Can Pre-Purchase Entrepreneurial Efforts Satisfy the Fourth Prong of the Howey Test? A Critique of SEC v. Life Partners, Inc.

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CAN PRE-PURCHASE ENTREPRENEURIAL EFFORTS SATISFY THE FOURTH PRONG OF THE HOWEY1 TEST? A CRITIQUE OF SEC V. LIFE PARTNERS, INC.2

I. INTRODUCTION

In federal securities litigation, the threshold inquiry is whether the transaction at issue involves a “security.”3 If the transaction does not involve a security, then federal securities laws do not govern the proceedings.4 Despite the importance of this issue, a “successful definition of ‘security’ has eluded American corporate law” for over sixty years.5 Some scholars have called this “one of the most notable intellectual failures [in this area of law].”6 Such “intellectual failure” has been most notable in the judicial analysis of “investment con-

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2. 87 F.3d 536 (D.C. Cir.), reh'g denied, 102 F.3d 587 (D.C. Cir. 1996).
3. Most commonly thought of as a share of stock in a corporation, a “security” is a commodity that has no intrinsic value in itself; rather, it represents rights in something else. See, e.g., DAVID RATNER, SECURITIES REGULATION IN A NUTSHELL 1 (5th ed. 1996). For example, a share of stock represents an interest in a company. The value of that stock depends upon the future profitability of the company that issued the stock. See generally, RICHARD W. JENNINGS ET AL., SECURITIES REGULATION 264-66 (7th ed. 1992 & Supp. 1996) (explaining the issue of “defining a security”).
5. Common violations of the 1933 Act include failure to comply with sections 5(a) and 5(c) of the Securities Act of 1933 for issuing securities that are not registered with the SEC. See 15 U.S.C. §§ 77e(a) & 77e(c) (1994).
6. See Douglas M. Branson & Karl Shumpei Okamoto, The Supreme Court's Literalism and the Definition of “Security” in the State Courts, 50 WASH. & LEE L. REV. 1043, 1044 (1993) (stating that the conclusion that a case does not involve a “security” will foreclose application of the relevant securities act).
8. See id. at 1596 n.27 (citing William J. Carney & Barbara G. Fraser, Defining a “Security:” Georgia's Struggle with the “Risk Capital” Test, 30 EMORY L.J. 73 (1981)).

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tracts— one category of securities. This comment critiques the recent decision of Securities and Exchange Commission ("SEC") v. Life Partners, Inc.,9 in order to expose an unresolved issue in investment contract analysis.

Although not defined in the federal securities acts,10 the seminal Supreme Court decision of SEC v. W.J. Howey Co.11 outlined the presently used test ("the Howey test") to determine whether an "investment contract" is a "security." Under this test, an investment contract is "[1] a transaction . . . [2] whereby a person invests money, [3] in a common enterprise, and [4] is led to expect profits solely from the efforts of the promoter." The Howey test, applied only to investment contracts,14 has generally been effective for analyzing whether "novel, uncommon, or irregular [investment] devices"15 come beneath the umbrella of federal securities

8. The term "investment contract" is listed as one of the categories that define a "security." See § 2(1) of the 1933 Act, 15 U.S.C. § 77(b)(1) (1994); see also infra note 86 and accompanying text.

An "investment contract," while not a conventional-security like a bond or share of common stock, has essential properties of a conventional security in that it is an undivided, passive (i.e. not managed by the investor), financial interest in a pool of assets, and, thus, is treated as a conventional security for purposes of securities laws. SEC v. Lauer, 52 F.3d 667, 670 (7th Cir. 1995), reh'g denied, 1995 U.S. App. LEXIS 11609 (7th Cir. May 17, 1995).

9. 87 F.3d 536 (D.C. Cir. 1996) (holding that viatical settlements were not securities under the Securities Act of 1933).


12. Id. at 298-99.

13. Id. (numerals added). Most courts reduce the Howey test to three elements. See, e.g., Life Partners, 87 F.3d at 542, 542-45 (citing the test as "(1) expectation of profits arising from (2) a common enterprise that (3) depends upon the efforts of others"). However, this comment will refer to the Howey test as originally laid out in a four-pronged test. Each element of the Howey test must be satisfied before a particular transaction is characterized as a "security." See Revak v. SEC Realty Corp., 18 F.3d 81, 87 (2d Cir. 1994).

14. Landreth Timber Co. v. Landreth, 471 U.S. 681, 692 (1985) (stating that application of the Howey test to traditional stocks and all other types of instruments would make the enumerated categories of section 2(1) of the 1933 Act superfluous).

15. See SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943) (using the phrase "novel, uncommon, or irregular devices" to describe types of arrangements that can qualify as investment contracts under the 1933 and 1934 Acts). While the Joiner decision offered the first test for "investment contracts," the Howey test remains the primary legal standard for determining whether an investment contract is a security. See, e.g., Park McGinty, What Is a Security?, 1993 Wis. L. REV. 1033, 1046 n.62 (1993).
Nevertheless, judicial analysis of this test continues to expose uncertainties regarding its proper application. The recent decision in SEC v. Life Partners, Inc. has revealed such an uncertainty with respect to the fourth prong of the Howey test. In Life Partners, the Court of Appeals for the District of Columbia Circuit had to resolve whether "fractional interests in viatical settlements" promoted by the defendant, Life Partners, Inc. ("LPI"), constituted "investment contracts" (thus, securities) under the Howey test. The court's resolution turned on an analysis of the fourth prong. The SEC argued that the pre-purchase efforts of LPI in selecting and promoting its viatical settlements, greatly influenced the investor's profits, thereby establishing the fourth prong of the Howey test. However, the court concluded that LPI's viatical settlements were not securities be-

18. 87 F.3d 536 (D.C. Cir), reh'g denied, 102 F.3d 587 (D.C. Cir. 1996). The SEC alleged violations of sections 5(a), 5(c) and 17(a) of the 1933 Act, 15 U.S.C. §§ 77e(a), 77e(c), 77q(a) (1994), and sections 10(b), 15(a) and 15(c) of the 1934 Act, 15 U.S.C. §§ 78j(b), 78o(a), 78o(c) (1994). See SEC v. Life Partners, Inc., 898 F. Supp. 14 (D.D.C. 1995).
19. Viatical settlements are transactions where one may purchase an interest in the life insurance policy of a terminally ill person—usually an AIDS patient—for some fraction of the policy's face value. See infra note 196. This comment does not address whether viatical settlements are securities. Rather, this comment uses a case about viatical settlements to point out an existing uncertainty regarding an application of the Howey test. For more information concerning legal issues surrounding viatical settlements, see Timothy P. Davis, Should Viatical Settlements Be Considered "Securities" under the 1993 Securities Act?, 6 KAN. J.L. & PUB. POLY 75 (1997); Malcolm E. Osborn, Rapidly Developing Law on Viatical Settlements, 31 WAKE FOREST L. REV. 471 (1996); Russell J. Herron, Note, Regulating Viatical Settlements: Is the Invisible Hand Picking the Pockets of the Terminally Ill?, 28 U. MICH. J.L. REFORM 931 (1995); and Shanah D. Glick, Comment, Are Viatical Settlements Securities Within the Regulatory Control of the Securities Act of 1933?, 60 U. CHI. L. REV. 957 (1993).
20. Life Partners, 87 F.3d at 538. It is likely they proceeded under the Howey test because viatical settlements are a recent form of investment product and do not easily fit within the established types of securities such as stocks, bonds and notes. See section 2(1) of the 1933 Act, 15 U.S.C. § 77(b)(1) (1994). Thus, viatical settlements represent "novel" investment devices. See supra notes 15-16 and accompanying text.
21. Life Partners, 87 F.3d at 545-48. Note, the Life Partners court referred to the "efforts of others" prong as the "third prong." Id. at 540.
22. See id. at 545-48.
cause the pre-purchase efforts by LPI, in the absence of substantial post-purchase efforts, could not satisfy the fourth element of the Howey test.\textsuperscript{23}

This comment critiques the Life Partners court’s analysis of the fourth prong of the Howey test. Specifically, this comment focuses upon whether the fourth prong can be met if the investor’s expectation of profits derives from the “efforts of a promoter” that take place prior to the purchase of the investment. Until the Life Partners decision, no federal case had explicitly decided whether pre-purchase efforts can satisfy this element.\textsuperscript{24} Furthermore, no Supreme Court decision has formally distinguished pre-purchase from post-purchase efforts in analyzing Howey’s fourth prong.\textsuperscript{25}

This comment maintains that a promoter’s pre-purchase entrepreneurial efforts can satisfy the fourth prong of the Howey test under the prescribed approach.\textsuperscript{26} Part II, the background section, provides a brief legislative history of the 1933 and 1934 Acts.\textsuperscript{27} It then underscores the essential principles underlying the federal securities laws\textsuperscript{28} and offers the statutory definition of a “security.”\textsuperscript{29} Part II also summarizes the Howey decision\textsuperscript{30} and highlights relevant portions of the Life Partners decision.\textsuperscript{31} Part III identifies the legal problem exposed by the Life Partners decision as it relates to the Howey test.\textsuperscript{32} Part IV, the analysis section, dissects the weaknesses of the Life Partners majority and uses the strength of the dissent, as well as support from other sources, to lay the foundation for the proposed approach regarding fourth prong Howey analysis.\textsuperscript{33} Finally, Part V, the proposal section, offers a five-part approach to analyze whether an investment promoter’s pre-purchase entrepreneurial efforts satisfy the fourth prong of the Howey test.\textsuperscript{34}

\begin{itemize}
  \item\textsuperscript{23} See id. at 547-48.
  \item\textsuperscript{24} Id. at 553 (Wald, J., dissenting).
  \item\textsuperscript{25} Id.
  \item\textsuperscript{26} See infra Part V.
  \item\textsuperscript{27} See infra Part II.A.
  \item\textsuperscript{28} See infra Part II.B.
  \item\textsuperscript{29} See infra Part II.C.
  \item\textsuperscript{30} See infra Part II.D-E.
  \item\textsuperscript{31} See infra Part II.F.
  \item\textsuperscript{32} See infra Part III.
  \item\textsuperscript{33} See infra Part IV.
  \item\textsuperscript{34} See infra Part V.
\end{itemize}
II. BACKGROUND

A. The Federal Securities Acts: A Brief Legislative History

Until 1933, securities regulation was exclusively the province of state "blue sky" laws. Congress enacted the 1933 and 1934 Acts in the aftermath of the stock market crash of 1929 "to eliminate serious abuses in a largely unregulated securities market." Accordingly, the federal securities acts are considered "remedial legislation." The federal government, when proposing the 1933 Act, did not intend to "approve or guarantee that newly issued securities are sound." Rather, as President Franklin D. Roosevelt declared at the time of its enactment, the 1933 Act "adds to the ancient rule of caveat emptor, the further doctrine, 'let the seller also beware.' It puts the burden of telling the whole truth on the seller . . . [to] give impetus to honest dealing in securities."

The 1933 Act regulates public offerings of securities by compelling the disclosure of material information through a registration statement submitted to the Securities and Ex-

35. For instance, in Howey, the Supreme Court adopted the definition of "investment contract" as had been "uniformly applied by state courts." See SEC v. W.J. Howey, 328 U.S. 293, 298-99 (1946). Blue sky laws are state-adopted securities statutes that require offerings to comply with certain substantive standards, and if the offerings fail to meet those standards, the securities cannot be sold in the particular state. See Rutherford B. Campbell, Jr., Blue Sky Laws and the Recent Congressional Preemption Failure, 22 Iowa J. Corp. L. 175, 177 (1997).


39. Id. In addition, some of the underlying policies of the federal securities acts shall be discussed in this comment. See infra Part II.B.

