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ARTICLES

PRIVATE ORDERING AND THE SECURITIES LAWS: THE CASE OF GENERAL PARTNERSHIPS

*Larry E. Ribstein**

This article develops a policy basis for limited waiver of affirmative disclosure provisions of the securities laws within the context of the statutory framework. It shows how private ordering can be implemented through the definition of a "security," and contrasts this private ordering approach to one based on policies underlying mandatory disclosure. Finally, the article shows how the "private ordering" approach rationalizes some important definition-of-a-"security" cases, particularly including cases involving general partnership interests.

* Professor of Law, George Mason University School of Law. Support for this article was provided by the Sarah Scaife Foundation. Helpful comments were offered by Barry Adler, Henry Butler and Robert Thompson.

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The mandatory disclosure requirements, anti-fraud rules and several provisions of the federal securities statutes cover any transaction involving the purchase or sale of a "security,"¹ unless an exemption applies. Courts have construed the broad definitions of "security" in a vast array of contexts, ranging from worm farms² to pension plans.³ Given the complexity of that task and the lack of legislative direction, the incoherence of the resulting set of rules and exceptions is not surprising.

However, one principle remains constant throughout the cases in this area: even if Congress and the courts are not consistent in determining when the securities laws apply, parties to a transaction should not be permitted to make this decision. As the Supreme Court admonished, "in searching for the meaning and scope of the word 'security', . . . form should be disregarded for substance and the emphasis should be on economic reality."⁴ In other words, "substance," as decided by the courts, trumps "form," as deter-

1. This article discusses the two principal securities laws, the Securities Act of 1933 (the "1933 Act"), 15 U.S.C.A. §§ 77a-77bbb (West 1981 & Supp. 1991) and the Securities Exchange Act of 1934 (the "1934 Act"), 15 U.S.C.A. §§ 78a-78kk (West 1981 & Supp. 1991). "Security" is defined in section 2(1) of the 1933 Act as follows:

[t]he term "security" means 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, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, 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.

Securities Act of 1933, § 2(1), 15 U.S.C. § 77b (1988). The 1934 Act defines "security" in similar terms with minor exceptions relating to mineral leases and the exclusion of instruments with a maturity of nine months or less. *See* Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C.A. § 78c(a)(10). As to the latter difference, *see infra* notes 236-39 and accompanying text.

2. *See* *Smith v. Gross*, 604 F.2d 639 (9th Cir. 1979) (holding investment contract to raise earthworms constituted a security within the meaning of both the 1933 and 1934 Acts).

3. *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 553 (1979) (holding that the Securities Acts do not apply to a noncontributory compulsory pension plan).

4. *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967) (citing *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293, 298 (1946)).

mined by the parties. This principle is consistent with both the broad definition of "security," which appears to encompass virtually all transaction "forms," and the mandatory nature of the securities laws, exemplified by their explicit anti-waiver provisions⁵ and application regardless of firms' states of incorporation.

This article challenges the entrenched principle of mandatory application both normatively and positively. From a normative standpoint this article shows that, notwithstanding the general theoretical case for the federal securities laws, parties should be permitted to opt out of the application of the securities laws in certain circumstances. From a positive law standpoint this article shows that the Supreme Court and lower federal courts interpreting the statutes have encouraged waiving or opting out of application of the securities laws by recognizing a role for private ordering. The article demonstrates how a private ordering approach helps explain the unsettled law concerning application of the federal securities laws to general partnerships.

The article proceeds as follows. Part I describes the "mandatory disclosure" approach to the definition of a security. Under this approach, "security" is defined in a manner consistent with policy justifications for federal mandatory disclosure rules. After summarizing these policies, Part I illustrates how they relate to the definition of a security.

Part II introduces the alternative "private ordering" approach to the definition of "security." That section begins with theoretical arguments for allowing parties to waive coverage of the securities laws. It then shows how limited private ordering is consistent with the anti-waiver provisions, as interpreted in recent Supreme Court opinions, as well as with the approach to waiver applied by the Supreme Court in the "sale-of-a-business" and "note" cases.

Part III demonstrates the usefulness of the private ordering approach in explaining cases involving general partnership interests as securities. The trend among these cases has been toward emphasis on the forms of transactions involved and *per se* exclusion of general partnership interests from the definition of "security." These results are consistent with the private ordering approach, but not

5. See § 14 of the 1933 Act, stating that: "[a]ny condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the Commission shall be void." Securities Act of 1933, § 14, 15 U.S.C. § 77n. A similar provision prevents waiver of the 1934 Act. See Securities Exchange Act of 1934, § 29(a), 15 U.S.C. § 78cc(a).

with the mandatory disclosure approach.

I. MANDATORY DISCLOSURE AND THE DEFINITION OF A "SECURITY"

The definition of a "security" is one of the most important, yet most ambiguous, provisions in the federal securities laws. The breadth of the definition and the constant evolution of financial instruments in the nearly sixty years since the laws were promulgated preclude a narrow, mechanistic approach to interpretation. As a result, the legislature has delegated substantial discretion to the courts to determine which transactions should be regulated under the federal securities laws.⁶ In making these determinations, courts are justified in taking into account the policies underlying federal mandatory disclosure. Consideration of these policy concerns is consistent with the view that the securities laws were intended to further the public interest.⁷ Therefore, this article analyzes the

6. Ambiguities in any federal statute revive the ongoing debate about the proper method of statutory interpretation — whether courts should be guided by policy considerations when construing statutes or adhere strictly to the statutory language. For a discussion advocating the former method of statutory construction, see HARRY M. HART & ALBERT M. SACKS, *THE LEGAL PROCESS: BASIC PROBLEMS IN THE MAKING AND APPLICATION OF LAW* 1415 (tent. ed. 1958) (Courts "should assume, unless the contrary unmistakably appears, that the legislature was made up of reasonable persons pursuing reasonable purposes reasonably."). For a review of various approaches to statutory interpretation, see RICHARD A. POSNER, *THE PROBLEMS OF JURISPRUDENCE*, 262-309 (1990).

7. For another view consistent with the "public interest" approach to defining "security," see William J. Carney, *Defining a Security: The Addition of a Market-Oriented Contextive Approach to Investment Contract Analysis*, 33 *EMORY L.J.* 311, 315 (1984) (suggesting that the market failure justification of securities regulation is implicit in the Supreme Court's approach for determining whether or not securities laws apply). The "public interest" view of the federal securities laws is contrary to an explanation of the federal securities laws as benefiting cohesive interest groups — for example, established investment banking firms seeking to impose barriers to entry in the form of onerous disclosure rules against new firms. See Henry G. Manne, *Economic Aspects of Required Disclosure Under Federal Securities Laws*, in *WALL STREET IN TRANSITION* (Henry G. Manne & Ezra Solomon eds. 1974).

The interest group theory of legislation suggests that laws or regulations are the products of a process in which various groups with diverse interests compete in the legislative arena to further their respective agendas. For discussions of interest group theory, see also ROBERT E. MCCORMICK & ROBERT D. TOLLISON, *POLITICIANS, LEGISLATION AND THE ECONOMY: AN INQUIRY INTO THE INTEREST-GROUP THEORY OF GOVERNMENT* 7 (1981); GEORGE J. STIGLER, *THE CITIZEN AND THE STATE: ESSAYS ON REGULATION* 139 (1975); *Symposium on the Theory of Public Choice*, 74 *VA. L. REV.* 167 (1988). For a leading article arguing that courts should recognize interest-group "deals" in interpreting statutes, see Frank H. Easterbrook, *The Supreme Court 1983 Term, Foreword: The Court and the Economic System*, 98 *HARV. L. REV.* 4, 18 (1984).

scope of coverage of the federal securities laws relative to their underlying policy justifications. This part discusses the "mandatory disclosure" approach to determining which transactions are appropriately regulated by federal disclosure laws. In contrast, the "private ordering" approach discussed in Part II defines "security" so as to permit private agreements to avoid coverage of the securities laws even where the transaction may otherwise be appropriate for mandatory disclosure.

The policy justifications discussed in this part relate both to the affirmative disclosure requirements of the Securities Act of 1933⁸ and to the background anti-fraud provisions in the 1933 and 1934 Acts.⁹ However, some justifications are more pertinent to rules mandating specific disclosures than to anti-fraud rules which primarily prohibit misstatements. Differences among the policies supporting the two types of provisions are summarized in Section I (C). That section also discusses reasons for differentiating the application of provisions that require disclosure in connection with investment transactions from provisions, such as insider trading prohibitions and proxy and tender offer rules, that relate to internal governance.

A. Justifications for Federal Mandatory Disclosure

This section discusses the "public interest" rationale for mandatory disclosure. As shown in Section B, this rationale is useful in understanding the factors courts have applied in defining "security."

The arguments for federal mandatory disclosure laws involve

Despite the plausibility of, and ample support for, the interest group theory as an explanation of legislation, particularly as applied to the federal securities laws, use of this theory in statutory interpretation may be inadvisable. First, it will often be quite difficult for courts to determine what, if any, interest group deal underlies a statute. *See*, POSNER, *supra* note 6, at 278 ("the presence of compromise makes the discernment of purpose difficult and often impossible"). Furthermore, if courts were to use the alternative "public interest" approach when interpreting ambiguous statutes, the judiciary may check inefficient rent-seeking conduct by politicians by forcing them to make interest-group "deals" they wish to be enforced clear. *See* Jonathan R. Macey, *Promoting Public-Regarding Legislation Through Statutory Interpretation: An Interest Group Model*, 86 COLUM. L. REV. 223, 227 (1986).

8. *See* Securities Act of 1933, §§ 1-26 & scheds. A, B, 15 U.S.C.A. §§ 77a-77aa (requiring parties to file registration statements and deliver prospectuses in connection with distributions of securities, and prohibiting certain selling efforts and representations prior to such filing and delivery).

9. These provisions include Securities Act of 1933, § 17(a), 15 U.S.C. § 77q(a) and Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78j(b).

at least four distinct steps: first, the rationale for *disclosure by firms*; second, the justification for *regulation* despite its costs and the existence of non-regulatory means of ensuring full disclosure; third, the need for *federal* regulation even though there are well-developed state laws of corporations and fourth, the rationale for application of disclosure rules to a *particular group* of investment instruments, or "securities," and not to other types of transactions. These steps are considered in the following subsections.

1. Why Disclosure by Firms?

It is not immediately obvious why disclosures by firms are important to investors. In the first place, it might seem that investors can safely ignore any such disclosures and simply rely on the market price of securities. The Efficient Capital Markets Hypothesis (EMH) states, in its most widely accepted, "semi-strong" form that prices of publicly traded securities respond quickly to publicly available information.¹⁰ Although there are credible arguments that securities prices do not accurately reflect all publicly disclosed information,¹¹ there is little doubt that market prices provide the

10. Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383, 383 (1970), suggested a widely accepted categorization of three "forms" of the efficient market theory: "weak," which holds that investors cannot gain by knowing and analyzing past price histories; "semi-strong," which holds that investors cannot gain by knowing public information; and "strong," which claims that investors cannot gain even by knowing inside information. See also JAMES H. LORIE et al., *THE STOCK MARKET: THEORIES AND EVIDENCE* 57 (2d ed. 1985).

Professor Carney argues that Congress, in adopting the federal securities laws, operated under an assumption of market failure and did not have before it modern theories of market efficiency. Carney, *supra* note 7, at 336-39. If Congress had no confidence in the markets, EMH should not be used as a basis for constructing a public interest model of the scope of the federal securities laws. However, this view would unduly restrict the courts' role in applying securities laws. Professor Carney himself employs modern theories of market failure in analyzing the justification for the securities laws. See *id.* at 343-45 (discussing market failure in terms of the modern theory of "bounded rationality"). It seems unrealistic to use modern arguments only to support and not to qualify justifications for securities laws. Moreover, the Supreme Court recognized the relevance of EMH when it adopted the "fraud-on-the-market" theory for determining reliance in 10b-5 actions. See *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988). In all events, mandatory disclosure requirements can be justified even in light of modern learning about efficient markets. See *infra* text accompanying notes 13-14.

11. These arguments are summarized in Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761, 761 (1985); Reinier Kraakman, *Taking Discounts Seriously: The Implications of "Discounted" Share Prices as an Acquisition Motive*, 88 COLUM. L. REV. 891, 897-98 (1988); William K.S. Wang, *Some Arguments that the Stock Market is Not Efficient*, 19 U.C. DAVIS L. REV. 341 (1986).

best available estimate of expected returns.¹²

There are two reasons why, despite EMH, investors can gain from issuers' disclosures. First, the semi-strong form of EMH does not mean that all information is disclosed, but only that disclosed information is quickly reflected in price. The amount of information available to be reflected in price depends in part on the extent of disclosure by issuers.¹³ Second, EMH does not apply, or applies only weakly, to markets (like those for general partnership interests) in which there are relatively few trades.¹⁴

Market inefficiency does not explain fully why disclosure by *firms* is important. Investors can adjust the prices they are willing to pay for the firm's securities to reflect a lack of information,¹⁵

12. See Daniel R. Fischel, *Efficient Capital Markets, the Crash, and the Fraud on the Market Theory*, 74 CORNELL L. REV. 907, 915 (1989).

13. More generally, the degree of market efficiency depends on the cost to issuers of disclosing information. See Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 551 (1984).

14. In a thin market, there may not be a recent trade that reflects current information about the firm. Larry E. Ribstein, *An Applied Theory of Limited Partnership*, 37 EMORY L.J. 835, 845 n.22 (1988). Also, thinly traded securities do not attract market professionals who generate and disseminate information about stocks. See Jonathan R. Macey & Geoffrey P. Miller, *Good Finance, Bad Economics: An Analysis of the Fraud-on-the-Market Theory*, 42 STAN. L. REV. 1059, 1086 (1990).

15. Lack of information can affect the market price of a security in part because it decreases certainty of outcomes, thereby increasing the variance, or "risk," of expected returns. See generally RICHARD A. BREALEY & STEWART C. MYERS, *PRINCIPLES OF CORPORATE FINANCE*, 49-56, 125-31 (3d ed. 1988). Investors can eliminate some risk associated with specific stocks, as distinguished from the market as a whole, by holding a diversified portfolio. See *id.* at 131-34. To the extent that there are gaps in information about Stock A that produce a variance in expected returns, an investor can reduce this risk by holding Stock B, an investment for which expected returns are negatively correlated with those of Stock A. For example, if Stock A is that of an umbrella manufacturer, the risks the investor must bear from a rash of sunny weather will depend, for example, on the extent of the backlog of orders for A's umbrella. But this risk for the investor can be reduced by holding stock in firm B, a manufacturer of sunglasses.

Portfolio diversification does not, however, solve all disclosure-related problems. First, investors need information about A's lines of business in order to diversify. Second, diversification is inherently imperfect because there is a component of risk — usually referred to as "market risk" — that cannot be eliminated by diversification. *Id.* at 156. In the above example, the extent of A's backlog may determine the sensitivity of the business to a general downturn in the economy, a market risk that cannot be reduced through diversification. Third, portfolio diversification does not eliminate discounts in expected returns resulting from investors' expectations that issuers are hiding negative information.

Nondisclosure or unreliable disclosure by issuers can also reduce expected returns because investors may assume that issuers are hiding *negative* information. However, it is also possible that investors will assume that issuers are hiding *positive* information in order to facilitate trading by the insiders who control disclosure.

Finally, lack of information can reduce market price by increasing asymmetry of

or they can research whether the market has mispriced the security.

Firms' disclosures are valuable in inefficient markets where investors and analysts may do less securities research than is socially optimal.¹⁶ Investors generally conclude their research when the cost of the search exceeds its expected benefit.¹⁷ Information that significantly changes investors' perceptions of a firm's value nevertheless may have little effect on the value of small investments.¹⁸ In addition, information about securities traded in an active market has a short useful life because the same information from other sources is rapidly incorporated in stock price. Thus, investors confronted with uncertainty about expected returns normally discount the price they are willing to pay rather than investigate firms to clarify uncertainties.¹⁹ As a result, investment dollars may be inefficiently diverted from better- to worse-managed firms with equivalent apparent values.²⁰

information among investors, leading, in turn, to increased bid-ask spreads and risk premiums which market makers charge back to traders. See Douglas W. Diamond & R. Verrecchia, *Disclosure, Liquidity and the Cost of Capital*, Center for Research in Security Prices Working Paper 289 (1990); Lawrence R. Glosten & Paul R. Milgrom, *Bid, Ask and Transaction Prices in a Specialist Market with Heterogeneously Informed Traders*, 14 J. FIN. ECON. 71 (1985).

