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Promoters Beware

Life Settlements may be securities, even if only one investor is involved - despite the recently reported Zang decision

There have been a few short articles written about a September 27, 2010, decision by a federal Magistrate Judge in the United States District Court, Northern District Illinois, Eastern Illinois.¹

The conclusion reached in the decision has been described as “Life Settlements are Not Securities When Only a Single Investor is Involved.”²

However, we should limit our enthusiasm for the ruling until additional courts have had the opportunity to adjudicate similar issues with fact patterns not as unusual as those set forth in Zang.

First, a decision by a Magistrate Judge is not precedent for any future cases.

Secondly, even assuming the Magistrate Judge is correct in his conclusion that the Seventh Circuit requires horizontal commonality under its application of the *Howey* test³, that is a demonstrated minority view (*i.e.*, most Federal Circuits have determined that the *Howey* common enterprise test may be satisfied by *either* horizontal or vertical commonality, see discussion below).

Moreover, under the Blue Sky laws of various states,⁴ a life settlement contract and/or a life settlement contract investment are included in the definition of a “security” regardless of the analysis under the *Howey* test.

Facts

In broad brush, below are the facts of the Zang case as recited by the Magistrate Judge. Zang, a Michigan resident, wanted to buy a few Midwest businesses. Defendant agreed to help Zang identify potential targets and arrange financing for the acquisitions. Zang paid defendant approximately \$37,500 for that purpose (a \$5,000 deposit and the balance as down payments for the acquisition of the two target companies). No acquisition or financing was ever completed, and Zang demanded his money back. Defendant refused, and subsequently, Zang sued.

So where is the life settlement you may well ask? The financing proposal, and it never amounted to anything more than just a proposal, involved acquiring life settlement policies and/or certain death benefits

under life settlement policies, pairing them with surety bonds for the policies to ensure maturity of such policies at seven years [from the date of purchase], and then use of the policies/bonds as collateral for loans, the proceeds of which would be used to acquire target companies. Zang argued that because life settlements were to be acquired (which were never actually acquired) as part of the collateral (no money was ever borrowed) that there was a violation of Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934.⁵ The eight enumerated “material” misrepresentations in the Second Amended Complaint that were the basis of Zang’s Rule 10b-5 claim were wholly unrelated to the life settlements part of the proposed purchase of companies/financing.

Defendant filed a [FRCP] Rule 12(b)(6) motion to dismiss the federal Rule 10b-5 claim and also asserted that there was no subject matter jurisdiction in federal court because Zang’s pendant state law claims did not meet the minimum jurisdictional amount requirement. Defendant lost on this issue, and the several state law claims survived. [Since the September 27, 2010, Memorandum and Order, a new attorney has filed an appearance for Plaintiff, and Defendant has filed a motion for summary judgment.]

The Rule 10b-5 claim was dismissed on the grounds that Zang had not sufficiently plead the required scienter [intent] element for a Rule 10b-5 claim. Because of that, there was no reason for the Magistrate Judge to reach the *Howey* “commonality” issue and also dismiss the Rule 10b-5 claim on those grounds as well. The Magistrate Judge did not reach another basis defendant asserted for dismissal, namely that Zang failed to satisfy the heightened pleading requirements of the Private Securities Litigation Reform Act of 1995 (“PSLRA”).⁶

The Magistrate Judge did conclude, however, that the Rule 10b-5 claim also failed because the common enterprise prong of *Howey* was not satisfied.

Law and Analysis

The *Howey* test is used by courts to define the term “investment contract,” a specific term included in the Section 3(a)(10) definition of a “security” under the Securities Exchange Act of 1934.⁷ The *Howey* test

provides that an investment contract is an agreement which involves: (1) an investment of money; (2) in a common enterprise; and (3) with an expectation of profit produced solely by the efforts of others.

