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IS A LIMITED PARTNERSHIP INTEREST A "SECURITY"?: THE CURRENT STATE OF THE CALIFORNIA AND FEDERAL DEFINITIONS ADD A LEGAL DIMENSION TO ECONOMIC SPECULATION

INTRODUCTION

Traditionally, limited partnerships have not been widely used investment vehicles. Among investments which limit the investor's liability, corporate securities are generally more available and provide for greater ease of transfer. During the past decade, however, tax shelter programs, and particularly limited partnerships, have become increasingly popular.¹ In California they have been employed for a wide range of investments, from real estate syndications² to the financing of vineyards and cattle feed lots.³ The advantage of the limited partnership form is that it allows the start-up costs, depreciation deductions and other business losses to flow directly through to the limited partners,⁴ who are thereby provided with some form of investment loss to offset income earned from other sources. In addition to saving tax dollars, an investor in a limited partnership may also benefit from any profits earned by

1. See Van Camp, *Living With Tax Shelters in California: A Discussion of the New California Real Estate Syndication Rules*, 7 U.S.F.L. REV. 403 (1973) [hereinafter cited as Van Camp].

Legislation has been proposed which could significantly reduce the tax shelter advantages of limited partnerships. H.R. 10261, 94th Cong., 1st Sess. (1975). The passage of such legislation will undoubtedly have an effect on the future use of limited partnerships as tax shelters, and it may cause some investors who have entered limited partnerships as tax shelters to seek a way out of an unwanted profit-making investment. Under such circumstances, the issue of whether or not the particular limited partnership interests are securities may be an important point of contention. Where the partnership interests have not been registered or qualified under the federal or state securities laws, a limited partner may attempt to prove that the interests in the partnership are securities and were therefore sold illegally. Under the federal and state securities laws an investor may recover his investment under such circumstances. 15 U.S.C. § 771 (1970); CAL. CORP. CODE § 25503 (West Supp. 1975).

2. Generally, "real estate syndicate" refers to any group of investors formed for an investment in real estate. Such investments may vary widely as to the type of real estate investments made. See generally Augustine & Hrusoff, *Special Problems of Public Limited Partnerships: Investment Fees and Transferability of Interest*, 7 CALIF. WEST. L. REV. 58-59 (1970) [hereinafter cited as Augustine & Hrusoff]; Comment, *SEC Regulation of California Real Estate Syndicates*, 61 CALIF. L. REV. 206 (1973).

3. See Van Camp, *From Garden Apartments to Cattle to Pistachio Groves: Regulating Tax Shelters in California*, 4 PAC. L.J. 703 (1973).

4. Profits and losses incurred by a limited partnership are taxed directly to the limited partners. INT. REV. CODE OF 1954, § 702.

the partnership enterprise.

With the expanded marketing of this type of investment, the need for regulation to protect investors is clear.⁵ Regulation is provided in California by the California Corporate Securities Law of 1968⁶ and the California Real Estate Syndicate Act.⁷ The Securities Act of 1933⁸ also governs the issuance of securities within California which come under its broad jurisdiction.⁹ Generally, these statutes require that a proposed offering be either "qualified" or specifically exempted from qualification before it can be marketed.¹⁰ Qualification insures that investment devices of a type which pose a potential risk to the public will meet certain standards of disclosure set by the regulatory agencies.¹¹ Specific legal remedies are available in the event of a failure to comply with the qualification requirements.¹² In addition, the California laws and the Securities Act of 1933 have express anti-fraud provisions.¹³

In order to come within the ambit of these regulations the investment device must be a "security."¹⁴ If the contemplated

5. Before the boom in tax shelter programs, limited partnership interests were typically confined to high-income investors who had the benefit of professional advice. As limited partnerships and other tax shelter programs proliferated, they were offered and sold to a broader range of investors who were generally less sophisticated and not as well advised as their earlier counterparts. Van Camp, *supra* note 1, at 403.

6. CAL. CORP. CODE § 25000 *et seq.* (West Supp. 1975).

7. CAL. BUS. & PROF. CODE § 10250 *et seq.* (West Supp. 1975).

8. 15 U.S.C. § 77a *et seq.* (1970).

9. The use of interstate commerce or the mails to offer, sell, or deliver a security triggers jurisdiction under the Securities Act of 1933. 15 U.S.C. § 77e (1970).

10. 15 U.S.C. §§ 77e-f (1970); CAL. BUS. & PROF. CODE § 10270 (West Supp. 1975); CAL. CORP. CODE § 25110 (West Supp. 1975).

11. "Qualification" is the term used in the California Code, and will be used in this comment to include "registration," which is the analogous term used in the federal securities laws.

The qualification statement is basically an information document. The actual process of qualification varies between the SEC, the California Department of Real Estate, and the California Department of Corporations. 15 U.S.C. §§ 77f-g (1970); CAL. BUS. & PROF. CODE § 10271 (West Supp. 1975); CAL. CORP. CODE §§ 25111-13 (West Supp. 1975).

12. 15 U.S.C. §§ 77i, q (1970); CAL. BUS. & PROF. CODE § 10288 (West Supp. 1975); CAL. CORP. CODE §§ 25400-01 (West Supp. 1975).

In addition to disclosure requirements and anti-fraud regulation, the California Corporate Securities Law and the Real Estate Syndicate Act give the commissioners of their respective departments discretion to withhold or revoke qualification permits if it is determined that the transaction or offering is not "fair, just, or equitable." CAL. BUS. & PROF. CODE §§ 10280-81 (West Supp. 1975); CAL. CORP. CODE § 25140 (West Supp. 1975).

13. 15 U.S.C. § 77i (1970); CAL. BUS. & PROF. CODE §§ 10238.6-.7 (West Supp. 1975); CAL. CORP. CODE §§ 25503, 25540 (West Supp. 1975).

14. 15 U.S.C. § 77e (1970); CAL. BUS. & PROF. CODE § 10270 (West Supp. 1975);

investment is not a "security" the regulations do not apply and no qualification is required. Consequently, the threshold legal question for a party marketing an investment vehicle must always be: is it a security? For many investments, such as corporate stocks, the answer is obvious. On the other hand, less common types of investment interests may require careful analysis. Interests in limited partnerships¹⁵ fall into this latter category.

Some of the authorities on the subject have asserted that all limited partnership interests are securities,¹⁶ although the reasons offered to support this view are vague and not based on current interpretation of the securities laws.¹⁷ Other commentators have indicated that limited partnership interests may or may not be securities,¹⁸ or that no bona fide limited partnership interest is a security.¹⁹ Three California appellate court decisions have adopted the third position.²⁰ Thus, the status of limited partnership interests under the securities laws is far from settled. Clarifying it, so that a syndicator²¹ can know with reasonable certainty that a limited partnership offering is or is not a security, will require an examination into the statu-

CAL. CORP. CODE § 25110 (West Supp. 1975).

