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Le Chateau Royal Corp. v. Pantaleo, 370 So. 2d 1155 (Fla. 4th Dist. Ct. App. 1979)

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Securities Regulation—INVESTMENT CONTRACT—COMMON ENTERPRISE—MORE THAN A SINGLE INVESTOR IS REQUIRED FOR A CONTRACT TO BE AN INVESTMENT CONTRACT CONSTITUTING A SECURITY—*Le Chateau Royal Corp. v. Pantaleo,* 370 So. 2d 1155 (Fla. 4th Dist. Ct. App. 1979).

In *Le Chateau Royal Corp. v. Pantaleo,*[1] Emil Pantaleo agreed to purchase three condominium units from Le Chateau Royal Corporation. The sales director orally assured Mr. Pantaleo that the three units would be resold, for a mutual profit, prior to the closing date. Relying on this promise, Mr. Pantaleo signed the three sales contracts and paid a total deposit of $24,700; he did not apply for a mortgage to finance the remaining purchase price. When the three units were not resold prior to the closing date, Mr. Pantaleo refused to close and filed suit to recover his deposits.[2] He claimed the right to rescind the contracts on the ground that they were investment contracts and thus constituted unregistered securities sold in violation of the Florida Sale of Securities Act.[3]

The trial court ruled in Mr. Pantaleo's favor.[4] The Fourth District Court of Appeal reversed holding that more than a single investor is required for a contract to be an investment contract constituting a security.[5] In so holding, the court reaffirmed its earlier decision in *Brown v. Rairigh.*[6]

In *Rairigh,* the defendant, Roger Brown, was a New York public relations executive whose avocation was to breed, raise, and race horses at the Pompano, Florida, harness racing track.[7] On February 28, 1974, Brown sold to a friend, William Rairigh, a ten percent interest in five race horses for $11,675, with the stipulation that Rairigh was entitled to ten percent of the winnings, if any, and was obligated to pay ten percent of all bills and stake fees. The agreement further provided that if Rairigh was dissatisfied with the horses' performance, he could resell his interest to Brown prior to January 1, 1975.[8] The horses failed to perform satisfactorily, and, in fact, performed rather miserably, so Rairigh demanded the return of his money. However, he failed to do so before the agreed cutoff

1. 370 So. 2d 1155 (Fla. 4th Dist. Ct. App. 1979) (reversed and remanded for consideration of other issues).
2. *Id.* at 1156.
3. *Id.* at 1157; FLA. STAT. § 517.211(1) (1979) provides that the purchaser of an unregistered security has the right to rescind the transaction upon the tender of the security sold to the person making the sale.
4. 370 So. 2d at 1157.
5. *Id.*
6. 363 So. 2d 590 (Fla. 4th Dist. Ct. App. 1978).
7. *Id.* at 591.
8. *Id.*

date, and Brown accordingly refused to make any refund. Rairigh sued Brown, demanding the return of his original investment on the ground that he had been sold an unregistered security in violation of the Florida Sale of Securities Act.[9] The Fourth District Court of Appeal reversed the trial court's judgment for Rairigh, holding that the definition of an investment contract as a security required more than a single investor.[10]

After the banking panic of 1907, many states passed laws to protect investors from unscrupulous promoters.[11] These Blue Sky Laws, as they have come to be known,[12] required that securities be registered with the state.[13] Contracts involving unregistered securities are automatically rescinded.[14] No proof of fraud or misrepresentation is required.[15]

After the stock market experience of 1929, both Congress and Florida jumped on the Blue Sky Law bandwagon.[16] Florida's Sale of Securities Act, adopted in 1931, is a typical Blue Sky Law.[17] It conforms almost perfectly with the Federal Securities Act of 1933[18] and the Securities Exchange Act of 1934.[19] The Florida acts extended the definition of "security" by inclusion of such general terms as "evidence of indebtedness, . . . investment contract, . . . and interests in . . . a profit-sharing or participation agreement."[20] It remained for the courts, however, to define those general terms. This note will concentrate on the development of the judicial definition of the term "investment contract."

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9. *Id.* at 591-92.

10. *Id.* at 593.