16. See John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 725 (1984); Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 681 (1984).

17. See George J. Stigler, *The Economics of Information*, 69 J. POL. ECON. 213, 220 (1961) (savings expected by consumers from search for price information depend on such factors as quantity to be purchased and dispersion of prices).

18. This effect is similar to the problem of voter non-participation which occurs in both political and corporate governance and is explained by the theory of "rational apathy." The "rational apathy" theory states that individuals who have the opportunity to participate in an election will choose not to exercise their voting rights if they determine that the benefits resulting from the acquisition of information concerning the election and voting do not outweigh the costs involved in those processes. See ANTHONY DOWNS, *AN ECONOMIC THEORY OF DEMOCRACY* 4-6, 260-76 (1957). For works relating the "rational apathy" theory to corporate governance, see Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259 (1967); Henry G. Manne, *Some Theoretical Aspects of Share Voting: An Essay in Honor of Adolf A. Berle*, 64 COLUM. L. REV. 1427 (1964).

19. Securities analysts are also unlikely to do an optimal amount of research. Researchers cannot easily sell the information to investors with large stakes because potential buyers of the information would be unwilling to pay much for "a pig in a poke." Disclosing the information before agreeing on a price could facilitate its sales, but pre-sale disclosure also exposes the researcher to possible opportunism by the potential buyer.

20. This is an example of the "lemons" problem. See George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488 (1970) (discussing the seller's incentive to market poor quality merchandise).

Disclosure by firms is valuable also because it reduces over-investment in securities research.²¹ Although, as just discussed, market participants lack incentives to exhaustively research firms, they nevertheless have some incentive to discover mispriced securities. As a result, investors and analysts will compete in a zero-sum game to find the same information. Disclosure by issuers can eliminate some of this duplicative research.

2. Why Regulation?

Even if disclosure by firms increases investor welfare and helps efficiently allocate resources, these benefits do not necessarily justify regulation. Firms have strong incentives to disclose information about themselves even if they are not legally compelled to do so. For example, firms can offer stock bundled with disclosure for a price higher than that of otherwise comparable stock unaccompanied by disclosure.²²

Notwithstanding firms' incentives to disclose, there are some justifications for disclosure regulation. First, not all firms produce an optimal amount of information on their own.²³ One reason is that an individual firm cannot capture all of the benefit from its disclosures. Some disclosures facilitate comparisons with other firms, and therefore benefit those firms.²⁴ Also, firms may be able to reap the benefit of other firms' development of more efficient disclosure formats without bearing the costs.²⁵

Second, even though firms have incentives to disclose, agents charged with disclosure responsibilities may withhold information. For example, a firm's agents may want to capitalize on the information themselves²⁶ or to avoid negative adjustments in their compensation or dismissal.

Third, investors may disbelieve even full and accurate disclo-

21. See Carney, *supra* note 7, at 346-47; Coffee, *supra* note 16, at 733 (noting the reduction in duplicative research as a benefit); Easterbrook & Fischel, *supra* note 16, at 681-82 (commenting that mandatory disclosure results in an optimal level of research).

22. See Douglas W. Diamond, *Optimal Release of Information by Firms*, 40 J. FIN. 1071, 1071 (1985) (some disclosure of information reduces risks of investment and makes investors better off by saving information costs and improving risk sharing); Diamond & Verrecchia, *supra* note 15, at 23 (firms can capture gains by reducing information asymmetry prior to sale of shares).

23. Easterbrook & Fischel, *supra* note 16, at 681-82.

24. *Id.*

25. *Id.*

26. See Coffee, *supra* note 16, at 739-43 (concluding that mandatory disclosure can result in insider trading, leveraged buyouts and management conflicts of interest).

sure by firms. Legal liability imposed by government regulations for fraudulent disclosures reduces costs firms otherwise would incur to signal the veracity of their disclosures.²⁷

The weakness in these arguments for regulation is their assumption that market alternatives are inadequate. For example, the problems associated with signalling the accuracy of firms' information and developing disclosure forms might be resolved through self-regulatory organizations. Stock exchanges that develop standard disclosure forms and invest their reputational capital in signalling the veracity of member firms' disclosure serve this self-regulatory function. Stock exchanges can capture the benefits of this activity through listing fees.²⁸ The misincentives of corporate executives regarding disclosure can be disciplined, like other agency problems, by such devices as incentive compensation, the market for corporate control and state law fiduciary duties.²⁹

27. See Easterbrook & Fischel, *supra* note 16, at 675-77 (reviewing the various procedures firms employ to certify the truthfulness of their disclosures, then noting that rules against fraudulent disclosure, if enforced, eliminate the need for expensive verification).

28. See Daniel R. Fischel, *Organized Exchanges and the Regulation of Dual Class Common Stock*, 54 U. CHI. L. REV. 119, 122 (1987) (in addition to providing a forum for convenient and economical transactions, stock exchanges may police the activities of their members and use this feature as an incentive to encourage brokers to purchase a seat on that exchange). It has been argued that state corporation and federal securities laws have diminished the value of these activities by stock exchanges. See Jonathan Macey & Hideki Kanda, *The Stock Exchange as a Firm: The Emergence of Close Substitutes for the New York and Tokyo Stock Exchanges*, 75 CORNELL L. REV. 1007, 1038-42 (1990). However, it does not necessarily follow that stock exchanges could not perform this task adequately in the absence of regulation. The adequacy of regulation by exchanges depends partly on whether investors could accurately evaluate the quality of exchange regulation, or instead would misallocate investment dollars to unlisted firms. It would also depend on whether, despite these costs of market alternatives, regulation would be inferior.

29. For a discussion of the interrelated functions of these devices in controlling agency costs see generally Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1 (1990). One problem with this argument favoring alternatives to securities regulations is that corporate executives have greater incentives to disclose *negative* information inadequately than to disclose *positive* information due to the effect of *negative* information disclosures on income and employment security. Furthermore, the executives' misincentives may be aligned with the interests of existing holders—who may be selling—and against the interests of potential buyers. Therefore, existing holders may not seek to discipline managers for mis-disclosures. However, shareholders' benefits from inadequate disclosure are only short-term and are likely to be swamped by negative long-term effects. A firm that causes investors to distrust its information increases the apparent riskiness of its expected cash flows and, thus, raises its cost of obtaining capital. These cost increases injure *the firm's* existing interest holders.

3. Why Federal Regulation?

Although state laws governing corporations are well developed,³⁰ federal law may operate more efficiently with regard to regulation of securities disclosures.³¹ States may over-regulate by imposing anti-fraud liability that inefficiently benefits securities buyers who reside in the regulating state while burdening out-of-state firms with higher costs.³² This may be due to the influence

30. State regulation of internal corporate affairs is subject to capital market discipline; firms in states that do a poor job of regulating would suffer increases in their costs of capital. See RALPH K. WINTER, *GOVERNMENT AND THE CORPORATION* 9 (1978). For evidence supporting this assertion see Peter Dodd & Richard Leftwich, *The Market for Corporate Charters: "Unhealthy Competition" Versus Federal Regulation*, 53 J. BUS. 259 (1980) (reporting results of a study showing that the value of stock generally rises in the months immediately preceding and following a change in the state of incorporation).

31. Note, however, that federal regulation of disclosure is also imperfect. For example, disclosure standards may be deliberately set at a high level at the behest of established disclosers in order to deter entry of newcomers. See Manne, *supra* note 7, at 35.

Empirical evidence of the effects of the federal securities laws is mixed. Two studies show that investors in new issues, as compared with investors in the rest of the market, fared insignificantly worse prior to the 1933 Act than those who invested in new issues after the Act. Gregg A. Jarrell, *The Economic Effects of Federal Regulation of the Market for New Security Issues*, 24 J. L. & ECON. 613, 638 (1981); George J. Stigler, *Public Regulation of the Securities Markets*, 37 J. BUS. 117, 121 (1964). Comparisons between new and existing issues are no longer helpful because the entire market was regulated after 1934. See Easterbrook & Fischel, *supra* note 16, at 711. Another study found that risk-adjusted stock performance was not aided by the 1934 Act requirement that sales figures be disclosed. George J. Benston, *Required Disclosure and the Stock Market: An Evaluation of the Benston Securities Exchange Act of 1934*, AM. ECON. REV., March 1973, at 132. But other required disclosures may have helped investors, or sales data may have been reflected in stock price even without affirmative disclosure. Thus, the results are consistent with the theory that the securities laws reduce the costs of uncovering information. See Gilson & Kraakman, *supra* note 13, at 635-42 (1984).

Finally, the most recent major study finds that investors in speculative new issues did better after 1933 than before, and that there was greater dispersion of abnormal returns prior to 1933. Carol J. Simon, *The Effect of the 1933 Securities Act on Investor Information and the Performance of New Issues*, 79 AM. ECON. REV. 295, 306 (1989). The results of the study support the theory that the information prevalent during the pre-regulatory period was of a lower quality than information available since the 1933 Act. *Id.* at 308-10. However, the results also support the theory that marginal companies, with more volatile returns, were forced out of the market in the regulatory period. *Id.* at 315.

32. See Easterbrook & Fischel, *supra* note 16, at 697-98. Courts have permitted actions against wholly out-of-state firms that solicited sales to residents of the regulating state. See *Bothwell v. Buckbee, Mears Co.*, 275 U.S. 274 (1927) (states can regulate solicitations by out-of-state firms that have not complied with their laws); *Green v. Weis, Voisin, Cannon, Inc.*, 479 F.2d 462 (7th Cir. 1973) (state securities statute held applicable to out-of-state firm soliciting sales in the state). See also *Paulos v. Best Sec., Inc.*, 109 N.W.2d 576 (Minn. 1961) (permitting service of process against out-of-state firm that solicited sales of securities in the state).

of interest groups in the state, such as lawyers seeking litigation business.³³

Conversely, states may under-regulate affirmative disclosure by firms. If firms' disclosure policies are not fully disciplined by the market,³⁴ it follows that states lack incentives to adopt corporation statutes with provisions that embody these policies. Moreover, states may fail to adopt statutes protecting their own residents from disclosure failures by out-of-state corporations if interest groups in the state have not promoted this type of regulation. The influence of interest groups may also explain why, although all states have securities statutes protecting residents from misrepresentations and non-disclosures, most have very small enforcement budgets.

4. Why Federal Regulation of "Securities?"

Many of the above arguments potentially apply to all kinds of transactions, including the sale or lease of consumer goods and services. Consumers may have little incentive to search for information, and those consumers who do search for information may duplicate the search efforts of others. Firms in all markets have trouble signalling the veracity of their information, and their agents have incentives to mislead the markets concerning the firms' products and its financial results. A critical aspect of the policy ap-

Note that the existence of federal regulation does not imply the non-existence of state regulations with the potential to shift costs out of state. Whether exploitative state regulation is unconstitutional depends on the commerce clause rather than on the existence of a federal statute. For an analysis of the state exploitation issue under the "negative" commerce clause see Daniel R. Fischel, *From MITE to CTS: State Anti-Takeover Statutes, the Williams Act, the Commerce Clause and Insider Trading*, 1987 SUP. CT. REV. 47 (1988).

Enactment of a federal law may, but does not necessarily, lead to invalidation of inconsistent state regulation under the supremacy clause. See *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69 (1987) (upholding a state anti-takeover statute against an argument that the statute was inconsistent with federal takeover legislation and therefore unconstitutional under the supremacy clause). For a particularly narrow view of the reach of the supremacy clause in the takeover context see *Amanda Acquisition Corp. v. Universal Foods Corp.*, 877 F.2d 496 (7th Cir. 1989), *cert. denied*, 110 S.Ct. 367 (1989). In fact, the federal disclosure statutes preclude a supremacy clause challenge to state disclosure laws by providing that they do not supplant state securities laws. Securities Act of 1933, §18, 15 U.S.C. §77r; Securities Exchange Act of 1934, §28, 15 U.S.C. §78bb(a).

33. See Jonathan R. Macey and Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 502-05 (1987) (discussing the relevance of lawyers to corporate law and applying the interest group theory to Delaware law).

34. See *supra* text accompanying notes 22-29.

proach to defining "security" is determining why federal regulation should be applied to investment interests but not to other property.³⁵ The reasons for this distinction are discussed in the following subsections.

a. Nature of Facts to be Disclosed

Disclosure regulation is arguably more necessary for investment securities than for other products because of the nature of the information required by investors. All products are evaluated on the basis of their expected future performance. The utility of a tangible product is determined in part by an assessment of its physical characteristics and in part by the past performance of products with similar characteristics. For example, the use value of an automobile depends partly on a determination of whether it is equipped with air bags, and partly on how air bags have performed in tests and in use on other cars.

Full disclosure in connection with a consumer product would involve both the identity of the product's characteristics and performance data related to these qualities. Because producers can make identification disclosures most cheaply, it is not surprising to observe producers disclosing such things as the ingredients of food and drugs and the mileage of used cars. But regulation of disclosure of product characteristics is less common because the relevant facts are obvious to consumers and easy to evaluate.³⁶ Disclosure by producers of performance data, such as the effects of vitamins and the amount of cholesterol in food, is less costly than acquisition of that information by individual consumers, and performance data are more difficult for consumers to evaluate than product

35. Federal laws regulate disclosure in connection with some non-"security" products. See Consumer Product Safety Act, 15 U.S.C. § 2056(a) (1988) (requiring warnings for consumer products); Magnuson-Moss Act, 5 U.S.C. § 2302(a) (1988) (governing disclosure requirements for disclaimer of warranties). However, these disclosure requirements are not nearly as extensive as those required for "securities." Also, there is no federal anti-fraud law for non-"security" products. Note that while many of the policies discussed in this section may justify a distinction between products and "securities" with regard to affirmative disclosure rules, the policies may not justify a distinction with respect to the need for anti-fraud rules. See *infra* text accompanying notes 36-38.

36. See Daniel R. Fischel, *Regulatory Conflict and Entry Regulation of New Futures Contracts*, 59 J. BUS. 885, 892-93 (1986) (employing the consumer goods analogy to argue that the "observability" of features of new futures contracts reduces the need for regulation of the futures market). Nevertheless, regulation of product disclosures is becoming more common. See Nutrition Labeling and Education Act of 1990, 21 U.S.C.A. §§ 343-1 (West Supp. 1991).

characteristics. However, third parties can compile and credibly signal the accuracy of facts about categories of products, reducing information costs for both producers and consumers. Thus, producers usually do not disclose such facts, and producer disclosures of this information generally are neither mandated nor regulated.

The value of products purchased for resale depends on the future performance of markets in which the product is traded. For example, while a defective house is always worth less than the equivalent nondefective house, the values of both defective and nondefective houses are influenced by the national economy, interest rates and conditions in the local real estate market. Because the producers usually know no more about future market performance than the purchasers, producers rarely disclose facts about the market. These observations also apply to commodity futures contracts.³⁷

Investment securities are distinguishable from other property because the resale value of the securities depends not only on market conditions generally, but also on the performance of managers and other parties to the firm's contracts. Thus, evaluation of securities requires disclosure of many facts relating to managers' skills, including their identities, past affiliations and past financial results. Because investors and third parties cannot easily discover these facts, total disclosure costs are significantly less if these facts are disclosed by promoters rather than discovered separately by each investor.

b. Formatting

There are also differences between investment securities and other products regarding the formatting of disclosures. In particular, earnings history is useful for evaluating securities, but only qualifiedly so. Past returns may have been generated by personnel or reflect circumstances that differ from current conditions, and depend to some extent on general market conditions regardless of management skill. But investors' judgment is often clouded by biases that may cause them to overlook these qualifications. Perhaps the most relevant bias affecting securities investors is "anchoring bias," in which investors give the starting point of evaluation,

37. See Dennis W. Carlton, *Futures Markets: Their Purpose, Their History, Their Growth, Their Successes and Failures*, 4 J. FUTURES MARKETS 237, 241 (1984) (discussing factors that determine prices of commodity future contracts).

i.e., past performance, undue weight without adjusting adequately for future contingencies.³⁸ To offset these biases securities disclosures ought to include prominent qualifications and disclaimers. In contrast, past performance results for mass-produced items are helpful in predicting future performance, and statements about the future performance of commodities are easily recognized as depending on the inherently unpredictable future performance of the markets in which they are traded.