15. A "limited partnership interest" refers to a right of participation as a limited partner and includes the right to have the advantages accruing from the limited partnership. Cf. BLACK'S LAW DICTIONARY 950 (4th rev. ed. 1951).

16. R. JENNINGS & H. MARSH, SECURITIES REGULATION 309 (3d ed. 1972); H. MARSH & R. VOLK, PRACTICE UNDER THE CALIFORNIA CORPORATE SECURITIES LAW OF 1968, at 161 (1969).

17. Both of the commentators cited in note 16, *supra*, maintain that limited partnership interests are securities because the limited partners may not, by definition, take part in the control of the partnership business. R. JENNINGS & H. MARSH, SECURITIES REGULATION 309 (3d ed. 1972); H. MARSH & R. VOLK, PRACTICE UNDER THE CALIFORNIA CORPORATE SECURITIES LAW OF 1968, at 161 (1969). While it is true that the applicable partnership law does not allow limited partners to participate in the control of the partnership enterprise, CAL. CORP. CODE § 15507 (West Supp. 1975), investor passivity, taken alone, has never been the test for finding a security under the state or federal definitions. See text accompanying notes 69-77, 98-103 *infra*.

18. 1 L. LOSS, SECURITIES REGULATION 503-05 (2d ed. 1961).

19. Dahlquist, *Regulation and Civil Liability Under the California Corporate Securities Act*, 33 CALIF. L. REV. 361-63 (1945) [hereinafter cited as Dahlquist].

20. *Solomont v. Polk Dev. Co.*, 245 Cal. App. 2d 488, 54 Cal. Rptr. 22 (1966); *Rivlin v. Levine*, 195 Cal. App. 2d 13, 15 Cal. Rptr. 587 (1961); *Farnsworth v. Nevada-Cal Management, Ltd.*, 188 Cal. App. 2d 382, 10 Cal. Rptr. 531 (1961).

21. For the purposes of this comment, "syndicator" shall mean the person, group, or corporation which initiates and forms the limited partnership, to include the offer and sale of the partnership interests. This consolidation of roles is done to avoid confusion, and in reality the parties who initiate, form and market partnership interests may not be the same.

tory definitions of "security" and the cases which interpret them.

It will be the purpose of this comment to provide such an examination, and a critical evaluation of the current state and federal definitions of "security" as they relate to limited partnership interests. The first section analyzes and argues against the proposition that limited partnership interests must be securities merely because some types of limited partnership interests fall within the exemption provisions of the securities laws. The second section sets out California's statutory definitions of securities and evaluates two judicial tests promulgated to interpret the meaning of "security" under the California Corporate Securities Law. Next, the judicial definition of "security" under the Securities Act of 1933 is described and its application to limited partnership interests analyzed. This process leads to the conclusion that in many cases it is impossible to determine, by applying current state and federal standards, whether or not particular limited partnership interests are securities, and consequently that the standards need to be more precisely defined. The final section presents a test employed by the Hawaii Supreme Court, which provides an example of how the California and federal definitions might satisfactorily be clarified.

A DEFINITION BASED ON THE EXEMPTION PROVISIONS

Certain types of securities do not require qualification because of specific exemption provisions in the state²² and federal laws.²³ In the case of limited partnerships, the "private offering" exemption, which exempts interests not offered and sold to the public at large,²⁴ is the most commonly used. One argument for the proposition that limited partnership interests are securities is that if they were not, there would be no need specifically to exempt *private* limited partnership offerings from the securities laws.²⁵ Carried to its logical extreme, this argument would hold that each and every interest or transac-

22. CAL. BUS. & PROF. CODE §§ 10260-62 (West Supp. 1975); CAL. CORP. CODE §§ 25100-06 (West Supp. 1975).

23. 15 U.S.C. §§ 77c-d (1970).

24. *Id.* § 77d(2); CAL. BUS. & PROF. CODE § 10261 (West Supp. 1975); CAL. CORP. CODE § 25102(f) (West Supp. 1975).

25. This argument has been made by one of the leading commentators on California limited partnerships. See Freshmen, *Partnership and the Corporate Securities Law of 1968*, 44 L.A. BAR BULL. 520 (1969).

tion which is exempted is necessarily a security.

While the presence or absence of an exemption may be some indication of the relative need for regulation, it is not determinative of the "security" question. It is doubtful that the drafters of the securities laws intended the exemptions from qualification to define what is and what is not a "security," especially in light of the fact that specific definitional sections were drafted for that purpose.²⁶ The threshold determination of whether or not a limited partnership interest is a security must be made independently of the qualification exemptions, and ultimately, with reference to the statutes which define "security."

THE CALIFORNIA DEFINITIONS

A California limited partnership interest may come under the jurisdiction of either the Department of Real Estate or the Department of Corporations. The Real Estate Syndicate Act applies only to real estate transactions,²⁷ while the Corporate Securities Law is not limited in scope as to the type of business transactions covered. As a general rule, limited partnerships with fewer than 100 partners formed solely for an investment in real property come within the jurisdiction of the Department of Real Estate.²⁸ All other limited partnership interests, including real estate limited partnership interests not covered by the Real Estate Syndicate Act, are governed by the Corporate Securities Law. This distinction is important because the statutory definitions of "security" are different under the two laws.

Statutory Definitions

The Real Estate Syndicate Act provides a broad, simple definition of "real estate syndicate security" which expressly includes limited partnership interests. A "real estate syndicate security" is "any interest in a real estate syndicate,"²⁹ and a real estate syndicate is

any general or limited partnership . . . owned beneficially

26. 15 U.S.C. § 77b(1) (1970); CAL. CORP. CODE § 25019 (West Supp. 1975).

27. CAL. BUS. & PROF. CODE § 10251 (West Supp. 1975).

28. *Id.* The California Department of Corporations has issued guidelines which specifically delineate jurisdiction between the Department of Real Estate and the Department of Corporations. See Cal. Dep't of Corp., Jurisdiction of Real Estate Syndicate Qualification Release No. 32-c (June 27, 1973).

29. CAL. BUS. & PROF. CODE § 10251(c) (West Supp. 1975).

by no more than 100 persons and formed for the sole purpose of and engaged solely in investment in or gain from an interest in real property, including, but not limited to, a sale, exchange, trade, or development.³⁰

Thus, the sale of any limited partnership interest that conforms to this definition will be considered the sale of a "real estate syndicate security" and will be subject to the regulatory provisions of the act, including the qualification requirement.

The characterization of limited partnership interests under the Corporate Securities Law presents a more difficult question of interpretation. While section 25019 of the Corporations Code defines "security" broadly, it does not specifically include interests in a limited partnership.³¹ Of the securities expressly enumerated in that section, a limited partnership interest could be described as either a "profit-sharing agreement" or an "investment contract"; but such characterizations are not determinative of the question. "Investment contract" and "profit-sharing agreement" are only a little less broad than "security," and themselves require definition. Rather than defining each of the statutory categories separately, it has been the practice of the California courts to focus on the underlying nature of the interests or transactions involved.³² It has consistently been held that form must yield to substance,³³ and the crucial question is whether the interest or transaction comes within the regulatory purpose of the Corporate Securities

30. *Id.* (a).

