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NOTE

LITIGATION FUNDING DEVICES FOR FRANCHISEES: ARE THEY SECURITIES?

I. INTRODUCTION

Commentators have characterized the 1990s as "the decade of 'franchisee empowerment.'" This describes the movement among franchisees to gain bargaining power over their franchisors. For decades, franchisees signed adhesion contracts, accepting that they had far less economic resources and negotiating expertise than their wealthy franchisors. They collected their life savings and agreed to well-drafted franchise contracts in hopes of achieving the dreams of owning their own businesses—unaware of the amount of ownership and control the franchisors would retain. In the late 1970s, in response to a growing number of complaints from franchisees, legislatures enacted various laws to protect the franchisees' interests against unfair trade practices. However, these statutes only addressed general provisions and disclosure.

2. See id. at 59-60 (discussing the role of adversarial franchisee associations which attempt to balance bargaining power with their franchisors through actions such as collectively renegotiating their franchise agreements and instituting litigation against their franchisors).
4. See Gillian K. Hadfield, Problematic Relations: Franchising and the Law of Incomplete Contracts, 42 Stan. L. Rev. 927, 960-63 (1990) (explaining how the combination of the franchisor's use of standard form contracts and the general lack of business experience on the part of franchisees creates the typical reliance relationship that can be found among franchisors and franchisees).
5. See id. at 959 (describing franchisors' campaigns to attract franchisees by advertising that the franchisees can own their own business and enjoy a sense of independence with minimal risk).
6. See Lawrence I. Fox, State Franchise, and Dealer Protection Laws, in DISTRIBUTION AND MARKETING: THE NEW ANTITRUST ENVIRONMENT 377, 386, 409-10 (PLI Litig. & Admin. Practice Course Handbook Series No. 511, 1986) (listing a number of federal and state statutes enacted by the legislature to protect franchisees including, but not limited to, the Lanham Act, the FTC Act, RICO, the Delaware Franchise Security Law, and the Indiana Deceptive Franchise Practices Law).
requirements, leaving the franchisees’ sole recourse for specific disputes in the court system. But due process is often expensive, and many franchisees found that they could not afford to bring suit or to remain in litigation with a wealthier franchisor for an extended period of time.

This Note analyzes three funding devices whereby franchisees, who generally cannot afford the financial cost of protracted litigation against their franchisor, can balance the economic playing field and finance their day in court. The three franchisee litigation funding devices are: class action suits, litigation trust agreements, and investor-financed lawsuits. Each device is described in detail below. As Part II of this Note demonstrates, the devices not only provide adequate funding to finance lawsuits against franchisors, but they often have the potential to generate profits for the participating franchisees. The Securities and Exchange Commission (“SEC”) is often suspicious of devices which unite individuals for the purpose of generating a profit, for fear that such devices will mislead an uninformed public. Therefore, it must be determined whether the SEC will classify these three devices as securities, under the federal securities acts, and regulate them accordingly. To determine if these devices will be characterized as securities, Part III performs a securities analysis using the “Howey Test” and reviews possible securities law exemptions. If such a classification is made, franchisees will be subject to strict disclosure and registration requirements. Such requirements could prove burdensome to the franchisees, causing them to seek refuge in securities law exemptions or possibly frustrating the very purpose of these devices.

II. GAINING ECONOMIC POWER

A. Class Action

Class actions are often thought of as economically efficient devices for prosecuting common claims of many individuals who

7. See id. at 409-82 (detailing various state franchise statutes which were directed at disclosure, termination, notice, renewal, and standards of conduct in franchise agreements).
10. Class action suits are an economically efficient means to litigate because when a class action suit, as opposed to many individual suits, is filed, the cost of filing fees, discovery, and other litigation procedures is lowered. With a class action, each procedure only needs to be performed once for the entire class. See Paula Batt Wilson, Note, Attorney Investment in Class Action

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would not be able to bring individual suits because of a lack of financial resources. Not surprisingly, some franchisees and commentators of franchise relationships have turned to class actions as a method whereby franchisees of the same franchise can collectively sue their franchisor. When franchisees from different states unite to commence a lawsuit against their franchisor or when franchisees of the same state raise a federal cause of action against their franchisor, such actions will be governed by Rule 23 of the Federal Rules of Civil Procedure.

1. Requirements under Federal Rule 23

To maintain a class action in federal court under Rule 23, a plaintiff must satisfy the following requirements: (a) joinder must be impracticable due to the large number of members in the class; (b) common questions of law and fact must exist; (c) representative parties’ claims or defenses must be typical of those of the class; and (d) representative parties must fairly and adequately protect the interests of the class.

Each requirement of Rule 23 has given rise to a substantial body of interpretive case law. For example, in determining whether joinder is impracticable, courts look to several factors including: (i) size of the class; (ii) ease of identifying members and determining their location; (iii) geographical distribution of members; (iv) size of the individual claims; and (v) the ability of class members to institute individual claims. Additionally, with regard to commonality, although courts...
disagree as to whether individual class members must have more than one question of law or fact in common, they agree that all claims raised by the members do not have to be identical. Factual variations in the claims may exist, so long as the claims arise out of the same legal theory. Furthermore, for the representative parties' claims and defenses to be "typical," they must "stem from the same event . . . that forms the basis of the claims" and must be based on the same legal theory as the claims and defenses of the members of the class. Finally, courts find the fourth requirement satisfied when "the representative [has] common interests with the unnamed members of the class" and it "appear[s] that the representative will vigorously prosecute the interests of the class through qualified counsel."21

Certain groups of franchisees can easily qualify for class certification when raising common claims against their franchisor. For example, franchisees associated with national franchises may satisfy the requirement for numerosity because, although the franchisees are easily identifiable, their geographic distribution, as well as their limited resources to bring individual claims, make it economically efficient for both the judicial system and the franchisees to try the claims together. Additionally, because of franchisors' use of standard practices, contracts, and procedures, franchisees will often have more than one common question of law and fact to raise a class action. Where commonality is
achieved between the individual franchisee members of the class because of similar experiences with their franchisor's business policies, it should not be difficult to choose a representative among them who shares a typical claim. Finally, once commonality and typicality are satisfied, the requirement of fair and adequate representation can be easily satisfied so long as the representative franchisee is dedicated to the litigation and the welfare of the class.