Another formatting problem applicable to investment securities is investors' need for standardization. Because disclosures concerning management are largely subjective, and consequently more complex, it is easy for risk factors to escape readers' attention. "Bottom line" financial results can be misleading because of non-comparable methods of calculation. Standardized formats organize complex information and facilitate comparison of different firms' financial results.

c. Efficiency of Central Disclosure to Multiple Investors

Regulation of securities disclosures insures that information will be produced centrally by firms rather than individually by investors. This overcomes investors' inadequate incentives to investigate³⁹ and reduces duplicative research.⁴⁰

Although the same justifications for regulation might seem applicable to any mass-produced product, investment securities differ from other products with respect to these considerations. First, because information needed for complete evaluation of a security is much more expensive for investors to produce than information regarding the utility of a product, both underproduction of information and duplication of research are more likely to result with regard to investment securities.

Second, central disclosure of securities information is efficient because the exact information is relevant to all securities investors.

38. For a review of the literature and application to securities investment, see Carney, *supra* note 7, at 344, nn.132-35. Professor Carney reviews factors that justify a special disclosure regime for securities. *Id.* at 339-49. This review is useful, but it fails to distinguish adequately securities from other commodities. For example, a single advertisement for an automobile may involve forward-looking statements that are difficult to verify, incentives to pass off shoddy products, judgment biases of purchasers and potentially high costs of fraud, to name some of the factors Carney emphasizes with respect to "securities."

39. See *supra* text accompanying notes 16-20.

40. See *supra* text accompanying note 21.

By contrast, because a product's utility varies to some extent among purchasers depending on intended use of the product, different information may be relevant to different purchasers.

d. Facilitating Litigation of Common Questions

Federal mandatory disclosure permits resolution of common factual and legal questions arising out of a national stock offering in a single proceeding.⁴¹ In contrast, litigation involving a nationally-marketed, defective product is likely to involve disparate questions concerning how and when the product was used by injured consumers. Thus, federal securities laws provide investors an additional benefit that a federal regulatory scheme could not provide to purchasers of other products.

5. Summary

The foregoing discussion supports the following conclusions concerning transactions for which federal disclosure regulation is efficient:

(1) The federal securities laws should be applied only to transactions that present the special problems of costly discovery, verification and formatting commonly associated with investment securities.

(2) The efficiency of central disclosure by firms increases as investments become more standardized, are sold in smaller blocks or are more widely distributed.

(3) Federal regulation is particularly appropriate for national offerings, as compared with intra-state sales of closely held companies.

B. Application to the Definition of a Security

This section shows that the justifications advanced for mandatory disclosure are consistent with, and help inform, some of the judicial tests for the existence of an "investment contract."⁴²

41. See Easterbrook & Fischel, *supra* note 16, at 679.

42. Whether a general partnership interest is covered by the securities laws depends on whether it is an "investment contract" under Section 2(1) of the 1933 Act or Section 3(a)(10) of the 1934 Act. Securities Act of 1933, § 2(1), 15 U.S.C. § 77b; Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C.A. § 78(c)(a)(10). A general partnership interest also could be characterized as a "participation in any profit-sharing agreement," which is another instrument included in the statutory definition of "security." Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C.A. § 78(c)(a)(10). However, this category has

1. Overview of Tests

In its first interpretation of the term "investment contract," the Supreme Court defined the term in light of what it deemed to be the legislative policy underlying the federal securities laws rather than according to some conventional meaning of the term.⁴³ Three years later, in *SEC v. W.J. Howey Co.*, the Court spelled out the elements of an investment contract:

[A]n 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, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise.⁴⁴

William Carney has argued that courts construing the term "investment contract" are applying factors in addition to those listed in *Howey*. The extra factors relate the need for federal regulation to the characteristics of the markets in which the transaction occurred.⁴⁵ This "public interest" approach applies the securities laws to the extent appropriate to redress market failure.⁴⁶ Thus, according to Carney, in contexts where the peculiar problems that supposedly infect the securities markets⁴⁷ are found to be lacking, the courts do not apply the securities laws. Examples Carney offers to support this conclusion include the Supreme Court's refusal to

not been applied in the partnership cases, and in general has been used infrequently. HAROLD S. BLOOMENTAL, *SECURITIES LAW HANDBOOK* 4.02 (1990-91 ed.).

43. *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943). In *Joiner*, the Court held that assignments of oil and gas leases combined with promises to drill were securities. *Id.* at 345.

44. 328 U.S. 293, 298-99 (1946).

45. Carney, *supra* note 7, at 317-30.

46. *Id.* at 332-33. For a discussion of the public interest approach generally, see *supra* note 7 and accompanying text. Carney compares this approach to justifying application of the securities laws with the more formalistic definition of a "security" devised in *Howey*. Discussion of the *Howey* factors later in this section shows that the courts have applied these factors in a manner consistent with the "public interest" approach.

47. Carney cites the complex, forward-looking nature of information relevant to securities, judgment biases and rational apathy of investors, incentives for promoters and dealers to lie about securities transactions, and high potential costs of securities fraud as reasons for market failure in the securities markets. Carney, *supra* note 7, at 339-49.

apply the securities laws where investors were protected by federal pension law⁴⁸ or deposit insurance,⁴⁹ in smaller offerings where investors would be likely to expend substantial resources to investigate,⁵⁰ or where a material aspect of the investment package was real estate or some other commodity that did not involve the peculiar information problems of other investments.⁵¹ The following subsections elaborate on some elements of tests for the existence of a security that are particularly relevant to general partnerships.

2. Expectation of Profits from Efforts of Others

The fourth element of the *Howey* test requires an expectation of profits from the efforts of others.⁵² It has been the factor stressed most in general partnership cases.⁵³ This test has evolved from its initial expression in *Howey* in that the courts now commonly find a "security" to exist even where the investor contributes some efforts. The leading case is *SEC v. Glenn W. Turner Enterprises, Inc.* in which the court held in favor of a security even though investors recruited prospects because the promoter was responsible for the actual selling.⁵⁴ The court concluded that *Howey* required only a showing that "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."⁵⁵

The *Howey* test can be rationalized on the ground that it is the investment in another's management skills that presents the peculiar

48. *Carney, supra* note 7, at 360 (discussing *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551 (1979)).

49. *Id.* at 361 (discussing *Marine Bank v. Weaver*, 455 U.S. 551, 559 (1982), which holds that a bank certificate of deposit protected by federal banking law is not a security).

50. *Id.* at 355-56 (discussing *United Hous. Found. v. Forman*, 421 U.S. 837, 858 (1975), which holds that an investment in common stock of a cooperative housing corporation did not constitute a security because the investment was not in the pursuit of profit, but was for personal consumption).

51. *Id.* at 361-63 (discussing *SEC v. Howey Co.*, 328 U.S. 293, 300 (1946), which holds that the securities laws do not apply to contracts that take the form of "land sales contracts").

52. *See supra* text accompanying note 44.

53. *See* Section III(A), *infra* notes 129-49.

54. 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

55. *Id.* at 482. The Supreme Court has not explicitly adopted this construction of the *Howey* test. However, in *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 852, n.16 (1975), the Court omitted the word "solely" from its recitation of the *Howey* "expectation of profits" test.

problems arguably justifying regulation of securities, as distinguished from other commodities.⁵⁶ The fact that expected returns depend on the skills of others means, among other things, that investigation by investors is costly, that the issuer is in a particularly good position to produce relevant disclosures, and that formatting of those disclosures is important.⁵⁷

3. Existence of a Common Enterprise: Incentive for Search and Overproduction of Information

The "common enterprise" element has been interpreted as involving two factors: "vertical commonality," a common enterprise between the investor and the promoter,⁵⁸ and "horizontal commonality," the pooling of fortunes of a number of investors.⁵⁹ With respect to vertical commonality, it is not clear why it matters whether the promoter's gains are proportionate to those of the other investors. Indeed, a vertical commonality requirement seems to cut in exactly the wrong direction: correlating the promoter's and investors' gains aligns their interests, which would arguably *decrease* the investors' risk and, therefore, reduce the need for disclosure. On the other hand, horizontal commonality arguably makes sense because if several investors share returns of the same issuer pro rata, requiring central disclosure by the issuer eliminates duplicative research.⁶⁰

56. For a discussion of special disclosure problems associated with investment securities see *supra* text accompanying notes 35-41. See Robert B. Thompson, *The Shrinking Definition of a Security: Why Purchasing All of a Company's Stock is Not a Federal Security Transaction*, 57 N.Y.U. L. REV. 225, 243-44 (1982) (arguing that securities are "intricate merchandise" justifying special disclosure regulation).

57. See *supra* text accompanying note 38.

58. For a holding that a common enterprise requires only "vertical commonality," but that this requirement is not satisfied with respect to a discretionary trading account because a broker's compensation is not based on the customers' profits, see *Brodt v. Bache & Co.*, 595 F.2d 459 (9th Cir. 1978) (holding that a discretionary commodities account is not an investment contract and therefore, not a security). See also *Meredith v. Conticommodity Serv.*, Fed. Sec. L. Rep. (CCH) ¶ 97,701 (D.D.C. 1980) (holding that a discretionary commodities trading account was not a security after finding neither horizontal nor vertical commonality).

59. For cases in which the absence of horizontal commonality contributed to the courts' findings that no security existed, see *Deckebach v. La Vida Charters, Inc.*, 867 F.2d 278, 281-82 (6th Cir. 1989) (yacht charter service); *Milnarik v. M-S Commodities, Inc.*, 457 F.2d 274, 276-77 (7th Cir.) (discretionary trading account), *cert. denied*, 409 U.S. 887 (1972); *Commonwealth Bank & Trust Co. v. Spectrum Leasing Corp.*, 719 F. Supp. 346, 352 (M.D. Pa. 1989) (leasing agreement).

60. See *supra* text accompanying note 21. For an argument relating mandatory disclosure as a means to reduce research costs to the test for the existence of a "security," but

Horizontal commonality in the sense of a large number of investors could also signal transactions susceptible to underproduction of necessary information; the larger an offering, the smaller each investor's financial share⁶¹ and, therefore, the smaller each holder's incentive to search for information. Under this rationale for requiring horizontal commonality, the size of the *offering* serves only as a proxy for the size of each buyer's *investment*.⁶² Thus, even an offering to a small number of investors might involve investments of sufficiently small size to raise the incentive-for-search problem and, conversely, a huge offering may involve sufficiently large investments to justify substantial search costs.

Viewed in light of the underlying policy justifications, the thrust of the horizontal commonality element appears to be a requirement of multiple investors rather than "commonality," or the nature of sharing among these investors.⁶³ *Marine Bank v. Weaver*⁶⁴ supports use of a multiple-investor test. In that case, the Court held that a two-party profit sharing agreement, involving the lease of a pasture was not a security.⁶⁵ The uniqueness of the arrangement meant that there would be only one information search rather than multiple searches. In addition, the sole investor had substantial incentives to search for information.

4. Application of Securities Laws to Closely Held Firms

The factors discussed above suggest that the federal securities laws often are inapplicable to closely held firms. Investors in closely held firms usually depend on their own managerial and monitoring skills, and therefore have relatively little need for information bearing on returns that may be expected from the "efforts of oth-

not explicitly to horizontal commonality, see Carney, *supra* note 7, at 355-57.

61. This assumes limited liability. For a discussion of the effect on this analysis of holding investors personally liable, see *infra* text accompanying notes 151-55.

62. See Carney, *supra* note 7, at 373.

63. For other commentary advocating a multiple-investor theory, see James D. Gordon III, *Common Enterprise and Multiple Investors: A Contractual Theory for Defining Investment Contracts and Notes*, 1988 COLUM. BUS. L. REV. 635, 636.

64. 455 U.S. 551 (1982).

65. *Id.* at 560. See also *Mace Neufeld Prod., Inc. v. Orion Pictures Corp.*, 860 F.2d 944, 947 (9th Cir. 1988) (contract for the production of the "Cagney and Lacey" television series was a joint venture negotiated one-on-one and therefore deemed not a security under *Marine Bank*). Note, however, that the *Marine Bank* Court did not explicitly rely on the *Howey* test, and the Supreme Court has never explicitly endorsed the horizontal commonality requirement. See *Mordaunt v. Incommco*, 469 U.S. 1115 (1985) (Justice White dissenting on denial of certiorari).

ers." Also, because the arrangement often involves a unique one-on-one contract like the agreement involved in *Marine Bank*,⁶⁶ central disclosure by the firm is rarely necessary to overcome problems of under- and over-production of securities research.

Excepting closely held firms from classification as "securities" is also justified by the fact that most close corporation financing involves entirely intra-state transactions. In this situation, there is no reason to believe that the transaction will be inadequately or excessively regulated by state law,⁶⁷ and no need for a federal mechanism to try issues arising out of a multi-state offering in a single proceeding.⁶⁸

Some potential arguments against a closely held firm exception do not withstand careful examination. One faulty contention is that because interests in such firms are not priced in an efficient market, investors need disclosures as a substitute for accurate market pricing. However, as previously discussed,⁶⁹ the need for mandatory disclosure is not necessarily correlated with efficient market pricing. A second argument against exempting close corporations from securities regulations is that, because investors in most of those firms cannot readily exit the firm by selling their shares, they are more at risk from potential mismanagement than investors in publicly traded firms. However, closely held firms trade "voice," in the form of direct input into management,⁷⁰ for "exit" as protection against potential mismanagement.⁷¹

Despite justifications for not applying the securities laws to closely-held firms, courts have not yet recognized this exception as an across-the-board rule. For example, while the Court in *Marine Bank* found no "security" in a one-on-one transaction, the Court later held in *Landreth Timber Co. v. Landreth* that the securities laws applied to the sale of an entire closely held business.⁷² Note,

66. See *supra* text accompanying notes 64-65.

67. See *supra* text accompanying notes 30-34.

68. See *supra* text accompanying note 41.

69. See *supra* notes 13-14 and accompanying text.

70. For a discussion of such protective devices in general partnerships see *infra* text accompanying notes 137-48. Analogous devices are available in close corporations. See generally LARRY E. RIBSTEIN, BUSINESS ASSOCIATIONS 132-86 (2d ed. 1990) (discussing shareholder voting arrangements and agreements controlling actions by the board of directors).

71. See generally ALBERT D. HIRSCHMAN, EXIT, VOICE AND LOYALTY 62-75 (1970) (seminal discussion of the choice between vocalizing dissent — "voice" — or leaving the firm — "exit").

72. 471 U.S. 681, 685 (1985). For further discussion of this case, see *infra* notes 226-

however, that *Landreth* involved "stock," a *per se* "security."⁷³ For transactions, like that in *Marine Bank*, that are not clearly within the statutory definition of "security," the Court may hold in favor of a broad exclusion for closely held firms.⁷⁴

Application of the securities laws to closely held firms is, therefore, confused both doctrinally and theoretically. The private ordering approach suggested by this article provides a way out of this confusion: investors should be able to choose coverage or non-coverage of the securities laws by selecting between the close corporation and partnership forms. As discussed below,⁷⁵ courts essentially do offer investors this choice.

C. Affirmative Disclosure v. Anti-fraud Protection

Thus far, the discussion in this part has concerned federal disclosure regulation generally. Some of the justifications advanced for federal securities regulation support only affirmative disclosure requirements, not federal prohibitions against fraud.⁷⁶ This is important where, as with the general partnership interests that are the focus of this article, the transaction is exempt from the 1933 Act's

36 and accompanying text. Another prominent case in which the Supreme Court applied the securities laws to a closely held firm is *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 9 (1971) (applying § 10(b) of the Securities Exchange Act of 1934 to determine if the sale of stock constituted fraud or deceit).