31. Section 25019 defines "security" as

any note; . . . certificate of interest or participation in any profit-sharing agreement; . . . investment contract; . . . certificate of interest or participation in an oil, gas or mining title or lease or in payments out of production under such a title or lease; . . . 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.

CAL. CORP. CODE § 25019 (West Supp. 1975).

32. Typically, a court will use one of the terms enumerated in section 25019 of the California Corporate Securities Law to describe the interest or transaction at issue, but the decisions focus on the meaning of "security" rather than particular statutory terms. *See, e.g.,* *Hamilton Jewelers v. Department of Corp.*, 37 Cal. App. 3d 330, 112 Cal. Rptr. 387 (1974); *People v. Witzerman*, 29 Cal. App. 3d 169, 105 Cal. Rptr. 284 (1972). In the landmark case, *Silver Hills Country Club v. Sobieski*, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961), the court did not identify the interest with one of those listed in the statutory definition.

33. *See* *Silver Hills Country Club v. Sobieski*, 55 Cal. 2d 811, 814, 361 P.2d 906, 907, 13 Cal. Rptr. 186, 187 (1961).

Law.³⁴ Such determination necessarily involves a case-by-case approach.³⁵

The Mutual Selection Test

A close examination of the case law reveals that California courts have used a number of standards to determine whether a particular investment vehicle is a security. The one which is most commonly associated with limited partnership interests has its roots in an article written by T. W. Dahlquist in 1945 defining the scope of the California securities laws.³⁶ Dahlquist cites four general attributes of securities:

an attempt by an issuer to raise funds for a business venture or enterprise; an indiscriminate offering to the public at large where the persons solicited are selected at random; a passive position on the part of the investor; and the conduct of the enterprise by the issuer with other people's money.³⁷

In his discussion of partnership interests Dahlquist focuses on the second attribute. He maintains that in a "bona fide" limited partnership, the memberships are never indiscriminately offered to the public.³⁸ A true limited partnership always involves a right of *delectus personarum*, a right to determine membership:³⁹ each partner must approve the admission of a new partner or the transfer of a partnership interest.⁴⁰ Where such a right of mutual selection exists, Dahlquist would hold that the partnership is a "bona fide" partnership and the sale of an interest therein does not constitute the sale of a security.⁴¹

Three California appellate court decisions dealing with limited partnership interests have focused on the mutual selection test without specifically adopting the other Dahlquist criteria.⁴² In *Farnsworth v. Nevada-Cal Management, Ltd.*,⁴³ the

34. *Id.* Generally, the securities laws are remedial in nature, and their purpose is to protect the public from unsubstantial or fraudulent investment schemes and the securities based upon them. *Hall v. Geiger-Jones Co.*, 242 U.S. 539, 550 (1917); *People v. Syde*, 37 Cal. 2d 765, 768, 235 P.2d 601, 603 (1951).

35. *People v. Syde*, 37 Cal. 2d 765, 768, 235 P.2d 601, 602-03 (1951).

36. Dahlquist, *supra* note 19.

37. *Id.* at 360.

38. *Id.* at 363.

39. *Id.*

40. *Id.*

41. *Id.*

42. One recent federal district court decision has also employed the mutual selection test in a case involving both general and limited partnership interests.

limited partners were co-owners of real property in Nevada and California. Each contributed his share of the property in return for an interest in the limited partnership, and no interests were offered or sold to parties outside the group.⁴⁴ The court held that the limited partnership interests were exempted from qualification with the Department of Corporations because they were "not offered to the public."⁴⁵ However, as an independent grounds for affirmance, the court applied the mutual selection test. Noting that the partnership was plainly a "closed venture"⁴⁶ in which the partners were previously associated, the court concluded that the undertaking was a bona fide limited partnership and the interests sold did not constitute securities within the meaning of the statute.⁴⁷

In another 1961 case, *Rivlin v. Levine*,⁴⁸ the court used the mutual selection test to find that limited partnership interests were securities. In *Rivlin*, the defendant had solicited various friends and acquaintances to invest as limited partners in a real estate venture; but, unlike the *Farnsworth* situation, there was no prior association among the limited partners and they never met as a group.⁴⁹ On this basis the court found that the element of mutual selection was missing and therefore no bona fide limited partnership was formed.⁵⁰ A third case, *Solomont v. Polk Development Co.*,⁵¹ involved essentially the same fact situation. The partnership interests had been offered to various individuals without an opportunity for a mutual meeting or a unanimous selection of the partners.⁵² The trial court found the interests to be securities and the appellate court affirmed, citing the *Rivlin* rule.⁵³

The Dahlquist article and the cases, taken together, create some confusion as to whether the element of mutual selection must be present at the inception of the limited partnership, or

Curiously, the court applied the test only to the general partnership interests. *Hirsch v. duPont*, 396 F. Supp. 1214, 1226-28 (S.D.N.Y. 1975).

43. 188 Cal. App. 2d 382, 10 Cal. Rptr. 531 (1961).

44. *Id.* at 388-89, 10 Cal. Rptr. at 534-35.

45. *Id.* at 386, 10 Cal. Rptr. at 533.

46. *Id.* at 389, 10 Cal. Rptr. at 535.

47. *Id.* at 390, 10 Cal. Rptr. at 535.

48. 195 Cal. App. 2d 13, 15 Cal. Rptr. 587 (1961).

49. *Id.* at 23, 15 Cal. Rptr. at 594.

50. *Id.*

51. 245 Cal. App. 2d 488, 54 Cal. Rptr. 22 (1966).

52. *Id.* at 497, 54 Cal. Rptr. at 28.

53. *Id.*

whether it is akin to a restriction on transfer which pertains only to the addition or substitution of partners. Dahlquist did not confront this issue directly, but as authority for his assertion that mutual selection is necessary in bona fide limited partnerships, he referred to the 1945 Civil Code sections⁵⁴ which required the signature of all the partners for the admission of additional or substituted limited partners. This supports the conclusion that Dahlquist intended the mutual selection test to be based on the statutory partnership law, and to be applicable only to the sale of interests after formation of the partnership.

The cases, however, indicate an opposite conclusion, and they are the only authority available for a correct application of the mutual selection test. While none of the cases employing the test specifically states that there must be a mutual selection of partners at formation, each of the three appellate court cases clearly bases its holding on factors relating to the inception of the partnership.⁵⁵ Thus, it can be implied from the consistent application of the principle that the mutual selection requirement is to be applied to the circumstances surrounding the formation of a limited partnership: where there is, at the inception of the venture, an exercise of the right of mutual selection by prospective partners, California courts applying the mutual selection test will find that the limited partnership interests offered are not securities and thus not subject to the provisions of the Corporate Securities Law.