Elements of the *Howey* test have been refined in later decisions. For example, various courts have employed any one or combination of the following tests to determine the presence of the second element or prong: “common enterprise” or “commonality:”

- **Horizontal Commonality:** This concept focuses on the relationship among investors and requires a pooling of investors’ contributions and distribution of profits and losses on a pro-rata basis among investors.⁸
- **Vertical Commonality:** This concept focuses on the relationship between an investor and the promoter and requires the mutual dependence of the fortunes of the investor and the promoter. “Vertical commonality” requires the fortunes of the investor to be “interwoven with and dependent on the efforts and success of those seeking the investment or of third parties.”⁹ “Vertical commonality” places emphasis on the relationship between the investors and the promoter, not on the relationship among the investors.¹⁰
- **Broad Vertical Commonality:** This concept focuses on the relationship between an investor and the promoter and requires the investor’s dependence on the promoter’s expertise. Courts adhering to this view consider whether the investor’s realization of profits is inextricably tied to the promoter’s effectiveness and skill. To establish “broad vertical commonality,” the fortunes of the investors need be linked only to the efforts of the promoter.¹¹
- **Strict Vertical Commonality:** “Strict vertical commonality” requires that the success of investors be tied to the success of the promoter (For example, where the promoter’s compensation is measured as a percentage of the profits realized by the investor).¹²

The Defendant in *Zang* argued that neither the second nor third prongs (*i.e.*, commonality and profits solely from the efforts of others) were satisfied. The Magistrate Judge did not rule on the third prong because he concluded, based on Seventh Circuit precedent (dating back no more recently than 1972, and which he readily acknowledged was not the law in the Ninth and Fifth Circuits), that horizontal commonality (*i.e.*, multiple investors) was required and, since there were no common investors (the life insurance policies were to be neither fractionalized nor pooled), the commonality prong of *Howey* was not satisfied.

Assuming this is a correct reading of Seventh Circuit law, it is most certainly a minority view in the other federal Circuits and under the laws of most states that have adopted the *Howey* test, or some form of the *Howey* test by statute or case law.

For example, Illinois’ securities statutes, 815 Ill. Comp. Stat. § 5 et seq., known as the Illinois Securities Law of 1953 (the “IL Securities Act”), defines in Section 2.1 thereof a security to include an “investment contract.” The Illinois Securities Department has consistently taken the position that investments in viatical settlements are investment contracts under the IL Securities Act.¹³ However, the facts in each of the above administrative proceedings are not described in any detail, and in those administrative matters there is no discussion as to why a particular instrument labeled as a “Viatical Settlement Contract” is a security under the IL Securities Act. *Chen*, for example, involved the issuance of certificates which the issuer claimed were backed by life insurance policies insured by a state fund. Those claims were patently false, so *Chen* was simply a “garden variety” securities fraud action. *Golden Years Planning* involved the offer and sale of viatical settlement contracts whereby, in one instance, the investor invested \$10,000 and was to receive a payment of \$20,000 in two years and in another the investor invested \$21,000 and was to receive a 12 percent return on the investment in three years. The Administrative Order of Prohibition and Fine does not provide sufficient details to

determine whether the underlying life insurance policies were fractionalized or whether an investor was issued a note secured by, or an undivided interest in, a pool of life insurance policies. Most importantly, the three administrative orders involved fraudulent schemes and were not situations where a contested issue decided in the case was whether the instrument offered was a security under the IL Securities Act.

We have not discovered any other Illinois authority that analyzes whether the offer and sale of an in-force, non-variable life insurance policy to an Illinois investor involves the offer and sale of a security for purposes of the IL Securities Act. However, the most recent (2002) reported litigated Illinois case involving application of the *Howey* test is *Integrated Research Services, Inc. v. Ill. Secretary of State, Securities Department*, where an Illinois court applied the *Howey* test to determine that the particular investment under review was an “investment contract” under the IL Securities Act. The investment at issue was a discretionary commodity trading account in foreign currencies with the promoter controlling and managing the investment account and being paid a fee calculated as 20 percent of the trading profits over time. The court found that an investment contract was “a contract, transaction or scheme whereby a person (1) invests money (2) in a common enterprise (3) with profits to come solely from the efforts of others.”¹⁴ The court stated that in Illinois, “to satisfy the common enterprise requirement, an investment must have either horizontal or vertical commonality.”¹⁵ In the *Integrated Research* case, the court focused on the vertical commonality analysis for the *Howey* test’s common enterprise prong and concluded that since the promoter’s compensation, post-sale, was a percentage of the return on the investor’s account, vertical commonality was present (*i.e.*, the promoter’s return on the transaction was intertwined with the investor’s return on the investment). The court did not discuss horizontal commonality in the context of the facts in this case, although it was clear from the facts of the case that investor accounts were segregated and not comingled and that there were separate and distinct

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currency trades with respect to each investor. The third prong of the *Howey* test was easily satisfied because the promoter managed the account, not the investor, post-sale.