73. See *infra* text accompanying notes 219-48.

74. See *Trecker v. Scag*, 679 F.2d 703, 710 (7th Cir. 1982) (Posner, J., concurring) (acknowledging strong reasons for not applying the securities laws to closely held firms, but noting that Rule 10b-5 probably does not allow such a limitation because it applies to the "purchase or sale of any security").

75. See *infra* text accompanying notes 163-263.

76. See Securities Act of 1933, § 17(a), 15 U.S.C.A. § 77g(a) and Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 77j(b). The anti-fraud provisions require affirmative disclosures only to the extent necessary to make an affirmative statement not misleading. There is no liability for other nondisclosures absent an independent duty to disclose. See *Basic Inc. v. Levinson*, 485 U.S. 224, 239 n.17 (1988) ("[s]ilence, absent a duty to disclose, is not misleading under 10b-5"); *Roeder v. Alpha Industr., Inc.*, 814 F.2d 22, 26 (1st Cir. 1987) (no affirmative duty to disclose corporate bribe even if it was material). However, such a duty may result from another federal law, as in the case of insider trading. See *Chiarella v. United States*, 445 U.S. 222, 227 (1980) ("an affirmative duty to disclose material information . . . has been traditionally imposed on corporate 'insiders,' particularly officers, directors, or controlling stockholders."). State law may also impose a duty to disclose. See *Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429, 434 (7th Cir. 1987) (discussing corporation's duty to disclose to an employee stockholder who was contemplating leaving the corporation and forfeiting stock). When a duty to disclose arises from state law, federal law essentially describes the remedy for a breach and the requisite scope of disclosure.

registration requirements as a private, limited or intrastate offering even if the transaction involves a "security."

To justify federal anti-fraud protection for "securities," it is necessary to consider why such protection should not be available for non-"securities." Most of the distinctions between "securities" and non-"securities,"⁷⁷ including efficiency of federal formatting rules and mandatory central disclosure, relate to affirmative disclosure obligations rather than to remedies for fraudulent misstatements. Only the role of federal regulation in facilitating national litigation of common questions applies to both fraud and affirmative disclosure.⁷⁸ This suggests that "security" should be defined for purposes of the anti-fraud provisions to apply only to broadly-marketed instruments which may give rise to national common-questions litigation.⁷⁹ Unfortunately, however, the securities laws include a single definition of "security" that arguably does not accommodate the theoretical distinctions between affirmative disclosure in public offerings and anti-fraud regulation.⁸⁰

77. See *supra* text accompanying notes 35-41.

78. See *supra* text accompanying note 41. Other justifications for regulation do not support a distinction between "securities" and other property. For example, the relative efficiency of federal as compared with state regulation applies to any nationally-marketed commodity. See *supra* text accompanying notes 30-34.

79. Ironically, in this context the anti-fraud affirmative-disclosure distinction is least important because the transaction probably is covered by both types of provisions.

80. A "bi-level" definition would be most significant for the 1933 Act, which includes both affirmative disclosure and anti-fraud provisions. The definitions of "security" in both the 1933 and 1934 Acts are qualified with the language "unless the context otherwise requires." Securities Act of 1933, § 2, 15 U.S.C. § 77b; Securities Exchange Act of 1934, § 3, 15 U.S.C.A. § 78c. "Context" logically refers to the defined terms as used in the statute rather than the transactional context. See Marc I. Steinberg & William E. Kaulbach, *The Supreme Court and the Definition of 'Security': The 'Context' Clause, 'Investment Contract' Analysis, and Their Ramifications*, 40 VAND. L. REV. 489, 505 (1987).

The application of the federal securities laws to matters other than disclosure in connection with investors' purchase or sale of securities, particularly proxy solicitation, tender offers and insider trading, raises different questions. It is hard to see why these matters should be singled out from other aspects of internal corporate governance and regulated at the federal level. Indeed, the justification for federal regulation of these matters is even weaker than the justification for affirmative disclosure regulation. While state statutes protecting residents from disclosure failures by out-of-state firms often suffer from inadequate or excessive regulation, state statutes applied only to locally incorporated firms are not plagued by these problems. See *supra* text accompanying notes 30-34. Furthermore, proxy and tender offer regulations most often apply to publicly traded corporations in which interests are exchanged in efficient markets that effectively discipline contract terms. Accordingly, federal regulation of those matters is less compelling than regulation of close corporations making initial public offerings, the situation where market discipline is weakest. However, concerns arising from regulation in these other matters are distinct from

II. THE PRIVATE ORDERING APPROACH

The private ordering approach discussed in this part diverges from the mandatory disclosure approach whenever the parties' contracts or expectations are enforced without regard to whether the transaction is one for which the justifications for mandatory disclosure generally apply. For example, a transaction deliberately structured as a private offering may avoid registration because the costs of disclosure would be deemed to outweigh the benefits, given the nature of the transaction. In this analysis, the policies governing mandatory disclosure determine the scope of securities law coverage. In contrast, under the private ordering approach, parties can effectively agree to avoid the securities laws even in transactions to which federal law otherwise would apply.

The central premise of the private ordering approach is that voluntary transactions in developed markets are presumed to be efficient. Accordingly, even if a federally-mandated disclosure system generally is cost-justified, it should be considered only a standard form which parties can draft around absent evidence of a problem requiring regulation. The policy justifications for the private ordering approach relate to the propriety of enforcing contracts rather than to the propriety of mandating disclosure.

Section A discusses policy justifications for permitting limited waiver of the securities laws. Section B shows how construing "security" to permit private ordering is consistent with the existing statutory and regulatory scheme, including the statutory definition of a "security," exemptions from registration and anti-waiver provisions of the securities laws.

A. A Policy Justification for Limited Waiver of the Securities Laws

The basic objection to waiver of the securities laws is that investors may improvidently forgo coverage in situations where mandatory disclosure is appropriate. The following discussion examines some specific problems with private contracting and methods of dealing with these problems short of prohibiting all waivers of mandatory disclosure requirements.

those discussed in this article, since they suggest there should be no federal remedy at all in these circumstances, rather than help to identify a "security."

1. Investor Information Problems

One problem with waiver is that investors may agree to transactions unaware that the terms include a waiver provision. Investors who purchase in an initial offering and subsequently receive contracting materials may not have even read their supposed contract. Similarly, investors who purchase in the secondary market may be bound by accepting terms in a firm's articles of incorporation or partnership agreement without even receiving a contract or other disclosure document. As a result, investors may not fully discount the price of the security to reflect waiver of the disclosure requirements, and promoters may opt out of the securities laws even where the benefits of coverage exceed the cost. Moreover, these problems may adversely impact even regulated securities because investors may be confused as to when the securities laws apply. Thus, opting out may be privately optimal for some firms but not socially optimal given costs imposed on firms that do not waive disclosure requirements.

More serious problems concern investors who know at the time of the transaction of the existence of a waiver, but who do not fully understand its effect. Because they are subject to judgment biases,⁸¹ investors might erroneously believe that relatively limited disclosures firms may choose to make are adequate without recognizing the need for qualifying and hedging disclosures that would be required by the federal securities laws. Furthermore, permitting waiver may lead to a proliferation of disclosure regimes that investors could not easily evaluate.

Those who object to private ordering might argue that these problems can be resolved only by mandating detailed disclosure. Advocates of private ordering would respond that efficient markets protect ignorant investors. Investor ignorance should not pose a problem where securities are traded in an active market because informed investors would discount waiver costs into securities prices.⁸² It has been shown in the consumer products context that

81. See *supra* text accompanying note 38.

82. Butler & Ribstein, *supra* note 29, at 42; Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1435 (1989).

Permitting waiver may increase investor uncertainty about the completeness of a firm's disclosure, thereby increasing information costs and decreasing market efficiency with regard to that firm. See generally Gilson & Kraakman, *supra* note 13 (discussing the elements which lead to and limit market efficiency). The important point is that investor

the market will reach a competitive equilibrium as to both price and contract terms as long as there are a substantial number of comparison shoppers in the market, even if many of the buyers do not shop.⁸³ With respect to financial products, analysts and the financial press occupy a role similar to that of comparison shoppers in the consumer product market.⁸⁴ In addition, the market prices of publicly traded securities are "informed" by the information and judgments of thousands of ordinary investors.⁸⁵

It follows from this analysis that opting out of the securities laws by firms traded in an efficient market is not a concern as long as it is not costly for investors to determine which firms have opted out. If it is costly for investors to make this determination, there is a potential externality problem, since even firms that do not waive securities law coverage may be adversely affected by the

concerns about decreased market efficiency will be reflected in the share prices of firms that opt out of the mandatory disclosure regime. See Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1566 (1989).

83. Alan Schwartz & Louis L. Wilde, *Imperfect Information in Markets for Contract Terms: The Examples of Warranties and Security Interests*, 69 VA. L. REV. 1387, 1404 (1983); see also Alan Schwartz & Louis L. Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. PA. L. REV. 630, 638 (1979).

84. Butler & Ribstein, *supra* note 29, at 47.

85. See Gilson & Kraakman, *supra* note 13, at 579-88 (1984). Empirical evidence regarding the effect of corporate contract terms on stock prices is consistent with this theoretical picture. See Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance: An Analysis of the Trans Union Decision and Subsequent Delaware Legislation*, 75 IOWA L. REV. 1, 69 (1990) (finding a "significant decrease in the relative value of Delaware firms both around the enactment of [a Delaware statute allowing corporations to amend their articles of incorporation to limit directors' liability for breach of the duty of care] and when they elect to adopt the provisions of the statute"). Studies concerning the effect of judicial decisions on stock prices have been more equivocal. See *id.* at 6 (finding that the Delaware court's opinion in *Smith v. Van Gorkum*, 488 A.2d 858 (Del. 1985), did "not appear to have had a significant effect on the stock price of Delaware corporations vis-a-vis corporations incorporated in other states"); Elliot J. Weiss & Lawrence J. White, *Of Econometrics and Indeterminacy: A Study of Investors' Reactions to "Changes" in Corporate Law*, 75 CALIF. L. REV. 551, 553 (1987) (finding "no statistically significant market reaction" to seven Delaware court decisions, not including *Van Gorkum*, "all of which appeared to make significant, unanticipated changes in Delaware corporate law"). But there are inherent problems in measuring the effect of judicial decisions, particularly the difficulty of determining how judicial decisions will be interpreted and applied. See generally, Ronald J. Gilson, *The Law and Finance of the Business Judgment Rule: Comments on Bradley & Schipani and Shapiro* (Stanford Law School John M. Olin Program in Law and Economics, Working Paper Series No. 55, August, 1989) (noting that *Van Gorkum* could be interpreted both as a management-entrenchment case and as a pro-fiduciary duty case). These problems do not necessarily apply to a clear statutory or contract provision.

decisions of other firms to opt out.⁸⁶

Waiver is more difficult to defend with respect to "unseasoned" companies or investments that are not actively traded. Because these firms are not followed by many analysts and because their security prices do not represent a consensus of many investors, their stock prices may not fully discount the effects of disclosure waivers as would the stock prices of more actively traded firms. Individual investors are protected in some offerings by the participation of institutional investors who are able to bargain knowledgeably over price and by promoters' and underwriters' incentives to protect their reputations for fair dealing. But these constraints may not fully compensate for the loss of efficient market protection.⁸⁷ The problems are particularly acute in relatively small offerings that do not involve the participation of a widely-known underwriter, institutional investors or a promoter who intends to engage in repeat dealings.⁸⁸

2. Reconciling Waiver with the Market Failure Assumption

Arguments for private ordering seem to founder on the basic objection that such waiver is inconsistent with the market failure assumptions underlying mandatory disclosure. But, even assuming that investors have a particular need for information with respect to the purchase of a "security" and that legally-regulated affirmative disclosure is generally cost-justified,⁸⁹ it does not necessarily follow that investors will be victimized by waivers of disclosure obligations. Even if opt-out were permitted, most firms probably would find it advantageous to adhere voluntarily to the standardized dis-

86. It has been argued that waiver should not be permitted even in the presence of efficient market pricing because it inhibits judicial testing, and therefore decreases the value, of standardized terms. See Gordon, *supra* note 82, at 1567-69. A corollary to this argument is that proliferation of customized disclosure regimes reduces the value of standard formatting provided by a single regime. See *supra* text accompanying notes 35-40. However, this problem arises only where many firms choose to opt out of the standard regime. In other words, assuming efficient market discipline of decisions to opt out, the Gordon argument would mandate coverage precisely where the market confirms it is most necessary to permit opt out. Butler & Ribstein, *supra* note 29, at 50.

87. For commentary concluding that pricing of fiduciary duty opt-outs is apt to be inaccurate in initial public offerings, see William J. Carney, *The Limits of the Fraud on the Market Doctrine*, 44 BUS. LAW. 1259, 1284 (1989) and Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1517-24 (1989).

88. See Gordon, *supra* note 82, at 1558-62 (1989) (pricing of fiduciary duty opt-outs is likely to be accurate in initial public offerings, but not in small offerings).

89. See Section I(A), *supra* notes 10-41.

closure regime in order to avoid increases in their cost of capital which could result from using disclosure regimes unfamiliar to investors. In such a world, opting out of disclosure regulation would send an unmistakable signal about quality that is much easier for investors to evaluate than the quality of disclosure in a wholly unregulated market.⁹⁰ Indeed, investors may be more likely to over-discount than to under-discount the securities of issuers who opt out of the federal disclosure regime.

Even if private markets will not completely discipline waivers of disclosure requirements, it is necessary to balance the costs of market deficiency against the benefit of forgoing compliance with the mandatory disclosure system in situations where mandatory disclosure may be inappropriate. First, the costs to investors are limited by the existence of "backup" protection in the form of common law fraud actions and the blue sky laws. Furthermore, concern with inefficient waiver is most acute in the context of small initial offerings where, in fact, waiver may be the most cost-justified. The cost of full-fledged compliance with 1933 Act registration requirements will likely be a large percentage of the total amount raised in the offer. By comparison, larger firms incur not only less cost per dollar raised, but possibly even less total cost because they can substitute filings they have already prepared under the 1934 Act for 1933 Act disclosures.⁹¹ Thus, for larger, more seasoned issuers, compliance with the 1933 Act is apt to be a relatively low-cost quality assurance with which few would dispense. While exemptions are available for relatively small offerings,⁹² it may be costly for the firms involved to make the investigations necessary to determine whether the exemptions exist and the disclosures to qualify for them.⁹³

90. Cf. Macey & Kanda, *supra* note 28, at 1041 (public offering of securities sends "highly credible signal" that firm's securities are valuable because of liability under the securities laws).

91. See Forms S-2 and S-3, 17 C.F.R. § 239.12-.13 (1991).

92. See Securities Act of 1933 §§ 3(a)(1)-(11), 3(b), 4, 15 U.S.C. §§ 77c(a)(1)-(11), 77c(b), 77d. The most important set of exemptions for small offerings is Regulation D, Rules 501-506. See 17 CFR § 230.501-.506 (1991).

93. For example, to take advantage of some of the exemptions under Regulation D, firms must disclose information and determine the wealth of investors. See Rules 501, 502, 505 and 506, 17 CFR § 230.501-.502, .505-.506 (covering offerings of over \$500,000).