The mutual selection test is intended to be applied only to partnership interests.⁵⁶ Essentially, it is a negative criterion. If the element of mutual selection is present, the partnership interest will not be considered a security. On the other hand, the mere fact that mutual selection is absent should not necessitate a finding that a partnership interest is a security. Certainly a court will require that other, positive characteristics of a security be present before it will declare the interest subject to the securities laws. The three cases employing the mutual selection test do not indicate precisely what elements make up any additional criteria for determining security status. Pre-

54. Dahlquist, *supra* note 19, at 363.

55. See *Solomont v. Polk Dev. Co.*, 245 Cal. App. 2d 488, 54 Cal. Rptr. 22 (1966); *Rivlin v. Levine*, 195 Cal. App. 2d 13, 15 Cal. Rptr. 587 (1961); *Farnsworth v. Nevada-Cal Management, Ltd.*, 188 Cal. App. 2d 382, 10 Cal. Rptr. 531 (1961).

56. See Dahlquist, *supra* note 19, at 361-65.

sumably a court would apply either Dahlquist's four-part description of securities⁵⁷ or the various criteria which are announced in other California securities cases not employing the mutual selection test.⁵⁸ Although the mutual selection test was originally formulated by Dahlquist, it has been applied independently of his general description of securities, and it is more realistic to view it as a primary test to be used in conjunction with other criteria only when limited partnership interests are in question.

The use of the mutual selection test will generally compel a result related to the number of limited partners in a particular partnership. As a practical matter, most larger limited partnerships are offered to the public, and in most instances a valid mutual selection would be highly improbable by virtue of the number and dispersion of the limited partners. Under the mutual selection test, the lack of a *delectus personarum* would militate towards a finding that the interests in such partnerships are securities. On the other hand, a smaller limited partnership, where mutual selection of members takes place, would not be subject to the securities laws in spite of the fact that an interest in the partnership may resemble a security in all other respects.

The Risk Capital Test

The major test used by California courts to define "security" is commonly referred to as the "risk capital" test. Under this test an interest will be deemed to be a security whenever the investor is required to provide the capital which will be risked in the promoter's enterprise. The test was originally applied by the California Supreme Court in *Silver Hills Country Club v. Sobieski*,⁵⁹ which involved the sale of memberships in a developing Marin County country club. Memberships were offered to the public and the proceeds were used to provide capital for purchase of the club's property.⁶⁰ The court quoted Dahlquist's four general attributes of a security,⁶¹ but then focused on an element the Dahlquist definition did not include: risk to the purchaser's capital.

57. See text accompanying note 37 *supra*.

58. See text accompanying notes 69-73 *infra*.

59. 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961).

60. *Id.* at 812-13, 361 P.2d at 906-07, 13 Cal. Rptr. at 186-87.

61. *Id.* at 815, 361 P.2d at 908, 13 Cal. Rptr. at 188.

We have nothing here like the ordinary sale of a right to use existing facilities. Petitioners are soliciting the risk capital with which to develop a business for profit Only because he risks his capital along with other purchasers can there be any chance that the benefits of club membership will materialize.⁶²

The court stated that the solicitation of risk capital constitutes the sale of a security whether or not there is an expectation of profit by those who supply the capital.⁶³

Since *Silver Hills*, the California courts have applied the risk capital test to categorize a broad spectrum of interests.⁶⁴ In each of the cases where the interest at issue has been found to be a security, the pivotal element has been the fact that the investor furnished the capital risked in the enterprise.⁶⁵ Where the investor's money was not at risk, courts have declined to characterize the interest as a security. In *Hamilton Jewelers v. Department of Corporations*,⁶⁶ for example, the court of appeals found that the sale of diamonds coupled with a buy-back guarantee did not involve risk to the purchaser, who was free to dispose of the gems or sell them back to the jewelry store with interest, and consequently held that the contract was not a security.⁶⁷

Risk to invested capital is clearly an essential characteristic of a security,⁶⁸ but if risk is the only criterion for finding a security, the test is too broad to be useful. Undoubtedly, the California courts that have used the risk capital test have also looked for other key elements; in stressing the risk feature, however, they have failed to expressly set out those other elements.

62. *Id.*

63. *Id.* at 815, 361 P.2d at 908-09, 13 Cal. Rptr. at 188-89.

64. *E.g.*, *Hamilton Jewelers v. Department of Corp.*, 37 Cal. App. 3d 330, 112 Cal. Rptr. 387 (1974) (sale of diamonds coupled with a buy-back guarantee); *People v. Witzerman*, 29 Cal. App. 3d 169, 105 Cal. Rptr. 284 (1972) (cattle care contracts); *Clejan v. Reisman*, 5 Cal. App. 3d 224, 84 Cal. Rptr. 897 (1970) (undescribed interests in ranch property); *People v. Walberg*, 263 Cal. App. 2d 289, 69 Cal. Rptr. 457 (1968) (unsecured promisory notes issued by a nonprofit corporation).

65. *See, e.g.*, *People v. Witzerman*, 29 Cal. App. 3d 169, 105 Cal. Rptr. 284 (1972); *Clejan v. Reisman*, 5 Cal. App. 3d 224, 84 Cal. Rptr. 897 (1970); *People v. Walberg*, 263 Cal. App. 2d 286, 69 Cal. Rptr. 457 (1968).

66. 37 Cal. App. 3d 330, 112 Cal. Rptr. 387 (1974).

67. *Id.* at 335-36, 112 Cal. Rptr. at 390-91.

68. The importance of the element of risk is given extensive treatment in Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?*, 18 CASE W. RES. L. REV. 367 (1967) [hereinafter cited as Coffey].

One of the more obvious elements, an investment in a common enterprise, can be implied from its presence in virtually all the cases following *Silver Hills*.⁶⁹ Another factor which can be found in a number of the California cases defining "security" is a requirement that investors take a passive role in the conduct of the enterprise.⁷⁰ In *People v. Syde*,⁷¹ a California Supreme Court case preceding *Silver Hills*, the court stressed the distinction between active and passive participation by investors,⁷² holding that the Corporate Securities Law is not applicable where investors are active participants in the enterprise.⁷³ Unfortunately, *Syde* and the cases which follow it do not delineate the amount or type of investor participation which will be allowed before investment interests are determined to be securities. It is not clear whether the investor must be entirely passive, or whether some limited participation in the conduct of the venture is permissible; nor is it certain whether the prohibition applies to all areas of possible participation, or only to managerial control.

It is also possible that the *Silver Hills* court intended to incorporate as criteria Dahlquist's four-part description of securities.⁷⁴ It is quoted in the *Silver Hills* decision⁷⁵ and again in a 1970 appellate court decision defining "security,"⁷⁶ but it is not clear whether it is intended actually to provide specific standards for the classification of an interest, or is included only as a general description of securities. Thus, the risk capital test, as it has developed in California, provides somewhat uncertain guidance for the identification of a "security."