11. *See* Note, *State Securities Regulation: Investor Protection Versus Freedom of the Marketplace*, 29 U. FLA. L. REV. 947, 947 n.2 (1977).

12. The phrase has been attributed to the opinion in Hall v. Geiger-Jones Co., 242 U.S. 539, 550 (1917), which referred to "speculative schemes which have no more basis than so many feet of 'blue sky.'" *Geiger-Jones* was the first case in which the United States Supreme Court upheld the constitutional validity of a state Blue Sky Law.

13. *See, e.g.*, FLA. STAT. § 517.07 (1979). It should be noted that certain kinds of security transactions are exempt from the registration requirement. *Id.*

14. *See, e.g.*, FLA. STAT. § 517.211(1) (1979).

15. *See* Note, *supra* note 11. The Florida Sale of Securities Act also contains anti-fraud provisions which are available to investors regardless of whether or not the securities they have purchased are required to be registered. *Id.* at 956-57. *See also* FLA. STAT. § 517.301 (1979).

16. *See* Note, *supra* note 11.

17. Ch. 14899, 1931 Fla. Laws 797 (current version at FLA. STAT. § 517 (1979)).

18. 15 U.S.C. § 77a (1976).

19. 15 U.S.C. § 78a (1976).

20. FLA. STAT. § 517.021(15) (1979). The definition of "security" as including an "investment contract" was incorporated into the Uniform Sale of Securities Act, which Florida enacted in 1931. Ch. 14899, 1931 Fla. Laws 797. Section 517.021(15), Florida Statutes (1979) also lists specific items as securities: notes, stocks, treasury stocks, bonds, debentures, certificates of interest in oil, gas, petroleum, mineral or mining leases. *See also* 15 U.S.C. § 77b(1) (1976).

The Minnesota Supreme Court was the first to address the meaning of the term "investment contract" and to justify its inclusion in the definition of a security. In *State v. Gopher Tire and Rubber Co.*, the court held that the use of a general term furthered the legislative intent of protecting the public from various "'get-rich-quick' schemes calculated to despoil credulous individuals of their savings."[21] Therefore, the court refused "to lay down a hard and fast" formula to determine whether a particular transaction was an investment contract subject to security regulation.[22] The *Gopher* decision relied on the United States Supreme Court holding in *Hall v. Geiger-Jones Co.*, that the legislative intent of the Blue Sky Laws was to "prevent deception and save credulity and ignorance from imposition."[23]

Until 1946, the term "investment contract" continued to be defined on an ad hoc basis. However, in *SEC v. Howey Co.*,[24] the United States Supreme Court synthesized a definition of investment contracts which has come to be called the "*Howey* test." Although the Court intended the definition to be a general guideline, adaptable to a wide variety of circumstances,[25] it has come to be rigidly applied.

As divided into its constituent elements, the test finds an "investment contract" in any scheme in which there is (1) an investment of money (2) in a common enterprise (3) with the expectation that profits will be derived solely from the efforts of the promoter or third parties.[26] The first element has rarely been an issue. Most courts applying the test have relied upon an examination of the facts strictly with regard to the third element. Thus, traditionally, under the *Howey* test, the dispositive issue as to whether a transaction is an investment contract subject to securities regulations has been the extent of the investor's involvement in generating profit.[27] This devolves upon determinations of fact.[28]

For example, the assignment of a fractional, undivided interest in

21. 177 N.W. 937, 938 (Minn. 1920).

22. *Id.* at 938.

23. 242 U.S. 539, 551 (1917).

24. 328 U.S. 293 (1946).

25. *Id.* at 299.

26. *Id.* It must be emphasized that the Court itself did not separate the definition into these three elements. Professor Loss, 1 L. Loss, SECURITIES REGULATION 491 (2d ed. 1961), seems to get credit for the innovation.

27. *See, e.g.*, Berman v. Orimex Trading, Inc., 291 F. Supp. 701 (S.D.N.Y. 1968); Maheu v. Reynolds & Co., 282 F. Supp. 423 (S.D.N.Y. 1967). *But see* Local 705, Int'l Bhd. of Teamsters v. Daniel, 439 U.S. 551 (1979) (noncontributory, compulsory pension plans are not investment contracts because there is no investment of money and no expectation of profits from efforts of others).