40. Section 5 of the 1933 Act requires new issues of securities to be registered with the Securities and Exchange Commission. 15 U.S.C. § 77e (1994); see also 15 U.S.C. §§ 77g and 77aa (1994) (information required in a registration statement); see generally, JENNINGS ET AL., supra note 3 at 168-71 (discussing the basic contents of a registration statement). In addition to filing
change Commission ("SEC"). The 1933 Act is a "more or less coherent and unified statute directed almost entirely to two fundamental objectives: full disclosure in connection with the distribution of securities and the prevention of fraud in the sale of securities." The 1934 Act regulates trading in securities by requiring companies to file various reports to the SEC. This comment refers primarily to the 1933 Act, since this is the act that governs the initial offering requirements of securities. Under the 1933 Act, "if an investment fulfills the Act's definition of a security, and has not been specifically exempted from compliance with the Act's provisions, the issuer of that security must comply with specific disclosure requirements before proceeding with the public offering."

B. General Principles Underlying the Federal Securities Laws

Three tenets underlying the federal securities acts are emphasized throughout this comment. First, the federal securities laws were passed with the goal of providing information to the investing public. Second, courts apply flexible approaches and liberal construction in addressing whether an investment program should fall within the purview of federal securities laws. Third, courts stress the economic substance underlying the investment at issue, rather than its form. These three principles reoccur throughout Supreme

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a registration statement with the SEC, the 1933 Act also requires that issuers of securities prepare a prospectus for the public, which contains similar material information as the registration statement. See 15 U.S.C. § 77j (1994) (information required in a prospectus).

41. The Securities and Exchange Commission is an independent, non-partisan regulatory agency created under the Securities and Exchange Act of 1934. JENNINGS ET AL., supra note 3, at 98. As the agency charged with administering and enforcing federal securities laws, the SEC's primary responsibilities "are to ensure that the securities markets are fair and honest and to provide investors with adequate disclosure." Id.

42. Id. at 531.

43. See generally, id. at 531-37 (providing an overview of the 1934 Act). According to Jennings, the 1934 Act "is something of a hodgepodge of different provisions, some of which are largely unrelated to others." Id. at 531.

44. Furthermore, the ensuing discussion focuses upon whether or not certain types of transactions are securities.

45. Glick, supra note 19, at 959 n.12 (quoting JAMES COX ET AL., SECURITIES REGULATION 215 (1991)).

46. See discussion infra Part II.B.1.

47. See discussion infra Part II.B.2.

48. See discussion infra Part II.B.3.
HOWEY'S FOURTH PRONG

Court precedent in addressing the “definition of a security.”

1. The Need to Provide Information to Investors

A basic objective of the 1933 Act is to provide investors with material information concerning new issues of securities offered for sale to the public. Thus, underlying the federal securities laws is the concept that information is the best form of investor protection from those who use deceptive practices to promote investment schemes. While the federal securities laws were still in their proposal phase, President Franklin Roosevelt said, “[t]here is . . . an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.” In 1933, the Senate underscored that “the aim [of the 1933 Act] is to prevent further exploitation of the public by the sale of . . . unsound securities . . . [and] place adequate and true information before the investor.” A fundamental purpose in implementing the 1933 Act “was to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry.”

Supreme Court precedent underscores the importance of providing information to the investor by way of the securities acts. For instance, in SEC v. Ralston Purina Co., the Su-

49. See infra note 94.
50. JENNINGS ET AL., supra note 3, at 103.
52. ELLENBERGER & MAHAR, supra note 38, at 937 (message from President Franklin D. Roosevelt, Mar. 29, 1933).
54. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963) (emphasis omitted); see also supra note 39 and accompanying text
55. See SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963) (fundamental purpose common to securities acts was to substitute philosophy of full disclosure for that of caveat emptor); see also Tcherepnin v. Knight, 389 U.S. 332, 336 (1967) (“one of [the Act’s] central purposes is to protect investors through the requirement of full disclosure by issuers of securities”); SEC v. Variable Annuity Life Ins. Co. of Am., 359 U.S. 65, 76 (1959) (“[a]t the core of the 1933 Act are the requirements of a registration statement and prospectus to be used in connection with the issuance of ‘securities’ . . . .”); A.C. Frost & Co. v. Coeur D’Alene Mines Corp., 312 U.S. 38, 40 (1941) (“essential purpose of securities acts is to protect investors by requiring publication of certain information concerning securities before offered for sale”).
preme Court stated that "[t]he design of the [1933 Act] is to protect investors by promoting full disclosure of information thought necessary to make informed investment decisions." The *Ralston Purina* court did not address the application of the Howey test, rather it focused upon whether the defendants were exempt from registering their securities under the 1933 Act. According to the Court, "[t]he focus of the inquiry [to determine whether there has been a public offering] should be on the need of the offerees for the protections afforded by registration." In *Ralston Purina*, whether the offerees needed these protections was determined by whether they had "access to the kind of information which registration would disclose." The employees who were offered the defendant's company stock did not have access to such information. Therefore, the Court held that the stock offering was not exempt from the registration requirements of the 1933 Act. This decision exemplifies the importance of the disclosure requirements mandated by the securities acts.

2. Flexible Approach and Liberal Construction Applied to the Securities Acts

   a. Flexible Approach

   A second tenet underlying securities regulations is the need to preserve judicial flexibility in determining whether an investment scheme constitutes a "security." While stocks or government bonds represent commonly known securities, unusual types of investments, such as interests in citrus groves, animal breeding programs, chinchillas, and

57. Id. at 124.
58. The *Ralston Purina* court addressed the proper application of section 4(1) of the 1933 Act, which exempts transactions "not involving any public offering" from the registration requirements of the securities laws. Id. at 120. Ralston Purina's stock offering to its employees was held to be a "public offering" and, therefore, the corporation violated section 5 of the 1933 Act by not registering its offering with the SEC. Id. at 127.
59. Id.
60. Id.
62. Id.
63. *Life Partners*, 87 F.3d at 550 (Wald, J., dissenting).
64. *Howey*, 328 U.S. at 295.
dental equipment have also been found to satisfy the definition of a "security" under the 1933 Act. These diverse examples illustrate that the securities laws offer the "SEC and the courts sufficient flexibility to ensure that those who market investments are not able to escape the coverage of the Securities Acts by creating new instruments that would not be covered by a more [rigid] definition."

b. Liberal Construction

In addition to the flexible approach underlying the federal securities acts, federal courts have historically given a liberal construction to these statutes. For instance, in SEC v. C.M. Joiner Leasing Corp., the Supreme Court had to determine whether one provision of the 1933 Act was to be construed liberally or strictly. In order to do so, the Court looked to state blue sky laws. Upon examining these state statutes, the Court found that the "weight of authority" is toward liberal construction, especially if there are civil sanctions imposed.

Numerous lower court decisions also stand for the proposition that securities laws are to be liberally construed to effectuate their remedial purpose. For example, in Timmreck v. Munn, the district court held that since the federal securities acts were "devised to protect the public from speculative or fraudulent schemes advanced by promoters, they must be construed liberally as remedial statutes." In essence, it is a familiar canon of legislative construction that:

67. See SEC v. Aqua-Sonics Products Corp., 687 F.2d 577 (9th Cir. 1982), cert. denied, 459 U.S. 1086 (1982) (holding that licenses for sale for certain dental devices were "investment contracts" under the Howey test).
68. Reves v. Ernst & Young, 494 U.S. 56, 63 n.2 (1990); see also SEC v. International Loan Network, Inc., 968 F.2d 1304, 1308 (D.C. Cir. 1992) (emphasizing that Howey's fourth element should be interpreted broadly).
69. 344 U.S. 344 (1943).
70. Id. at 353 (analyzing 15 U.S.C. § 77(t) (Section 20 of the 1933 Act, "Injunctions and Prosecutions")).
71. Joiner, 320 U.S. at 353.
72. Id. at 353-54.
73. See, e.g., SEC v. Briggs, 234 F. Supp. 618, 622 (N.D. Ohio 1964) (securities laws are remedial in nature and must be liberally construed in favor of the investing public); SEC v. Starmont, 31 F. Supp. 264 (E.D. Wash. 1940) (1933 Act is a remedial enactment and should be liberally construed).
75. Id. at 399 (citing SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476, 481 (9th Cir. 1973)).
“remedial legislation should be construed broadly to effectuate its purpose.”

3. The Emphasis on Economic Reality

A third key principle underlying the securities laws is the significance given to the economic reality underlying an investment transaction. "In searching for the meaning and scope of the word 'security' in the [Securities] Acts, form should be disregarded for substance and the emphasis should be on economic reality." Due to the economic character of securities transactions, "Congress intended the application of these statutes to turn on the economic realities underlying a transaction, and not on the name appended thereto."

In the most recent Supreme Court case addressing the definition of a security, *Reves v. Ernst & Young*, the Court declared that it is ultimately the federal courts that must decide "which of the myriad financial transactions . . . come within the coverage of [the federal securities acts]." Moreover, the Court emphasized that "in discharging our duty, we are not bound by legal formalisms, but instead take account of the economics of the transaction under investigation." The Court continued, "Congress' purpose in enacting the securities [acts] was to regulate investments, in whatever form they are made and by whatever name they are called."

C. The Statutory Definition of a Security Under Section 2(1) of the 1933 Act

When drafting the definition of a security in the 1933 Act, Congress had to draw the line between being overly broad and underinclusive. According to some scholars, the 1933 Act represents a compromise between the two extremes

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80. 494 U.S. 56 (1990). Although this case addressed whether “notes” constituted securities under section 2(1) of the 1933 Act, it provides relevant background to this discussion of economic realities. *Id.* at 60-63.
81. *Id.* at 61 (quoting Forman, 421 U.S. at 848).
82. *Id.*
83. *Id.*
of restrictive simplicity and expansive overbreadth. The resulting statutory definition of a security as provided in section 2(1) of the 1933 Act states, in pertinent part:

When used in this chapter, unless the context otherwise requires—(1) (t)he term ‘security’ means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, ... investment contract, ... or, in general, any interest or instrument commonly known as a ‘security’ ... 

Since the promulgation of this definition, the courts have construed the term “security” broadly enough to include a wide variety of schemes, but narrowly enough to exclude those “arrangements whose names may fortuitously suggest a security but whose economic realities do not.” “The securities [acts are] remedial in nature, and the definitional paragraph contain[s] the phrase ‘investment contract,’ a category ... sufficiently broad to reach ‘devious’ schemes” intended to repackage investment plans in order to avoid coverage under the securities acts. In short, the inclusion of the term “investment contract” in the definitional paragraph was intended as a “catch-all category.”

Promoters of investment schemes that qualify as “investment contracts” must comply with the registration requirements of the 1933 Act and with the rules promulgated

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85. See id. at 1039-40.

86. 15 U.S.C. § 77(b) (1994) (emphasis added). Furthermore, the definition of a security in section 3(a)(10) of the 1934 Act is virtually identical and, for present purposes, the coverage of the two Acts may be considered the same. Tcherepnin v. Knight, 389 U.S. 322, 338-39 (1967) (establishing the general proposition that, absent special circumstances, the definition of a security is the same under the 1934 Act as the 1933 Act).

87. McGinty, supra note 15, at 1038 (giving an overview of the Court’s changing approach to securities laws generally); see also ALAN R. BROMBERG & LEWIS D. LOWENFELS, SECURITIES FRAUD & COMMODITIES FRAUD § 2.4 (1992). In addition, the Supreme Court held in United Housing Found., Inc. v. Forman, 421 U.S. 837 (1975), that even though the investors’ interests in low-cost, cooperative housing was labeled “stock,” these instruments were not securities. Id. at 858.


