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update

Supreme Court Interprets "Investment Contract" for Purposes of Federal Securities Laws

Introduction

On January 13, 2004, the United States Supreme Court held unanimously that an investment scheme that offered a fixed rather than a variable rate of return, could nonetheless be an "investment contract," and thus a "security," under Section 2(a)(1) of the Securities Act of 1933 ("Securities Act") and Section 3(a)(10) of the Securities Exchange Act of 1934 ("Exchange Act"), thereby subjecting it to those laws.[1] In reaching this conclusion, the Court noted that drawing a distinction between schemes promising fixed returns and those promising variable returns, would be inconsistent with the intent of the securities laws as well as established case law.

Background

The investment scheme in question involved defendant Charles E. Edwards, founder, chairman, chief executive officer, and sole shareholder of ETS Payphones, Inc. ("ETS"), and founder of Payphone Systems Acquisitions Inc. ("PSA"), a wholly owned subsidiary of ETS. Through these entities, Edwards offered the public an opportunity to purchase payphones.[2] ETS offered payphones in conjunction with a package that included a site lease, a five year leaseback and management agreement, and a buyback agreement. Investors would purchase a payphone from an independent distributor of ETS and PSA, and thereafter would lease the phone back to ETS for a fixed monthly fee, resulting in a 14% annual return. Under the lease agreements, ETS would be responsible for the day-to-day operation and management of the payphones, including choosing the site for the phone, installing the equipment, gathering the coin revenues, arranging for installation of long-distance service, and repairing and maintaining the phones. The investor had the ability to require ETS to purchase the phone at the end of the lease period or if, for any reason, the purchaser was not satisfied with the arrangement.

Despite assertions by ETS in its advertisements and marketing materials that it offered a profitable opportunity for investors, it consistently lost money on its payphone

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1 SEC v. Edwards, Slip Op. No. 02-1196 (Jan. 14, 2004).

2 ETS provided various management services to the owners of payphones such as advertising, maintenance, collection of coin revenue, and accounting, while PSA purchased the telephone equipment and locations and sold it to distributors who thereafter sold directly to the public. SEC v. ETS Payphones Inc., 300 F.3d 1281, 1282 (11th Cir. 2002).

operations. The payphones failed to generate sufficient revenue to cover ETS' operating expenses, and thus, ETS had continually to seek out new investors to meet its obligations. Ultimately, ETS and PSA filed a voluntary petition for bankruptcy, and consequently failed to continue making lease payments to telephone owners and honoring buyback guarantees.

Following the bankruptcy filing, the SEC filed suit, alleging that ETS sold securities in violation of the registration and anti-fraud provisions of federal securities laws. Specifically, it asserted that the business venture was, in fact, a "massive Ponzi scheme," and a violation of the registration requirements of Sections 5(a) and (c) of the Securities Act, the antifraud provisions of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder.

However, Edwards asserted that the sale and leaseback arrangement was not a "security" within the meaning of the federal securities laws, and therefore, not subject to those provisions. The District Court rejected this argument, finding that the arrangement was an "investment contract" and thus a security, warranting the issuance of an injunction to prevent Edwards from operating these investment schemes in violation of the federal securities laws in the future.[3]

On appeal, the Eleventh Circuit Court of Appeals reversed this decision.[4] In finding that Edwards' scheme was not an "investment contract," the court reasoned that the investors did not have "an expectation of profits derived solely from the efforts of others" as required by the Supreme Court's interpretation of the definition of "investment contract."[5] First, it asserted that "profits" refer only to either a participation in earnings of the enterprise or capital appreciation, and thus does not include schemes offering a fixed rate of return.[6]

The court noted that the lease payments made to owners of the payphones under this scheme could not be considered a participation in earnings because the owners would receive a fixed monthly sum regardless of the profits or losses of the company.[7] Thus, the earnings of the company were completely irrelevant. Second, the court concluded that even if the investors' returns were to be considered "profits," they were not "solely the result of the efforts of others," but rather, merely the result of the contractual provisions.