28. *Howey*, 328 U.S. at 300.

an oil lease was held not to be an investment contract because the investors (assignees) were not relying solely on the assignors' efforts for a return of their investment.[29] The investors controlled operations to the extent of discharging one of the defendant assignors when they became dissatisfied with his management of the property.[30]

On the other hand, distributor agreements wherein investors gave money to the corporation in exchange for merchandise which would really be sold by company salesmen were held to be investment contracts since the investing "distributors" expected profits solely from the efforts of others.[31]

In both *Rairigh* and *Le Chateau,* the Florida Fourth District Court of Appeal found that the investors expected a return solely from the efforts of others. That finding would traditionally have sufficed for the finding of an "investment contract" within the definition of a security.[32] Recently, however, courts have begun to expand upon the second element of the *Howey* test requiring a "common enterprise." There are two schools of thought as to what constitutes a common enterprise. One emphasizes the economic interest between the promoter and the investor and is called the vertical approach.[33] The other emphasizes the economic interest among the investors and is called the horizontal approach.[34]

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29. Woodward v. Wright, 266 F.2d 108, 114 (10th Cir. 1959).

30. *Id.*

31. United States v. Herr, 338 F.2d 607 (7th Cir. 1964), *cert. denied,* 382 U.S. 999 (1966).

32. *See, e.g.,* Berman v. Orimex Trading, Inc., 291 F. Supp. 701 (S.D.N.Y. 1968); Maheu v. Reynolds & Co., 282 F. Supp. 423 (S.D.N.Y. 1967).

33. *See* SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476 (9th Cir.), *cert. denied,* 414 U.S. 821 (1973); Los Angeles Trust Deed & Mortgage Exch. v. SEC, 285 F.2d 162 (9th Cir. 1960), *cert. denied,* 366 U.S. 919 (1961). The Ninth Circuit has insisted that a common enterprise "is one in which the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties." *Turner Enterprises* at 482 n.7. For a comprehensive discussion of the horizontal and vertical approaches to defining common enterprise see Moreno, *Discretionary Accounts,* 32 U. MIAMI L. REV. 401 (1978). *See also* SEC v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974); SEC v. Koscot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974). The Fifth Circuit expressly accepted the Ninth Circuit's definition in *Continental.*

34. Milnarik v. M-S Commodities, Inc., 457 F.2d 274 (7th Cir.), *cert. denied,* 409 U.S. 887 (1972), was the first case to find that a transaction was not an investment contract on the ground that there was no common enterprise. In *Milnarik,* the court used the horizontal approach. The court held that the individual investor's discretionary commodity futures trading account was not an investment contract subject to securities regulations because there was no pooling of funds provided by several investors which was traded uniformly by the broker for a common purpose. *Id.* at 278. The court emphasized that the investor-broker relationship was more analogous to principal-agent than to investor-promoter. *Id.* at 277. *See also* Blacker v. Shearson Haydon Stone, Inc., 358 So. 2d 1147 (Fla. 3d Dist. Ct. App. 1978). The facts of *Blacker* so closely parallel the facts in *Milnarik,* that the court simply quoted and adopted the *Milnarik* opinion. It is possible that under a different set of facts the court would use the Fifth Circuit's vertical approach.

In *Rairigh,* the Fourth District Court of Appeal held that under either the horizontal or vertical approach, more than a single investor was required to constitute a common enterprise.[35] This may be true under the horizontal approach, but it does not logically follow from the vertical approach. The incapacity of the vertical approach to necessarily imply that more than a single investor is required for the "common enterprise" in an "investment contract" can be seen by examining the primary cases upon which the vertical approach is based.