89. Id. at 1042.

90. Id.

91. See supra notes 40-41. Those that issue “securities” without comporting with registration requirements violate section 5 of the 1933 Act and are subject to civil liabilities under federal law. JENNINGS ET AL., supra note 3, at 104. The SEC usually seeks to enjoin promoters from selling such securities in violation
by the SEC.\textsuperscript{92} However, the amorphous, catch-all term "investment contract" is neither defined in the federal securities acts nor in their congressional history.\textsuperscript{93}

D. Howey: The Foundation of Investment Contract Analysis

Thus far, eleven Supreme Court cases have addressed the issue of the definition of a security ("definition cases").\textsuperscript{94} For almost forty years after the securities laws were enacted, the Supreme Court's definition cases exclusively involved investment contracts.\textsuperscript{95} The problem faced by the Court "was giving the term 'investment contract' suitable parameters."\textsuperscript{96}

In \textit{Howey}, the investment scheme at issue involved the company's promotion of citrus grove land plots to guests of the company's Florida hotel.\textsuperscript{97} In addition to buying land plots, purchasers were required to employ a service company to tend to the citrus groves.\textsuperscript{98} Purchasers could choose their own service company or the service company owned by the W.J. Howey Company.\textsuperscript{99} The SEC sought to enjoin the W.J.
Howey Company from selling unregistered and non-exempt securities in violation of the 1933 Act. The defendants argued that there was no violation of the 1933 Act because their citrus grove investment program was not a security as defined in section 2(1) of the 1933 Act.

The legal issue in Howey was whether the citrus grove land plot plus service contract constituted an “investment contract” under section 2(1). As the Court stated, “an affirmative answer brings into operation the registration requirements of section 5(a) [of the 1933 Act].”

In reaching its conclusion, the Court adopted a four part test to determine that the citrus grove-service agreement promoted by the W.J. Howey Company constituted an investment contract, and, thus, a “security.” Under the adopted test, an investment contract, for purposes of the 1933 Act, means “a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.” According to the Howey court, this test necessarily permitted the fulfillment of Congress’ intent by compelling full and fair disclosure relative to the issuance of “the many types of instruments that in our commercial world fall within the ordinary concept of a security.” The test 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.”

The Howey four-pronged test would seem to lend itself to

100. Id. at 294.
101. Id.
102. Id. at 297.
103. SEC v. W.J. Howey, Co., 328 U.S. 293, 297 (1946). Section 5(a) of the Securities Act of 1933 provides that, “unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly . . . to make use of any means or instruments . . . in interstate commerce . . . to sell such security.” 15 U.S.C. § 77(e) (1994).
104. See Howey, 328 U.S. at 297-300; see also supra note 13 and accompanying text.
105. Howey, 328 U.S. at 300. Although the first of the “definition cases” was SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943), see supra note 15, a revised test was enunciated in Howey. See Howey, 328 U.S. at 299.
107. Id. at 299 (citing H.R. Rep. No. 73-85, at 11 (1933)).
108. Id.
straightforward analysis. Yet, this seemingly simple test has led to many court holdings and law review articles that indicate an uncertainty regarding how to interpret its elements. As new types of investment schemes and programs develop in the financial world, courts, both federal and state, continue to struggle with the proper application of the elements of the Howey test.

E. Focus: The Fourth Element of Howey

In order for an investment contract to be deemed a "security," each element of the Howey test must be fulfilled. Much litigation has centered upon interpreting the first three elements of this test, but those debates are beyond the scope of this comment. Assuming that a court finds that an investment scheme satisfies the first three prongs of the Howey test, then the fourth element—expectation of profits from the

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111. See Joseph, supra note 6, at 1597; see also United States v. Holtzclaw, 950 F. Supp. 1306 (S.D.W. Va. 1997) (addressing whether the "pyramid scheme" sold by the defendants is an investment contract and, thus, a security); SEC v. Comcoa Ltd., 855 F. Supp. 1258 (S.D. Fla. 1994) (applying the Howey test to investments in Federal Communications Commission licensing program); People v. First Meridian Planning Corp., 658 N.E.2d 1017 (N.Y. 1995) (applying the Howey test to investment program in numismatic coin portfolios).
112. See, e.g., SEC v. Life Partners, 87 F.3d 536, 545-48 (D.C. Cir. 1996) (discussing the difficulty in applying Howey's fourth prong to fractional interests in viatical settlements marketed by defendants).
113. Monaghan, supra note 110, at 2146.
114. The first element requires the existence of a "scheme or transaction"—an element that is often met, but rarely mentioned as part of the Howey test. Howey, 328 U.S. at 298-99.

The second element requires an investment of money. Id. at 299. Courts have generally held that consideration other than cash will suffice to meet this element. See Joseph C. Long, An Attempt to "Return Investment Contracts" to the Mainstream of Securities Regulation, 24 OKLA. L. REV. 135, 161 (1971) (noting that consideration does not have to be cash to meet the second element); see also International Bhd. of Teamsters v. Daniel, 439 U.S. 551 (1979) (holding that employee interests in a non-contributory compulsory pension plan did not meet the investment of money requirement).

The third element requires a "common enterprise" which "posits some ongoing relationship or nexus among individuals with respect to a transaction." Monaghan, supra note 110, at 2148. For a good discussion of the interpretation problems associated with this element, see Monaghan, supra note 110.
efforts of the promoter\textsuperscript{115}—becomes the linchpin of the analysis. Before reaching the main issue of this comment—pre-purchase entrepreneurial activities—the next three sections break the fourth prong of the \textit{Howey} test into manageable components to highlight their current interpretation by federal courts.

1. \textit{Expectation of Profits}

The courts have interpreted the term “profits” broadly, by refusing to confine the term to any one form of financial return.\textsuperscript{116} In \textit{United Housing Foundation, Inc. v. Forman},\textsuperscript{117} the Supreme Court held that shares in a cooperative apartment complex did not meet the “expectation of profits” requirement of \textit{Howey} because the purchaser’s incentive in entering into the transaction was to obtain affordable housing and not to earn a financial return.\textsuperscript{118} Under \textit{Forman}, there needs to be a capital appreciation or a “participation in earnings resulting from the use of investors’ funds,” to meet this prong of the \textit{Howey} test.\textsuperscript{119} In addition, courts generally agree that both monetary and non-monetary forms of returns or earnings on one’s investment will meet the “expectation of profits” sub-element.\textsuperscript{120} Although there need not be any guarantee of profits, for very few investments can guarantee profits, all that \textit{Howey} requires is a “reasonable expectation of profits.”\textsuperscript{121}

2. “\textit{Sole}” Reliance Equals “\textit{Predominant}” Reliance

The \textit{Howey} court also stated that the investor must “solely rely” on the promoter’s efforts to realize profits.\textsuperscript{122} However, none of the cases cited in \textit{Howey} required “sole reliance.”\textsuperscript{123} Additionally, three decades after the \textit{Howey} decision, the SEC noted that “requiring sole reliance would merely offer a blueprint for fraud.”\textsuperscript{124}

\begin{footnotes}
\footnotetext{115}{\textit{Howey}, 328 U.S. at 301.}
\footnotetext{116}{Monaghan, \textit{supra} note 110, at 2148.}
\footnotetext{117}{421 U.S. 837 (1975).}
\footnotetext{118}{\textit{Id.} at 856-57.}
\footnotetext{119}{\textit{Id.} at 852.}
\footnotetext{120}{See Monaghan, \textit{supra} note 110, at 2135 nn.102-04.}
\footnotetext{121}{\textit{Forman}, 421 U.S. at 852 (emphasis added).}
\footnotetext{122}{\textit{Howey}, 328 U.S. at 299.}
\footnotetext{123}{McGinty, \textit{supra} note 15, at 1051.}
\footnotetext{124}{\textit{Id.}}
\end{footnotes}
In the early 1970s, two Court of Appeals cases, SEC v. Glenn W. Turner Enterprises\textsuperscript{125} and SEC v. Koscot Interplanetary, Inc.,\textsuperscript{126} addressed the "sole reliance" requirement.\textsuperscript{127} Both cases involved whether the pyramid (or multilevel marketing) schemes fostered by the defendants were securities.\textsuperscript{128} Turner, the master-mind of the defendants in both cases, promised lavish wealth for investors, but required them to recruit other investors to lure their investments and augment the enterprise.\textsuperscript{129} In both Turner and Koscot, the Courts of Appeal addressed "whether the exertion of some effort by an investor is inimical to the holding that a promotional scheme falls within the definition of an investment contract."\textsuperscript{130}

Rejecting this contention, the Turner court held that this prong of Howey was satisfied when the "efforts made by those other than the investor are the undeniably significant ones" ("the Turner test").\textsuperscript{131} According to the court, the defendant's promotional efforts before potential investors represented the linchpin of the enterprise's success.\textsuperscript{132} The court determined that "if it construed 'solely' literally, any investor participation in the activity would unreasonably deny the investor the protection of the securities laws."\textsuperscript{133}

Similarly, the Koscot court found the scheme in Turner parallel to the Koscot scheme. The Koscot court evaluated its facts along similar lines as did the Turner court, in order to reach the same conclusion.\textsuperscript{134} Thus, in adopting the Turner test, federal courts, as in Koscot, have watered down the term "sole reliance" to mean "predominant reliance."\textsuperscript{135}

Although this liberal construction of Howey's fourth element is not followed in all circuits,\textsuperscript{136} most Courts of Appeals

\textsuperscript{125} 474 F.2d 476 (9th Cir. 1973), cert. denied, 414 U.S. 821 (1973).
\textsuperscript{126} 497 F.2d 473 (5th Cir. 1974).
\textsuperscript{127} McGinty, supra note 15, at 1052.
\textsuperscript{128} Id. at 1051. See Turner, 474 F.2d at 478-80 (explaining the scheme's operation).
\textsuperscript{129} Koscot, 497 F.2d at 475-76; Turner, 474 F.2d at 478-80.
\textsuperscript{130} Koscot, 497 F.2d at 479; see also Turner, 474 F.2d at 482.
\textsuperscript{131} Id. at 482.
\textsuperscript{132} Id.
\textsuperscript{133} Glick, supra note 19, 972 (citing Turner, 474 F.2d at 482).
\textsuperscript{134} Koscot, 497 F.2d at 484-85.
\textsuperscript{135} McGinty, supra note 15, at 1051.
\textsuperscript{136} See, e.g., SEC v. Comocoa Ltd., 855 F. Supp. 1258, 1961 n.4 (S.D. Fla. 1994) (citing cases that exemplify the split of authority in the 11th Circuit and those that have failed to address the issue of whether to adopt the Turner test).
HOWEY'S FOURTH PRONG

adopt the Turner test in analyzing the “sole reliance” requirement.\(^{137}\) For example, in \textit{SEC v. Comcoa},\(^ {138}\) the Florida district court had to determine whether Comcoa’s program for procuring Federal Communications Commission (“FCC”) licenses for investors constituted investment contracts.\(^ {139}\) The \textit{Comcoa} court, in noting the split of authority that existed in the Eleventh Circuit on whether the term “solely” should be applied literally or broadly,\(^ {140}\) adopted the Turner test to determine that Comcoa’s program—obtaining and marketing FCC licenses on behalf of its investors—constituted “investment contracts” under the \textit{Howey} test.\(^ {141}\) In reaching this decision, the court maintained that since the investors did “not have the \textit{required technical expertise} to market their licenses themselves, they could not possibly realize a profit from this scheme without significant involvement of others.”\(^ {142}\) In the court’s view, “the scheme is no less an investment contract because some participation by the investor is required.”\(^ {143}\)

The Court of Appeals for the District of Columbia Circuit has also adopted the \textit{Turner} test with respect to the “sole reliance” requirement.\(^ {144}\) In \textit{SEC v. International Loan Network, Inc.},\(^ {145}\) the court held that the fourth prong of the \textit{Howey} test required that the “expectation of profits” stem “predominately from efforts made by others.”\(^ {146}\) In \textit{International Loan Network}, the defendants were managers of a “financial distribution network,” a complex pyramid scheme.\(^ {147}\) The SEC brought an action against the defendants for selling unregistered securities and for violations of