2. Funding a Class Action

While satisfying the requirements for class certification may not prove difficult for many groups of franchisees, funding the class action may present a problem. There are three methods for funding a class action lawsuit: the class representative can fund the suit, the class representative and the class members can pool their money to fund the suit, or the class attorney can agree to a contingency arrangement.\(^{24}\)

As a general rule, because class representatives are plaintiffs to the action, they are responsible for assuming "certain" costs and liabilities associated with conducting a class action.\(^{25}\) Alternatively, class representatives may choose to fund the entire litigation.\(^{26}\) Class actions in which the class representative pays for the entire litigation against the franchisor are ideal for franchisees who have limited resources and cannot afford to contribute to the action.

Where the class representative chooses to fund only part of the lawsuit, the class members (all franchisees with common questions of law or fact who are not named parties to the suit) may contribute the remaining funds.\(^{27}\) The class representative may solicit funds from the class members to finance the lawsuit. Such solicitation of funds will not disqualify the representative party or automatically deny certification of the class under Rule 23.\(^{28}\) It should be noted, however, that contribution


\(^{25}\) Solovy et al., supra note 16, at 54.

\(^{26}\) See Norris, 77 F.R.D. at 673.

\(^{27}\) See id.

\(^{28}\) See id. (upholding a class' certification following a request by the class representative for contribution to the funding of the lawsuit by stating that such an act did not reveal that the representative could not "fairly and adequately protect the interests of the class," as required under Fed. R. Civ. P. 23). Some jurisdictions maintain very strict requirements for solicitation of funds from class members by requiring advance approval from the court prior to both the solicitation and withdrawal of funds. Even with such approval, funds can then only be used to pay litigation expenses, excluding attorney fees. Additionally, these jurisdictions often require the class representative to "clearly advise [class members] that [they] are not obligated to contribute, and that
is not required to be a class member. Such an arrangement may be beneficial to franchisees because those who want to contribute will find that the costs are a fraction of what they would have been if they had brought the litigation individually.

Alternatively, franchisees may fund their class litigation by entering into a contingency arrangement with their attorney. Attorneys may be more inclined to accept a franchisee's case on a contingency fee basis when it is a class action suit, as opposed to an individual franchisee's suit, because the potential profit from a class action is greater than from an individual action.

A contingency arrangement is useful to franchisees because, in the event of a successful verdict or settlement, the attorney receives a predetermined percentage of the judgment or settlement in addition to expenses. In the event the franchisees lose, the class members are not responsible for attorney fees. While this arrangement lessens the amount of recovery collected by the franchisees, it provides them access to the court system without which there would be no recovery.

B. Litigation Trust Agreement

Franchisees who cannot satisfy the requirements under Rule 23 (for example, because of their close geographic distribution or a small class size) may use an alternative funding device called a litigation trust agreement to finance their cause of action. The novel structure of a litigation trust agreement creates a device that is different than a traditional litigation trust. With a traditional litigation trust a trustee manages a single cause of action for the benefit of respective beneficiaries. With a litigation trust agreement the trust is structured simply as a funding device and the trustee does not manage the litigation but only funds the litigation. Additionally, the new litigation trust agreements are

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rights of recovery [are] the same for contributors and noncontributors." Norris, 77 F.R.D. at 673.
29. See id.
30. See Solovy et al., supra note 16, at 54.
31. See Wilson, supra note 10, at 298-99.
32. This method of calculating the attorney's contingency fee is known as the "percentage of recovery method." See id. at 306. An alternative method is the "lodestar method" where the court multiplies the reasonable number of hours the attorney worked on the case by the attorney's reasonable hourly fee to "create an objective 'lodestar.'" Courts may then adjust the "lodestar" depending on various factors, including "high-risk litigation." See id. at 305-06.
33. See Lokker, supra note 8, at 60.
created to fund more than one cause of action\textsuperscript{34} and therefore, typically do not terminate at the end of the litigation.\textsuperscript{35} Furthermore, unlike traditional trusts, litigation trusts may not be the real party to the lawsuit.\textsuperscript{36}

Because they are such a novel arrangement, litigation trust agreements are rarely found in the franchise industry. However, such trusts have recently been employed in three separate disputes involving Mail Boxes Etc., Phar-Mor, Inc., and Pritchard Engineering and Operating, Inc.\textsuperscript{37} While these disputes are but three examples, they provide an interesting starting point for examination.

1. Provisions in a Litigation Trust Agreement

Although specific provisions in litigation trust agreements vary, (based upon the aforementioned litigation trust agreements) the following are examples of provisions franchisees may want to include in their agreement.

Franchisee litigation trust agreements may state their purpose as representing the interests of the franchisees in the negotiation, arbitration, litigation, or settlement of common complaints or disputes against their franchisor,\textsuperscript{38} with "no objective [of] conduct[ing] a trade or business."\textsuperscript{39}

\begin{itemize}
\item \textsuperscript{34} See id. at 59; see also Mailbox Franchisee Legal Trust: Declaration of Trust Indenture & Adoption Agreement, art. 1 (Nov. 1, 1993) (hereinafter Mail Boxes Trust) (on file with author) (representing a litigation trust agreement between franchisees of a national franchise). "Th[e] [Mail Boxes] Trust is established for the exclusive purpose of representing the interests of Participants in the Trust in the negotiation, arbitration, litigation, or settlement of the common claims or disputes against Mail Boxes . . . ." Id.
\item \textsuperscript{35} See Mail Boxes Trust, supra note 34, § 7.02 ("This Trust shall terminate on or before the year 2025 unless terminated sooner.").
\item \textsuperscript{36} See Lokker, supra note 8, at 59.
\item \textsuperscript{37} See Mail Boxes Trust, supra note 34; Phar-Mor, Inc.: Members Agreement of P-M Litigation, L.L.C. Members Agreement (1995) (hereinafter Phar-Mor Trust) (on file with author) (representing a franchisor litigation trust agreement for a national drug store franchise); B. J. Tanenbaum, Jr. and Thomas H. Chmielewski, SEC No-Action Letter, Dec. 4, 1986, available in LEXIS, Fedsec Library, No-Act. File (hereinafter Pritchard Trust Letter) (including a letter from Ted N. Drake, the attorney who established the Pritchard Litigation Fund, to the SEC detailing a proposed litigation trust agreement by a number of investors of oil and gas wells who sought to sue a drilling company they employed). At the time the no-action letter was written, the investors had not yet filed an action against Pritchard Engineering and Operating, Inc. The investors explained that they were waiting for approval by the SEC to create the litigation trust to determine if they could fund the lawsuit before they filed suit. See id. at *16-18.
\item \textsuperscript{38} See Mail Boxes Trust, supra note 34, art. 1.
\item \textsuperscript{39} Phar-Mor Trust, supra note 37, § 1.5.
\end{itemize}
Unlike investor-financed lawsuits which allow outsiders (third parties disinterested in the merits of the litigation) to participate in the trust, litigation trust agreements only allow insiders to participate in such a trust. The trust agreement may require that, in order to participate in the trust, the franchisees must sign a consent form adopting the provisions of the trust agreement.

