protect investors by requiring full disclosure by those who issue securities.[115] Congress did not intend for the definition of a "security" to be restrictively applied.[116] "[T]he term 'security' [in the Securities Act of 1933 is defined] in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security."[117]

An adoption of horizontal commonality would require multiple investors to be involved before the securities laws could be applied to an investment contract. This result is not properly founded. Why should the securities laws only protect investors in groups? Is a single investor not entitled to the same protections that the securities laws offer to multiple investors? In *Koscot*, the court pointed out that in the *Howey* opinion the Supreme Court did not emphasize the pooling of the profits, but rather the fact that the entire enterprise in attracting investors depended solely on the availability of Howey's management program.[118]

VII. RESTRICTED VERTICAL COMMONALITY

The Ninth Circuit has adopted a more strict interpretation of vertical commonality.[119] In *Brodt v. Bache & Co.*,[120] the court held that a discretionary commodity account was not a security because it did not meet the "common enterprise" test of *Howey*.[121] The court refused to adopt the very broad interpretation of the Fifth Circuit and instead adopted a test whereby the "fortunes of the investor [must be] interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties."[122] The court in *Brodt* held that a discretionary commodity account did not meet the "common enterprise" element because the investors' profits were not directly related to either the promoter's financial well-being or his ability to perform a duty which would "secure" the investment.[123] The Ninth Circuit requires the profits of the investor and the promoter to be interdependent.[124] In other words, the promoter and the investor must either fail or succeed together.

---

113. *Id.* (quoting State v. Gopher Tire & Rubber Co., 146 Minn. 52, 56, 177 N.W. 937, 938 (1920)).
114. Tcherepnin v. Knight, 389 U.S. 332, 336 (1967).
115. *Id.*
116. *Id.* at 338.
117. *Id.* at 338 (quoting H.R. REP. No. 85, 73d Cong., 1st Sess., 11 (1933)).
118. SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 478 (5th Cir. 1974).
119. *See, e.g.*, Brodt v. Bache & Co., 595 F.2d 459, 461 (9th Cir. 1978).
120. 595 F.2d 459 (9th Cir. 1978).
121. *Id.* at 462.
122. *Id.* at 460 (quoting SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 476, 482 n.7 (9th Cir. 1973)).
123. *Id.* at 462.
124. *Id.* at 460.

In the more recent case of *Hocking v. DuBois*,[125] involving an investment in a condominium and participation in a rental pool arrangement,[126] the Ninth Circuit clarified its position as to the "common enterprise" element.[127] The court stated that it had not replaced horizontal commonality with vertical commonality; rather, it merely broadened the test beyond the "strict pooling" requirement of strict horizontal commonality.[128] "In other words, we simply added an additional means of establishing a common enterprise, which comes into play only when there is no pooling of funds by several investors in a venture."[129]

Although the Second Circuit Court of Appeals has yet to rule on the "common enterprise" issue, a series of district court opinions from that circuit appears to adopt the restricted vertical requirement of the Ninth Circuit.[130] The court in *Lowenbraun v. Rothschild*[131] stated that "[v]ertical commonality is present when there is interdependence between broker and client for both profits and losses of the investment."[132] The court in *Lowenbraun* held that a broker-client relationship did not satisfy the vertical commonality test stated in *Kaplan v. Shapiro*.[133] The district courts of the First Circuit have also adopted the strict vertical commonality approach of the Ninth Circuit.[134]

VIII. Rationale for Adopting Restricted Vertical Commonality

The Ninth Circuit is the only circuit to formally adopt restricted vertical commonality, although districts in the First and Second Circuits also seem to have adopted this test.[135] The difference between vertical commonality and restricted vertical commonality is that the latter requires the profits of the promoters and investors to be interdependent.[136] The broader interpretation of vertical commonality does not require this interdependence. The argument for this view is very similar to the arguments for horizontal commonality. The Ninth Circuit is trying to give more meaning to the term "common enterprise" by requiring the profits of the promoter and investor to be interdependent.[137] At least within this view the promoter and investor are in a "common enterprise." The Ninth Circuit is not willing to define "common enterprise" so broadly as to practically excise the ele-

125. 839 F.2d 560, 562-63 (9th Cir.), *reh'g granted*, 852 F.2d 503 (9th Cir.), *vacated* 863 F.2d 654 (9th Cir. 1988).

126. *Id.* at 562-63.

127. 839 F.2d at 566-67.

128. *Id.* at 567 (citing *Brodt*, 595 F.2d at 460).

129. *Id.*

130. *See, e.g., Brodt*, 595 F.2d at 461.

131. 685 F. Supp. 336 (S.D.N.Y. 1988).

132. *Id.* at 341.

133. *Id.* (citing Kaplan v. Shapiro, 655 F. Supp. 336 (S.D.N.Y. 1987)). *See also* Department of Economic Dev. v. Arthur Andersen & Co., 683 F. Supp. 1463, 1473 (S.D.N.Y. 1988) (stating that "either horizontal or narrow vertical commonality satisfies the 'common enterprise' requirement").

134. *See, e.g.*, Morgan v. Financial Planning Advisors, Inc., 701 F. Supp. 923, 926 (D. Mass. 1988); Copeland v. Hill, 680 F. Supp. 466, 468 (D. Mass. 1988).

135. *See supra* notes 130 and 134.

136. 595 F.2d 459 (9th Cir. 1978).

137. *Id.*

ment from the definition of "investment contract."[138] This is the strongest argument against the Fifth Circuit's view. The restricted vertical commonality approach is a compromise between horizontal and vertical commonality. However, the reasoning behind this approach fails because a plaintiff in a case that passes restricted vertical commonality does not deserve any greater degree of protection than a plaintiff in a case that only passes the broad test of vertical commonality. For this reason, the theory behind the securities laws does not warrant a distinction between the two cases. In fact, the investors would probably need less protection in a case that passes restricted vertical commonality than would the investors in a case that only passes vertical commonality, because the promoter in the former case would have more incentive to protect the investors because profits are interdependent.

IX. CONCLUSION

The Supreme Court should grant certiorari in a case that will not pass the horizontal commonality test so that the split between the circuits can be reconciled. The rationale behind the three different views is clear. The circuits supporting horizontal commonality adhere to a strict interpretation of the *Howey* decision as applied to the facts in *Howey*. The circuits supporting vertical commonality rely more on the intent of the securities laws. Restricted vertical commonality is a compromise between vertical and horizontal commonality. In order to carry out the intent of Congress, the Supreme Court should rule in favor of vertical commonality. Congress enacted the securities laws to protect the public and to deter fraud. There is no logical distinction between horizontal and vertical commonality in terms of public protection. The definition of an "investment contract" should be interpreted broadly because the public needs protection in both cases. The court in *Howey* expressly stated that the definition of "investment contract" should not be given a restrictive interpretation.

Stephen M. Maloney

---

138. *Id.*