\(^{137}\) \textsc{Jennings et al.}, \textit{supra} note 3 at 222.
\(^{139}\) \textit{Id.} at 1259-60. Defendants also assisted the investors in marketing their FCC licenses. \textit{See id} at 1261.
\(^{140}\) 855 F. Supp. 1258, 1261 (S.D. Fla. 1994).
\(^{141}\) \textit{Id.} (holding that the promises of the post-licensing involvement of Comcoa militates in favor of finding that investors’ profits would be derived from the significant efforts of Comcoa).
\(^{142}\) \textit{Id.} (emphasis added).
\(^{143}\) \textit{Id.}
\(^{144}\) \textit{See, e.g., Life Partners}, 87 F.3d at 545.
\(^{145}\) 968 F.2d 1304 (D.C. Cir. 1992).
\(^{146}\) \textit{Id.} at 1308.
\(^{147}\) \textit{Id.} at 1305-06. To participate in International Loan Network’s (“ILN”) pyramid sales scheme, one would sign on as an “Individual Representative” to sell ILN memberships. That member would earn commissions by recruiting members and on sales made by members he or she recruits. \textit{Id.}
the SEC's antifraud rules.\textsuperscript{148} In affirming the district court's finding that the defendant's scheme was a security, the Court of Appeals held that the investor's profits were expected to accrue "if not solely, at least predominantly from the efforts of others."\textsuperscript{149} Such a reading of the term "sole reliance" is consistent with the flexible and liberal principles underlying the federal securities acts.\textsuperscript{150}

3. Efforts by Promoter Must Be Managerial or Entrepreneurial

a. Supreme Court Application

The fourth element of \textit{Howey} addresses the degree of control exercised over the investment by the promoter.\textsuperscript{151} Two Supreme Court definition cases, \textit{United Housing Foundation, Inc. v. Forman}\textsuperscript{152} and \textit{International Brotherhood of Teamsters v. Daniel},\textsuperscript{153} described the "touchstone" of the \textit{Howey} test to be "the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial . . . efforts of others."\textsuperscript{154} Both \textit{Forman} and \textit{Daniel} underscored the idea that the efforts by a promoter must be entrepreneurial or managerial, not merely administrative or ministerial.\textsuperscript{155} An example of ministerial or administrative activities is mere preparation of documents or record-keeping.\textsuperscript{156} On the other hand, entrepreneurial efforts could entail the use of the promoter's personnel, expertise, and equipment with the principal aim of enabling investors to earn a return on their investments.\textsuperscript{157} If the investor is "an outsider whose profits depend on [such]
exertions by [the promoter], then the disclosure policies of the [1933 Act] are directly implicated.\footnote{158}

b. Authority of the Courts of Appeals

Appellate decisions applying the Howey test have provided guidance on the “entrepreneurial efforts” requirement underscored in both Forman and Daniel. For instance, in Williamson v. Tucker,\footnote{159} the court addressed whether interests in a real estate joint venture (or general partnership) constituted an “investment contract,” and, thus, a “security.”\footnote{160} The plaintiffs argued that their interests in the joint ventures were “investment contracts.”\footnote{161} They asserted that the “entrepreneurial efforts of others” requirement of the Howey test was satisfied because the central tasks in managing the venture were performed by the defendants.\footnote{162} However, the defendants maintained that the plaintiffs possessed meaningful powers under the joint venture agreement and contended that these powers were enough to preclude a finding that the joint venture interests were securities.\footnote{163}

In its analysis of the fourth prong of the Howey test, the Williamson court focused upon the degree of dependence existing between the partners and the manager of the joint venture.\footnote{164} According to the Williamson court, an interest in a general partnership can constitute a “security” if one partner is so dependent on “some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager.”\footnote{165} Under this rubric, the Williamson court concluded that the interests in the joint ventures were not securities.\footnote{166} While finding that the interests in this case were not securities, the court highlighted that “an inves-

\footnote{158. Monaghan, \textit{supra} note 110, at 2149.}
\footnote{159. 645 F.2d 404 (5th Cir. 1981), \textit{cert. denied}, 454 U.S. 897 (1981).}
\footnote{160. \textit{See id.} at 409-17, for a discussion of the procedural posture of the case. Essentially, plaintiffs Williamson, et. al., filed suit to rescind a joint venture agreement related to joint interests in real estate and alleged violations of the federal securities acts against the manager of the property and the original owners of the property. \textit{Id.} at 406-9.}
\footnote{161. \textit{Id.} at 417.}
\footnote{162. \textit{Id.} at 419.}
\footnote{163. \textit{Id.} at 425.}
\footnote{165. \textit{Id.} at 424.}
\footnote{166. \textit{Id.} at 425.}
tor who claims his general partnership or joint venture interest is an investment contract has a difficult burden to overcome. Yet, the court suggested that such a burden can be surmounted by a showing of "dependence on the unique or irreplaceable expertise" of the promoter.

4. The Timing of the Entrepreneurial Efforts

The foregoing three sections underscore that the fourth element of Howey requires that an investor must reasonably expect profits that predominantly derive from reliance on the entrepreneurial efforts by the promoter or a third party. But, when must those efforts occur? Must the entrepreneurial efforts of the promoter take place after the investor commits his funds? Most litigation concerning the fourth element of Howey focuses upon the nature of the post-purchase managerial functions of promoters. Yet, many cases emphasize pre-purchase efforts to meet this element.

For example, in Glen-Arden Commodities, Inc. v. Costantino, the Court of Appeals for the Second Circuit addressed whether investments in Scotch whisky warehouse receipts were securities. The court found all elements of the Howey test satisfied. In particular, the Glen-Arden court found the fourth element of the test satisfied because "[a]n investor was dependent upon appellants for the utilization of their 'expertise in selecting the type and quality of Scotch whisky and casks to be purchased.'" "It [was] not as if they were buying simply X carloads of wheat or barley... which could be supplied by the furnishing of any other carload of wheat or barley. Rather, the very investment made was in goods to be specifically selected by the appellants." Thus, the Glen-Arden decision emphasized the promoters pre-purchase ef-

167. Id. at 424.
168. Id. at 425 (emphasis added).
169. See supra Part II.D.1.
170. See supra Parts II.D.2-3.
171. See Life Partners, 87 F.3d at 555 (Wald, J., dissenting).
172. See infra notes 173-194 and accompanying text.
173. 493 F.2d 1027 (2d Cir. 1974).
174. Id. at 1030.
175. Id. at 1035.
176. Id.; see also id. at 1031 (describing how the defendant-appellants promoted the investment program and procured the Scotch whisky in a manner that enabled defendants to mark up their whisky investments substantially).
177. Id. at 1035.
forts to find that Howey's fourth prong was met.

More recently, the Court of Appeals for the District of Columbia Circuit determined whether investments in a pyramid scheme promoted by the defendants constituted a “security” in *SEC v. International Loan Network, Inc.* An investor in the pyramid scheme was required to invite others to come to a promotional meeting to lure them into the scheme. At this meeting, if the International Loan Network (“ILN”) manager was successful in persuading the potential recruit to actually become a member, then the person who originally extended the invitation would earn income from it. Therefore, the court held that ILN’s promotional efforts, *before* the investor made his or her financial commitment, contributed to profits for all of the pyramid scheme investors and promoters. Thus, the court viewed the defendant’s pre-purchase efforts as influencing investors’ profits and held that the final prong of Howey had been satisfied.

Finally, the Court of Appeals for the Fourth Circuit placed great importance on the promoter’s pre-purchase managerial efforts in the 1990 decision of *Bailey v. J.W.K. Properties, Inc.* In *Bailey*, plaintiffs had acquired interests in the defendants’ cattle breeding program. When the defendants abandoned the program, plaintiffs filed suit alleging inadequate disclosures in violation of federal securities laws. The main issue focused on whether the cattle breeding investment program constituted “securities” under the Howey test. The district court determined that the main stumbling block for the plaintiffs was that they “did not expect profits solely from the efforts of the [defendants].”

On appeal, the plaintiffs urged the court to look at the circumstances surrounding the cattle breeding transactions in order to realize that the investors possessed no meaningful

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178. 968 F.2d 1304, 1305-7 (D.C. Cir. 1992) (describing the details of the real estate pyramid scheme).
179. *Id.* at 1306-07.
180. *Id.* at 1308 n.9.
181. *Id.* at 1308.
182. *Id.*
183. 904 F.2d 918 (4th Cir. 1990).
184. *Id.* at 919.
185. *Id.*
186. *Id.*
187. *Id.* at 920.
control over the investment. The court agreed that the essential functions of the program "were in the hands of the defendants."

In Bailey, the court found that the key element to the success of the cattle breeding plan was the defendants' pre-purchase selection of cow embryos and crossbreeding efforts. Since "plaintiffs had no expertise in making selections of embryos and had an extremely limited range of alternative sources of information," they had practical dependence on the defendant's "special expertise" in the selection of cow embryos, prior to committing their funds to the program. The court relied on the fact that the promoter's pre-purchase expertise in selecting embryos, apart from its post-purchase efforts, was the linchpin to the profits realized by the investors. Therefore, the Bailey court determined that the cattle breeding program was an investment contract under the Howey test.

The foregoing cases illustrate the prior judicial emphasis on pre-purchase entrepreneurial efforts by promoters in finding the fourth prong of the Howey test satisfied.

F. SEC v. Life Partners, Inc.

1. Facts of Life Partners

In SEC v. Life Partners, Inc., the defendant was a leading marketer of viatical settlements. In order to qualify for

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188. Id. at 921.
190. Id. at 919.
191. Id. at 924.
192. Id.
193. Id. at 923-24.
194. Id. at 925.
196. Essentially, these transactions function whereby a terminally ill person (usually an AIDS patient) assigns ownership of his or her life insurance policy to a buyer. For a description of viatical settlements, see supra note 21.

These viatical settlements "provide AIDS victims with much needed income in the final years of their lives while allowing investors to collect the face amount of the policy at the insured's death." Life Partners, 912 F. Supp. at 4, 6 (D.D.C. 1996).

There are approximately 60 firms in the United States that broker viatical settlements; LPI is the largest in the country. Life Partners, 87 F.3d at 539.
LPI's program, the policy holder (the "viator" or "insured") must have met specific criteria, which enabled LPI to market and sell its viatical settlements to individuals in a manner distinct from other firms. Essentially, the company sold "fractional interests" in the insurance policies of people with "full blown AIDS" who had a life expectancy of two years or less. One could pay a small amount (about $650) to acquire as little as a three percent interest of an insured's policy.

To effectuate this viatical settlement transaction, LPI performed a number of pre-purchase functions requiring a great deal of expertise. Specifically, an LPI physician conducted life expectancy estimates based upon numerous factors such as T-cell count and pulmonary studies, as well as taking into account potential advances in the treatment of AIDS. In addition, LPI reviewed the viator's insurance policy, negotiated a price of the policy and prepared legal documents for the investor. In its brochures, LPI emphasized its detailed assessment of the insured's medical condition. Prior to the Enforcement Proceedings initiated by the SEC in 1995, LPI performed a number of post-transaction functions, such as making sure the viators did not lapse on premium payments, monitoring the condition of the insured.