In *SEC v. Koscot Interplanetary, Inc.*[36] a large number of investors were involved in a pyramid sales scheme. Basically, the investors not only earned money from marketing the product (cosmetics), they also earned money for recruiting other investors. The recruitment aspect of the enterprise was challenged as an investment contract. The Fifth Circuit held that the recruitment efforts of the investors were "nominal" and thus did not defeat the requirement that expected profits be generated solely by the efforts of others.[37] The investor's role was merely to get potential investors to attend sales meetings organized and controlled by the company. The court also held that the scheme involved a common enterprise. The court adopted the vertical approach, stating, "[t]he critical factor is not the similitude or coincidence of investor input, but rather the uniformity of impact of the promoter's efforts."[38]

A month later, in *SEC v. Continental Commodities Corp.*[39] the Fifth Circuit repeated that statement in finding that trading in discretionary commodities accounts fell within the definition of a security. In *Continental,* the broker gave individual advise to each investor. The investments were not pooled. The court, nevertheless, held that since each investor depended on the promoter's expertise there was a common enterprise.[40] The court stated, "the critical inquiry is confined to whether the fortuity of the investments collectively is essentially dependent upon promoter expertise."[41]

In *Rairigh,* the Florida court relied on that language to conclude that more than a single investor was required for a common enterprise.[42] It was not the first court to do so.

In *Sunshine Kitchens v. Alanthus Corp.,* the United States Dis-

35. 363 So. 2d at 593.
36. 497 F.2d 473 (5th Cir. 1974).
37. *Id.* at 485.
38. *Id.* at 478.
39. 497 F.2d 516 (5th Cir. 1974).
40. *Id.*
41. *Id.* at 522. The court expressly rejected the horizontal approach used in Milnarik v. M-S Commodities, Inc., 457 F.2d 274 (7th Cir.), *cert. denied,* 409 U.S. 887 (1972).
42. 363 So. 2d at 593.

trict Court for the Southern District of Florida refused to find a computer-lease agreement to be a security, stating that the common enterprise element formulated in *Koscot* requires that there be more than a single investor involved.[43] In *Sunshine,* however, the plaintiff failed two elements of the *Howey* test. Sunshine purchased computers from defendant Alanthus Corporation and leased the computers back to Alanthus. Sunshine's motive, as stated in the complaint, was to reap the benefits of a tax shelter during the term of the lease and to realize a return on their investment when the computers were sold in the future.[44] The court held that tax benefits are not profits and that Sunshine was depending more on its own accounting procedures than on Alanthus's expertise.[45] As to the common enterprise prong of the *Howey* test, the court used an analogy to a wheel: the several spokes (investors) do not have to be connected with each other, only with the hub (promoter), "but this does not mean that a common enterprise may exist with a hub and only one spoke . . . ."[46]

The *Rairigh* and *Sunshine* decisions are to be contrasted with *Huberman v. Denny's Restaurants, Inc.,* in which the United States District Court for the Southern District of California held that it was "immaterial" that only a single investor was involved.[47] The court defined common enterprise as "a common interest in the success of the venture" shared by the investor and promoter.[48]

More recently, the United States District Court for the Southern District of New York, in *Troyer v. Karcagi,*[49] accepted *Huberman* and interpreted the *Koscot* and *Continental* decisions as implying "that a link between any single investor and the promoter is sufficient to satisfy the common enterprise element of the *Howey* test."[50]

In *Rairigh,* however, the Florida court rejected the *Huberman* definition, stating that it went "too far" and left the *Howey* test without meaning.[51] In propounding this statement, the *Rairigh* court is implying that, under *Huberman,* a single investor is sufficient for finding an "investment contract".[52] On the contrary, the *Huberman* rationale merely says that a single investor is sufficient

43. 403 F. Supp. 719 (S.D. Fla. 1975).
44. *Id.* at 720.
45. *Id.* at 722.
46. *Id.* Although the *Rairigh* court didn't cite *Sunshine,* appellant relied heavily upon it in his brief.
47. 337 F. Supp. 1249, 1251 (S.D. Cal. 1972).
48. *Id.*
49. [1979] FED. SEC. L. REP. (CCH) ¶ 96,929 (S.D.N.Y. July 11, 1979).
50. *Id.* at n.7.
51. 363 So. 2d at 593.
52. *Id.*

for finding a "common enterprise", but that there remain two other important elements of the test which must be satisfied in order to find an "investment contract."[53]