The initial source of funding for a franchisee litigation trust comes from mandatory assessments from the franchisees. The amount of the initial payment is stipulated in the agreement and may be uniform for all participants.

In addition to defining the participants of the trust (the franchisees), a litigation trust agreement may also name a trustee or group of trustees, often called litigation managers, to manage the assets of the trust. The trustee may be authorized to temporarily invest the funds in treasury bills, money market funds, or other investments, in order to earn interest that will also be used to finance the litigation. The trust may also require the trustee to establish a budget and make mandatory assessments on participating franchisees in order to fund on-going litigation.

Generally, the trustee is to be indemnified against liability to the trust or to any participant except in cases of willful misconduct or breach

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40. See infra note 57 and accompanying text.
41. See Pritchard Trust Letter, supra note 37, at *4 (claiming that all investors will be plaintiffs in the action); Mail Boxes Trust, supra note 34, § 2.02 (allowing only individuals who have invested in a Mail Boxes Etc. franchise to participate in the agreement).
42. See Mail Boxes Trust, supra note 34, § 2.03 ("The Trustees shall submit to all Participants a copy of this Trust Indenture and Adoption Agreement to be executed and returned to the Trustees . . . .").
43. See id. § 3.01 (requiring a mandatory assessment of $500 to participate in the trust); Pritchard Trust Letter, supra note 37, at *7 (stating that each investor may contribute "up to $10,000 in increments of $1,000" to the fund).
44. See Mail Boxes Trust, supra note 34, § 3.01; cf. Pritchard Trust Letter, supra note 37, at *7.
45. See Mail Boxes Trust, supra note 34, § 3.01; Phar-Mor Trust, supra note 37, § 3.1 (naming their attorney as litigation manager).
46. See Phar-Mor Trust, supra note 37, § 3.6.4. All funds received by the Company may be temporarily invested by the P-M Litigation Manager in United States treasury bills and notes with maturities of 12 months or less, institutional money market funds, and time deposits and certificates of deposit with commercial banks organized under the laws of the United States, or any State thereof, having primary capital of not less than $500,000,000.
47. See id. § 3.9 (requiring the litigation manager to report no less than annually all resolutions of litigation claims as well as payments made or received).
of his/her fiduciary duties.\textsuperscript{48} Similarly, participants are not liable for the acts of the trustee or for "losses of the [t]rust assets beyond such [p]articipant's interest in the [t]rust."\textsuperscript{49}

Litigation trust agreements may be drafted so that the trustee has sole discretion to determine whether the trust's funds should be allocated in support of a cause of action raised by a member franchisee.\textsuperscript{50} Although the franchisee who initiated the litigation is the named party to the lawsuit, a trust should be structured so that any judicial award or settlement derived from the litigation reverts to the trust for the benefit of all.\textsuperscript{51} The trustee may then distribute the award or settlement based upon the following order of priority: (i) compensatory damages to reimburse the trust for litigation expenses; (ii) distribution of remaining compensatory damages to the named plaintiffs; and (iii) reversion of punitive damages to the trust for the benefit of all participants.\textsuperscript{52} An alternative order for distributing the funds is: (i) repayment to the individual participants in an equivalent amount to their initial investment; (ii) reimbursement of the trust for litigation expenses; (iii) distribution of a guaranteed return (often a multiple of the amount invested) to all participants;\textsuperscript{53} and (iv) payment of the balance to the named plaintiffs.\textsuperscript{54} Upon ultimate liquidation of the trust, funds generally will be distributed to the participants of the trust on a pro rata basis, according to each participant's total investment in the trust.\textsuperscript{55}

\textsuperscript{48} See id. § 3.13.1 (providing that "[t]o the fullest extent permitted by the Delaware Act, the Company, to the extent of its assets legally available for that purpose, will indemnify and hold harmless the P-M Litigation Manager . . . from and against any and all loss, cost, damage, expense . . . or liability").

\textsuperscript{49} Mail Boxes Trust, supra note 34, § 6.02; see also Phar-Mor Trust, supra note 37, § 3.13.1.

\textsuperscript{50} See Mail Boxes Trust, supra note 34, art. 1 (giving the trustee power to determine if the claims represented by individual members of the trust represent common claims or disputes of the franchisee members as a whole for the purpose of allocating money to the individuals to fund a lawsuit against Mail Boxes).

\textsuperscript{51} See Pritchard Trust Letter, supra note 37, at *8-9; Mail Boxes Trust, supra note 34, § 3.04 ("Upon termination of litigation, whether by judgment or settlement, any awards from the court, or any proceeds from any out-of-court settlements, however received and however designated, collectively or individually to one or more Participants, shall revert to and be disbursed by the Trust.").

\textsuperscript{52} See Mail Boxes Trust, supra note 34, § 3.04.

\textsuperscript{53} See Pritchard Trust Letter, supra note 37, at *9 (claiming the investors have a right to receive a five-to-one return on their investment if the litigation is successful).

\textsuperscript{54} See id.

\textsuperscript{55} See id. at *8-9.

Monies remaining in the Fund which have not been spent prior to adding the proceeds from litigation will be distributed to the Contributing Investors on a pro rata basis using a fraction, the numerator of which is the amount contributed by the Contributing Investor.
2. Benefits of a Litigation Trust Agreement

Collective efforts of franchisees may prove to be a powerful force. By joining their economic resources under a litigation trust agreement, franchisees can fuel the battle against their franchisor and litigate common causes of action. In addition to providing financial support, a litigation trust agreement will unite franchisees and most likely encourage open communication between them—conceivably revealing future claims against the franchisor.