1994, this firm earned more than half of the industry's estimated annual revenues of $300 million. Id.
198. Life Partners, 87 F.3d at 539.
199. Life Partners, 898 F. Supp. at 22; Life Partners, 87 F.3d at 539.
200. Life Partners, 87 F.3d at 539. Thus, if the investor acquired three percent of a life insurance policy with a face value of $100,000 then, upon the death of the insured, the investor would receive $3,000 as a beneficiary of the policy. In addition, LPI was the first company to develop a plan where groups of investors could participate in a viatical settlement through an Individual Retirement Account. Id. at 539. However, this offering by LPI is beyond the scope of this comment. Instead this comment focuses on the controversy surrounding LPI's program for individual investors.
201. Life Partners, 87 F.3d at 539.
202. Id. at 555 (Wald, J., dissenting) (citing testimony of Dr. John Kelly, an LPI-employed physician).
203. Id. at 539.
204. Id. at 555 (Wald, J., dissenting) (citing the brochure LIFE PARTNERS, INC., COMMONLY ASKED QUESTIONS (Jan. 1993)).
205. See District Court Grants Preliminary Injunction against Life Partners and Brian Pardo, SEC NEWS DIGEST, Sept. 1, 1995; District Court Grants Emergency Motion for Supplemental Provisional Relief against Life Partners and Brian Pardo, SEC NEWS DIGEST, Mar. 21, 1996, all available in LEXIS, Nexis Library, SEC NEWS DIGEST File.
and arranging for the resale of the investor’s interest in the life insurance upon request.\footnote{206}

In August 1995, the SEC sought to enjoin LPI from marketing its viatical settlements without first complying with securities regulations.\footnote{207} The SEC maintained that the manner in which LPI promoted its viatical settlements constituted the sale of “securities” within the purview of the federal securities acts.\footnote{208} Specifically, the SEC asserted that LPI violated the registration requirements of the 1933 Act,\footnote{209} as well as antifraud provisions of the 1934 Act.\footnote{210}

2. Judicial History at the District Court Level

Between August 1995 and March 1996, the district court issued three injunctions against LPI.\footnote{211} In August 1995, the court held that LPI violated various sections of the federal securities acts and ordered LPI to bring its operations into compliance with the Securities Acts “forthwith.”\footnote{212} In response to this order, LPI modified its viatical settlement program by minimizing the number of post-purchase functions it performed, while continuing the same pre-purchase functions.\footnote{213}

In January 1996, the district court held that LPI had not adequately complied with the August 1995 directive.\footnote{214} Thus, the district court enjoined LPI from offering or selling unregistered fractional interests in viatical settlements.\footnote{215}

\begin{footnotes}
\item[206] Life Partners, 87 F.3d at 540.
\item[207] Life Partners, 898 F. Supp. at 17.
\item[208] The SEC did not contend that all viatical settlements are securities, but limited its focus to LPI’s offerings to individual investors, as opposed to the viatical settlements sold through participation in Individual Retirement Accounts. \textit{Id.} at 18.
\item[209] Sections 5(a) and 5(c) of 1933 Act, 15 U.S.C. §§ 77e(a), 77e(c) (1994); \textit{Life Partners}, 87 F.3d at 538.
\item[210] \textit{Life Partners}, 87 F.3d at 538.
\item[212] \textit{Life Partners}, 898 F. Supp. at 24.
\item[213] \textit{Life Partners}, 87 F.3d at 540. In Version I, either the company president or LPI appeared as the legal owner of the insurance policies. \textit{Id.} at 539. In Version II, the investors were at all times the owners of record. \textit{Id.} at 540. In Version III, the investor remained the legal owner and LPI declared that it would no longer provide any post-purchase services to purchasers either directly or indirectly. \textit{Id.} at 539-40.
\item[214] \textit{Life Partners}, 912 F. Supp. at 5-6.
\item[215] \textit{Id.} at 12.
\end{footnotes}
its January 1996 opinion, the district court stated that “pre-purchase activities cannot alone” subject LPI to the federal securities acts, even though such efforts were “undeniably essential to the overall success of the investment.”\footnote{216} LPI interpreted this statement to mean that so long as the company discontinued its post-purchase services, the company could resume its sales of viatical settlements.\footnote{217} LPI decided to resume marketing its viatical settlements by its own initiative,\footnote{218} whereby once an investor committed his or her funds, LPI would cease all but the most clerical post-purchase services.\footnote{219}

In response to these actions, the district court preliminarily enjoined LPI from selling fractional interests in viatical settlements “by any . . . means whatsoever” in March 1996.\footnote{220} The district court held that LPI’s “technical changes had done little to alter the substance of the services provided to the investors.”\footnote{221} Thereafter, LPI appealed the orders issued by the district court.\footnote{222} One of the main issues on appeal was whether the fractional interests in viatical settlements sold by LPI amounted to “securities” within the meaning of the federal securities acts.\footnote{223}

3. The Life Partners Decision on Appeal

a. The Majority Ruling

In July 1996, the Court of Appeals for the District of Columbia Circuit concluded that LPI’s contracts were not “securities” under the Howey test; thus, the allegations of securities laws violations were dismissed.\footnote{224} The issue turned on whether fractional interests in viatical settlements, as marketed by LPI, met the fourth prong of the Howey test.\footnote{225}
However, the crux of the analysis was whether the fourth element of the *Howey* test can be met, based primarily upon the promoter’s pre-purchase entrepreneurial efforts. According to the majority, the profits from the viatical settlements, realized upon the death of the insured, did not derive predominantly from the pre-purchase or post-purchase efforts of LPI. Instead, the court found that it was “the length of the insured's life that [was] of overwhelming importance to the value of the viatical settlements marketed by LPI.” Therefore, the Court of Appeals remanded the case to the district court with an order to vacate the injunctions.

The majority relied on Ninth and Tenth Circuit cases to support its opinion that pre-purchase entrepreneurial functions by a promoter were “irrelevant” to the expectation of profits if not coupled with meaningful post-purchase efforts. The Ninth Circuit Court of Appeals’ opinion in *Noa v. Key Futures, Inc.* involved investments in silver bars where the promoter made pre-purchase efforts to identify the investment and to locate prospective investors. In *Noa*, the court held that “[o]nce the purchase . . . was made, the profits to the investor depended upon the fluctuations of the silver market, not the managerial efforts of the promoter.”

The majority also relied on the decision of the Tenth Circuit Court of Appeals in *McCown v. Heidler*. In *McCown*, the court addressed whether investments in undeveloped land were securities. The pre-purchase marketing techniques of the defendants involved the promise to make future improvements to the lots. However, only the defendants’ subsequent improvements to the lots actually spurred profits for the investors.

In both of these cases, the courts regarded the promoter’s pre-purchase efforts as insignificant in determining whether

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226. *See id.* at 548.
227. *Id.* at 545-48.
228. *Id.* at 548.
229. *Id.* at 549.
231. 638 F.2d 77 (9th Cir. 1980) (per curiam).
232. *Id.*
234. 527 F.2d 204 (10th Cir. 1975). *See Life Partners*, 87 F.3d at 546-47.
235. 527 F.2d 204 (10th Cir. 1975).
236. *Life Partners*, 87 F.3d at 546-47.
237. *Id.* at 547 (quoting *McCown*, 527 F.2d at 211).
the investments were securities. \(^{238}\) The *Life Partners* court found that, in each of these cases, the promoter's commitment to perform meaningful post-purchase functions led to the determination of whether the *Howey* test was satisfied. \(^{239}\)

Apart from its reliance on the *Noo* and *McCown* cases, the *Life Partners* majority also found the administrative fee charged by LPI to be significant. \(^{240}\) To the majority, the promoter's fees represented the value of the pre-purchase efforts to the investor. \(^{241}\) The majority surmised:

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\text{[If the value of the promoter's efforts has already been impounded into the promoter's fees or into the purchase price of the investment, and if neither the promoter nor anyone else is expected to make further efforts that will affect the outcome of the investment, then the need for federal securities regulation is greatly diminished.}\]

Furthermore, the *Life Partners* court used language from the January 1996 district court opinion which stated that LPI's pre-closing activities alone were not sufficient to sustain a finding that investors' profits derive from the activities of LPI. \(^{242}\) The majority found that the SEC "identified no post-purchase service provided by LPI...that could fairly be characterized as entrepreneurial and combined with LPI's pre-purchase services to affect the outcome of the *Howey* test." \(^{243}\) For these reasons, the majority maintained that the time of sale is a "legal construct but a significant one." \(^{244}\)

The majority agreed with the district court's finding that LPI's pre-purchase efforts were "undeniably essential to the overall success of the investment." \(^{245}\) "The investors rely heavily, if not exclusively, upon LPI to locate insureds and to

\(^{238}\) See id. at 547.

\(^{239}\) See id. at 547-48. The district court went further to state that it based its decision in reliance on the "pre-closing in addition to the post-closing activities that LPI continue[d] to perform." *Life Partners*, 912 F. Supp. at 9 n.7. However, after this 1996 District Court decision, LPI ceased all post-closing activities. See *Life Partners*, 87 F.3d at 540 ("LPI declared that it would no longer provide any post-purchase services to purchasers either directly or indirectly... ").

\(^{240}\) *Life Partners*, 87 F.3d at 547.

\(^{241}\) Id.

\(^{242}\) See id. at 547-48. The district court went further to state that it based its decision in reliance on the "pre-closing in addition to the post-closing activities that LPI continue[d] to perform." *Life Partners*, 912 F. Supp. at 9 n.7. However, after this 1996 District Court decision, LPI ceased all post-closing activities. See *Life Partners*, 87 F.3d at 540 ("LPI declared that it would no longer provide any post-purchase services to purchasers either directly or indirectly... ").

\(^{243}\) Life Partners, 87 F.3d at 540.

\(^{244}\) Life Partners, 87 F.3d at 548.

\(^{245}\) Id.

\(^{246}\) Id.
evaluate them and their policies.\textsuperscript{247} Nevertheless, the majority did not deem LPI’s pre-purchase activities sufficient to meet the fourth prong of the \textit{Howey} test.\textsuperscript{248} Rather, the majority declared that the expectations of profits by the investors depended upon one independent variable: the time of the insured’s death.\textsuperscript{249} Thus, the majority asserted that LPI’s pre-purchase managerial efforts were irrelevant to meeting the fourth prong of the \textit{Howey} test, and “doubt[ed] that pre-purchase services should ever count for much . . . .”\textsuperscript{250}

On December 20, 1996, the Court of Appeals denied the SEC’s petition for rehearing.\textsuperscript{251} Judge Ginsburg clarified portions of the July 1996 opinion and denied establishing a “bright line rule” with respect to the fourth element of \textit{Howey}.\textsuperscript{252} In addition, she stated that “[n]othing in our application of the \textit{Howey} test can be reasonably construed to suggest that pre-purchase efforts are ‘irrelevant.’”\textsuperscript{253} The court, however, reemphasized that pre-purchase activities alone could not meet the fourth prong of the \textit{Howey}.\textsuperscript{254}

\textbf{b. The Dissent}

Judge Wald, in her dissent to the July 1996 opinion, argued that the fractional interests in viatical settlements promulgated by LPI satisfied the fourth requirement of the \textit{Howey} test.\textsuperscript{255} Before developing her theory, Judge Wald first set out three basic principles to guide her analysis.\textsuperscript{256} First, she underscored the idea that the securities laws are to be flexible enough to encompass a wide range of investment products.\textsuperscript{257} Second, Judge Wald stated that “the securities laws do not grant federal protection to all investments, but only to that subcategory of investments that are securities.”\textsuperscript{258} Third, the judge emphasized that information is the best

\begin{tabular}{l}
\textsuperscript{247.} Id. \\
\textsuperscript{248.} Id. \\
\textsuperscript{249.} Id. \\
\textsuperscript{250.} \textit{Life Partners}, 87 F.3d at 548. \\
\textsuperscript{252.} Id. at 588. \\
\textsuperscript{253.} Id. \\
\textsuperscript{254.} Id. \\
\textsuperscript{255.} \textit{Life Partners}, 87 F.3d at 549-57 (Wald, J., dissenting). \\
\textsuperscript{256.} Id. at 549-50. \\
\textsuperscript{257.} Id. \\
\textsuperscript{258.} Id. at 550. 
\end{tabular}
form of investor protection. With this backdrop, Judge Wald proceeded to examine why pre-purchase managerial activities should satisfy the fourth prong of the Howey test.

Judge Wald’s answer to this question stressed the “kind and degree of dependence between the investors profits and the promoters’ activities.” In order to be deemed entrepreneurial efforts, “[t]hese pre-purchase activities must be directed at the sale of the investment opportunity.” If the success of such pre-purchase activities, either entirely or predominantly, determines whether profits are eventually realized, then such efforts by a promoter should meet the fourth element of the Howey test. She supported her assertion with the Supreme Court’s application of the Howey test, and its concern that securities are determined by their underlying economic reality instead of their form. Judge Wald used several federal cases to illustrate that courts frequently stress pre-purchase as well as post-purchase activities of the promoter to satisfy the fourth prong of the Howey test.