Perhaps the *Rairigh* court meant to say that if a single investor is sufficient for finding a "common enterprise" then "the [common enterprise element] set forth in the *Howey* test is meaningless."[54] The term "common enterprise" appeared for the first time in the definition of an "investment contract" in the *Howey* decision itself.[55] The *Howey* Court expressed approval for its definition because "It 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."[56] Surely the *Howey* Court did not believe that a single investor was any less susceptible to such "countless and variable schemes" than, for example, two investors. The *Howey* Court could not intend, by inserting the phrase "common enterprise" into the definition of an investment contract, to leave single investors without the protection of the Blue Sky Laws. Yet, that is precisely the result of the *Rairigh* and *Le Chateau* decisions. The result is manifestly inconsistent with the Supreme Court's express admonition in *Howey* that "the statutory policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae."[57]

The *Rairigh* court cannot be faulted for performing a rather strict mechanical application of the *Howey* test; most courts which have used it have done likewise. Ultimately, however, the application of the *Howey* test must conform to the legislative purposes behind the Blue Sky Laws. The United States Supreme Court held that "the law is a regulation of business, constrains conduct only to that end, the purpose being to protect the public against the imposition of unsubstantial schemes and the securities based upon them."[58]

The problem, of course, is determining which schemes are "unsubstantial." Implicit in cases such as *Rairigh* and *Le Chateau,* is the policy issue concerning the extent to which the courts should protect investors from possible fraud while protecting promoters from the high initial costs of compliance with security registration

53. 337 F. Supp. at 1251.

54. 363 So. 2d at 593.

55. An excellent analysis has been performed by Professor Joseph Long on the federal and state opinions which *Howey* relied upon in the formulation of its decision. Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation,* 24 OKLA. L. REV. 135 (1971).

56. 328 U.S. at 299.

57. 328 U.S. at 301.

58. Hall v. Geiger-Jones Co., 242 U.S. 539, 550 (1917).

requirements.[59] The Florida Sale of Securities Act, however, provides statutorily for a number of exemptions from the registration requirement.[60] Thus, in resolving this policy issue the court should more appropriately determine whether the scheme fits into one of the statutory exemptions. The issue should not be arbitrarily resolved by assuming that schemes which attract single investors are not large enough to warrant the cost of compliance with the law. The *Le Chateau* decision opens the door for unfair condominium sales practices.[61] The same inducement which was offered to Mr. Pantaleo to make him part with his money might now be offered to other unwary individuals.

There is no valid reason for deciding to protect only "those hapless capitalists who are not alone in their misfortune."[62] Indeed, the use of this arbitrary criterion does not really even simplify the problem of determining whether a transaction is an investment contract subject to security regulation. What would happen, for example, if the developer in *Le Chateau* sold options to purchase condominium units to two different investors and was able to prove that there was no pooling of funds for a common purpose? Would the Fourth District Court of Appeal find a "common enterprise" and therefore an "investment contract" under the vertical approach, now that there was more than a single investor involved? Or would the court refuse to find a "common enterprise" and thus no "investment contract" since the investors' funds were not pooled for a common purpose, as required by the horizontal approach?

Under the *Rairigh* and *Le Chateau* decisions investors are left uncertain about the extent of the law's requirements. Such uncertainty is not good for the economy. It encourages neither entrepenurial inventiveness nor intelligent risk-taking.

The courts of Florida should be encouraging promoters to conform to the statutory duties of fairness and disclosure rather than encouraging them to avoid these duties by developing investment schemes which attract only an isolated, uninformed, and unprotected investor.

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59. *See, e.g.*, FLA. STAT. §§ 517.081(6), .12(10), .12(5), .131, .141 (1979) which provide for registration fees, bonds, and deposits.

60. FLA. STAT. § 517.061 (1979).

61. *But see*, FLA. STAT. § 718.504 (1979), which provides remedies and protections for condominium purchasers.

62. Marshall v. Lamson Bros., 368 F. Supp. 486, 489 (S.D. Iowa 1974) (holding that discretionary commodity trading account meets the common enterprise test even without a pooling of funds).