C. Investor-Financed Lawsuit

Unlike litigation trust agreements which are funded solely by franchisees, "syndicated, or investor-financed, lawsuit[s] [are] financed by investors who would otherwise have no stake in the case." Such an arrangement often involves plaintiffs selling shares in their lawsuit to investors in return for a percentage of the proceeds from the litigation. Thus, "[t]he litigant might sell shares prior to litigation or during litigation as funds are needed." Investor-financed lawsuits allow franchisees who have little economic resources of their own to associate with outside investors in an effort to level the financial staying power of the franchisor.

In such a circumstance, the franchisees might sell interests in their potential recovery from litigation with their franchisors either through a public stock offering or a "Recovery Participation Agreement" with

and the denominator of which is the total amount contributed by all Contributing Investors.

Id.; see also Mail Boxes Trust, supra note 34, art. 4.

56. See Emerson, supra note 12, at 1518 ("One of the traditional control mechanisms of a franchisor has been to keep its franchisees disorganized." (quoting McAlpine v. AAMCO Automatic Transmission, Inc., 461 F. Supp. 1232, 1273 (E.D. Mich. 1978))).


59. Cox, supra note 58, at 153 (footnote omitted).


61. See Cox, supra note 58, at 153-56 (describing an inventor who raised four million dollars for his patent infringement lawsuit by selling, through a public stock offering, interests in his potentially favorable outcome).
named investors. In either case, if the franchisee wins the litigation, the investors receive a predetermined percentage of the profits. However, if the franchisee loses the litigation, the investors lose the amount of money they invested.

Alternatively, parties to a lawsuit might raise money from the sale of shares in their lawsuit and then invest that money, using only the interest to fund the litigation. Here, if the franchisee wins, the investor not only would be entitled to the predetermined percentage of the proceeds, but the initial investment would also be returned to the investor. Additionally, even if the franchisee loses, the initial investment would be returned to the investor because only the interest would have been used to fund the litigation. Due to the fact that the principal investment remains in escrow throughout the duration of the litigation and investors can often redeem their shares at any time, this type of litigation funding arrangement poses little risk to the investor.

1. Champerty: Potential Barrier to Investor-Financed Litigation

Despite its apparent benefits, investor-financed litigation faces a barrier in the common law doctrine of champerty. "Champerty is a kind of maintenance" in which the investor receives a share of the proceeds

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62. See Killian v. Millard, 279 Cal. Rptr. 877, 878 (Ct. App. 1991) (discussing a plaintiff who was unable to personally finance his lawsuit and therefore sold 50 “units” at $10,000 per unit with a 2-unit minimum to specific investors, as opposed to the general public, through a “Recovery Participation Agreement” in return for a “right to a percentage share in the net profits of the lawsuit”).

63. See id. at 878.

64. See Cox, supra note 58, at 155-56 (describing an inventor who attempted to sell 50% of his interest in his anti-trust lawsuit against a toy manufacturer by selling shares that would provide the investors with a 25% annual return in the event of a favorable judgment and would return their initial investment in the event of an unfavorable judgment, because the litigation expenses were only to be paid from interest earned on the investments and the principal amount would remain untouched); see also A Scheme to Sell Pieces of an Action, Bus. Wk., May 24, 1976, at 35 [hereinafter A Scheme to Sell].

65. See Cox, supra note 58, at 155-56.

66. See id.

67. See A Scheme to Sell, supra note 64, at 36 (describing a syndicate lawsuit in which only the interest earned from the proceeds of the sale of shares would be used to fund the litigation while the principal would remain in escrow and investors could “redeem their shares at any time, and the shares would be subject to recall, with interest accrued to the date of recall”).

68. See Cox, supra note 58, at 155-56.

69. Maintenance is a common law doctrine that “generally refers to an arrangement in which one person agrees to support another in bringing or defending a legal action.” Martin, supra note 60, at 485.
of the lawsuit in exchange for financing the legal action.70 "Because money is solicited from disinterested parties to fund litigation, syndicated lawsuits, by definition, constitute champerty."71 The primary purpose for prohibiting champerty is the fear of encouraging meritless litigation whose only purpose is to harass the defendant and create a financial gain for the investor, as well as the fear of discouraging reasonable settlements.72

Many commentators argue that the champerty doctrine is out-dated and the conditions of modern society increasingly justify the support of litigation by third parties.73 They claim that "[i]n reality, it is highly unlikely that investors would put up money to support lawsuits that were not meritorious" for fear of not receiving a reasonable return on their money.74 But, because a small, yet substantial, number of states continue to follow the common law doctrine of prohibiting champerty,75 franchisees must determine if their state is included in that group before seeking outside investors to finance their lawsuit.

III. SECURITY BARRIER TO FUNDING DEVICES

Apart from the issues and problems addressed above, a securities analysis is important for determining the appropriate funding device for franchisees in financing a lawsuit against their franchisor, because if the chosen device is deemed a "security" under the federal securities acts76 then registration requirements imposed on securities by the SEC may prove to be too burdensome for compliance by the franchisee.77 If the franchisee employs the funding device without registering with the SEC,

70. Id. at 485.
71. Abraham, supra note 57, at 1303-04; see also Catherine Yung, Psst! Wanna Buy a Lawsuit?, FORBES, May 19, 1986, at 67 ("There is no doubt that syndicated litigation is a modern-day version of champerty and maintenance." (quoting attorney Mark Morrill)).
72. See Martin, supra note 60, at 509-11.
73. See, e.g., id. at 507; see also Cox, supra note 58, at 160.
74. Martin, supra note 60, at 510.
75. The following states have adopted the common law champerty prohibition: Florida, Georgia, Illinois, Kansas, Kentucky, Maine, Mississippi, Missouri, Nevada, Pennsylvania, Utah, and Wisconsin. Delaware, Michigan, New York, and West Virginia have adopted champerty in a modified form. Arizona, California, Connecticut, Idaho, Louisiana, New Jersey, and Texas are among the states which have not adopted the champerty prohibition doctrine in any form. See id. at 488-89; Abraham, supra note 57, at 1304.
77. See 15 U.S.C. § 77e(a) ("Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly . . . to sell such security . . . .").
and the device is declared to be a security, then the franchisee may be subject to criminal or civil liability.\textsuperscript{78}

\section*{A. What Is a Security?}

The Securities Act of 1933 ("Securities Act") provides a statutory "laundry list"\textsuperscript{79} of devices which are deemed "securities."\textsuperscript{80} Although the statute names specific forms a security may take, the drafters included terms such as "investment contract" and "in general, any instrument commonly known as a 'security'" as catch-all phrases to broaden the scope of the definition.\textsuperscript{81} The drafters of the Securities Act intended for the definition to "embod[y] 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."\textsuperscript{82} Although class actions, litigation trust agreements, and investor-financed litigation are not specifically named in the statute as securities, they bear a striking resemblance to an "investment contract" which is listed in the statute.