69. See cases cited note 64 *supra*.

70. See, e.g., *People v. Witzerman*, 29 Cal. App. 3d 169, 105 Cal. Rptr. 284 (1972); *Sarmiento v. Arbax Packing Co.*, 231 Cal. App. 2d 421, 41 Cal. Rptr. 869 (1964).

71. 37 Cal. 2d 765, 235 P.2d 601 (1951).

72. In *Syde* the California Supreme Court stated:

It is settled that the Corporate Securities Law was not intended to afford supervision and regulation of instruments which constitute agreements with persons who expect to reap a profit from their own services or other active participation in a business venture. Such contracts are clearly distinguished from instruments issued to persons who, for a consideration paid, stipulate for a right to share in the profits or proceeds of a business enterprise to be conducted by others

37 Cal. 2d at 768, 235 P.2d at 603.

73. *Id.*

74. See text accompanying note 37 *supra*.

75. 55 Cal. 2d at 815, 361 P.2d at 908, 13 Cal. Rptr. at 188 (1961).

76. *Clejan v. Reisman*, 5 Cal. App. 3d 224, 234, 84 Cal. Rptr. 897, 902 (1970).

Limited Partnership Interests Under the Risk Capital Test

Combining those components which, by implication, are central in the California cases, the risk capital test appears to require (1) an investment in a common enterprise, (2) where the investor furnishes the capital to be placed at risk, (3) with or without an expectation of profit,⁷⁷ (4) and takes a passive role in the conduct of the enterprise. On these criteria, nearly all limited partnership interests would be securities. Limited partners invest all or part of the capital which is risked in the common partnership enterprise, and as a general rule, they do not participate actively in the partnership enterprise. However, in situations where the limited partners perform some active functions in the venture, the ambiguity of the investor passivity requirement may present a problem. Under the California Uniform Limited Partnership Act, a limited partner may not take part in the "control" of the partnership enterprise without losing his "limited" status and thus his immunity from personal liability.⁷⁸ This prohibits managerial activity on the part of the limited partners, but it does not bar all participation.⁷⁹ Whether the passivity requirement of the risk capital test merely reflects the statutory ceiling on participation by a limited partner, or whether it imposes stricter limitations, is not clear. Consequently, in a venture where the limited partners take or can be expected to take an active but less than managerial role, the risk capital test offers little guidance to promoters who need to know whether the limited partnership interests they expect to market are subject to California securities laws.⁸⁰

77. See text accompanying note 63 *supra*.

78. CAL. CORP. CODE § 15507(a) (West Supp. 1975) provides:

A limited partner shall not become liable as a general partner unless, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business.

79. See *Plasteel Prod. Corp. v. Helman*, 271 F.2d 354 (1st Cir. 1959); *Grainger v. Antoyan*, 48 Cal. 2d 805, 313 P.2d 848 (1957).

The Uniform Limited Partnership Act also provides that limited partners may not contribute services. CAL. CORP. CODE § 15504 (West 1955). A Colorado Supreme Court decision has held that "contribution" refers to contributions by limited partners at the time of formation only. *Silvola v. Rowlett*, 129 Colo. 522, 272 P.2d 287 (1954). A federal district court decision states that the limitation is not confined to contributions at the formation of the partnership, but applies whenever the *only* contributions for which profits are to be paid are services. *Plasteel Prod. Corp. v. Eisenberg*, 170 F. Supp. 100, 103 (D. Mass.), *aff'd on other grounds*, 271 F.2d 354 (1st Cir. 1959). Under either of these definitions a "contribution" in the form of minor participation by the limited partners, where it did not constitute their original or only contribution, would be permitted.

80. An identical problem would arise under the mutual selection test if investor

Mutual Selection v. Risk Capital

The risk capital test is now the generally accepted test for defining "security" in California.⁸¹ While it has been used to categorize a wide variety of investment interests, it has never been applied in a case involving limited partnership interests. On the other hand, all three of the cases employing the mutual selection test dealt with limited partnership interests,⁸² and they have never been overruled or disapproved in the subsequent risk capital cases. From that standpoint it would appear that a California court would apply the mutual selection test when charged with determining whether or not a particular limited partnership interest is a security. However, mutual selection may no longer provide a useful or consistent standard for characterizing limited partnership interests, especially in light of the subsequent widespread use of the risk capital test. Consequently, a question arises as to what test a California court should apply to determine whether a limited partnership interest is a security as defined in section 25019 of the Corporate Securities Law.

There are a number of reasons to doubt the continued usefulness of the mutual selection test. First, the test is too narrow: it ignores the whole range of limited partnerships which are offered and sold to the public at large—and consequently do not offer a right of mutual selection—by excluding such organizations from the class of "bona fide" partnerships. It is a strained interpretation to insist that an association formed in compliance with the Uniform Limited Partnership Act⁸³ is not a "bona fide" partnership. A more logical interpretation is that any limited partnership which conforms to the provisions of the Act is a bona fide partnership, and that the participatory interests in some of these partnerships may also be securities under the Corporate Securities Law. In so far as the mutual selection test serves only to identify and exclude "true" limited partnerships, it is irrelevant. Both the large public partnership and the small organization with controlled

passivity is one of the positive criteria of that test. Presumably, investor passivity would be included whether the mutual selection test draws its positive criteria from the California case law or from Dahlquist's four elements, which also include the requirement that investors be passive. See text accompanying note 37 *supra*.

81. *Hamilton Jewelers v. Department of Corp.*, 37 Cal. App. 3d 330, 335, 112 Cal. Rptr. 387, 390 (1974).

82. See text accompanying notes 43-53 *supra*.

83. See CAL. CORP. CODE § 15502 (West Supp. 1975).

membership may be securities and should be judged, for the purpose of determining the status of their investment interests, in accord with a more relevant set of criteria.

Another objection to the acceptance of the mutual selection test is that it would create a double set of standards for defining "security" under the Corporate Securities Law. Since all other types of interests apparently are to be subjected to the risk capital test, maintaining the mutual selection test for partnership interests would require segregating them and judging them according to different criteria.⁸⁴ A dual standard would not be objectionable if peculiarities of the limited partnership as an investment vehicle made the risk capital test an inadequate standard, or even if the two tests achieved the same result when applied in generally similar circumstances. However, neither of these conditions exists. The risk capital test provides a uniform standard; while it is not entirely clear in all its aspects, it is no less applicable to limited partnership interests than to any other type of investment interest. Moreover, the risk capital and mutual selection tests may compel contradictory conclusions on identical facts.⁸⁵

Finally, use of the mutual selection test would create a potential anomaly: disparate treatment of limited partnership interests under the Real Estate Syndicate Act and the Corporate Securities Law. A limited partnership with fewer than 100 members formed for an investment in real estate is a security under the Real Estate Syndicate Act⁸⁶ even where there has been a mutual selection of partners. In contrast, a similar partnership formed for non-real estate investment and thus outside the jurisdiction of the Real Estate Syndicate Act would not be a security under the Corporate Securities Law if the mutual selection test were applied: the existence of a right of *delectus personarum* would make it a "bona fide" limited partnership

84. Although the mutual selection test, in origin and application, deals only with partnership interests, there is no reason why it could not be applied in many of the fact situations presented in the risk capital cases. See cases cited note 64 *supra*. Possibly, the fact that it has not been used more extensively reflects on its usefulness as a standard for determining the reach of the securities laws.