3. Middle-Ground Alternatives

Even if the costs of unregulated waiver are likely to exceed the benefits of such a policy, there are alternatives to a blanket prohibition on waiver that may represent an efficient middle ground.

a. Highlighting Waiver

Permission for waiver might be conditioned on sending investors in both the primary and secondary markets documents that include clearly highlighted waiver terms. Methods devised in other contexts for highlighting important terms can be applied to disclosure of waivers.⁹⁴ Because of the difficulties of ensuring that waivers are brought to the attention of secondary purchasers, issuers that opt out of the securities laws may have to restrict transfers.

b. Limiting Eligible Purchasers

Concerns about investor ignorance of the effect of waiver could be addressed by enforcing waiver only as to investors most likely to understand its consequences. Existing rules permitting opt-out for "accredited investors"⁹⁵ have the same effect.

c. Broker/Dealer Regulation

Concerns about waiver could also be addressed by shifting responsibilities from issuers to the brokers and dealers who actually sell the securities and by imposing special rules governing the sale of unregulated securities. This philosophy underlies recent reforms relating to "penny stocks." Because of abuses associated with low-priced securities, including lack of price information and risky "blank check" offerings by issuers who will begin operating in the future, the SEC has adopted Rule 15c2-6,⁹⁶ which prohibits brokers from selling certain of these low-priced securities to customers for whom the investment is unsuitable.⁹⁷ In addition, Congress re-

94. The closest analogy is the requirement that legends warning of any transfer restrictions appear on stock certificates. See U.C.C. § 8-204(a) (Supp. 1991) (providing that restrictions may be imposed by the issuer if "conspicuously" noted); *Allen v. Biltmore Tissue Corp.*, 141 N.E.2d 812, 814 (N.Y. 1957); *Ling & Co. v. Trinity Sav. & Loan Ass'n*, 482 S.W.2d 841, 843 (Tex. 1972).

95. See *infra* text accompanying notes 125-28.

96. 17 C.F.R. § 240.15c2-6 (1991).

97. The rule prohibits brokers from selling certain "designated securities," (including

cently adopted the Penny Stock Reform Act of 1990⁹⁸ which, among other things, requires brokers selling "penny stocks"⁹⁹ to disclose to customers the special risks associated with this market.¹⁰⁰

Regulations that screen sales at the broker/dealer level may be more cost-effective than the mandatory disclosure regime. First, for the same reasons investors lack incentives to research securities,¹⁰¹ they also will lack incentives to read lengthy disclosure documents.¹⁰² Second, securities act disclosure requirements may be counter-productive if some investors rely too heavily on the protection provided by federal law. Investors may not realize that the SEC does not review many disclosure documents. Investors may also fail to realize that the firms having the least to lose from sanctions under the federal law are the firms most likely to flout it.¹⁰³ It is noteworthy that penny stock regulation was deemed necessary for securities already subject to much of the mandatory disclosure regime, including the 1933 Act's registration requirements.

equity securities that are *not* traded on a national securities exchange or NASDAQ, issued by a registered investment company, or issued by a company having more than \$2,000,000 in net tangible assets, *id.* § 240.15c2-6(c), unless the brokers (1) obtain personal investment-related information from customers; (2) reasonably determine on the basis of this information that transactions in these securities are suitable for those customers and that the investors or their independent advisers are capable of evaluating the risks of such transactions; (3) deliver a written statement to the customer setting forth the broker's determination of suitability and stating that it is unlawful for the broker to sell the security without such a written statement and the customer's written agreement; (4) obtain a signed copy of the statement from the customer *id.* § 240.15c2-6(b), and (5) obtain from the customers written agreements to the transactions which specify the identity and quantity of the security involved. *Id.* § 240.15c2-6(a). The rule exempts transactions in securities having a price over \$5.00 per share, transactions not recommended by the broker, and transactions by non-market makers. *Id.* § 240.15c2-6(c).

98. Pub. L. No. 101-429, 104 Stat. 951 (codified in scattered sections of 15 U.S.C.).

99. The definition of "penny stock" in the amended Section 3(a)(51)(A) of the 1934 Act, 15 U.S.C.A. § 78c(51)(A) (West Supp. 1991), is similar to that of "designated security" under Rule 15c2-6. *See supra* notes 97-98 and accompanying text.

100. *See* Securities Exchange Act of 1934, § 15(g), 15 U.S.C.A. § 78o(g).

101. *See supra* text accompanying notes 15-19.

102. For a leading article questioning the efficacy of disclosure to ordinary, non-professional investors, see Homer Kripke, *The SEC, the Accountants, Some Myths and Some Realities*, 45 N.Y.U. L. REV. 1151, 1164-70 (1970).

103. This proposition is the corollary of the statement above that to avoid sending an overly negative signal about the quality of their disclosures most firms will not opt out of the securities laws. *See supra* text accompanying note 90.

d. Limiting the Type of Transaction

A final alternative to a blanket prohibition of waiver is to limit the option only to transactions which, by their nature, indicate that investors are likely to know of and be able to assess the consequences of waiver. This is the policy basis underlying the private ordering approach to characterizing partnership interests as non-“securities.”¹⁰⁴

4. Waiver of Anti-Fraud Provisions

The foregoing discussion applies generally to waiver of federal affirmative disclosure rules, and in particular to those rules provided in the 1933 Act. There is an additional issue concerning the propriety of distinguishing between affirmative disclosure and anti-fraud provisions with regard to waiver. The anti-fraud rules are intended to ensure a sort of “fall-back” or “safety net” protection for investors. As a result, waiver of these provisions should be regarded suspiciously. However, the importance of this “safety net” to investors is unclear since the anti-fraud rules do not vary substantively from state common law fraud protection.¹⁰⁵ The principal differences between state common law fraud and the federal anti-fraud provisions arise in multi-state actions where there is concern about the efficiency of state regulation¹⁰⁶ and a need to facilitate national common-questions litigation.¹⁰⁷ For the usually single-state general partnership cases that are the focus of this article, these particular concerns justifying the federal anti-fraud provisions are relatively unimportant.¹⁰⁸

Differences between waiving disclosure obligations in connection with an initial sale, and waiving anti-fraud and other obligations that operate throughout the life of the issuing company may justify a distinction between 1933 Act affirmative disclosure requirements and other disclosure or anti-fraud rules. Even if inves-

104. See *infra* text accompanying notes 154-58.

105. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976) (requiring “scienter” for Section 10(b) damage actions); see also, *supra* text accompanying note 76 (anti-fraud rules do not provide affirmative disclosure duty).

106. See *supra* notes 39-40 and accompanying text.

107. See *supra* text accompanying note 41.

108. Ironically, the general partnership case is the sort in which the anti-fraud remedy has the most practical importance because an intrastate, private, or small-offering exemption from 1933 Act registration is commonly available.

tors are in a position to assess waiver costs with respect to a particular disclosure document such as, for example, a 1933 Act registration statement, it might be argued that investors cannot determine the cost of waiving all future disclosures. Among other things, while investors may trust the current insiders under current conditions, they cannot assess the actions of future insiders under future conditions. Thus, investors could not accurately price a waiver provision that would operate during the indeterminate future.¹⁰⁹ Investors' inability to predict the future suggests that waiver should be permitted only on a disclosure-by-disclosure basis, and not for all future transactions by a firm, as would be the case for any waiver rule operating through the definition of a "security." On the other hand, there is little reason to believe that investors would under-discount, rather than over-discount, these indeterminate risks, or that they would under-value the future benefits of opting out of the mandatory disclosure regime. Moreover, requiring repeated waivers would significantly increase the costs of waiver, and may effectively force many firms to accept the costs of mandatory disclosure.

B. Legal Recognition of the Private Ordering Approach

Section A discussed policy considerations for allowing at least limited waivers of federal disclosure requirements. This section shows that there is also legal recognition that private ordering is sometimes effective in determining the application of the securities laws.

1. Interpretation of Anti-Waiver Provisions

The securities laws explicitly provide that agreements waiving compliance with them are ineffective.¹¹⁰ A broad interpretation of these provisions might preclude the court from enforcing any agreement that had the *effect* of a waiver, including parties' selection of a particular form of transaction. For instance, the court in *Roger v. Ilikon Corp.*¹¹¹ construed an agreement providing that the plaintiff was not relying on the promoter-defendants' represen-

109. For a similar argument against fiduciary duty waivers see John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618, 1648-51 (1989).

110. See *supra* note 5.

111. 361 F.2d 260 (1st Cir. 1966).

tation as substantively, even if not formally, a waiver of the disclosure requirements.¹¹² The court said, "A party should not be permitted to do indirectly that which he may not do directly."¹¹³

Nevertheless, the Supreme Court's recent decisions on arbitration support a narrower interpretation of the waiver provisions. In *Shearson/American Express, Inc. v. McMahon*, the Court held that investors could be required, pursuant to their customer agreements, to arbitrate claims against their brokers arising under Section 10(b) of the 1934 Act¹¹⁴ and RICO.¹¹⁵ The Court interpreted the statutory prohibitions on any agreement that requires the parties "to waive compliance with any provision" of the securities laws¹¹⁶ to apply only to provisions that impose substantive obligations.¹¹⁷ In *Rodriguez de Quijas v. Shearson/American Express, Inc.*,¹¹⁸ the Court overruled its earlier decision in *Wilko v. Swann*¹¹⁹ and held that investors could be forced to arbitrate a claim under an *express* remedy.¹²⁰

Thus, the Court in effect held, through restrictive interpretations of the anti-waiver provision, that private agreements *could* modify the application of the securities laws. Moreover, the Court found that "[t]he voluntariness of the agreement is irrelevant to this inquiry" because the customer's contract law rights are not at issue.¹²¹ Thus, where the anti-waiver provision does not apply, the agreement is enforceable to the full extent permitted under contract law, without regard to the securities laws' supposed protection of powerless investors.¹²²

However, these cases provide only limited support for private ordering. The Court's holdings favoring mandatory arbitration were

112. *Id.* at 268.

113. *Id.* at 267. See also Samuel A. Gruenbaum, *Avoiding the Protection of the Federal Securities Laws: The Anti-Waiver Provisions*, 20 SANTA CLARA L. REV. 49, 73 (1980) (endorsing broad interpretations of sections 14 and 29(a)).

114. 482 U.S. 220, 234 (1987).

115. *Id.* at 239.

116. See Securities Act of 1933 § 14, 15 U.S.C. § 77n; Securities Exchange Act of 1934, § 29(a), 15 U.S.C. § 78cc(a).

117. 482 U.S. at 228-30.

118. 490 U.S. 477 (1989).

119. 346 U.S. 427 (1953).

120. *Rodriguez de Quijas*, 490 U.S. at 479-85.

121. *McMahon*, 482 U.S. at 230.

122. A strong dissent on this point chided the majority for ignoring the investor-protection policy of the securities laws in its decision to enforce the agreement. *Id.* at 243 (Blackmun, J., concurring in part and dissenting in part).

based in part on the federal policy to the same effect expressed in the Federal Arbitration Act,¹²³ and in part on a finding that arbitration adequately protects investors' substantive rights, particularly in view of SEC oversight of brokerage agreements.¹²⁴ Thus, to some extent the Court found securities law protection unnecessary.

2. Exemptions: The "Accredited Investor" Concept

The private ordering approach has also been endorsed through the concept of "accredited investors" incorporated in the 1933 Act¹²⁵ and in the SEC's Regulation D.¹²⁶ "Accredited investors" include certain institutional investors and insiders, as well as any person with a net worth over \$1,000,000 or individual annual income over \$200,000.¹²⁷ SEC Regulation D essentially allows unregistered sales of any amount of securities to any number of "accredited investors."¹²⁸

The "accredited investor" exemption obviously is not conditioned on a determination of whether the nature of the transaction makes application of the mandatory disclosure rules appropriate. In fact, the exemption applies even to a transaction clearly involving "security"-type information and hundreds of investors. Rather, the underlying theory holds that certain investors are in a position to bargain for the information they need, and therefore those investors should be allowed to opt out of the 1933 Act's registration requirements. This approach is consistent with this article's private ordering hypothesis.

123. The Court concluded that the preference for arbitration embodied in the Act justified placing on the party opposing arbitration the burden of establishing that Congress intended through another federal statute to preclude resort to arbitration. *See id.* at 226-27.

124. *Id.* at 233.

125. *See* Securities Act of 1933, §§ 2(15), 4(6), 15 U.S.C. § 77b(15) (defining "accredited investor") and § 77d(6) (providing for an exemption for transactions involving offers or sales solely to "accredited investors").

126. *See* SEC Rules 501-08, 17 C.F.R. § 230.501-508 (1991).

127. *See* SEC Rule 501(a), 17 C.F.R. § 230.501(a).

128. *See* SEC Rule 501(e), 17 C.F.R. § 230.501(e) ("accredited investor" not included in calculation of maximum number of purchasers allowed in offering); SEC Rule 502(b), 17 C.F.R. § 230.502(b) (no information need be furnished to "accredited investor"); SEC Rule 506(b)(2)(ii), 17 C.F.R. § 230.506(b)(2)(ii) ("accredited investors" need not meet sophistication requirement for offers over \$5,000,000).

III. THE CASE OF GENERAL PARTNERSHIPS: MANDATORY DISCLOSURE OR PRIVATE ORDERING?

This part applies the analysis above to general partnership interests. It demonstrates that the general partnership cases are more consistent with private-ordering than with mandatory-disclosure analysis. Section A shows that the factors relating to the mandatory disclosure approach support characterizing at least some general partnerships as securities. Section B, on the other hand, shows that the factors relating to the private ordering approach justify characterizing general partnerships *per se* as non-securities. Section C confirms the analysis of the preceding two sections by showing that courts have moved toward a *per se* rule that general partnerships are non-securities. Section D sets the private-ordering perspective of partnership cases in sharp relief by contrasting these cases with analogous non-partnership cases that emphasize mandatory-disclosure policies.

A. The Mandatory Disclosure Approach

This section applies the traditional "mandatory-disclosure" tests for defining a "security" to general partnership interests and demonstrates that there are strong arguments for characterizing some general partnership interests as "securities" under that approach. This conclusion suggests that courts' broad exclusion of general partnership interests, discussed below in section B, is explained at least in part by factors other than the mandatory disclosure justifications reflected in the traditional tests — specifically, by the "private ordering" approach proposed in this article.

1. Efforts of Others

A "standard form" general partnership would not meet the "efforts of others" element of the *Howey* test because, under the Uniform Partnership Act (U.P.A.), all partners participate equally in the management of the firm.¹²⁹ Like most partnership law provisions, however, the "equal participation" rule is subject to contrary agreement.¹³⁰ In many firms, such as real estate investment orga-

129. UNIF. PARTNERSHIP ACT § 18(e), 6 U.L.A. 213 (1914).

130. *See id.* (introduction states that "[t]he rights and duties of the partners in relation to the partnership shall be determined [by the U.P.A.], subject to any agreement between them").

nizations, general partners delegate substantial authority to the promoters who recruit them and who serve as managing partners.¹³¹ In these partnerships, the value of the partners' investments may be just as dependent on the quality of management as the value of a share in a publicly traded corporation. The fact that the promoter may structure the deal so that investors have a formal right to control does not diminish the need for investor protection.¹³² Thus, the partners' retention of a power to veto management decisions should not necessarily prevent a "security" from existing.¹³³

2. Common Enterprise

Most general partnerships constitute "securities" under the "common enterprise" test. They would qualify under "vertical commonality" because even managing partners often share the profits generated, and under "horizontal commonality" because partners typically share pro rata in the earnings of the firm.

To the extent that horizontal commonality is really a "multiple investor" requirement,¹³⁴ that element would seem to be satisfied at least in cases of larger syndications adopting the general partnership form.

The personal liability arising inherently in the general partnership form arguably cuts against classification as a "security" with respect to at least one of the justifications for the multiple investor requirement: that purchasers of small fractions of the firm lack adequate incentives for research. On the other hand, even if each partner has sufficient incentives for research, mandatory disclosure may still be justified by the other rationale underlying the multiple investor requirement: that disclosures by the firm avoid wasteful

131. The prevalence of centrally-managed general partnerships may seem puzzling because such firms do not use limited liability to facilitate passive ownership. Cf. Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 94 (1985) (explaining limited liability contracts partly on this basis). However, for some firms, specialized management may not provide a benefit sufficient to offset the cost of limited liability. In addition, the general partnership form may offer sufficient tax advantages to offset costs of personal liability. See Ribstein, *supra* note 14, at 871-76 (showing how tax law may cause perverse selection of the partnership form).

132. See William J. Carney & Barbara G. Fraser, *Defining a "Security": Georgia's Struggle with the "Risk Capital" Test*, 30 EMORY L.J. 73, 93-95 (1981) (arguing that an investor who lacks substantial knowledge of an enterprise's operations or who is not offered management participation rights at the time of the investment should have the interest classified as a security and be afforded protection of the securities laws).