\subsection*{1. What Is an Investment Contract?}

The seminal case determining what constitutes an investment contract under the Securities Act is \textit{SEC v. W. J. Howey Co.}\textsuperscript{83}

\footnotesize{\textsuperscript{78} See id. § 77x ("Any person who willfully violates any of the provisions of this subchapter, or the rules and regulations promulgated by the Commission under authority thereof . . . shall upon conviction be fined not more than $10,000 or imprisoned not more than five years, or both.").}


\footnotesize{\textsuperscript{80} The Supreme Court has consistently held that the definitions of a security in the Securities Act of 1933 and the Securities and Exchange Act of 1934 are "virtually identical" and that the coverage of the acts may be considered the same. Reves v. Ernst & Young, 494 U.S. 56, 61 n.1 (1990) (quoting United Hous. Found., Inc. v. Forman, 421 U.S. 837, 847 n.12 (1975)). The definition of a security in the Securities Act of 1933 provides:}

\footnotesize{any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, . . . or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.}

\footnotesize{15 U.S.C. § 77b(1).}

\footnotesize{\textsuperscript{81} Id.}

\footnotesize{\textsuperscript{82} SEC v. W. J. Howey Co., 328 U.S. 293, 299 (1946).}
The SEC commenced an action against the W. J. Howey Company for offering for public sale small units of a citrus grove along with service contracts to develop the grove without issuing a registration statement. The service contract gave the company exclusive possession of the land and the fruit on the land. The oranges from the entire grove were picked, pooled, and sold, and the profits were distributed among the investors. The Supreme Court found that the combination of the land sale contract and the service contract amounted to an “investment contract.”

The Court defined an investment contract as “a contract, transaction or scheme whereby a person [(a)] invests his money [(b)] in a common enterprise and [(c)] is led to expect profits solely from the efforts of the promoter or a third party.” Each element of the Howey test has given rise to a substantial body of interpretive case law.

a. Investment of Money

Despite the Howey test’s specific reference to “an investment of money,” it is well established that cash is not the only form of consideration that will satisfy the first requirement. Goods and services are also sufficient consideration. The standard is whether there is an “exchange of value” in which the investor “‘commit[s] his assets to the enterprise in such a manner as to subject himself to financial loss.”

83. Id.
84. Id. at 300.
85. Id. at 298-99.
86. Id. at 299.
87. See International Brotherhood of Teamsters v. Daniel, 439 U.S. 551, 560 & n.12 (1979) (finding that while the first prong of the Howey test does not require an investment in cash only, but also includes goods and services, an exchange of labor in return for a pension plan does not satisfy the requirement because such labor is for the primary purpose of earning a living and not making an investment); Uselton v. Commercial Lovelace Motor Freight, Inc., 940 F.2d 564, 574-75 (10th Cir. 1991) (finding that an employee’s agreement to surrender a portion of his or her wages in exchange for an interest in an employee stock ownership plan was an “investment of money” for purposes of the Howey test because there was an “exchange of value”); Hocking v. Dubois, 885 F.2d 1449, 1471 (9th Cir. 1989) (finding that a buyer’s commitment of his condominium to a rental pool constituted an “exchange of value” and therefore satisfied the first prong of the Howey test).
88. But see Peyton v. Morrow Elecs., Inc., 587 F.2d 413 (9th Cir. 1978) (finding a marketing manager’s employment contract not to be an investment contract, based on failure to satisfy the first prong of the Howey test, because the manager’s only consideration was his services and there was absolutely no investment of money involved).
89. Hocking, 885 F.2d at 1471 (quoting Hector v. Wiens, 533 F.2d 429, 432 (9th Cir. 1976)).
b. Common Enterprise

A common enterprise is a venture "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." The Court in Howey did not explain this prong of the test and federal circuit courts are divided as to whether a common enterprise is a function of horizontal commonality, where the fortunes of the investors are linked to each other, or vertical commonality, where the fortunes of the investors are linked to the interests of the promoter.

Horizontal commonality requires a pooling of investors' funds, usually combined with a pro rata distribution of profits. Thus, the profitability of each individual investor depends on the profitability of the enterprise as a whole. Vertical commonality is established by showing "that the fortunes of the investors are linked with those of the promoters." Courts apply both strict and broad vertical commonality. Strict vertical commonality "requires that the fortunes of investors be tied to the fortunes of the promoter." Unlike horizontal commonality, strict vertical commonality does not require a distribution of the profits pro rata but often involves an arrangement to share profits on a percentage basis between the