85. This would be so in the case of a small limited partnership where the members had exercised a right to determine membership, provided the risk capital for the enterprise, and took a passive role in its conduct. Under the mutual selection test, such a partnership is a "bona fide" limited partnership and, therefore, not a security. Conversely, under the risk capital test, such a partnership is a security because of risk to the investors' capital and their passive position in the conduct of the enterprise.

86. See notes 27-28 and accompanying text *supra*.

exempt from securities regulation. While the Department of Real Estate and the Department of Corporations have different jurisdictions, there is a certain degree of interaction,⁸⁷ and agencies which regulate similar interests with similar objectives should not arrive at contradictory definitions of such key jurisdictional terms as "security."

In summary, the mutual selection test provides an inadequate standard for determining whether limited partnership interests are securities under the Corporate Securities Law. When Dahlquist proposed the test in 1945, large public partnerships were neither prevalent nor anticipated.⁸⁸ Consequently, the application of the mutual selection test to modern limited partnership interests results in an artificial distinction between "bona fide" limited partnerships and all others. Neither the Uniform Limited Partnership Act nor the Corporate Securities Law makes such a distinction. More important, the use of the mutual selection test would set up a separate standard for defining "security" applicable only to limited partnership interests. Where the predominant test is adequate to accomplish the same purpose, a second and potentially inconsistent test is undesirable. In addition, the use of the mutual selection test could, in some circumstances, lead to contradictory definitions of "security" under the Real Estate Syndicate Act and the Corporate Securities Law, with no policy to be served or benefit to be achieved by such variance.

As between the mutual selection and risk capital tests, the latter is a preferable standard. Nevertheless, the ultimate fact is that it is impossible to predict which test now represents the judicial preference. Confronted with a limited partnership interest, a California court could apply the mutual selection test as settled law or opt for the risk capital test as representing the

87. In many cases the division of jurisdiction between the Department of Corporations and the Department of Real Estate is highly technical. For example, a limited partnership formed solely for an investment in real estate owned by 90 partners would come under the jurisdiction of the Department of Real Estate. The same partnership with 110 partners would come under the jurisdiction of the Department of Corporations. CAL. BUS. & PROF. CODE § 10251 (West Supp. 1975). In the case of limited partnerships which own and operate agricultural land, jurisdiction between the two departments depends upon whether the harvested products are processed or converted into a different form. Cal. Dep't of Corp., Jurisdiction of Real Estate Syndicate Qualification, Release No. 32-c, June 27, 1973.

88. In his article, Dahlquist states that limited partnerships "do not readily lend themselves to bold and dishonest schemes whereby capital is raised to carry out a venture by indiscriminate solicitation of the public at large." Dahlquist, *supra* note 19, at 363.

modern weight of authority. Possibly, a court would apply both tests simultaneously: if there is mutual selection among partners, the partnership interests would never be securities; but where there is no mutual selection, risk capital criteria would apply.

The end result is uncertainty. The syndicator of a limited partnership cannot know which test will apply or precisely what its elements are. Obviously, the safe procedure is to assume that the interests to be offered are securities and subject to the securities laws. However, this does not resolve the problem for the syndicator, the limited partners, or other parties such as the Department of Corporations, in an action after the fact where it must be determined whether or not the particular interest offered or sold was a "security."

THE FEDERAL DEFINITION

The Securities Act of 1933 applies to securities offered or sold within the state⁸⁹ and, unless it is exempted,⁹⁰ requires registration of any investment device that meets the Act's definition of "security," regardless of its status under state law.⁹¹

The definition of "security" in the 1933 Act⁹² is substantially identical to that contained in section 25019 of the California Corporate Securities Law,⁹³ and presents similar problems of interpretation. The two statutes are also similar in purpose⁹⁴ and general construction,⁹⁵ but the federal courts have placed more emphasis on identifying and defining the separate statu-

89. See note 9 *supra*.

90. The Act provides for a number of exemptions. See 15 U.S.C. §§ 77c-d (1970). Partnerships offered and sold only within the state are exempted by the "intrastate" offering exemption. 15 U.S.C. § 77c (1970). The exemption, however, is only from the registration requirements.

91. 15 U.S.C. §§ 77e-f (1970).

92. The Securities Act of 1933 defines "security" as
any note, . . . evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, . . . investment contract, . . . fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security"

15 U.S.C. § 77b(1) (1970).

93. See note 31 *supra*.

94. Generally, the purpose of the federal Securities Act is to "protect the American public from speculative or fraudulent schemes of promoters." SEC v. Glenn W. Turner Ent., Inc., 474 F.2d 476, 481 (9th Cir. 1973), *cert. denied*, 414 U.S. 821 (1973).

95. The Act is construed broadly, and form is disregarded for substance. Tcherpnin v. Knight, 389 U.S. 332, 336, 337 (1967).

tory categories. Of these, "investment contract" has received a great deal of attention in the courts, and at least one federal decision has found that limited partnership interests fall within this category.⁹⁶

The Howey Test

The federal definition of "investment contract" has developed through a line of cases relying primarily on the U.S. Supreme Court decision, *SEC v. W.J. Howey Co.*⁹⁷ In *Howey*, the Court held that an investment contract, for purposes of the Securities Act, means "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party"⁹⁸ The investors in *Howey* had purchased acreage units of citrus groves, the transactions including agreements that the Howey Company would cultivate and market the produce.⁹⁹ The Court noted that all the elements of a profit-seeking venture were present.¹⁰⁰ The investors provided the capital and shared in the profits, while the promoters managed the enterprise.¹⁰¹ Under the Court's definition, the interests sold were "investment contracts" and therefore securities within the meaning of the 1933 Act.¹⁰²

The *Howey* definition of "investment contract" contained four elements: (1) the investor invests money, (2) in a common enterprise, (3) with the expectation of profit, (4) to be derived solely from the efforts of others. This test has been employed throughout the federal courts, but not without criticism.¹⁰³

The Profit Expectation Criterion

All limited partnerships meet the first two *Howey* criteria: (1) the investment of money, (2) in a common enterprise. The third requirement is an expectation of profit,¹⁰⁴ but it is not

96. *McGreghar Land Co. v. Megniar*, CCH FED. SEC. L. REP. ¶ 95,273 (9th Cir. 1975).

97. 328 U.S. 293 (1946).