133. See Steinberg & Kaulbach, *supra* note 80, at 522.

134. See *supra* text accompanying notes 61-65.

duplication of research. Indeed, overproduction of information is likely to be a more serious problem in the partnership context than for other investments precisely because the risk of personal liability increases the partners' incentives to research the firm before investing.

3. Application to Closely Held Firms

General partnerships are inherently closely held because personal liability makes free transferability of interests impractical.¹³⁵ Although close ownership makes some of the rationales underlying mandatory disclosure inapplicable, courts have not generally excepted closely held firms from the definition of "security."¹³⁶ Accordingly, the closely held nature of general partnerships is not in itself sufficient to justify characterizing general partnership interests as non-"securities."

4. Protective Elements of the General Partnership Form

Even if general partnerships could be considered investment contracts under *Howey*, they arguably should not be classified as "securities" since various elements of the general partnership standard form significantly reduce the benefits of mandatory disclosure. Protections offered by the partnership form might justify the sort of implied exemption the Supreme Court has applied where purchasers were protected, for example, by deposit insurance or by federal retirement law.¹³⁷

Several characteristics of the partnership form support implied exemption from the securities laws. First, the U.P.A. standard form

135. In order to enforce personal liability, shareholders must be prohibited from transferring that liability away. Otherwise, investors could transfer liability to low-asset holders on the eve of bankruptcy. Where trading is allowed, personal liability inhibits transfer of interests by encumbering every purchase with the additional assumption of a guarantee, increasing the buyer's need for specific information about the company. Personal liability forces creditors and co-shareholders to keep track of who owns a company's stock and how wealthy these owners are, an undertaking which is more costly if stock is transferable. For discussions of the effect of personal liability on transferability, see Easterbrook & Fischel, *supra* note 131, at 95; Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259, 262 (1967); Susan E. Woodward, *Limited Liability in the Theory of the Firm*, 141 J. INST. & THEORETICAL ECON. 601, 602 (1985).

136. See *supra* text accompanying notes 66-75.

137. See *supra* text accompanying notes 48-50.

gives all partners equal rights to participate in management.¹³⁸ While the partners can contract around this right, the U.P.A. right of equal participation fills any gaps remaining in the parties' explicit agreement.¹³⁹ Accordingly, partners may block any management decision with which they disagree, and not only the sort of major decisions on which corporate shareholders vote. Second, the U.P.A. provides that all partners are entitled to full disclosure of information about a firm.¹⁴⁰ Third, each partner has the power to dissolve the partnership at will,¹⁴¹ and to obtain on dissolution either a pro rata share of proceeds from the sale of partnership property¹⁴² or, if the partnership is continued after dissolution, the value of the partner's interest in the firm.¹⁴³ These "voice" rights can provide more potent protection than corporate shareholders' power to "exit" by sale of their stock¹⁴⁴ because the market price of corporate stock necessarily reflects any prospective detriment to holders resulting from their minority status.¹⁴⁵

These protections provided by the U.P.A. do not, however, justify exempting general partnerships from the securities laws. Participation in management does not provide an adequate substitute for mandatory disclosure during the course of the business for partners who are unsophisticated or uninformed. Participation is irrelevant if the investor was expecting profits from the promoter's efforts. Disclosure under the U.P.A. inadequately substitutes for federal laws' mandates as to the detail and formatting of disclosure. In all events, there is probably no duty of affirmative disclosure between a promoter and one who is not yet a partner.¹⁴⁶

138. See *supra* text accompanying note 129.

139. See ALAN R. BROMBERG & LARRY E. RIBSTEIN, *BROMBERG & RIBSTEIN ON PARTNERSHIP*, 6:40-41 (1988).

140. U.P.A. § 20, 6 U.L.A. 256.

141. *Id.* §§ 29, 31, 6 U.L.A. 364, 376.

142. *Id.* at § 38 (1), 6 U.L.A. 456 (any partner who has not wrongfully dissolved the partnership can compel liquidation of the partnership business); *Id.* at § 40, 6 U.L.A. 468 (detailing the rules for distribution of partnership assets).

143. *Id.* at § 42, 6 U.L.A. 521; see also Larry E. Ribstein, *A Statutory Approach to Partner Dissociation*, 65 WASH. U.L.Q. 357, 382-83 (1987).

144. As to trade-offs between "exit" and "voice" see *supra* note 71.

145. See William J. Carney, *The Theory of the Firm: Investor Coordination Costs, Control Premiums and Capital Structure*, 65 WASH. U. L.Q. 1, 19 (1987) (noting that prospective investors will discount shares when they are wary of a potential "squeeze out" by a dominant shareholder).

146. See *Walker v. Patterson*, 208 N.W. 3 (Minn. 1926); *Waite on Behalf of Bretton Woods Acquisition Co. v. Sylvester*, 560 A.2d 619 (N.H. 1989); *Densmore Oil Co. v. Densmore*, 64 Pa. 43 (1870); BROMBERG & RIBSTEIN, *supra* note 139, at 6:63.

Even the partners' power to compel dissolution and liquidation or buyout is insufficient to warrant withdrawing securities law protection. The power may be materially qualified by penalties should a partner dissolve prior to the expiration of a term or undertaking,¹⁴⁷ or where the agreement includes a non-competition clause or provides for a payment on dissolution of significantly less than the full value of the partner's interest.¹⁴⁸ Even the power to receive a full pro rata share does not fully redress the frustrated expectations of a partner who was misled about the prospects of the venture.

5. Summary

The above discussion shows that the traditional elements of the definition of "security" do not support characterizing general partnership interests as *per se* non-"securities." To the extent that the definition of "security" turns on policies justifying mandatory disclosure, exclusion is appropriate only for particular partnerships in which, for example, the efforts of others or common enterprise elements of the *Howey* test are not met. Thus, to the extent that the courts have recognized a *per se* exemption for general partnerships,¹⁴⁹ this section points to some basis for those decisions other than the mandatory-disclosure approach. That basis is the private-ordering approach discussed in the next section.

B. Application of Private Ordering Approach to General Partnerships

Under the mandatory-disclosure approach to defining "security,"¹⁵⁰ partnership interests would be securities where, for example, several relatively passive investors rely on the efforts of managing partners, irrespective of whether those partners had a technical power to control the firm. This determination would depend on the facts of the particular transaction. Under the private ordering approach, on the other hand, general partnership interests would be *per se* non-"securities" based entirely on the investors' selection of

147. U.P.A. § 38(2), 6 U.L.A. 456 (providing that on wrongful dissolution, the dissolving partner is liable for damages and is not entitled to the value of goodwill in the computation of the interest).

148. See BROMBERG & RIBSTEIN, *supra* note 139, at 7:142-146 (discussing the extent to which courts are willing to enforce such agreements).

149. See Section III(C), *infra* notes 165-216.

150. See Section II(A), *supra* notes 81-109.

the partnership form, irrespective of whether, under the particular circumstances, investors needed the protection of the securities laws. This section demonstrates that it is appropriate to apply the private ordering approach to define general partnership interests as "securities." Subsection 1 offers policy arguments supporting this approach, while subsection 2 shows how its application is consistent with the statutory definition of "security."

1. Policy Considerations

Characterizing partnership interests as *per se* non-"securities" under the private ordering approach would address the principal policy objections to enforcing waivers of the securities laws.¹⁵¹ First, questions of whether notice of the waiver were brought home to the investor are mitigated by embedding the waiver in the unmistakable structure of the deal. Obviously, investors need only a cursory understanding of the agreement to know whether they are participating in a general partnership. Thus, once it is clear that the securities laws do not apply to such investments, purchasers in both the primary and secondary markets can be expected to be aware of the waiver without having to read a detailed agreement. Investors would have notice of the non-application of the securities laws not only from case law reaching this result, but also because the result follows logically from a conventional, and therefore widely understood, approach to the definition of "security."

Second, because the waiver is an inherent part of the deal, investors are in a position to evaluate non-coverage by the securities laws and negotiate non-coverage along with the other aspects of the partnership agreement. By contrast, if the waiver is brought to the attention of the purchaser only in the final agreement, it may come after considerable negotiations and unregulated selling effort that may cause the investor to discount or disregard the absence of securities regulation.

Third, use of the general partnership form inherently mitigates potential problems of investors being unable to understand the

151. See *supra* text accompanying notes 81-93. While this analysis justifies permitting the parties to use the general partnership form to waive application of the securities laws, it also justifies enforcing parties' bargains, evidenced through a provision in the partnership agreement, to have securities laws apply. This is the effect of the Supreme Court's recognition that use of the "stock" format rather than the asset-purchase format in the sale of a business automatically triggers application of the securities laws. See *infra* text accompanying notes 217-48.

effect of a securities law waiver. Irrespective of the specific terms adopted by general partners, the partners are personally liable for the debts of the business.¹⁵² Thus, only investors who are willing to risk personal liability participate in general partnership deals.¹⁵³ This willingness to accept risk provides the same sort of assurance of sophistication that is provided by the wealth and net income criteria for "accredited investor" status.¹⁵⁴

The foregoing discussion demonstrates that allowing investors to opt out of the securities laws by selecting the general partnership form does not exalt form over substance in the sense that the elements of the general partnership form are related to policy concerns with waiver. This distinguishes the significance of choice of form for securities law purposes from tax rules on choice of form that are either irrelevant to or perversely inconsistent with governance objectives.¹⁵⁵

2. Statutory Considerations

The private ordering approach to defining general partnerships as non-"securities" is consistent with the "conventional" view of a security, which focuses on the parties' expectations rather than on the underlying policies of the act.¹⁵⁶ The principle identifying feature of conventional securities is their embodiment in a *document* or certificate.¹⁵⁷ The statutory definition itself includes this feature: "security" includes, for example, a "*certificate of interest or participation* in any profit-sharing agreement" rather than a "profit-sharing agreement."¹⁵⁸ In this context, certification is significant not as a check on fraud or as a method of notifying third parties, but because it facilitates transferability of interests. Certif-

152. U.P.A. § 15, 6 U.L.A. 174.

153. Although investors in close corporations often put their entire capital at stake, many close corporations, unlike general partnerships, also have small, passive investors who have only a limited stake in the business. Consequently, a *per se* rule is not justified for close corporations on private ordering grounds. *See supra* text accompanying notes 105-09.

154. *See supra* text accompanying notes 125-28.

155. *See* Ribstein, *supra* note 14, at 871-77.

156. The private ordering approach is similar to that applied by the Supreme Court in the sale-of-business and note cases. *See infra* text accompanying notes 217-48.

157. 14 OXFORD ENGLISH DICTIONARY 854 (2d ed. 1989), defines "security" as follows: "10. A document held by a creditor as guarantee of his right to payment. Hence any particular kind of stock, shares, or other forms of investment guaranteed by such documents. Also, in the U.S., such a document issued to investors to finance a business venture."

158. Securities Act of 1933, § 2(1), 15 U.S.C. § 77b(1) (emphasis added).

ication accomplishes this by providing transferees with clear notice of the holder's voting and financial share, rather than forcing the transferee to determine these rights by examining the company's books. In other words, as commonly understood, a "security" is an interest in an enterprise capable of being traded.

The common understanding of a general partnership interest does not conform to this conventional meaning of "security." Although general partnership agreements often are written, they need not be, and they are rarely represented by transferable certificates. Moreover, non-transferability is inherent in the partnership form.¹⁵⁹ The U.P.A. provides that all partners must consent to the admission of new partners.¹⁶⁰ Although this provision is subject to the partners' contrary agreement,¹⁶¹ partners normally would expect to be able to veto admission of new partners in light of their potential personal liability for contracts or other acts of their co-partners. Partners may assign their financial interests in the firm without co-partner consent.¹⁶² However, because these interests carry no management rights, there is usually little market for them.¹⁶³ Even if these partnership interests were freely traded, this activity would generate a market for only a portion of partners' rights under their partnership agreements.

Under the conventional definition of a "security," the mere fact that parties have selected the general partnership form indicates that they do not expect to be covered by the securities laws even if mandatory disclosure is arguably appropriate as a policy matter.¹⁶⁴ The central thesis of this article is that this choice of form

159. Non-transferability distinguishes general partnership interests from stock in such corporations. While stock in closely held corporations often is not readily marketable, all corporate stock is presumptively freely transferable. *See, e.g., Rafe v. Hindin*, 288 N.Y.S.2d 662, 665 (refusing to enforce a consent restriction on transfer of stock in a two-person corporation because it was inconsistent with the rule against unreasonable restraints on alienation of personal property), *aff'd mem.*, 244 N.E.2d 469 (N.Y. 1968).

160. U.P.A. § 18(g), 6 U.L.A. 213.

161. *See id.* § 18, 6 U.L.A. 213.

162. *Id.* § 27(1), 6 U.L.A. 353.

163. Assignees have only the right to seek judicial dissolution of a partnership where there is no remaining term or uncompleted undertaking. *Id.* §§ 27(1), 32(2), 6 U.L.A. 353, 394.

164. Had courts clearly and consistently applied the mandatory disclosure approach to general partnership interests and determined on that basis that those interests were "securities," this judicial precedent arguably would have shaped investors' expectations. But, as discussed in Section III(C), *see infra* text accompanying notes 165-216, the courts never applied the mandatory disclosure approach more than tentatively in a few early cases. In any event, because application of the mandatory disclosure approach to general partner-

is tantamount to a contractual waiver of securities law coverage.

It is not essential to the contractual characterization of form choice that either of the parties purposely selected the partnership form in order to avoid the securities laws, or even that the parties were aware of the consequences of their choice of form with respect to securities law coverage. In either of these situations there would be a contract in which legal default rules rather than explicit intentions fill in blank terms.

C. General Partnership Interests as Non-Securities

This section traces the evolution of cases evaluating general partnership interests as securities and shows a change from a fact-specific, mandatory-disclosure approach to a *per se* rule that general partnerships are non-securities. The rule which has developed is consistent with the private ordering approach advocated in this article.

1. Pre-Williamson Cases

The law on general partnership interests as securities began with the assumption that the *Howey* analysis would apply in this context as it had been applied to other purported investment contracts. An early article on the subject argued that a general partnership would be a security if the general partners were sufficiently passive or uninvolved in management that they could be deemed to be investing in the efforts of others.¹⁶⁵ The author extended this analysis even to large professional firms, such as law, accounting or brokerage partnerships in which the partners made financial investments.¹⁶⁶

The leading case on general partnership interests as securities during this period, *Pawgan v. Silverstein*, did not really test this

ships would turn on the circumstances of particular cases, investors would be unable to form clear expectations concerning coverage. More importantly, the private ordering approach is based not merely on investor *expectations*, but on the notion that investors should be able to *choose* non-coverage of the securities laws by selecting the general partnership form. In that respect, the private ordering approach is consistent with the Supreme Court's holdings that corporate stock is *per se* a "security," which, in effect, permits investors to choose the coverage of securities laws. See *infra* text accompanying notes 217-48.

165. Joseph C. Long, *Partnership, Limited Partnership and Joint Venture Interests as Securities*, 37 MO. L. REV. 581, 613-15 (1972).

166. *Id.* at 614.

assumption.¹⁶⁷ In *Pawgan*, three promoters acquired a motel, leased it back to the seller and then assigned the contract to a partnership in which the promoters participated as managing partners with seventeen other partners. The non-managing partners provided ninety percent of the financing for the firm. Apart from the fact that a majority vote of the partners would be required to approve sale or refinancing of the property, the non-managing partners had no role in management.¹⁶⁸ The managing partners were even given the power to admit new partners without a vote by the other partners. In fact, the powers of the general partners in the *Pawgan* firm did not differ from those of the limited partners in another of the promoters' firms.¹⁶⁹

The court seems to have been persuaded that the firm was, in substance, a limited rather than a general partnership. It referred to the firm as a "syndication," saying, "[i]t is obvious that this venture was not a general partnership in the accepted sense, and calling it one does not properly reflect its real business form."¹⁷⁰ Without further discussion, the court went on to hold that the partnership was "either [a] certificate of interest or participation in a profit sharing agreement or investment contract, and therefore a security."¹⁷¹

A case at the other extreme from *Pawgan* decided during the same period is *Oxford Finance Co. v. Harvey*.¹⁷² The *Harvey* court found no "security" in a two-party joint venture in which the plaintiff had the substantial managerial control characteristic of a joint venture.¹⁷³

Hirsch v. duPont is the most interesting pre-*Williamson* case because it proved to be an important precursor to the special *per se* rule ultimately applied in general partnership cases.¹⁷⁴ In *Hirsch*, the plaintiffs purchased general partnership interests in

167. 265 F. Supp. 898 (S.D.N.Y. 1967).