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90. SEC v. Glenn W. Turner Enters., 474 F.2d 476, 482 n.7 (9th Cir. 1973).
91. See Revak v. SEC Realty Corp., 18 F.3d 81, 87 (2d Cir. 1994).
93. See id.; Revak, 18 F.3d at 87; see also SEC v. W. J. Howey Co., 328 U.S. 293 (1946); Crook, supra note 79, at 328 n.27, 329 nn.28 & 34, 331 n.43 (listing which courts use vertical commonality and which courts use horizontal commonality).
94. See Revak, 18 F.3d at 87 (finding the sale of condominiums not to constitute a sale of a security, because there was no pooling of funds where each condominium owner was responsible for his or her own rent and expenses and could sustain profits or losses independent of other investors); see also Stone v. Kirk, 8 F.3d 1079, 1085 (6th Cir. 1993) (finding that investors in a tax shelter scheme clearly satisfied the horizontal commonality requirement of the Howey test because there was a common pool of funds from which all could benefit); Hart v. Pulte Homes Corp., 735 F.2d 1001, 1004 (6th Cir. 1984); Saloer v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 682 F.2d 459, 460 (3d Cir. 1982).
95. See Revak, 18 F.3d at 87.
96. R.G. Reynolds Enters., 952 F.2d at 1130 (quoting SEC v. Goldfield Deep Mines Co., 758 F.2d 459, 463 (9th Cir. 1985)) (describing a promoter who promised a high rate of return on investors' money by investing such funds in the stock market for them and retaining a percentage of the profits).
98. Revak, 18 F.3d at 88.
investor and the promoter. The profits of the investors may, therefore, vary when vertical commonality exists. Broad vertical commonality requires the profits of the investors to be "linked only to the efforts of the promoter." A Florida district court has analogized broad vertical commonality to a wheel, "with the promoter as the hub of the wheel and the individual investors as the spokes." "[A]lthough all the spokes are connected to the hub, they are in no way linked to each other. If one spoke breaks, the wheel will continue to turn; if the hub is removed, the wheel falls apart."

The third prong of the Howey test requires the investor to expect profits solely from the efforts of the promoter or a third party. The profits can be "in the form of capital appreciation or participation in earnings resulting from the investment." Due to the fact that a strict interpretation of the word "solely" would result in a "mechanical, unduly restrictive view of what is and what is not an investment contract," the Ninth Circuit took the view that it is not fatal to the analysis if the investor participated in the efforts to earn profits so long as "the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise." While the Supreme Court has not explicitly adopted this liberal approach to the third prong of the Howey test, in United Housing Foundation, Inc. v. Forman, the Court took notice of the

99. See R.G. Reynolds Enters., 952 F.2d at 1130 (finding that an investment satisfied the commonality requirement of the Howey test when the promoter's profit was contingent upon the investors' profit).
100. See Revak, 18 F.3d at 87.
101. Id. at 88.
103. Id.
104. Uselton v. Commercial Lovelace Motor Freight, Inc., 940 F.2d 564, 576 (10th Cir. 1991) (finding profit in the form of dividends and stock appreciation, which resulted solely from the efforts of managers and employees, to satisfy the third prong of the Howey test).
106. Id. (holding that a get-rich-quick scheme satisfied the third prong of the Howey test even though the investors' profits were partially dependent on their own selling efforts; the significant efforts were those of employees of the enterprise).
Ninth Circuit's interpretation and appellate courts have expressly followed the approach.\textsuperscript{108}

\subsection*{B. Is a Class Action a Security?}

Class action lawsuits have been employed for over sixty years as an efficient means of litigating common claims. No one, however, has questioned whether class actions constitute a "security," particularly in light of the \textit{Howey} test. If a class action was considered a security, the pursuit of such actions would be subject to the regulation of the SEC. Regulation, particularly in the form of registration requirements,\textsuperscript{109} might prove burdensome on franchisees and may very well frustrate the purpose of a class action—to efficiently and economically litigate common claims.

To determine if a class action is a security, each of the methods of funding a class action (class representatives financing the lawsuit, both class representatives and class members financing the lawsuit, and the attorney financing the suit based upon a contingency arrangement)\textsuperscript{110} should be analyzed. After applying the \textit{Howey} test to each funding method conclusions will be drawn regarding whether such methods violate federal securities laws.

\subsection*{1. Class Representatives Fund the Class Action}

In the first example, where the class representative funds the class action, the first prong of the \textit{Howey} test is satisfied as there clearly is an investment of money by the class representative. Due to the fact that the second prong of the \textit{Howey} test, commonality, requires the \textit{profits} of the investor to be dependent upon the efforts and success of the other investors or the promoter,\textsuperscript{111} the third prong, expectation of profits, must be analyzed first to determine if a class action in fact involves a profit. Do plaintiffs (here the class representatives) actually expect to profit from the resolution of their own claims or do they merely expect

\begin{itemize}
\item \textsuperscript{108}See id. at 852 n.16; SEC v. Aqua-Sonic Prods. Corp., 687 F.2d 577, 582 (2d Cir. 1982) (admitting that the Supreme Court in \textit{Forman} was not willing to make a determination as to whether the word "solely" should be read literally, the court reasoned that it should not be because of the Supreme Court's repeated instruction to consider investment schemes in "light of their economic realities").
\item \textsuperscript{109}See supra note 77 and accompanying text.
\item \textsuperscript{110}See SEC v. W. J. Howey Co., 328 U.S. 293, 299 (1946); see also \textit{supra} note 24 and accompanying text.
\item \textsuperscript{111}See \textit{supra} note 89 and accompanying text.
\end{itemize}
to be compensated for a past loss when they participate in a class action? Arguably, when an action only seeks compensatory damages there is no expectation of profits, but when the action pleads punitive damages, plaintiffs have an expectation to receive more than mere compensation—they expect to receive a profit. The second half of the third prong (“solely from the efforts of the promoter or a third party”\textsuperscript{112}) is satisfied because, although the class representative is required to fairly and adequately represent the members of the class,\textsuperscript{113} the “essential managerial efforts which affect the failure or success of the enterprise” belong to the class attorney.\textsuperscript{114} Therefore, class actions satisfy the third prong of the \textit{Howey} test when the class representative expects profits, in the form of a potential punitive damage award, from the attorney’s efforts.

When a class representative finances the lawsuit, horizontal commonality is not satisfied as there is no common pooling of funds to finance the litigation. Nevertheless, both broad and strict vertical commonality are easily satisfied. Broad vertical commonality is satisfied because the profits of the investor (the representative) are linked to the efforts of the promoter (the attorney). If the attorney argues the case persuasively and recovers punitive damages, arguably the class representative will profit. Similarly, because the class representative only profits when the attorney profits and vice versa, strict vertical commonality is satisfied.

While it is rare that a class representative would fund the entire class action, under certain circumstances (where punitive damages are plead) such an arrangement may satisfy the \textit{Howey} test. But, arguably, because such an investment may not have been made for traditional investment purposes, a class action suit would most likely not be treated as a security under present securities laws.\textsuperscript{115}

2. Class Representative as Well as Class Members Fund the Class Action

Where the representative, as well as the class members, finance the lawsuit, the first prong of the \textit{Howey} test is clearly satisfied. Once again

\textsuperscript{112} See supra note 85 and accompanying text.

