

Is a Country Club Membership a Security?

By June Lin

Introduction

Imagine a country club that has purchased a ranch with houses, swimming pool, steam room, health and exercise equipment and golf course, financing the purchases in part by the sale of memberships in the country club. Apart from the price of a membership a member must also pay monthly dues. A member has the right to use all club facilities but no rights to the income or assets of the club. Memberships are transferable, but only to persons approved by the board of directors of the country club.

These country club memberships are not securities, right? Wrong! (at least if the country club is in California)

“Risk Capital” Test

The California Supreme Court developed the “risk capital” definition of a security in the 1961 case, *Silver Hills Country Club v. Sobieski*.¹ In that case promoters of a new country club established a membership plan to finance the club, which they planned to run as a business for profit.² However, there was a substantial risk that the venture would fail because the country club was inadequately capitalized and would require additional memberships to survive. The court held the membership plan to be a security because the country club was soliciting “risk capital” with which to develop a business for profit. The court found that calling the interest a “membership” did not lessen the member’s risk. Only by the member risking his capital along with other members could the benefits of club membership materialize. It is immaterial to the

¹ 55 Cal.2d 811, 13 Cal.Rptr. 186, 361 P.2d 906 (1961).

² If the country club had not been conducted for profit, its membership plan might have been exempt from the California Corporate Securities Law under the nonprofit exemption. However, this would require that the country club not be used in any way to further any business or activity of a promoter or other individual, and nobody involved in putting the club together could expect or intend to make a profit from the club.

“risk capital” test that the member has no right to participate in profits, in contrast to the traditional *Howey* federal securities law definition of an “investment contract.”³

The "risk capital" test for determining whether an interest constitutes a security looks at whether the money being put to work in a given venture will be used to develop or acquire the business or enterprise in which the interest is offered. If that test is satisfied, then such interest is deemed to be a security. Thus, a key factor under the risk capital test can be the extent of the development of the business at the time the interest is purchased. This means it is possible that otherwise identical club memberships may be a security in the hands of one member and not in the hands of another member, depending on the time the member acquired the membership and the maturity of the club at such time.

Following the *Silver Hills Country Club v. Sobieski* case, the California Attorney General indicated that he considered a security to be involved whenever an initially undercapitalized franchisor relies upon franchise fees to raise his initial capital.⁴ When California adopted its Franchise Investment Law, effective January 1, 1971, the California definition of “security” in the Corporate Securities Law of 1968 was amended to exclude any franchise subject to the Franchise Investment Law.⁵

California Law Diverges from Federal Securities Law and Securities Laws of Other States

Under the federal securities laws and in most states, acquiring a membership and becoming a member of a private country club typically would *not* be considered the offer of a security by the club or the purchase of a security by the member. As mentioned above, the federal securities law definition of a security focuses on whether investors have a right to participate in profits, which California’s “risk capital” test disregards. Courts in some states

³ *Securities and Exchange Commission v. W.J. Howey Co.*, 328 U.S. 293 (1946).

⁴ 49 Ops.Cal.Atty.Gen. 124 (1967).

⁵ California Corporate Securities Law of 1968, Section 25019.

have held that the sale of memberships in an organization in which members have no interest in the assets or profits is not a sale of securities. As opposed to the offer and sale of notes, stock, bonds, debentures or options, all of which usually signify some form of transaction involving capital raising or the acquisition of an ownership interest for investment purposes, acquiring a membership in a country club is generally considered as consumer consumption for federal securities law purposes and therefore does not involve the purchase of a security.

Country club membership is one type of consumer transaction that California courts have analyzed under the “risk capital” definition of a security. Other consumer-related transactions could easily be analyzed in the same way. For example, you could have a membership club that offers the promise of a consumer product, such as the use of luxury cars (some of which may not yet have been procured), for an up-front fee. Such product, though intended for consumer consumption, may have elements of risk and promise in the event the business venture fails. Such a startup business venture that has the purpose of providing goods or services for consumer consumption could inadvertently be deemed to be engaged in the offer and sale of securities by merely launching its products.

Conclusion

Business enterprises, especially startups, in California should be sure to analyze their proposed conduct to see if it constitutes an offering of securities under the “risk capital” test. An uninformed business may not realize that what it proposes to do or what it already has done may constitute an offering of securities, even if the intention was not to address the "investing public."

This article is intended to provide a general summary and should not be construed as a legal opinion nor a complete legal analysis of the subject matter. June Lin is an attorney at Niesar & Vestal LLP in San Francisco, a law firm specializing in business law and corporate finance.