168. *Id.* at 900. The *Pawgan* court derived these facts from an opinion issued in an earlier, related case, *United States v. Silverstein*, 237 F. Supp. 446 (S.D.N.Y.), *aff'd* 344 F.2d 1016 (2d Cir. 1965). In *Silverstein*, the court held that the partnership was sufficiently impersonal that the Fifth Amendment would not protect the managing partners from having to produce partnership papers. *Silverstein*, 237 F. Supp. at 449-50.

169. *Id.* at 447.

170. *Pawgan*, 265 F. Supp. at 900.

171. *Id.*

172. 385 F. Supp. 431 (E.D. Pa. 1974).

173. *Id.* at 434. *See also* *Vincent v. Moench*, 473 F.2d 430 (10th Cir. 1973) (interests in a partnership of three families are not securities).

174. 396 F. Supp. 1214 (S.D.N.Y. 1975), *aff'd* 553 F.2d 750 (2d Cir. 1977).

connection with a sale of their firm to DuPont, Glore Forgan & Co. The court held that these interests were not securities under *Howey* because, although general management power was formally delegated to a management committee, each partner had a real power to participate in management, and in fact actively participated.¹⁷⁵ As a separate ground for its decision, the court held that, unlike *Pawgan*, the *Hirsch* enterprise was a partnership "in the accepted sense" because the partnership interests were not freely transferable, the interests were not offered to the public, and the plaintiffs had professional and business relationships with the other partners.¹⁷⁶

The *Hirsch* court's stress on the formal elements of general partnership is arguably consistent with application of a *per se* rule. One indication of the court's formal approach is its ruling that *limited partnership* interests in the same firm, owned by the same plaintiffs, were securities based on the circumscribed statutory rights of limited partners. However, the court also employed a standard *Howey* analysis by emphasizing that the plaintiffs were among the largest holders of voting units and so "were clearly in a position to seek a majority for their position, and thereby exercise managerial control over the firm."¹⁷⁷

Thus, at this stage of the case law development, the question for the courts was whether an investment formally structured as a general partnership interest and not merely a disguised limited partnership would be (a) a non-"security" *per se*; or (b) a "security" under the *Howey* analysis if the investors delegated substantial management power to one or more managing partners.

2. *Williamson v. Tucker*

In *Williamson v. Tucker*, a promoter offered investments in a real estate development project in the form of three joint ventures with approximately fifteen venturers in each.¹⁷⁸ The promotional

175. 396 F. Supp. at 1221-22. In reaching its conclusion about the nonexistence of securities, the *Hirsch* court also relied on *New York Stock Exch., Inc. v. Sloan*, 394 F. Supp. 1303 (S.D.N.Y. 1975), in which the "security" issue arose in the unusual context of general partners of a brokerage firm seeking standing to sue for a violation of stock exchange rules arising partly out of the partners' breach of their supervision duties. The *Sloan* court ruled that the partners lacked standing, basing its decision in part on the ground that allowing suit would not encourage compliance with the rules. *Id.* at 1315.

176. *Hirsch*, 396 F. Supp. at 1226.

177. *Id.* at 1222.

178. 645 F.2d 404, 408 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981).

materials emphasized that the promoter would "aggressively pursue[] all zoning and proper land planning efforts to assure the maximum profit potential of each investment."¹⁷⁹ There was strong evidence that the investors would be relying on the promoter's efforts. However, the joint venture agreements clearly gave the investors substantial management power, including authority to approve new development proposals and to remove the promoter as manager.¹⁸⁰ The case, therefore, squarely presented the question left open after *Hirsch*.

The *Williamson* court applied essentially a two-part analysis. First, it determined that the firm was a *bona fide* joint venture.¹⁸¹ Unlike *Pawgun*, the partners had real power which was not diluted by the offering of a large number of interests. In this situation, the court said, an investor "should be on notice . . . that the federal securities acts will not protect him from a mere failure to exercise his rights."¹⁸² This first step of the *Williamson* analysis is oriented toward investor expectations arising from the form of their investments.

But then the court ruled that, in order for the plaintiff to prove the investment was a security, the plaintiff had to show that "he was so dependent on the promoter or on a third party that he was in fact unable to exercise meaningful partnership powers."¹⁸³ The court summarized its test as follows:

A general partnership or joint venture interest can be designated a security if the investor can establish, for example, that (1) an agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership; or (2) the partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or (3) the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership

179. 645 F.2d at 408.

180. *Id.* at 408-09.

181. *Id.* at 407-09.

182. *Id.* at 422.

183. *Id.* at 424.

or venture powers.¹⁸⁴

At first glance, the second and third prongs of the *Williamson* test seem to apply *Howey*. Upon closer analysis, it is not clear the court relied on *Howey*. The *Williamson* court observed that an investor in a *bona fide* partnership has "an extremely difficult factual burden"¹⁸⁵ to establish that the interest is a security and indicated that the plaintiff in the case before it failed that task.¹⁸⁶ The *Williamson* plaintiffs' general business expertise and past investments in similar ventures made characterization of the interests as "securities" inappropriate under the second prong of the court's test.¹⁸⁷ With respect to the third prong, the court concluded that even if the plaintiffs had relied on the promoter, they failed to prove that the promoter was uniquely capable managing the partnership and, therefore, irreplaceable. This aspect of the test is not only very difficult to satisfy,¹⁸⁸ but it is also inconsistent with the *Howey* "efforts of others" test. As long as the facts show that investors expect a profit from a particular promoter's managerial efforts (as appeared to be the case in *Williamson*), the investors' power to remove the promoter should be as irrelevant in determining the existence of a "security," as corporate shareholders' right to vote out current management.¹⁸⁹

Thus, *Williamson* comes very close to holding that a *bona fide*

184. *Id.*

185. *Id.*

186. *Id.* at 424. Notwithstanding the court's conclusion that the partnership interests were not "securities," it found the district court's dismissal for lack of subject matter jurisdiction improper. At the time of the dismissal, "neither the Supreme Court nor [the Fifth Circuit] had considered the effect of meaningful powers retained by joint venturers on the inclusion of joint venture interests within the investment contract concept." *Id.* at 425. Therefore, the plaintiffs' claims were not "immaterial" or "wholly insubstantial and frivolous." *Id.* at 426.

187. For other cases finding plaintiffs sufficiently sophisticated to pass the second prong of *Williamson*, see *Youmans v. Simon*, 791 F.2d 341, 347 (5th Cir. 1986); *Roark v. Belvedere, Ltd.*, 633 F. Supp. 765, 768 (S.D. Ohio 1985). For cases holding that the plaintiff had raised fact issues as to unsophistication see *Stewart v. Germany*, 631 F. Supp. 236, 240 (S.D. Miss. 1986); *McConnell v. Frank Howard Allen & Co.*, 574 F. Supp. 781, 786 (N.D. Cal. 1983).

188. For another case holding that the plaintiff was not dependent on the promoter's unique skills see *Youmans*, 791 F.2d at 346-47. For cases holding that plaintiffs had raised factual issues about dependency see *Stewart*, 631 F. Supp. at 240; *Gordon v. Terry*, 684 F.2d 736, 743 (11th Cir. 1982), *cert. denied*, 459 U.S. 1203 (1983).

189. See *Carney*, *supra* note 7, at 322 n.44 ("The [*Williamson*] court failed to notice . . . that these requirements for a lack of practical control go beyond the lack of control of ordinary shareholders.")

general partnership interest is *per se* not a security even if the *Howey* factors are satisfied. The case is therefore more consistent with an expectations-based private ordering approach than with a mandatory-disclosure approach oriented toward assessments of transactions as appropriate or inappropriate for federal disclosure rules.

3. *Goodwin v. Elkins & Co.*¹⁹⁰

In *Goodwin v. Elkins & Co.*, a Third Circuit panel issuing three separate opinions unanimously concluded that a general partnership interest in a stock brokerage firm structured as a limited partnership was not a "security."¹⁹¹

Referring only to the partners' powers and personal liability under the applicable partnership statute, Judge Garth held that plaintiff's partnership interest was not a "security" as a matter of law. He said:

[i]t is manifest that any person who possesses the powers, rights, and responsibilities described [in the statute] cannot have invested his capital with the expectation of profits derived solely from the efforts of others, and therefore cannot be the holder of a "security" as intended by the Act. Whatever subjective perceptions Goodwin may have entertained about his position in the firm, and whatever may have been the role he actually assumed, the legal interest which he enjoyed does not fall within the scope of the term "security" as intended by Congress.¹⁹²

Judge Garth refused to adopt the *Williamson* rule, noting that it was "inapposite" because it assessed dismissal based on lack of subject matter jurisdiction.¹⁹³ Nonetheless, Judge Garth proceeded to consider the plaintiff's *Williamson* argument and rejected the

190. 730 F.2d 99 (3d Cir.), *cert. denied*, 469 U.S. 831 (1984).

191. *Id.* at 103. Judge Garth wrote the opinion announcing the judgment of the court; Chief Judge Seitz and Judge Becker wrote separate concurring opinions. *Id.* at 100, 111 & 113. The judges' divergence of opinion was precipitated by the plaintiff's failure to attach a copy of the partnership agreement to his complaint. Chief Judge Seitz argued that the defendant's motion should have been viewed as a motion for summary judgment, *id.* at 111, while Judge Becker concluded that the motion was properly treated as a motion to dismiss. *Id.* at 113. Judge Garth found it unnecessary to decide that issue. *Id.* at 104 n.9.

192. *Id.* at 104 (emphasis omitted).

193. *Id.* at 106 n.11. *See supra* note 191.

plaintiff's contention that the partnership agreement reduced his power to that of a limited partner. The court concluded: "[w]hatever may have been the effect of the Partnership Agreement, we are not persuaded that it could so diminish the statutory powers of a general partner in the partnership, such as Goodwin, that the partnership interest which he possessed could qualify as a security."¹⁹⁴ While Judge Garth recognized that the agreement could modify the partners' statutory rights in some respects, he found that the agreement could not take away the partners' agency power and personal liability, saying: "Even if the Elkins Partnership Agreement contained the most draconian restrictions on the rights of non-management partners therefore, such partners would still possess a quantum of powers and responsibilities which, as a matter of law, would preclude their interest from being considered a security under the Act."¹⁹⁵ Moreover, this remained true even in a firm with many general partners:

If we were to consider a large Wall Street law firm with 54 partners, as contrasted with a small close corporation of only 20 shareholders, we still would find the latter to comprise a "security" but not the former. General partners, no matter how many or few they may be, are still, as a group, legally responsible for the management of the firm.¹⁹⁶

Judges Seitz and Becker also held that no "security" existed, but based their opinions on the plaintiff's substantial powers under the partnership agreement. Both judges found that the plaintiff had not sufficiently alleged facts outside the agreement to support the existence of a "security," but they disagreed slightly over what facts would be sufficient. Judge Seitz noted that the plaintiff had not alleged that he was denied management power provided in the contract. Furthermore, he concluded that an allegation that the managing partner usurped power not provided in the partnership agreement was not enough to make the plaintiff's interest a security. Similarly Judge Becker noted that plaintiff "ha[d] not alleged that the [agreement's] provisions . . . were shams."¹⁹⁷

Goodwin steps closer than *Williamson* toward accepting the private ordering theory. Judge Garth's opinion goes a long way in

194. *Id.* at 107.

195. *Id.*

196. *Id.* at 107 n.14.

197. *Id.* at 114.

this direction by holding that a statutory general partnership necessarily is not a security. As discussed in Part III (A), this position cannot be justified on the ground that a standard form partnership is *per se* an inappropriate subject of mandatory disclosure regulation.¹⁹⁸ While Judges Seitz and Becker appear to take an approach more like that in *Howey*, their opinions also moved toward a *per se* approach and away from *Williamson* by emphasizing the terms of the agreement rather than plaintiff's actual dependence on the promoter.

4. Post-Goodwin Cases: A Compromise Approach

Recent cases have struggled over whether to adopt the *per se* approach employed by Judge Garth in *Goodwin*, the more fact-sensitive queries of the second and third prongs of *Williamson*, or the Seitz-Becker approach in *Goodwin* of relying primarily on the partnership agreement to determine whether or not application of the securities laws is warranted.

In *Matek v. Murat* several investors converted a Navy vessel into a fish processing plant.¹⁹⁹ The majority opinion, upholding summary judgment for the defendants on the "security" issue, explicitly rejected what it termed Judge Garth's "bright line" test in *Goodwin* in favor of what it termed "economic reality."²⁰⁰ The court also rejected the second and third prongs of *Williamson*, finding that those tests "create uncertainty" by requiring the promoter to investigate the sophistication of all investors and could lead to the "untenable" result that in the same offering some investors are buying "securities" and others are not.²⁰¹

The *Matek* majority applied only the first prong of *Williamson*, which requires a determination of whether an agreement is properly characterized a general partnership rather than a disguised limited partnership, and found the agreement before the court a *bona fide* general partnership. Therefore, the court concluded, the agreement was not a security even though it delegated power to managing partners because the non-managing partners could consult with the managing partners, could veto decisions on important matters and

198. See *supra* text accompanying notes 129-49.

199. 862 F.2d 720 (9th Cir. 1988).

200. *Id.* at 727.

201. *Id.* at 729.

had access to information.²⁰²

Judge Canby, concurring, argued that the court could not properly determine "economic reality" without looking outside the agreement to see whether the investors were unsophisticated or had depended on the promoter.²⁰³ However, he agreed with the result reached by the majority because he found undisputed evidence that the plaintiffs were active and sophisticated participants.²⁰⁴

A recent Ninth Circuit panel opinion in a partnership "security" case leaves some uncertainty about the authority of *Matek*. In *Koch v. Hankins*,²⁰⁵ the court held that *Matek* had been implicitly rejected by *Hocking v. DuBois*,²⁰⁶ an *en banc* Ninth Circuit opinion in a non-partnership case. As a result, the court reversed a summary judgment for defendant on the "security" issue, reasoning that there were fact issues as to plaintiffs' sophistication and reliance on the promoter's expertise under the second and third *Williamson* factors. Other panels in the Ninth Circuit may not agree that *Hocking* implicitly rejected *Matek*.²⁰⁷ In any event, *Koch's* holding is consistent with *Matek's* "economic reality" test. *Koch* involved 35 partnerships that collectively controlled a single jojoba plantation. Irrespective of a plaintiff's sophistication or actual reliance on the promoter, he arguably did not *legally* control the *firm* as distinguished from his own partnership.

Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc., involved a general partnership of 23 partners and a managing partner which was formed to own and lease fishing boats.²⁰⁸ The court, in an opinion written by former Justice Lewis Powell, affirmed summary judgment for defendants on the security issue.²⁰⁹ It relied primarily on the non-managing partners' extensive access to information and voting powers provided under both the partnership agreement and Virginia partnership law, as well as the fact that the partners actually exercised these rights by replacing managers.²¹⁰

202. *Id.* at 731.

203. *Id.* at 734-35.

204. *Id.* at 735.

205. 928 F.2d 1471 (9th Cir. 1991).

206. 885 F.2d 1449 (9th Cir. 1989). *See infra* text accompanying notes 255-259 (discussing *Hocking*).

207. *See infra* at text accompanying note 259 (arguing that *Hocking* should not be so interpreted).

208. 840 F.2d 236 (4th Cir. 1988).

209. *Id.*

210. *Id.* at 242.