\textsuperscript{113} See FED. R. CIV. P. 23(a)(4).

\textsuperscript{114} SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 476, 482 (9th Cir. 1973); see also Solovy et al., supra note 16, at 57 (discussing the role of class counsel as the person who “directs, manages, and controls, the litigation with little or no input from the ‘client’ class”).

the focus shifts to the third prong to determine if the class members and class representatives expect a profit from a favorable outcome. As discussed above, where the plaintiffs plead punitive damages they arguably expect more than reimbursement for past damages—they expect profits from the essential managerial efforts of their attorney.\textsuperscript{116}

Such a funding arrangement satisfies horizontal commonality because the class members and class representatives pool their funds for the benefit of all. Strict and broad vertical commonality are also satisfied because assuming there is a profit, the profits of the investors (the class members and representative) are intrinsically tied or linked to the profits and efforts of the promoter (the attorney). If the attorney does not make efforts to win the lawsuit, the members and representative do not profit. Additionally, the attorney's profits are tied to the investors' because either they all win or all lose the potential profits. Therefore, where both the class representative and the class members fund the litigation, it may be found to be a security.

3. Attorney Finances the Class Action Through a Contingency Arrangement

When an attorney invests his services as well as out-of-pocket expenses to fund the suit through a contingency arrangement, the first prong of the \textit{Howey} test is satisfied.\textsuperscript{117} Such a class action suit does not satisfy the horizontal commonality requirement because there is no pooling of funds—the attorney is the only investor. However, when an attorney invests his time and expenses through a contingency arrangement, he is both the investor and the promoter of the litigation and his profits are therefore tied to his profits or efforts, thereby satisfying both strict and broad vertical commonality.

But, because the attorney is both the investor and the promoter, such an arrangement fails the third prong of the \textit{Howey} test. The attorney does not expect profits solely from the efforts of others, but rather from the attorney's own efforts (time and expenses).

\textsuperscript{116} See supra Part III.B.1.

\textsuperscript{117} See supra notes 86-88 and accompanying text.
4. Conclusions Regarding Funding a Class Action Without Violating Federal Securities Laws

Based upon the above discussion, one could argue that class actions, in fact, violate the federal securities laws when either the class representative and/or the class members fund the action and punitive damages are plead. However, because no one has pursued such an approach in the courts or other academic literature, and it is not a traditional type of investment, it is unlikely that the SEC will begin regulating class actions as securities.

C. Is a Litigation Trust Agreement a Security?

While litigation trust agreements appear to be an effective device for franchisees to pool their money and act collectively to finance litigation against their franchisor, if they are found to be securities under the federal securities laws then franchisees may avoid using the trusts because of the burdensome requirements imposed upon securities. This problem is exacerbated for those franchisees who have already formed litigation trusts without complying with the securities laws, as they may find themselves subject to civil and possibly criminal penalties.

Following an analysis similar to that performed on class actions, litigation trusts satisfy the first prong of the Howey test because they require an investment of money. Typically, a litigation trust agreement requires franchisees to make a mandatory payment to the trust as a prerequisite to becoming a participant.

Both horizontal and vertical commonality are satisfied. The relationship between the franchisees in a litigation trust agreement amounts to horizontal commonality because the franchisees pool their funds for the benefit of all participating franchisees and therefore, the profitability of one is tied to the profitability of all. Additionally, if the franchisee wins the litigation, the profits are distributed pro rata to all

118. See supra note 113 and accompanying text.
119. See Lokker, supra note 8, at 81; see also Securities Act of 1933, 15 U.S.C. § 77x (1994) ("Any person who willfully violates any of the provisions of this subchapter, or the rules and regulations promulgated by the Commission . . . shall upon conviction be fined not more than $10,000 or imprisoned not more than five years, or both."); id. § 77l ("Any person who offers or sells a security in violation of section 77e of this title . . . shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction . . .").
120. See supra notes 43-44 and accompanying text.
participants following dissolution and liquidation of the trust.121

Strict vertical commonality exists when the trust names specific investor franchisees as trustees. The trustee franchisees, as well as the investor franchisees, only gain when the trust is profitable; thus, the profits of the investor franchisees are tied to the profits of the trustee or promoter franchisees. But, where an attorney or someone outside of the franchise relationship is appointed trustee, strict vertical commonality may not be satisfied because the profits or compensation of the trustee may be predetermined and may have no relation to the profits of the investors.

Finally, no matter who the trustee is (a franchisee or an attorney), litigation trust agreements satisfy broad vertical commonality because the trustee is generally responsible for determining if the trust should fund a potential litigation by making assessments, budgeting the participants’ contributions, investing the contributions to generate interest, and allocating the funds for an approved litigation, all of which affect the investors’ profits.

Lastly, the third prong of the Howey test appears to be satisfied because the participants of a litigation trust generally enter the agreement for two reasons: (1) to balance the amount of economic resources available to the franchisee in order to finance litigation, and (2) to profit from financing a successful litigation. Franchisees who participate in litigation trusts expect to make a profit; they expect that upon liquidation of the trust they will receive a pro rata profit composed of successful litigation earnings and interest from the trustees’ wise investments of participants’ contributions.124 Although courts no longer require the profits to come “solely” from the efforts of others, litigation trusts are an example of investors (other than the trustee) not participating in any aspect of the management of the fund.126 The participating franchisees expect their profits to come solely from the efforts of the trustees (the named franchisee(s)) and the litigating attorney. The sole function of the participating franchisees is to fund the trust, not to manage it.127

