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SEC v. Edwards: Traditional Investment Contract Analysis Applied By Supreme Court To Payphones Sold And Leased Back With A Fixed Return

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I. Introduction. In *SEC v. Edwards*, 124 S.Ct. 892, (2004), the United States Supreme Court held that traditional investment contract analysis should be applied to a sale-lease back arrangement promising investors a fixed return. Much has been read into *Edwards* by certain commentators. However, the author believes that the Supreme Court merely reaffirmed the Court's traditional investment contract analysis set forth in *SEC v. W. J. Howey, Co.* 328 U.S. 293 (1946) and subsequent cases. The author believes that this holding is far from novel and breaks no new ground.

II. Facts. Edwards was the Chairman, Chief Executive Officer and sole shareholder of ETS Payphones, Inc., which sold payphones to the public and leased them back for a fixed monthly rent equal to a 14% return. Approximately 10,000 people purchased a total of $300 million of ETS payphones. ETS was responsible for all aspects of operating the payphones, including site selection, installation, connections, long distance service, coin collection, maintenance, and repairs; the purchasers were not involved in the day-to-day operations of the payphones.

The payphones did not generate enough revenue for ETS to make the required lease payments but, instead, ETS depended on funds from new investors to meet its obligations to old investors. ETS did not register its offerings with the SEC or any state regulatory authority.

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In September of 2002, ETS filed for bankruptcy protection and the SEC brought a civil enforcement action alleging that ETS was a "massive Ponzi scheme" that violated the registration requirements and anti-fraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934. The District Court concluded that the arrangement was an investment contract subject to the Federal securities laws, granted a preliminary injunction prohibiting ETS from engaging in future violations of securities laws, and froze ETS's assets in anticipation of possible future disgorgement. The Court of Appeals for the Eleventh Circuit reversed, holding that, because the returns were contractually guaranteed, they were not derived "solely from the efforts of others" as required under the *Howey* analysis.

III. Issue. Was the Eleventh Circuit correct that the ETS scheme should be "excluded from the term 'investment contract' because the arrangement offered a contractual entitlement to a fixed, rather than a variable, return?" *Id.* at 895.

IV. Holding. The Supreme Court held that an investment scheme promising a fixed rate of return can be an investment contract and thus a security subject to the Federal securities laws. The Eleventh Circuit was reversed and the case was remanded for further proceedings consistent with the holding.

V. Analysis. The test for determining if a particular scheme is an investment contract was established by the Supreme Court in *Howey*, which the *Edwards* court cited as follows:

> "'[W]hether the scheme involves an investment of money in a common enterprise with profits that come solely from the efforts of others.' This definition 'embodies a flexible rather than a static principal, one that is capable of adaptation to meet the countless and various schemes devised by those who seek the use of the money of others on the promise of profits.'" *Edwards* at 896 [citations omitted.]

The *Edwards* court continued its investment contract analysis as follows:

> "[W]hen Congress included 'investment contract' in the definition of security, it 'was using a term the meaning of which had been crystallized' by the state courts' interpretation of their 'blue sky' laws.... Thus, 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. We used 'profits' in the sense of

income or return, to include, for example, dividends, other periodic payments, or the increased value of the investment.

> "There is no reason to distinguish between promises of fixed returns and promises of variable returns for purposes of the test, so understood. In both cases, the investing public is attracted by representations of investment income, as purchasers were in this case by ETS' invitation to 'watch the profits add up.' Moreover, investments pitched as low risk (such as those offering a 'guaranteed' fixed return) are particularly attractive to (individuals more vulnerable to investment fraud, including older and less sophisticated investors." *Id.* [Internal citations omitted.]

Respondent contended that including investment schemes promising a fixed return among investment contracts conflicts with Supreme Court precedent. The court disagreed, stating that no distinction between fixed and variable returns was drawn in the blue sky cases that the *Howey* Court used in formulating the test, and as evidenced by Congress's understanding of the term. The *Edwards* Court noted that two of those cases involved an investment contract in which a fixed return was promised. Moreover, none of the post-*Howey* decisions is to the contrary. For example, in *United Housing Foundation, Inc. v. Foreman*, 421 U.S. 837, the Supreme Court contrasted examples in which the investor is attracted solely by the prospects of a return with the investment in issue in housing cooperative shares, where the purchaser is as motivated by a desire to use or consume the item purchased. 421 U.S. 837 at 852-853.

VI. Conclusion. The Supreme Court merely applied the traditional investment contract analysis to the facts. It should be noted that the Supreme Court did not hold that the ETS scheme was a security, merely that the lower court erred and should have applied the traditional analysis to make the determination. Further, no cases were overruled and no broad implications should be drawn.