Under Judge Wald’s analysis, an investor in LPI’s viatical settlements relied almost entirely upon LPI’s pre-purchase managerial activities in calculating the life expectancy of the insured. Therefore, the judge argued that these efforts should satisfy the fourth prong of the Howey test. She asserted that, in the case of LPI, the realization of the investor’s profits depended “not on the timing of the insured’s death per se [as declared by the majority] but rather on whether the death occurs within the period estimated by LPI.” As a final point, the dissenting opinion of-

259. Id.
260. Id.
261. Life Partners, 87 F.3d at 551 (Wald, J., dissenting).
262. Id. at 551
263. Id. at 551
264. Id. at 550 (quoting Tcherepnin v. Knight, 389 U.S. 332, 336 (1967)).
265. Id. at 553 (citing Bailey v. J.W.K. Properties, Inc., 904 F.2d 918 (4th Cir. 1990); Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 756 F.2d 230, 240-41 (2d Cir. 1985) (stressing Merrill Lynch’s promise to maintain a secondary market for resale of certificates of deposit in finding Howey satisfied); Glen-Arden Commodities, Inc. v. Costantino, 493 F.2d 1027 (2d Cir. 1974) (noting that investors’ profits depended on the promoter’s expertise in selecting whiskey)).
266. Life Partners, 87 F.3d. at 555 (Wald, J., dissenting).
267. Id. at 556.
268. Id. at 564 (emphasis added).
ferred other investment contexts whereby an investor relies heavily on the promoter's pre-purchase efforts. For these reasons, Judge Wald would have concluded that LPI's viatical settlement program represented an "investment contract," thus a "security," under the federal securities acts.

Judge Wald also dissented in the denial of rehearing by the Court of Appeals in December 1996. In response to the majority's statement that it did not draw a "bright line rule," Judge Wald stated:

The majority's original opinion, with its comment that "we doubt that pre-purchase activities should ever count for much"... and its conclusion that the "undeniably essential" activities performed by LPI do not create a security because they occur prior to purchase... leaves the distinct impression that pre-purchase activities are largely irrelevant and never, by themselves, sufficient to support finding that a security exists.

To conclude, Judge Wald underscored the problems that applying the majority's "bright line rule" would have with respect to asset-backed investments, as she had done in her July 1996 opinion. Furthermore, she discussed the rapid growth in the viatical settlement industry and warned that the majority's ruling precludes investors from the unscrupulous practices by promoters of these settlements.

III. IDENTIFICATION OF THE PROBLEM

The fourth prong of the Howey test mandates that the investor's expectation of profits derive predominately from the entrepreneurial efforts of others. Yet, there is no precedent declaring that such efforts must occur after the purchase of the investment. Despite Judge Ginsburg's remarks to the contrary in the December 1996 denial of rehearing, the Life Partners decision in July 1996 imposes an

269. Id. at 556-57 (discussing the application of the majority's "bright line rule" to derivatives).
270. Id. at 556.
271. Life Partners, 87 F.3d at 589-90 (Wald, J., dissenting).
272. Id. at 589.
273. Life Partners, 102 F.3d at 590 (Wald, J., dissenting).
274. Id.; see also supra note 269.
275. Life Partners, 102 F.3d at 590 (Wald, J., dissenting).
276. See supra Part II.E.
277. Life Partners, 87 F.3d at 536.
arbitrary time-line (the "time-line test") upon the fourth prong of the Howey test. By the logic of the Life Partners court, if the promoter of an investment contract makes pre-purchase efforts that influence profitability, such efforts, in the absence of substantial post-purchase efforts, could not satisfy the Howey test's fourth prong. Thus, investment promoters that make substantial pre-purchase managerial efforts could simply eliminate any major post-purchase efforts in order to skirt the mandates of federal securities regulation. In effect, the Life Partners court's strict delineation between pre- and post-entrepreneurial efforts undermines the flexible approach reflected in the Howey test.

Viatical settlements, as discussed in the Life Partners case, are among the few types of investment products where pre-purchase activities can have a strong corollary to the investor's profits. In Life Partners, the promoters relied on highly specialized information before deciding to purchase a patient's insurance policy for the viatical settlement transaction. This data is precisely the type of information that would be included in a publicly available prospectus and in a registration statement on file with the SEC. If LPI had been forced to comply with the statutory prospectus requirements of the 1933 Act, then the investors would have been more adequately informed in order to assess whether or not to invest. Thus, the Life Partners ruling also minimizes the SEC's goal of ensuring investors are given adequate disclosure about highly specialized investments prior to purchase.

Apart from viatical settlements, other investments contexts exist or may develop where the investor's profits are linked to the pre-purchase efforts of the promoter which depend upon the utilization of highly specialized information.

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278. Although Judge Ginsburg, in the December 1996 statement, called this a "bright line rule," Life Partners, 102 F.3d at 589, the phrase "time-line test" shall be used in this comment as a more descriptive term.
279. See supra Part II.F.3.a.
280. See infra Part V.
281. See Life Partners, 87 F.3d at 549 (Wald, J., dissenting).
282. Id.
283. See id. at 555.
284. See supra Part II.B.
285. See Life Partners, 87 F.3d at 556-57 (Wald, J., dissenting) (applying the majority's test to derivatives); see also Life Partners, 102 F.3d 590 (applying the majority's test to risky asset backed investments).
Thus, the “time-line rule” set forth in *Life Partners*, if followed in other jurisdictions, threatens to immunize other novel types of investment schemes from the purview of the securities acts when the substance of the transaction may mandate protection.

The following section critiques the *Life Partners* decision in order to propose a more appropriate way to analyze Howey's fourth prong that stays faithful to the underlying “spirit” of the federal securities acts.

IV. ANALYSIS

This comment proposes that pre-purchase entrepreneurial efforts by a promoter should be able to satisfy the fourth element of *Howey* under particular circumstances. In order to reach the proposed solution, this section first briefly critiques the weaknesses of the majority's decision in *Life Partners* to suggest that its “time-line rule” should not be followed in future cases analyzing the fourth prong of the *Howey* test. Second, this analysis illustrates that the flexible approach underlying the *Howey* test, and the liberal construction given to the securities acts, render the majority's decision in *Life Partners* unwarranted. The third section underscores the informational disadvantage posed to investors if the “time-line test” espoused by the majority were applied to other types of investments in the future. The fourth section highlights the economic realities underlying LPI's viatical settlements in order to show why a promoter's pre-purchase efforts can satisfy *Howey*'s fourth prong.

A. Critique of the Majority Opinion in *Life Partners*

The *Life Partners* court concluded that LPI's viatical settlements were not securities, primarily because the transac-

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286. See, e.g., *Life Partners*, 87 F.3d at 557 (Wald, J., dissenting) (using the example of a derivative arrangement, where profits depend on dealer's expertise in balancing positions in different markets, rather than what happens in the market).
287. See discussion supra Part II.B.
288. See infra Part V for further development of the proposed solution.
289. See infra Part IV.A
290. See infra Part IV.B.
291. See infra Part IV.C.
292. See infra Part IV.D.
tions did not meet the fourth prong of the Howey test. The combination of LPI's pre-purchase services as a finder-promoter and its largely ministerial post-purchase services was not enough to establish "that the investors' profits flowed predominantly from the efforts of others." The opinion states that pre-purchase entrepreneurial efforts by LPI were significant to the "overall success of the investment," but could not, by themselves, fulfill the fourth element of the Howey test. These seemingly contradictory statements were overcome by the majority's determination that the profitability of the viatical settlements "overwhelmingly" depended upon the death of the insured. Although the SEC advocated the position that pre-purchase managerial efforts alone should satisfy this fourth element, the majority rejected this position because the SEC "offer[ed] no [legal] support at all" for its assertion. However, this analysis shall reveal that there is legal support for the view that pre-purchase efforts can satisfy the Howey test.

The majority relied upon two federal cases to bolster the assertion that pre-purchase efforts cannot fulfill the fourth element of the Howey test. Yet, the decision by the Ninth Circuit Court of Appeals in Noa v. Key Futures, Inc. did not state that pre-purchase efforts cannot fulfill the Howey test. As the district court pointed out in its January 1996 decision, the key distinction between Noa and Life Partners was that the defendant in Life Partners performed pre-investment work that was "undeniably essential to the over-

293. SEC v. Life Partners, Inc., 87 F.3d 536, 549 (D.C. Cir. 1996). As a minor point, the court also found that there was "no 'venture' associated with the ownership of an insurance contract from which one's profit depends entirely upon the mortality of the insured . . . ." Id. at 548. However, the crux of the court's Life Partners decision was its focus upon the "efforts of others" prong of the Howey test. Id. at 544-48.
294. Id. at 549.
295. Id. at 547.
296. Id. at 548.
297. Life Partners, 87 F.3d at 547.
298. Id.
299. Id. at 546-47 (per curiam) (citing Noa v. Key Futures, Inc., 638 F.2d 77 (9th Cir. 1980); McCown v. Heidler, 527 F.2d 204 (10th Cir. 1975)); see discussion supra Part II.E.3.
300. 638 F.2d 77 (9th Cir. 1980).
301. Noa, 638 F.2d at 79-80 (focusing on the post-sale fluctuations of the silver market as source of investor's profits, no discussion of pre-purchase efforts).
all success of the investment.\textsuperscript{302} In \textit{Noa}, although the promoters made some pre-purchase efforts, the investor's profits from the silver bars depended upon price fluctuations in the silver market that were independent of the promoter's efforts.\textsuperscript{303} However, in \textit{Life Partners} there was no "market" to determine an investor's profits because the viatical settlements were not "liquid" assets like other types of investments such as stocks or bonds.\textsuperscript{304} Instead, the profits realized to the investor were determined by \textit{whether the deaths occurred within the time-frame predicted} by the LPI physician.\textsuperscript{305}

In \textit{McCown v. Heidler},\textsuperscript{306} the Tenth Circuit Court of Appeals never addressed whether pre-purchase efforts could satisfy the fourth element of \textit{Howey} because the defendants performed significant post-purchase functions as well.\textsuperscript{307} Nevertheless, the majority in \textit{Life Partners} used this case to help determine that pre-purchase functions by a promoter are irrelevant.\textsuperscript{308} This determination overlooks those unusual, financial instruments where the pre-purchase efforts can independently "make or break" the investment, exemplified in \textit{Bailey v. J.W.K. Properties, Inc.}\textsuperscript{309} and \textit{Glen Arden Commodities, Inc. v. Costantino}.\textsuperscript{310} Thus, neither \textit{Noa} nor \textit{McCown} actually espoused the view advocated by the majority in \textit{Life Partners}.

In addition, the majority in \textit{Life Partners} considered the administrative fee charged by LPI as significant.\textsuperscript{311} The \textit{Life Partners} majority narrowly interpreted the meaning of the phrase "value of the promoter's efforts" to the investor by ignoring the fact that promoters of securities almost always earn a commission or charge a fee for their investment serv-

\textsuperscript{303} Life Partners, 87 F.3d at 546 (citing Noa, 638 F.2d at 79-80).
\textsuperscript{304} See id. at 553-55 (Wald, J., dissenting). While the majority maintained that it was only the death of the insured that determined profit realization, this comment accepts the view of the dissent—that it was how accurately LPI predicted the death of the insured which determined profits. Id. at 556.
\textsuperscript{305} Id. (emphasis added).
\textsuperscript{306} 527 F.2d 204 (10th Cir. 1975).
\textsuperscript{307} Id. at 211.
\textsuperscript{308} Life Partners, 87 F.3d at 556 (Wald, J., dissenting).
\textsuperscript{309} 904 F.2d 918 (4th Cir. 1990).
\textsuperscript{310} 493 F.2d 1027 (2d Cir. 1974); see supra Part II.E.4
\textsuperscript{311} Life Partners, 87 F.3d at 547.
ices.\textsuperscript{312} Simply because a promoter's efforts may come before the investment purchase should not have made the promoter's fee pertinent to the \textit{Howey} test analysis in the \textit{Life Partners} decision.