98. *Id.* at 298-99.

99. *Id.* at 295-96.

100. *Id.* at 300.

101. *Id.*

102. *Id.* at 298.

103. *See Coffey, supra* note 68.

104. *See* text accompanying note 98 *supra*. Unlike a regular partnership, there is no requirement in the California Uniform Limited Partnership Act that the partner-

entirely clear what this test encompasses. It is apparently intended to be an objective test focusing on the investor's expectation of profits, occasioned by specific inducements or by the nature of the enterprise.¹⁰⁵ All limited partnerships contemplate profits,¹⁰⁶ but investors seeking a tax shelter clearly are looking initially—if not exclusively—for a loss.

In order to create a tax shelter, the partnership enterprise must show some kind of loss, whether it be an actual loss, a "paper loss," or a deductible depreciation of capital assets.¹⁰⁷ Typically, the losses are not sustained (or the promoters do not intend them to be sustained) throughout the whole term of the partnership, and in the end there may or may not be a net profit based on the earnings of the enterprise. It is not clear that a partnership designed to generate both an immediate loss and an eventual profit would meet the profit-expectation test. The requirement of profit expectation can be construed in three ways: (1) that profit be the sole expectation of the investor; (2) that it be the primary expectation; or (3) that it merely be present. If profit must be the *sole* expectation of the investor, most tax-shelter limited partnerships would escape classification as securities, because they also contemplate the type of losses which will produce a tax savings for the limited partners. If profit must be the *primary* expectation of the investor, determination will require an elaborate case-by-case investigation into the representations made to the investor and the expectations that might reasonably follow from them. On the other hand, if profit expectation simply has to be *present*, virtually all limited partnerships will meet the test.

ship be carried on for profit. Compare CAL. CORP. CODE § 15006 (West 1955) with *id.* § 15501 (West Supp. 1975).

105. In setting out the *Howey* test, the Court required that the person be "led to expect profits." SEC v. W.J. Howey Co., 328 U.S. 293, 299 (1946) (emphasis added). This could mean that the investor is reasonably led to expect profits because of the profit-seeking nature of the enterprise, or that he is led to expect profits because of promises made by a promoter, or both. In either case, the test would be an objective one.

106. Just from a practical economic standpoint, it is improbable that a syndicator would form a partnership to carry on an enterprise if there were no profit to be derived.

In addition, the Internal Revenue Code forbids deduction of losses on activities not engaged in for profit. INT. REV. CODE OF 1954, § 183. Consequently, a limited partner would not be allowed a deduction if the limited partnership interest was purchased for tax shelter purposes only.

107. See Augustine & Hrusoff, *supra* note 2, at 58-59; Freshman & Frost, *Tax and Economic Analysis of Soft Dollar Syndications*, 46 L.A. BAR BULL. 281 (1971).

It is not merely the "expectation" concept that creates difficulties, however; the problem is complicated by the ambiguity of the word "profit." If it merely means "benefit," then from the standpoint of the limited partner, tax savings may be considered part of his net profit. Even in cases where the partnership enterprise shows a small net loss, the limited partner, by adding in his tax savings, might show a net profit. The question arises whether this would be a sufficient profit expectation. May the expected profit appear only in the limited partner's cumulative investment balance, or must there be an expectation of profit from the business operations of the partnership itself?

The question is not academic. If "profits" equal "benefits," every limited partnership carries with it the profit expectation feature, regardless of what quantum of profit expectation is required. The investor who buys into an enterprise only to reap the benefit of the start-up losses and accelerated depreciation deductions, would nonetheless meet the strictest profit-expectation requirement: his *sole* motive is to garner enough losses to offset other income and produce a net "profit." If "profit" refers to enterprise profit, however, there must be an expectation that the enterprise will prosper, and the question of the proper quantum of profit expectation remains relevant: must it be "primary," or merely "present"?

The Efforts-of-Others Criterion

The fourth of the *Howey* criteria is the efforts-of-others test. As a general rule, limited partnerships will meet this test, since the limited partners, by the nature of their interest, usually do not participate in the business enterprise. However, there is no prohibition against minor, non-managerial participation on the part of the limited partners,¹⁰⁸ and thus it is important whether the efforts test is construed strictly or liberally.

Some earlier decisions applying the *Howey* test have interpreted the requirement that investors profit "solely from the efforts of others" quite literally.¹⁰⁹ Consequently, promoters

108. See notes 78-79 *supra*.

109. See, e.g., *Chapman v. Rudd Paint & Varnish Co.*, 409 F.2d 635 (9th Cir. 1969); *Gallion v. Alabama Mkt. Centers, Inc.*, 282 Ala. 679, 213 So. 2d 841 (1968); *Emery v. So-Soft of Ohio, Inc.*, 30 Ohio Op. 2d 226, 199 N.E.2d 120 (Ohio Ct. App. 1964).

were able to avoid the securities laws by requiring some minor participation on the part of the investors. Recognizing this problem, the Ninth Circuit Court of Appeals, in *SEC v. Glenn W. Turner Enterprises, Inc.*,¹¹⁰ held that "solely" should be read realistically rather than mechanically.¹¹¹ Where the efforts of others are "undeniably significant ones"¹¹² which affect the management of the enterprise,¹¹³ participation by the investor will not negate the finding of an "investment contract," unless it has a substantial effect on the conduct of the venture. This view has gained wide acceptance in recent federal decisions construing "investment contract,"¹¹⁴ and it is clearly the standard in the Ninth Circuit.¹¹⁵ Nevertheless, the Supreme Court has never clarified its definition of "solely" and has specifically declined to express its opinion of the *Turner* interpretation of *Howey*.¹¹⁶

The more liberal *Turner* interpretation clearly is to be preferred, for several reasons. A strict construction of the "efforts" language is contrary to the thrust of the Court's opinion in *Howey*, which stresses that the concept of a "security" embodies a flexible rather than a static principle.¹¹⁷ Also, an interpretation that would prohibit any activity on the part of the investor, however minimal, represents a misreading of the *Howey* test. In context, that test requires that *profits* be made solely from the efforts of others.¹¹⁸ Profits are generated not by the peripheral activities permissible for limited partners, but by the "undeniably significant"¹¹⁹ efforts of those who manage and control the enterprise. *Turner* merely reiterates what is implicit in *Howey*: the significant, profit-producing efforts must be made solely by the managers and not by the investors. Non-managerial participation by limited partners, consistent with

110. 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

111. *Id.* at 482.

112. *Id.*

113. *Id.*

114. See, e.g., *Bitter v. Hoby's Int'l, Inc.*, 498 F.2d 183 (9th Cir. 1974); *SEC v. Koscott Interplanetary, Inc.*, 497 F.2d 473 (5th Cir. 1974); *Miller v. Central Chinchilla Group, Inc.*, 494 F.2d 414 (8th Cir. 1974); *Lino v. City Investing Co.*, 487 F.2d 689 (3d Cir. 1973); *Anspach v. Bestline Prod., Inc.*, 382 F. Supp. 1083 (N.D. Cal. 1974). *But cf. Hirsch v. duPont*, 396 F. Supp. 1214 (S.D.N.Y. 1975).