There were disputes over the level of control that investors retained over the telephone operations, but the court held that the determining factor was that the returns were guaranteed by the contract and thus were a result of contractual bargaining rather than the efforts of Edwards or any other ETS employees. Finding that the SEC failed to prove the existence of a "security," the court determined that the district court did not have subject matter jurisdiction under the federal securities laws and reversed the lower court's holding.

Supreme Court Decision

In holding that the promise of a fixed return does not preclude a scheme from being an investment contract,

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3 SEC v. ETS Payphones, Inc., 123 F. Supp 2d 1349 (N.D. Ga. 2000). The court also froze Edwards' assets in order to preserve secure assets should disgorgement be deemed appropriate.

4 SEC v. ETS Payphones, Inc. 300 F.3d 1281 (11th Cir. 2002).

5 In SEC v. W.J. Howey Co, 328 U.S. 293 (1946), the Court established this test for determining whether an investment scheme is an "investment contract" and thus a "security" for purposes of the federal securities laws. See infra notes 8-10 and accompanying text.

6 The Court relied on language from a prior Supreme Court case, United Housing Foundation v. Forman, which stated that "[b]y profits, the Court has meant either capital appreciation resulting from the development of the initial investment . . . or a participation in earnings resulting from the use of investors' funds." 421 U.S. 837, 852 (1975).

7 The court also summarily concluded that capital appreciation was not at issue in the case. ETS Payphones, Inc., 300 F.3d at 1285.

the Supreme Court reversed the decision of the Eleventh Circuit Court of Appeals and found Edwards' scheme to be within the purview of the federal securities laws. Beginning with a discussion of established case law interpreting the definition of "investment contract," the Court set out the test established in *Howey*.[8]

Rejecting the Eleventh Circuit's narrow interpretation of "profits," the Court noted that this term refers generally to "income or return" and may include dividends, other periodic payments, or the increased value of the investment. The Court clarified the language in *Howey* stating, "when we held that 'profits' must 'come solely from the efforts of others,' we were speaking of the profits that investors seek on their investment, not the profits of the scheme in which they invest."[9] Thus, the fact that the investors received a fixed monthly lease payment from the scheme and did not expect a profit based on earnings from the company, did not disqualify the scheme from being deemed a "security" for purposes of the federal securities laws.

In adopting a broader definition of "profits," the Court rejected Edwards' reliance on *United Housing Foundation Inc. v. Forman*, ("Forman")[10] which, he argued, limited the meaning of the term "profits" to either "capital appreciation resulting from the development of the initial investment" or "participation in earnings resulting from the use of investors' funds."[11] The Court held that rather than restricting the definition of "profits," *Forman* was merely providing two examples of instances where the Court had found investor interests to be "profits."[12] Further, the Court conceded that its decision in *Reves v. Ernst & Young*,[13] had incorrectly interpreted the language of *Forman* to be an exhaustive list, rather than merely an "illustrative description of prior decisions on 'profits.'"[14] The Court emphasized that this language was merely dictum and to adopt such an interpretation would frustrate Congress' intent to regulate all investments.[15]

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8 Edwards, Slip Op. at 4 (citing Howey, 328 U.S. at 301) *See supra*, text at note 5.