Finally, the majority also dismissed the value of the pre-purchase efforts of LPI because "the length of the insured's life" was of "overwhelming importance" to the value of the viatical settlements marketed by LPI.\textsuperscript{313} However, this conclusion ignores an important facet of the economic reality underlying viatical settlement transactions.\textsuperscript{314} As the dissent noted, the expectation of profits to the LPI investor did not depend on the death of the viator.\textsuperscript{315} Rather, the return to the investor depended upon how accurately LPI predicted the time of death of the viator.\textsuperscript{316} As this analysis will later reveal, the majority's view on this point was myopic.

\textbf{B. The Flexible Approach and Liberal Construction Applied to the Interpretation of the Securities Laws}

The majority in \textit{Life Partners} incorporated a "time-line rule" into \textit{Howey}'s fourth prong, even though courts have never suggested that such an artificial line be drawn.\textsuperscript{317} The majority's "time-line rule" appears to contradict the underlying purposes of the securities laws. The \textit{Howey} test was meant to embody "a flexible . . . principle, . . . 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."\textsuperscript{318}

The SEC argued that drawing a bright line with respect to the timing of entrepreneurial efforts would be "hypertechnical."\textsuperscript{319} This "hypertechnicality" is contrary to the liberal construction courts have traditionally applied to the federal securities acts.\textsuperscript{320} As the SEC urged in \textit{Life Part-
ners, the Howey case (or any Supreme Court definition case since) did not draw a bright line distinction between pre- and post-purchase efforts by a promoter.\textsuperscript{321} Viatical settlements are one, albeit rare, example where a promoter's managerial efforts before the sale can determine whether the investor realizes any profit.\textsuperscript{322} Therefore, such investments should not be arbitrarily excluded from the purview of the federal securities acts. Since there is no clear precedent on this matter and because we are in an age of rapidly developing financial investment structures,\textsuperscript{323} it seems contrary to the underlying policies of the securities laws to incorporate a rigid "time-line rule" into the fourth element of the Howey test. The absence of precedent on such a bright line distinction should serve as a clear sign that the Life Partners majority lacked support for its "time-line rule."

Many federal cases have placed great emphasis upon a promoter's pre-purchase expertise when analyzing the fourth prong of the Howey test. This comment proffers an extension of such cases, and urges that federal courts consider pre-purchase efforts in investment contract analysis if merited. In SEC v. International Loan Network, Inc.,\textsuperscript{324} the D.C. Circuit Court emphasized the defendant's promotional efforts in luring new recruits into a pyramid scheme as having a financial impact upon investors.\textsuperscript{325} Furthermore, in Bailey v. J.W.K. Properties, Inc.,\textsuperscript{326} investors in a cattle breeding program depended upon the special expertise of the promoter in the selection of cow embryos.\textsuperscript{327} The Bailey court found that

\textsuperscript{321} Life Partners, 87 F.3d at 547.

\textsuperscript{322} See id. at 553 (Wald, J., dissenting). Judge Wald also examines certain forms of "derivatives" and whether it is conceivable that the promoter's pre-purchase efforts determine the success of the investment. See id. at 556-57. In her dissent of the December 1996 rehearing denial, Judge Wald also postulated that certain forms of risky "asset backed interests" would be exempt from the securities acts under the majority's analysis. See Life Partners, 102 F.3d at 590 (Wald, J, dissenting). With certain types of long term bond packages, "the realization of profits turns on the promoter's skills in selecting what bonds to purchase." Id. (Wald, J, dissenting).

\textsuperscript{323} For instance, much has been written in regard to limited liability companies. See Joseph, supra note 6, at 1596; see also Park McGinty, Limited Liability Companies: Opportunity for Selective Securities Law Deregulation, 64 U. CIN. L. REV. 369 (1996).

\textsuperscript{324} 968 F.2d 1304 (D.C. Cir. 1992).

\textsuperscript{325} Id. at 1308; see discussion supra Part II.E.4.a.

\textsuperscript{326} 904 F.2d 918 (4th Cir. 1990).

\textsuperscript{327} Id. at 923; see discussion supra Part II.E.4.a.
such pre-purchase expertise in selecting embryos was the linchpin to the success of the investment. In *Glen-Arden Commodities, Inc. v. Costantino,* the court found the Howey test satisfied based upon the defendant's "expertise in selecting the type and quality of Scotch whiskey and casks to be purchased" and that "the very investment made was in goods specifically selected by the appellants." The *Glen-Arden* court found that the Scotch whisky investment scheme was one where "what was being sold was an investment entrusting the promoters with both the work and the expertise to make the tangible investment pay off." Each of these cases suggest that courts have placed importance upon the pre-purchase efforts of the promoter. By placing emphasis on the pre-purchase managerial functions of investment promoters, these decisions adhere to the flexible principles that underlies the Howey test.

The majority ruling in *Life Partners* imposes unnecessarily formal restrictions in determining that pre-purchase efforts by a promoter cannot meet the final prong of the Howey test. However, courts should apply the securities acts flexibly in order to achieve their broad remedial purpose. Specifically, the interests of the investing public should be the driving force behind the judicial determination of whether investors need the protection of the securities acts.

The *Life Partners* holding that pre-purchase managerial efforts cannot satisfy Howey's fourth prong, could offer a "blueprint for fraud" to the investing public. Similarly, in *SEC v. Glenn W. Turner Enterprises, Inc.*, the court recognized that the term "sole reliance" in the Howey test should not be construed literally because such a construction would

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328. *Bailey,* 904 F.2d at 924.
329. 493 F.2d 1027 (2d Cir. 1992).
330. *Id.* at 1035; *see discussion supra Part II.E.4.* Furthermore, "[appellants also represented that they would handle all the necessary arrangements for warehousing the Scotch and insuring it." *Glen-Arden Commodities,* 493 F.2d at 1035. "Finally, and probably most important to the customers, appellants represented that they would find buyers for the Scotch or buy it back themselves." *Id.*
331. *Glen-Arden Commodities,* 493 F.2d. at 1035.
333. *See McGinty, supra* note 15, at 1051 (discussing the SEC's concerns, of applying a too literal construction of the word "solely" in *Howey* test).
334. 474 F.2d 476 (9th Cir. 1973).
“lead to unrealistic results if applied dogmatically.”

The Life Partners ruling could influence how promoters of other investments structure their arrangements. Promoters of investment schemes who perform significant pre- and post-purchase efforts could eliminate their post-purchase efforts to avoid coverage by securities acts. This is precisely what LPI did after the January 1996 directive by the district court. Thus, by setting a formal time-line regarding when the entrepreneurial efforts must take place, the court is encouraging other companies to follow LPI's lead on how to avoid the grasp of the federal securities acts. Therefore, adopting the Life Partners view could undercut Howey's flexible principle of adapting to the "countless and variable schemes" that are possible in the investment world.

The following hypothetical illustrates why a liberal view should be applied with respect to the fourth element of the Howey test. The purpose of this hypothetical is to show that the rigidity of the majority's opinion could lead to an illogical conclusion.

Suppose that an investment promoter, on the verge of forming a competing viatical settlement program with LPI, convince a group of people, Group A, to invest their money in the promoter's proposed enterprise. Through a written contract, the parties would agree that the promoter would use the investor's money to locate insured, terminally ill patients who would participate in viatical settlement transactions. The promoter would research use Group A's funds to the life expectancy of the patients who agree to participate. Those viators calculated by the promoter (or its employed physician) to have life expectancies of two years or less would be the only ones selected to participate in the viatical settlement transactions. Once these viators agreed to sell interests in their life insurance policies, the original investors, Group A, would be given interests in these policies. Under these facts, clearly a court would hold that the transaction between the promoter and Group A constitutes an "investment contract" under section 2(1) of the 1933 Act, because all of the entrepreneurial efforts took place after Group A's commitment of

335. Id at 483.
336. Life Partners, 87 F.3d at 556 (Wald, J., dissenting).
337. Id. at 538.
338. Howey, 328 U.S. at 299; see supra notes 53-56 and accompanying text.
funds.

After this initial round of investments, suppose that the promoter conducts additional research, using the funds vested by Group A, and locates more patients that are also calculated to have a life expectancy of two years or less and who want to participate in a viatical settlement transaction. At this point, the promoter finds a second group of investors, Group B, to participate in the viatical settlement transaction. Prior to Group B's financial commitment, most of the promoters' entrepreneurial efforts have taken place, for all viatars have been located. Yet, under the rubric put forth in the Life Partners decision, the investments made by Group B would not constitute "securities" simply because the efforts of the promoter took place prior to the sale of the investment. For Group A, the viatical settlements would be deemed "securities;" however, for Group B, they would not.

This hypothetical illustrates the contradictory results that could take place under the Life Partners ruling. It also bolsters the assertion that the fourth prong of the Howey test also should be liberally interpreted to include pre-purchase efforts, in order to encompass unusual investments.

C. The Investor's Need for Information

The Howey decision underscored the importance of disclosing key information to investors prior to their commitment of funds. The federal securities acts reflect the belief that information is the most important form of investor protection. In SEC v. Ralston Purina Co., the Supreme Court remarked that "the design of these statutes is to protect investors by promoting full disclosure of information thought necessary to informed decisions." As Judge Wald remarked in her dissent:

[What the investor needs to know is . . . what the specific risk factors attached to the investment are and whether there is any reason why the investor should be leery of the promoter's promises. This need for information holds true in regard to investors prior to purchase as much as to investors who have committed their funds—indeed, more so,

339. See supra notes 37-52 and accompanying text.
340. See supra Part II.B.
342. Id. at 119; see supra notes 56-67 and accompanying text.
if they are to avoid over-risky investments.\footnote{Life Partners, 87 F.3d at 552 (Wald, J., dissenting).}

The Life Partners majority conceded that coverage of the LPI viatical settlements by the federal securities acts “might increase the quantity (and perhaps the quality) of information available to the investor prior to the closing.”\footnote{Id. at 547.} However, the court did not find this a sufficiently persuasive justification to compel LPI’s compliance with the federal securities acts.\footnote{Id. at 549.}

When applying the Howey test, courts have expressed an interest in protecting passive investors who are at an informational disadvantage “or who must rely on a promoter for some unique expertise.”\footnote{Id. at 554 (Wald, J., dissenting) (emphasis added).} In the case of the viatical settlements marketed by LPI, investors were at a distinct “informational disadvantage.” The information pertinent to the profitability of LPI’s viatical settlements was based upon knowledge and data that the average, or even sophisticated, investor would have had great difficulty in accessing or discovering through independent means.\footnote{See supra notes 324-31 and accompanying text for other cases where courts emphasized a promoter’s pre-purchase entrepreneurial efforts.}

For example, LPI’s investors relied on the expertise of the company’s reviewing physician in deciding whether to participate in the viatical settlement transaction.\footnote{Id. at 555 (Wald, J., dissenting) (emphasis added). See supra notes 324-31 and accompanying text for other cases where courts emphasized a promoter’s pre-purchase entrepreneurial efforts.} This physician based the crucial life expectancy estimates on factors including: T-cell count, incidence of opportunistic infection, platelet count, pulmonary studies, and advances in the treatment of AIDS.\footnote{Life Partners, 87 F.3d at 555-56 (Wald, J., dissenting).} Besides this scientific information, an investor had to rely upon LPI’s pre-purchase investigations for price valuations of insurance policies and LPI’s knowledge of insurance laws and laws affecting viatical settlements.\footnote{See id. for a more detailed explanation of the pre-purchase investigations LPI performed.} Clearly, the utilization of such information requires a level of education and training that most investors would not possess. Furthermore, in order for LPI’s potential investors to learn of its pre-purchase research concerning its viatical set-

\footnote{Id. at 555.}
tlements, they had to go to LPI’s office. By contrast, under federal securities regulations, LPI would have had to disclose to the SEC detailed information about its pre-purchase investigations through a registration statement and prospectus. This information would become public information and would enable investors to form an independent educated opinion about whether to invest in an LPI viatical settlement. In addition, such disclosure to the SEC would reduce the likelihood that promoters of viatical settlements could deceptively portray their assessments to the public.