115. See *Bitter v. Hoby's Int'l, Inc.*, 498 F.2d 183 (9th Cir. 1974); *Anspach v. Bestline Prod., Inc.*, 382 F. Supp. 1083 (N.D. Cal. 1974).

116. *United Housing Foundation, Inc. v. Forman*, 95 S. Ct. 2051, 2060 n.15 (1975).

117. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 299 (1946).

118. See text accompanying note 98 *supra*.

119. *SEC v. Glenn W. Turner Ent., Inc.*, 474 F.2d 476, 482 (9th Cir. 1973).

their role as defined by the Uniform Limited Partnership Act,¹²⁰ would not and should not prevent the classification of limited partnership interests as securities. Finally, a narrow interpretation of the "efforts" test would permit syndicators to circumvent the registration requirements of the federal securities law by inserting a simple requirement of minor investor participation. In many cases such a requirement would have no practical effect other than to evade the S.E.C. regulations. Certainly the *Howey* Court did not intend the application of the securities laws to be a matter of choice for the promoter.

Limited Partnership Interests Under the Howey Test

Like the risk capital test, the *Howey* test suffers from lack of precision. As a rule, a limited partnership interest will meet the first two criteria, and probably the fourth, since few limited partnerships require or receive the active participation of investors. Even where limited partners are active, they cannot, by definition, assume managerial functions, and the application of *Turner* in the Ninth Circuit would keep limited partnership interests within the definition of "security." But the lack of certainty as to the meaning of "profits" and the quantum of profit expectation required impairs the usefulness of the test. So long as this remains unsettled, it is impossible to precisely state whether some limited partnership interests are "investment contracts" and must be registered in compliance with federal securities law.

THE HAWAII DEFINITION

In an effort to develop a more certain and realistic approach to the definition of securities, the Hawaii Supreme Court has formulated a new standard combining elements of the *Howey* and risk capital tests. This test, as set out in *State v. Hawaii Market Center, Inc.*,¹²¹ declares that an investment contract is created whenever

- (1)[a]n offeree furnishes initial value to an offeror, and (2) a portion of this initial value is subjected to the risks of the enterprise, and (3) the furnishing of the initial value is induced by the offeror's promises or representations which

120. CAL. CORP. CODE § 15507 (West Supp. 1975).

121. 52 Hawaii 642, 485 P.2d 105 (1971).

give rise to a reasonable understanding that a valuable benefit of some kind, over and above the initial value, will accrue to the offeree as a result of the operation of the enterprise, and (4) the offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise.¹²²

This test incorporates the desirable features of both the federal and risk capital tests, and provides a predictable standard for gauging the status of limited partnership interests as securities.

The general framework of the Hawaii court's test is derived from *Howey*,¹²³ but the important element of risk is added. The ambiguity inherent in *Howey*'s profit expectation requirement is resolved by requiring a "valuable benefit" rather than a profit. A limited partner will always expect a benefit, which, unlike "profit," clearly includes tax savings. Since benefit ordinarily will be the investor's only motive, whether that benefit is from profits, tax savings or both, there is no need to speculate about the required quantum of profit expectation. Finally, the Hawaii test expressly accepts the liberal *Turner* construction of the "efforts" requirement. Obviously, this approach also resolves one of the difficulties with the risk capital test, in that it expressly sets out those criteria over and above the risk element which are necessary for a finding that a particular interest is a security.

It has been suggested that the Hawaii test is destined to become the pre-eminent test for defining "investment contract."¹²⁴ The similarities between the Hawaii and California definitions of "security"¹²⁵ suggest that the Hawaii test could usefully be adopted by the California courts, either as the sole test for the existence of a security, or at least as a practical list of supplementary factors to be used in conjunction with the risk capital determination. While these may be promising solutions, they are not yet reality. Recent decisions in both Califor-

122. *Id.* at 649, 485 P.2d at 109.

123. The Hawaii Supreme Court acknowledged that its test was suggested by Professor Coffey's article. 52 Hawaii at 642 n.5, 485 P.2d at 105 n.5. Professor Coffey, in turn, asserted that his test is a refinement of the *Howey* criteria. Coffey, *supra* note 68, at 376.

124. Long, *Partnership, Limited Partnership, and Joint Venture Interests as Securities*, 37 Mo. L. Rev. 605 (1972).

125. Compare HAWAII REV. STAT. 485-1(12) (Supp. 1974) with CAL. CORP. CODE § 25019 (West Supp. 1975).

nia and federal courts have taken note of *Hawaii Market Center*, but none have adopted its test.¹²⁶

CONCLUSION

It has not been the purpose of this comment to assert that the prevailing California and federal standards for defining "security" are inherently bad standards. The problem in both jurisdictions is that existing tests are unclear. Under the *Howey* test the profit expectation criterion offers an uncertain standard, especially in dealing with tax shelter limited partnerships where profit from the enterprise may not be the investor's primary expectation. In California, the Real Estate Syndicate Act provides a clear standard which specifically defines limited partnership interests as securities. On the other hand, the existence of two unrelated and potentially conflicting tests for defining "security" under the Corporate Securities Law is undesirable.

The acceptance of the test developed by the Hawaii Supreme Court would resolve the uncertainties that currently plague both syndicators and courts charged with determining whether limited partnership interests are securities under the Securities Act of 1933 and the California Corporate Securities Law. Adoption in the federal jurisdiction would merely add risk-to-capital as a criterion and eliminate the ambiguities of the efforts-of-others and profit-expectation tests. Acceptance of the Hawaii test in California would clearly eliminate mutual selection as a separate test, and clarify additional elements of the present risk capital test.

While more precise tests are needed, a rigid standard is neither desirable nor acceptable. The definition of "security" must remain flexible as long as the marketplace invents new investment vehicles. However, flexibility need not be synonymous with uncertainty. While the securities laws should serve primarily the purpose of protecting the public, they must also provide a certain degree of predictability for those who must operate within their ambit. It is submitted that the present

126. See, e.g., *Lino v. City Investing Co.*, 487 F.2d 689 (3d Cir. 1973); *Nash & Assoc., Inc. v. Lum's of Ohio, Inc.*, 484 F.2d 392 (6th Cir. 1973); *SEC v. Glenn W. Turner Ent., Inc.*, 474 F.2d 476 (9th Cir. 1973); *A.B.A. Auto Leasing Corp. v. Adam Ind., Inc.*, 387 F. Supp. 531 (D. Penn. 1975); *Hamilton Jewelers v. Department of Corp.*, 37 Cal. App. 3d 330, 112 Cal. Rptr. 387 (1974).

standards do not provide sufficient guidance in the case of limited partnership interests.

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