Although a litigation trust agreement appears to satisfy all prongs

121. See supra note 55 and accompanying text.
122. See supra note 45.
123. See supra notes 45-47 and accompanying text.
124. See supra notes 46, 55 and accompanying text.
125. See supra notes 104-06 and accompanying text.
126. See supra note 45 and accompanying text.
127. See supra Part II.B.
of the Howey test, commentators have disagreed as to whether it should be classified as a security. In a letter to the editor of the Franchise Law Journal, Robert L. Purvin, Jr.\textsuperscript{128} defended litigation trusts against attacks by stating that they are not securities.\textsuperscript{129} However, Purvin’s argument, in response to a commentator who argued that such trusts may qualify as securities,\textsuperscript{130} does not deny that a litigation trust satisfies all of the elements of the Howey test but simply argues that there is no profit in recovering compensatory damages and, therefore, litigation trusts are not securities.\textsuperscript{131} While Purvin attempts to attack the “expectations of profits” requirement of the Howey test, he ignores the interest earned on the contributions as well as profits derived from punitive damages\textsuperscript{132} (which are clearly included in the Mail Boxes Trust which Purvin drafted\textsuperscript{133}). Additionally, although Purvin argues that a litigation trust agreement is valid based upon the California State Bar Association’s finding that such a trust is not objectionable,\textsuperscript{134} the SEC has not found this type of trust to be so unobjectionable.\textsuperscript{135} In 1986, an attorney who established the Pritchard Trust requested that the SEC declare the litigation trust not a security or, alternatively, provide the plaintiffs with a no-action letter regarding the trust.\textsuperscript{136} The SEC refused to do either. Instead, the SEC remarked, “[T]his Division is unable to conclude that the proposed creation of the fund to finance litigation . . . would not involve the offer and sale of a security as that term is defined in the Securities Act of 1933 . . . .”\textsuperscript{137} The question therefore remains as to whether a litigation trust is a security.

D. Is an Investor-Financed Lawsuit a Security?

An examination of investor-financed lawsuits shows that the first prong of the Howey test is easily satisfied because such lawsuits require

\begin{itemize}
  \item \textsuperscript{128} Robert L. Purvin, Jr. is the attorney who drafted the Mail Boxes Trust. See Robert L. Purvin, Jr., Letter to the Editor, 14 FRANCHISE L.J. 102, 103-04 (1995).
  \item \textsuperscript{129} See id.
  \item \textsuperscript{130} See Lokker, supra note 8, at 79-81.
  \item \textsuperscript{131} See Purvin, supra note 128, at 104.
  \item \textsuperscript{132} See Mail Boxes Trust, supra note 34, § 3.04 (“Any punitive damages awarded shall revert \textit{in toto} to the Trust for the benefit of all Participants, to be distributed as set forth in Article 4 . . . .”).
  \item \textsuperscript{133} See Purvin, supra note 128, at 103.
  \item \textsuperscript{134} See id.
  \item \textsuperscript{135} See Pritchard Trust Letter, supra note 37, at *1.
  \item \textsuperscript{136} See id.
  \item \textsuperscript{137} Id.
\end{itemize}
a commitment of money by third parties not otherwise involved in the lawsuit. Additionally, the pooling of these investors’ funds, by the franchisee, to finance the litigation fulfills the horizontal commonality requirement. Investor-financed lawsuits satisfy strict vertical commonality because the investors’ profits are tied to the promoter’s (franchisee) profits as the investors receive a distribution of the profits only if the franchisee wins the lawsuit and recovers a judgment, or agrees to a settlement. Similarly, the dependency of the investors’ profits on the franchisees’ efforts satisfies broad vertical commonality because the investors do not profit if the franchisees fail to put forth reasonable efforts to obtain a judgment or settlement in their favor.

The investor-financed lawsuit satisfies the third prong of the Howey test because an “expectation of profit” is the sole incentive for outside investors to contribute funds to a litigation in which they otherwise would have no interest. The outside investors in a syndicate lawsuit are silent investors and, therefore, do not have a managerial role in the success of the lawsuit. They rely solely on the efforts of the franchisee, named as the party to the lawsuit, and the attorney representing the franchisee.

As illustrated by the effortless satisfaction of the Howey test, it would not be surprising for investor-financed lawsuits to be found to qualify as securities under federal securities laws.

E. Possible Exemptions to the Securities Act

This preliminary analysis of securities laws and litigation funding devices points to a number of issues that seemingly impede the desirability of collective action. However, the important forces motivating these devices indicate that litigants are likely to seek resolution of these issues or will attempt to seek shelter in the form of securities law exemptions. For example, franchisees of a national franchise who want to create a litigation trust which would not be subject to securities regulation might choose to invite only franchisees from their state to participate in the agreement so that they may fall under 15 U.S.C. § 77c(a)(11), exempting “[a]ny security which is a part of an issue offered and sold only to persons resident within a single State or Territory.”138 Alternatively, if any of the three litigation funding

138. Securities Act of 1933, 15 U.S.C. § 77c(a)(11) (1994). It should be noted that this exemption is difficult to qualify for and to maintain because not only must all investors be residents of a single state, but the issuer or seller of the security must be “doing business” in that state.
devices does not require funds in excess of five million dollars, the franchisees may not be required to file a registration statement.\(^{139}\) Finally, a private offering exemption, which is available under § 77d of the Securities Act of 1933, might provide relief for a litigation funding device which involves fewer than thirty-five people.\(^{140}\)

**IV. CONCLUSION**

All in all, it is not clear whether securities regulation issues preclude the use of litigation funding devices. However, in light of the issues raised above, potential franchisee litigants should be aware of the possible encumbrances.

Due to the ease with which an investor-financed lawsuit satisfies the *Howey* test, in addition to the well-recognized common law doctrine of champerty, this litigation device appears to be the least desirable of the three. Similarly, due to the infrequent use of litigation trust agreements, especially in the franchise industry, as well as the SEC’s current “no-action” position towards them, their future remains undetermined and franchisees should be cautious in participating in them. Alternatively, franchisees may seek greater comfort through the use of class action suits to fund litigation against their franchisor. For over sixty years, plaintiffs have raised class action suits without fear of regulation by the SEC and although certain types of class actions (those funded by the class representative or by both the class representative and class members, which plead punitive damages) may technically satisfy the *Howey* test, it is unlikely that the SEC will declare them to be securities under the present securities laws because class action suits do not resemble traditional investment contracts.

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Additionally, once the exempted securities are sold, their resale may be restricted for a number of years. See 17 C.F.R. § 230.147 (1995).

139. See 15 U.S.C. § 77c(b). Note that the franchisees who rely upon this exemption may still be required to file an offering circular with the SEC. An offering circular is often less complex and burdensome than a registration statement.

140. See id. § 77d(2); 17 C.F.R. §§ 230.505-506 (1995) (stating that the funding device can include an unlimited number of accredited investors, as defined by § 230.501, but there must be a maximum of 35 unaccredited investors to qualify for this exemption).

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