D. Economic Realities Underlying LPI’s Pre-Purchase Entrepreneurial Efforts

The definition cases that followed Howey have underscored the idea that the “form [of an investment] should be disregarded for substance and the emphasis should be on economic reality.” The majority in Life Partners made “economic” observations as to why the viatical settlements at issue were not “securities.” As highlighted above, two economic reasons the majority used to reach its conclusion were: (1) the promoter’s fee represented the full extent of the value of the pre-purchase efforts; and (2) the profit realization by the investor depended entirely upon the death of the insured. However, these findings by the Life Partners majority did not acknowledge the nexus between the pre-purchase efforts by the promoter and the ultimate profit realization by the investor. The dissent’s better-reasoned interpretation of the economic realities underlying LPI’s viatical settlements suggests how LPI’s pre-purchase managerial efforts substantially affected the investor’s profit realization and should, therefore, have come within the purview of the securities laws.

The dissent carefully scrutinized the nexus between in-

351. Id. at 555 (Wald, J., dissenting).
352. See supra Part II.A.
353. See supra Part II.A.
354. It should be noted that no purchasers of LPI’s viatical settlements had filed complaints against the company. Life Partners, 87 F.3d at 539.
356. See supra Part IV.A.
357. Life Partners, 87 F.3d at 554-55 (Wald, J., dissenting).
358. Id. at 554-56.
vestment and profit realization in determining whether LPI's pre-purchase managerial efforts satisfied Howey's fourth prong.\(^{359}\) The majority stressed that it was the time of death of the patient that determined the level of investor profit.\(^{360}\) However, under Judge Wald's analysis, the true indicator of the profits realized by an investor stemmed from the diligence and accuracy of LPI in determining the life expectancies of the viators.\(^{361}\)

In its promotional materials, LPI highlighted its performance of a detailed assessment of the viator's medical condition.\(^{362}\) If the LPI examining physician grossly underestimated the viator's life span, the profit realization would be greatly diminished.\(^{363}\) For example, if the physician did not look at the availability of certain AIDS treatment drugs, which could increase the average life expectancy of the viators, then the investor would have to wait substantially longer to collect on his investment, thus decreasing the rate of return on the viatical settlement purchase. Another scenario could arise in which the LPI physician misinterpreted or intentionally misstated scientific data concerning the viator's medical condition.\(^{364}\) LPI's highly skilled pre-purchase research could have adversely affected the investors' profits.

The following hypothetical illustrates the economic consequences of LPI's pre-purchase managerial efforts.

Suppose that an investor has acquired a 3% fractional interest in the $100,000 life insurance policy of a terminally ill person (a $3,000 face value) for just $650 (disregarding any administrative fees).\(^{365}\) This investor hopes to reap the $3,000 payment within a time frame that lets the investor enjoy a high yearly rate of return. As in Life Partners, sup-

\(^{359}\) Id. at 551 (Wald, J., dissenting); see supra note 14.  
\(^{360}\) Id. at 548.  
\(^{361}\) Id. at 556 (Wald, J., dissenting); Life Partners, 912 F. Supp. at 8-9 (observing that pre-investment work by LPI was undeniably essential to the overall success of the investment).  
\(^{362}\) Life Partners, 87 F.3d at 555 (Wald, J., dissenting).  
\(^{363}\) Id. (Wald, J., dissenting).  
\(^{364}\) This negligence or misstatement by LPI, if conveyed in a prospectus, as required under section 5(a) of the 1933 Act, could become the basis for a Rule 10b-5 antifraud suit by the investors. See supra note 113; see also 17 C.F.R. § 240.10b-5 (1997).  
\(^{365}\) Life Partners, 87 F.3d at 539. The fractional interest purchase option was one of the unique options offered by LPI that distinguished it from other dealers in viatical settlements. Id.
pose the promoter selected patients whose life expectancy was determined to be twenty-four months or less. If the viators were to die within two years, as calculated by the examining physician, then the $3,000 (or $2,350 profit) would represent a 115% yearly rate of return on the investment, an earnings rate much higher than most aggressive stocks or mutual funds. If, through gross oversight during the promoter's pre-purchase efforts, the doctor overlooked the introduction of new AIDS treatment drugs in the assessment and the insured lived ten years longer than predicted, the same $2,350 profit twelve years from the investment would represent only a 13% yearly rate of return. Because the death of the insured is the point at which the investor receives his earnings, the underestimation in life expectancy prediction would lead to a significantly lower realized rate of return. Thus, this hypothetical illustrates that the economic realities underlying a promoter's pre-purchase efforts can support a finding that the fourth prong of the Howey test is met.

In sum, the foregoing analysis reveals that legal and economic support exists to bolster the idea that pre-purchase managerial efforts should be relevant to an analysis of whether the fourth prong of the Howey test is satisfied. As the court in Bailey v. J.W.K. Properties, Inc. underscored, a "broad consideration of all the surrounding circumstances" should be used in determining whether an investment scheme is a "security." Most importantly, the flexible approach advocated in Howey should be controlling in any investment contract analysis. The "time-line rule" established by the D.C. Circuit counters this notion of flexibility. This comment does not suggest that any kind of pre-purchase efforts would meet the fourth prong of Howey, just those efforts that satisfy the criteria proposed in the following section.

367. The yearly rate of return, \( r \), can be calculated by solving \( 650(1 + r)^t = 3000 \) (setting \( t \) equal to the number of years until the $3000 is paid).
368. See supra note 367.
369. 904 F.2d 918 (4th Cir. 1990).
370. Id. at 922.
371. See supra Part II.D.
372. See supra Part III.
V. Proposal

Prior to *Life Partners*, no case explicitly held that pre-purchase activities could not satisfy *Howey’s* fourth prong.\(^{373}\) Future courts should not embrace the “time-line rule” advocated by the *Life Partners* majority. This comment proposes a test that embraces the views of the SEC and of the dissent as expressed in *Life Partners*. According to the approach advocated by Judge Wald, pre-purchase managerial efforts can satisfy the fourth prong of the *Howey* test.\(^{374}\) Judge Wald proffered a test that would focus on the “kind and degree of dependence between the investors’ profits and the promoter’s activities.”\(^{375}\) Using this as a basis, this comment proposes the following approach to addressing the legal uncertainty surrounding the *Howey* test’s fourth prong. This liberal approach considers a variety of factors.

In order to trigger the application of this approach, two threshold matters must be ascertained with respect to the investment. First, as it is uncommon for a promoter’s efforts to come almost exclusively before the sale of the investment,\(^{376}\) this approach would apply only if the promoter’s entrepreneurial efforts take place primarily before the sale of the investment. Second, the investment must meet the first three elements of the *Howey* test: (1) a transaction or contract, (2) concerning the investment of money, (3) in a common enterprise.\(^{377}\)

Once these criteria are established, the third part of this approach emphasizes the quality and quantity of information that a promoter relies upon in trying to establish and market the investment opportunity. If the information is particularly specialized—that which even a sophisticated investor could not easily ascertain through diligent research—then it suggests a finding that the “pre-purchase efforts” should

\(^{373}\) *Life Partners*, 87 F.3d at 553 (Wald, J., dissenting); see also supra note 13.

\(^{374}\) Id. at 554-57.

\(^{375}\) Id. at 551.

\(^{376}\) Id. at 553.

\(^{377}\) This approach would only apply to those novel investments that fall into the “investment contract” category. As noted by the Supreme Court in *Landreth*, the application of the *Howey* test to traditional stocks and all other types of instruments would make the enumerated categories of section 2(1) of the 1933 Act superfluous. *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 692 (1985).
satisfy the fourth prong of the Howey test. This consideration stems from the concept, well established in securities law, that information is the best form of investor protection. Such specialized information would, therefore, be publicly disclosed by the promoters in accordance with the requirements of the 1933 Act.

The fourth part of this approach addresses the economic realities underlying the transaction at issue. The pre-purchase efforts must be significant and inextricably linked to the profit realization, incorporating the approach advocated by Judge Wald's dissent. The courts should examine the link between the investor's profits and the efforts by the promoter. The courts could consider whether there is a direct correlation between the pre-purchase efforts and profits or whether the profits stem from an independent variable—such as the price fluctuations in an independent commodities market.

As a final consideration, the courts must isolate the pre-purchase entrepreneurial efforts and ascertain whether these efforts, if taken after the investor committed his funds, would satisfy the fourth prong of the Howey test. An affirmative answer to this inquiry suggests a finding that the investment is a security. The hypothetical utilized in the previous section illustrated the inconsistent results that could ensue if the "time-line test" advocated by the Life Partners majority were adopted by other courts. Should a promoter's efforts satisfy the "efforts of others prong" were they to come after the purchase, then the same pre-sale efforts must meet the fourth prong of the Howey test.

This five part approach embraces the "totality of the circumstances" that courts may examine in determining whether certain unusual types of investments satisfy the fourth element of the Howey test. Of the five parts of the approach, courts should stress the type of information relied upon by the promoter because it can help determine whether

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378. See discussion supra Parts II.B, IV.C.
379. See discussion supra Part II.A.
380. See discussion supra Part IV.D. This element of my proposed test considers the economic reality underlying the transaction.
381. See Life Partners, 87 F.3d at 550-55 (Wald, J., dissenting).
382. See, e.g., Noa v. Key Futures, Inc., 638 F.2d 77 (9th Cir. 1980) (per curiam).
383. See supra Part IV.B.
the disclosure requirements compelled by the 1933 Act would favor the investor. The more specialized the information, the more an investor is at an "informational disadvantage." The greater the disadvantage, the more appropriate it would be to compel the promoters to comply with the disclosure requirements of the 1933 Act.

This approach would be useful in future litigation concerning investment contract analyses where there are overwhelming pre-purchase managerial efforts exerted by the promoter on behalf of the investment product. Viatical settlements are one such instance. The approach advocated in this comment is faithful to the Howey test's notion of flexibility in an increasingly complex financial world. This test could apply to other types of financial arrangements where the efforts of the promoter take place prior to purchase. Unlike the majority's opinion in Life Partners, this approach embraces the principles underlying the Howey test: flexibility, emphasis on economic reality, and the belief that disclosure is the best form of investor protection.

VI. CONCLUSION

This comment focused on the "definition of a security" as it applies to investment contracts. Although the test enunciated in the Howey decision remains the principal test for investment contract analysis, much uncertainty remains re-
garding how to interpret its elements. As to the fourth element, this comment has espoused the idea that pre-purchase, entrepreneurial efforts by the promoter of an investment scheme can satisfy this prong of the Howey test under the prescribed approach outlined above.

This comment used the recent decision in SEC v. Life Partners to analyze an unresolved issue with respect to the fourth prong of the Howey test. While the Life Partners case involved viatical settlements, the purpose of the comment was not to argue that viatical settlements are securities per se. Rather, this comment used the case of viatical settlements to expose an existing uncertainty about the fourth prong of the Howey test. The viatical settlements at issue in Life Partners represent a rare type of investment where significant efforts by the promoter take place prior to the sale. The Life Partners holding suggests that only the efforts of an investment promoter which take place after the sale of an investment can be considered in meeting this element. However, such a "time-line rule" undermines the flexible approach afforded by the seminal Howey decision.

As financial markets advance, new types of investment instruments and schemes will continue to develop. The profitability of some of these investments, like viatical settlements, may stem from a promoter's pre-purchase entrepreneurial efforts. Thus, the "time-line rule" espoused in Life Partners would preclude such investments from coverage under the federal securities acts, even though economic realities may dictate otherwise. Similarly, such a rigid test could be an inducement for fraud. Given the flexible approach advocated in Howey and in subsequent Supreme Court decisions, future courts should analyze pre-purchase managerial efforts using the advocated five part approach to determine if such efforts satisfy the fourth prong of the Howey test.

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391. 87 F.3d 536 (D.C. Cir. 1996).
392. Id.
393. Id. at 555 (Wald, J. dissenting).
394. See id. at 545-49.