Based on this case, we can conclude that it is more probable than not that had Zang included a count under the IL Securities Act, the Magistrate Judge, applying Illinois law, could have concluded for the purposes of a Rule 12(b)(6) motion, that vertical commonality was present and that Defendant's motion to dismiss an Illinois state law securities fraud claim should be denied on this basis.

We also can conclude that had Zang, a Michigan resident, included a count for securities fraud under Michigan's Blue Sky statute, he also would have survived a motion to dismiss because Michigan expressly includes within its definition of a security "an investment in a viatical or life settlement agreement."¹⁶ Michigan also states that "the term 'security' involves an investment in a common enterprise with the expectation of profits to be derived primarily from a person other than the investor. As used in this paragraph, a 'common enterprise' means an enterprise in which the fortunes of the investor are interwoven with those of either the person offering the investment, a third party or other investors."¹⁷

Conclusion

The Zang decision is an unusual aberration. The facts are "strange," to say the least, the decision is not a reported decision and, therefore, of no precedential value, the case could have been similarly decided on alternative grounds, and if brought in a federal court in jurisdiction other than the Seventh Circuit, or in Illinois or Michigan state courts under either of those states' Blue Sky laws, the decision would likely have resulted in a very different outcome.

Endnotes

- 1 *Zang v. Alliance Financial Services of Illinois, Ltd., et al.*, 2010 WL 38423660 (N.D. Ill. 2010).
- 2 *Life and Health National Underwriter, Insurance News* October 19, 2010.
- 3 *S.E.C. v W.J. Howey Co.*, 328 US 293 (1946).
- 4 Brian T. Casey & Thomas D. Sherman, State Broker-Dealer Registration Pitfalls for Life Settlement Brokers, 41 *The Review of Securities & Commodities Regulation* 147, (2008).
- 5 15 U.S.C. § 78j(b) (2010); 17 C.F.R. § 240.10b-5 (2010).
- 6 15 USC § 78u-4 (2010).
- 7 15 USC §§ 77b and 78c (2010).
- 8 See e.g., *Stenger v. R.H. Love Galleries*, 741 F.2d 144 (7th Cir. 1984); *Newmyer v. Philatelic Leasing, Ltd.*, 888 F.2d 385, 394 (6th Cir. 1989).

- 9 See e.g., *Villeneuve v. Advanced Business Concepts Corp.*, 698 F.2d 1121, 1124 (11th Cir. 1983), aff'd en banc, 730 F.2d 1403 (1984).
- 10 *SEC v. Unique Financial Concepts, Inc.*, 196 F.3d 1195, 1199 (1999).
- 11 See *Long v. Shultz Cattle Co., Inc.*, 881 F.2d 129, 140-41 (5th Cir. 1989).
- 12 See *Brodt v. Bache & Co., Inc.*, 595 F.2d 459, 461 (9th Cir. 1978).
- 13 See e.g., *In the Matter of: Fidelity Assurance Associates, et al.*, II. Sec. Dept. Consent Order Op. (October 16, 2006) 2006 II. Sec. LEXIS 297; *In the Matter of: Qi Chen, Alexander Financial Services, et al.*, II. Sec. Dept. Order of Prohibition (April 18, 2006) 2006 II. Sec. LEXIS 121; and *In the Matter of: Golden Years Planning, et al.*, II. Sec. Dept. Order of Prohibition and Fine (April 22, 2005) 2005 II. Sec. LEXIS 88.
- 14 *Integrated Research Servs. v. Ill. Secy. of State*, 328 Ill. App. 3d 67, 765 N.E.2d 130, 2002 Ill. App. LEXIS 82, 262 Ill. Dec. 304, Blue Sky L. Rep. (CCH) P74261 (Ill. App. Ct. 1st Dist. 2002); appeal denied, *Integrated Research Servs. v. Ill. Secy. of State*, 201 Ill. 2d 570, 786 N.E.2d 184, 2002 Ill. LEXIS 1000, 271 Ill. Dec. 926 (2002).
- 15 *Id* at 135.
- 16 Mich. Comp. Laws § 451.2102c(c) (2010).
- 17 Mich. Comp. Laws § 451.2102c(c)(v) (2010).

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