9 Id. at 5. Because the Court was not called upon to decide the issue, the Court did not further consider that courts have held that, at least in the context of pyramid schemes, return does not have to be "solely from the efforts of others." In SEC v. Glenn W. Turner Enterprises, the SEC successfully argued that the element of the Howey test requiring expectation of profits "solely from the efforts of others" was not to be read literally. The court stated that "the word 'solely' should not be read as a strict or literal limitation on the definition of an investment contract, but rather must be construed realistically, so as to include within the definition those schemes which involve in substance, if not form, securities." The court further noted that with a literal application of the Howey test, "it would be easy to evade [the securities laws] by adding a requirement that the buyer contribute a modicum of effort." 474 F.2d 476, 482, *cert. denied*, 414 U.S. 821 (1973). Other courts have followed this precedent, see e.g., Steinhardt Group v. Citicorp, 126 F.3d 144, 152-53 (3d Cir. 1997); SEC v. Aqua-Sonic Products Corp., 687 F.2d 577, 582 (2d. Cir. 1982), *cert denied sub nom*., Hecht v. SEC, 459 U.S. 1086 (1982); SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 480-83 (5th Cir. 1974), but the Supreme Court has never ruled on the issue. See Forman, 421 U.S. at 852 n.16. In Forman, the Court cited the language of the Ninth Circuit's decision in Glenn W. Turner regarding the interpretation of the term "solely," but noted that because the issue of the interpretation of "solely" was not at issue in the case, it would "express no view . . . as to [that] holding."

10 421 U.S. 837 (1975).

11 Id. at 852-53.

12 Edwards, Slip Op. at 6 (noting that the examples were provided in order to illustrate the difference between investment contracts where the 'investor is attracted solely by the prospects of a return' on the investment and housing cooperative shares, where the investor 'is motivated by a desire to use or consume the item purchased) (quoting Forman, 421 U.S. at 852).

13 494 U.S. 56 (1990).

14 Edwards, Slip Op. at 7. Reves involved a question of whether a particular investment was a "note" and thus a "security" under the federal securities laws. In a footnote, the Court stated that it would not adopt the "more restrictive" definition of "profit" advanced by the Forman Court for determining whether a scheme was an "investment contract." It stated that while Forman established that "profit" under the Howey test meant "either 'capital appreciation' or 'a participation in earnings,'" the Howey test was irrelevant to the issue before the court and thus such a restrictive definition need not be used.

15 Edwards, Slip Op. at 7.

Further, the Court stressed that to distinguish between fixed returns and variable returns would be contrary to the purpose behind the securities laws.[16] It noted that in either type of scheme, the investor is lured to promises of investment income. Alluding to an even greater need to regulate schemes with fixed returns, the Court agreed with the SEC that investments offering a guaranteed fixed return often attract less sophisticated and older investors, who are more susceptible to investment fraud.[17] In addition, the Court noted that omitting these schemes from the definition of investment income would create an opening for "unscrupulous marketers" of investments to circumvent the securities laws by merely offering a fixed rate of return.

Finally, the Court noted that this interpretation of "investment contract" is consistent with the established case law and SEC authority. Adopting the position argued by the SEC, the Court stressed that the blue sky law cases which provided the basis for the *Howey* decision[18] made no distinction between fixed and variable rates of return, nor did the decisions subsequent to *Howey*. In addition, the Court pointed out that the SEC has consistently maintained that schemes offering a fixed rate of return are within the definition of investment contract.

In sum, the Court held that an investment scheme that offers a fixed rate of return can be an "investment contract" and therefore a security subject to the federal securities laws. To hold otherwise, the Court determined, would be inconsistent with the purposes of the securities laws and established case law.

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16 Id. at 3 (noting that Congress enacted a broad definition of "security" in order to protect investors by "regulat[ing] investments, in whatever form they are made and by whatever name they are called") (citing Reves v. Ernst & Young, 494 U.S. 56, 61 (1990)).

17 The brief filed by the SEC argued that purchasers of fixed-return investments need the protections of the securities laws just as much, if not more, than purchasers of variable return investments, and noted that often those who perpetrate fraudulent schemes, promise fixed or guaranteed returns. Brief of the SEC, SEC v. Edwards, No. 02-1196 at *20 (June 26, 2003).

18 The Court explained that when Congress included the term "investment contract" in the definition of security, it had taken the term from state court cases interpreting their blue sky laws. Id. at 4. The Court further noted that two of the blue sky law cases that the Howey Court used in devising its test involved investment contracts in which a fixed return was promised.