Although the *Rivanna* court said that the presumption against the existence of a "security" which arises from these agreed powers could "be rebutted by evidence that it [was] not possible for the partners to exercise those powers,"²¹¹ the court explicitly rejected application of *Williamson's* second and third prongs. The court reasoned that the *Williamson* approach, "to the extent it requir[ed] a court to look to the actual knowledge and business expertise of each partner, . . . would unduly broaden the scope of the Supreme Court's instruction that courts must examine the economic reality of partnership interests."²¹² The court later said the fact that some of the partners may have been unsophisticated would not affect the outcome because those partners could always have gotten advice from other partners or third parties.²¹³ Finally, the court did not preclude the possibility that a finding of non-"security" could be based on state partnership law, even if the partners' powers under the agreement had been weaker.²¹⁴

Subject to the uncertainty left by *Koch*, *Matek* and *Rivanna* indicate significant support for the "private ordering" theory. These cases show that a general partnership is not a "security" at least where the partnership agreement gives the members general partner-like powers, irrespective of the partners' actual dependence on the promoter.²¹⁵ The selection of the general partnership form therefore controls to a significant extent, although even a *bona fide* general partnership agreement might be a "security" if it is sold widely to many dispersed investors whose effective ability to control the managers is no greater than that of corporate shareholders.²¹⁶

D. The General Partnership Cases in Context

This Section further supports the emerging emphasis on private ordering over mandatory disclosure policies in the partnership cases

211. *Id.* at 241.

212. *Id.* at 241 n.7.

213. *Id.* at 242 n.10.

214. *See id.* at 241 n.6 (noting that because the partnership agreement conferred broad powers on the general partners, the court would not consider the effect of state law in the case before it).

215. *See also* *Banghart v. Hollywood Gen. Partnership*, 902 F.2d 805 (10th Cir. 1990).

216. *See* *SEC v. Professional Assoc.*, 731 F.2d 349 (6th Cir. 1984) (holding that joint venture interests were securities, despite a provision in the agreement empowering investors to participate in major decisions, where the interests were sold through seminars to approximately fifteen hundred investors in thirty states).

by considering two types of analogous cases. Section 1 discusses the Supreme Court's recent decisions characterizing "stock" in the sale of a business as a "security" *per se*. Section 2 contrasts the partnership cases with others involving the "investment contract" issue.

1. Stock and Notes as *Per Se* Securities

The Supreme Court's rule that stock and notes are securities without regard to the outcome of a *Howey* analysis supports an emphasis on the form of the investment in characterizing partnerships as non-securities. The Court has recognized in stock and note cases that the formal aspects of an investment may constitute a sort of agreement to opt into the securities laws. It should follow from this conclusion that, as argued in this article, the form of the investment may also support a kind of securities law waiver as well.²¹⁷

The history of the Court's treatment of "stock" and "notes" begins with *United Housing Foundation, Inc. v. Forman*, in which the Court upheld dismissal of securities law claims brought by residents of a cooperative housing project whose ownership interest in their apartments was evidenced by "stock."²¹⁸ Even though "stock" is explicitly listed in the statutory definition of a "security," the Court held that "form should be disregarded for substance and the emphasis should be on economic reality."²¹⁹ Following this approach the Court concluded that the shares lacked the ordi-

217. This proposition is consistent with the statutory language defining a "security" as "any interest or instrument commonly known as a 'security.'" Securities Act of 1933, § 2(1), 15 U.S.C. § 77b(1) and Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C.A. § 78c(a)(10). This language suggests an emphasis on the form of the transaction regardless of whether, as a matter of "economic reality," the mandatory disclosure rules should apply. One writer characterizes the statutes as approaching the definition of a "security" "in a conventional manner." Carney, *supra* note 7, at 317. I suggest that the use of a "conventional" approach amounts to an emphasis on form over substance.

This conclusion is subject to the qualification that the Supreme Court may have been less concerned about problems with over-extension of the securities laws (in the sale-of-business context) than under-application (to partnerships). However, this characterization of the Court's concerns would be inconsistent with its restrictive view of the application of federal securities laws over the last fifteen years. See, e.g., *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977) (requiring deceptive conduct for Section 10(b) action); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (applying scienter standard under Section 10(b) of 1934 Act); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) (imposing purchaser-seller standing requirement for suits under Section 10(b)).

218. 421 U.S. 837 (1975).

219. *Id.* at 848 (quoting *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967)).

nary characteristics of securities, including a right to dividends, negotiability, voting rights and possibility of appreciation in value. Accordingly, the Court applied *Howey* factors in determining whether the investment was a security.

The most important aspect of *Forman*, when viewed in the light of later cases, was not the Court's willingness to disregard form, but rather was its recognition that form can be important in appropriate circumstances. The Court said:

In holding that the name given to an instrument is not dispositive, we do not suggest that the name is wholly irrelevant to the decision whether it is a security. There may be occasions when the use of a traditional name such as "stocks" or "bonds" will lead a purchaser justifiably to assume that the federal securities laws apply. This would clearly be the case when the underlying transaction embodies some of the significant characteristics typically associated with the named instrument.

In the present case respondents do not contend, nor could they, that they were misled by use of the word "stock" into believing that the federal securities laws governed their purchase. Common sense suggests that people who intend to acquire only a residential apartment in a state-subsidized cooperative, for their personal use, are not likely to believe that in reality they are purchasing investment securities simply because the transaction is evidenced by something called a share of stock.²²⁰

Significantly, the Court gave as its reason for considering the form of transactions the policy of upholding investor expectations.

After *Forman*, some cases interpreted that decision as holding that stock with the usual attributes of conventional common stock was a "security" irrespective of *Howey*.²²¹ Other courts emphasized "economic reality" and applied a *Howey*-type analysis even to cases involving ordinary common stock.²²² Under the latter approach, "sale-of-business" cases arguably would be non-securities.

220. *Id.* at 850-51.

221. *E.g.*, *Golden v. Garafalo*, 678 F.2d 1139 (2d Cir. 1982) (holding that the purchase of 100 percent of a small business was a securities transaction).

222. *E.g.*, *Frederiksen v. Poloway*, 637 F.2d 1147 (7th Cir. 1981) (holding that the purchase of assets and stock in a corporation was not a securities transaction because the purchaser took control of the business).

Although the buyer's post-sale control of the enterprise does not itself guarantee access to information in connection with the purchase, the securities laws guarantee full disclosure only where the special information problems connected with "securities" are involved. Arguably, no such problems exist where the purchaser expects profits after the sale to come from her own managerial efforts rather than from her reliance on another's efforts.²²³

The Supreme Court resolved the uncertainty concerning common stock in the companion cases of *Landreth Timber Co. v. Landreth*²²⁴ and *Gould v. Ruefenacht*.²²⁵ The Court held that the sale of ordinary common stock, whether it involved all of the common stock of a business (*Landreth*) or only fifty percent of the stock (*Gould*), involved the sale of a "security" without regard to a *Howey* analysis.

The Court's policy rationale for these decisions was consistent with this article's private ordering interpretation.²²⁶ Most importantly, the Court stressed the expectations of the parties. Comparing the conventional stock in *Landreth* to the cooperative housing interests involved in *Forman*, the Court observed that it was "much more likely here than in *Forman* that an investor would believe he was covered by the federal securities laws."²²⁷ Similarly, when the Court compared stock with notes it concluded that "traditional stock 'represents to many people, both trained and untrained in business matters, the paradigm of a security.' Thus persons trading in traditional stock likely have a high expectation that their activities are governed by the Acts."²²⁸ The *Landreth* Court also em-

223. As Judge Posner reasoned in one sale-of-business case, the purpose of the securities laws is to protect "investors" rather than "entrepreneurs." *Sutter v. Groen*, 687 F.2d 197, 201 (7th Cir. 1982). On the other hand, the purchaser of control arguably needs securities-type disclosures to evaluate the value of the company's "goodwill," including the quality of the company's managerial infra-structure.

224. 471 U.S. 681 (1985).

225. 471 U.S. 701 (1985).

226. In addition to policies discussed in the text, the Court also reasoned that "the plain meaning of the statutory definition mandates that the stock be treated as "securities" subject to the coverage of the Acts." *Landreth*, 471 U.S. at 687. This rationale is inherently suspect, since words do not have absolute meaning isolated from context. See Posner, *supra* note 6, at 262-69. Criticism of the "plain meaning" approach is particularly apt with regard to the statutory definition of a "security," which is qualified by the lead-in "unless the context otherwise requires." See Carney, *supra* note 7, at 333-34 (noting that the "context" clause has facilitated use of a "public interest" approach to interpreting the definition of a "security").

227. *Landreth*, 471 U.S. at 687.

228. *Id.* at 693 (quoting *Daily v. Morgan*, 701 F.2d 496, 500 (5th Cir. 1983)). This

phasized the need for clarity and predictability of laws associated with a transaction. It said that applying the "sale of a business" doctrine would make "coverage by the Acts . . . in most cases . . . unknown and unknowable to the parties at the time the stock was sold"²²⁹ because whether or not the "stock" was a "security" would depend on whether the purchaser acquired control.²³⁰ The Court noted in its *Gould* opinion that control would turn not only on the percentage of stock being purchased, but also on specific voting rights or the purchaser's expectations of being involved in management.²³¹ The need for clarity and predictability was a central theme of the *Gould* opinion, and apparently explains why the Court chose to review both 50% and 100% sales at the same time.

Even more significant than the Court's emphasis on clarity and predictability, however, is that the Court related these policies to private ordering. In response to the defendant's argument that *per se* application of the securities laws to "stock" would increase courts' workloads, the *Landreth* Court said: "[w]e find more daunting . . . the prospect that parties to a transaction may never know whether they are covered by the Acts until they engage in extended discovery and litigation over a concept as often elusive as the passage of control."²³² In *Gould* the Court left no mistake why parties' expectations are important: "[T]he parties' inability to determine at the time of the transaction whether the Acts apply neither serves the Acts' protective purpose nor permits the purchaser to compensate for the added risk of no protection when negotiating the transaction."²³³ Thus, the Court has plainly opted for an approach conducive to the parties' *contracting for* protection of the securities laws over an approach more consistent with the policies underlying mandatory disclosure.²³⁴

observation by the *Landreth* Court signifies an apparent shift in emphasis from the Court's statement in *Forman* that "we do not suggest that the name [of the instrument] is wholly irrelevant." *Forman*, 421 U.S. at 850. Note that *Landreth* reversed some earlier cases that had applied *Howey* in sale-of-business cases. See *supra* note 224 and accompanying text. Thus, the Court seems to conclude that that legal rule should not be deemed to have shaped the parties' expectations about application of the securities laws. See *supra* note 171 (arguing for this outcome).

229. *Landreth*, 471 U.S. at 696.

230. *Id.*

231. *Gould*, 471 U.S. at 705. In *Gould* itself, this determination would have been complicated by the fact that plaintiff was promised a right to participate in control subject to the president's veto.

232. *Landreth*, 471 U.S. at 696-97.

233. *Gould*, 471 U.S. at 706.

234. *Id.* Justice Stevens' dissent in *Landreth* further demonstrates that the Court deliber-

In *Reves v. Ernst & Young*, the Court continued to emphasize private-ordering over the "economic reality"-type *Howey* approach when it held that demand notes are "notes" within the statutory definition of a security and, therefore, covered by the securities laws without regard to *Howey*.²³⁵ The *Reves* Court's analysis was more complex than its opinion with respect to "stock" because, as the Court had pointed out in *Landreth*,²³⁶ the public perception regarding the "security"-like nature of notes was not as clear as that regarding "stock." For example, under a literal reading of the Securities Acts, a consumer note financing the purchase of a washing machine would involve the sale of a "security."²³⁷ Thus, the Court articulated standards for determining when "notes" were not securities. Significantly, as in *Landreth*, these standards emphasize the public's expectations rather than facts bearing on whether mandatory disclosure is appropriate.²³⁸

ately endorsed a private-ordering approach in *Gould* and *Landreth*. Justice Stevens articulated the position rejected by the majority:

[I]t is only a matter of interest to the parties whether the transaction takes the form of a sale of stock or a sale of assets, and the decision usually hinges on matters that are irrelevant to the federal securities laws such as tax liabilities, the assignability of Government licenses or other intangible assets, and the allocation of the accrued or unknown liabilities of the going concern. If Congress had intended to provide a remedy for every fraud in the sale of a going concern or its assets, it would not have permitted the parties to bargain over the availability of federal jurisdiction.

Landreth, 471 U.S. at 699 (Stevens, J., dissenting).

235. 110 S. Ct. 945, 951 (1990).

236. 471 U.S. at 694.

237. See *Reves*, 110 S. Ct. at 957 ("[T]he Securities Acts define 'security' to include 'any note.'")

238. The factors include (1) whether the notes are to be used to finance a business or other substantial investment, (2) the plan of distribution, (3) the public's perceptions and reasonable expectations about the nature of the interest, and (4) the existence of a regulatory scheme which would make application of securities laws unnecessary. *Id.*

Notwithstanding the emphasis on public expectations reflected in these factors, the Court seemingly departed from the expectation-based approach. The respondent argued that the demand notes at issue fell within a statutory exception in the securities laws. This argument rested on a definition of "maturity" derived from state law. *Id.* at 953-54. The court rejected the respondent's attempt to use the state law definition of maturity and held that federal securities law should be applied to determine the maturity date of a demand note. *Id.* at 955.

Investors' expectations regarding the character of a note are arguably shaped by state law, including the "ancient" law cited by the dissent that deems demand notes immediately due. *Id.* at 957-58 (Rehnquist, C.J., dissenting). But even in rejecting application of state law, the majority's decision was consistent with an emphasis on the parties' expectations. The expectation on which the court focused was not the specific timing of maturity

The role of private ordering in the definition of a "security" also has been stressed in a post-*Landreth* federal appeals court decision. In *Adena Exploration, Inc. v. Sylvan*, the court applied *Landreth* in determining that a fractional undivided interest in minerals was a "security."²³⁹ The court reached this conclusion without regard to the factual context of the transaction because the interest fit within those listed in the statutory definition.²⁴⁰ Although recognizing the argument that sophisticated, active investors did not need federal securities law protection, the court said that "even where sophisticated investors are involved, clarity and predictability of rules are particularly prized in commercial transactions."²⁴¹ While the court noted that characterization of the interest as a "security" would automatically trigger federal jurisdiction, it expressed minimal concern about this ramification: "parties are free to negotiate for arbitration, and private ordering is likely to be enhanced by a rule sufficiently predictable in its reach to allow the parties to adjust their affairs."²⁴²

In sum, *Landreth*, *Gould* and *Reves* clearly stand for the proposition that "security" should be interpreted in a way that facilitates private ordering. The Court has not abandoned "economic reality," but rather has factored private ordering concerns into this "reality."²⁴³ Where, as in *Landreth*, *Reves* and *Adena*, the form of the transaction triggers strong expectations that the securities laws apply, the applicable legal rules should enforce those expectations and thereby facilitate the parties' pricing and structuring of the deal. The relevant "economic reality" in that situation is the common understanding within the market place about the state of gov-

for demand notes, but whether or not federal securities laws would apply. The public's expectations are more likely to be shaped by the type of general market characteristics stressed by the majority than by the intricacies of state law stressed by the dissent.

239. 860 F.2d 1242 (5th Cir. 1988).

240. *Id.* at 1249.

241. *Id.* at 1251.

242. *Id.* (footnote omitted). For a discussion of arbitration and its relevance to the opt-out question see *supra* text accompanying notes 114-24.

243. The *Adena* court erroneously reasoned that, while finance theory was generally important to the application of the securities laws, its application was foreclosed in the circumstances of the case "by precedent, statutory text, and Congressional intent." *Id.* at 1253. In fact, as discussed above, neither the text nor Congressional intent compel a literal reading of the statute. See *supra* text accompanying notes 6-7. It would have been more accurate for the court to say that under the circumstances of the case, economic theory justified emphasizing the parties' expectations rather than policies regarding the appropriate scope of mandatory disclosure.

erning law. As the court said in *Adena*, “[o]ne need not be a botanist to know that a rose by any other name would smell as sweet.”²⁴⁴

The rule that has evolved in the sale-of-a-business and note cases is closely analogous to that urged here for general partnerships. Even before *Landreth*, one commentator argued that the “sale-of-business” rule emphasizing the substance rather than the form of a transaction was inconsistent with partnership cases which emphasize the partners’ power under the agreement (form) over their ability to exercise this power (substance).²⁴⁵ The connection between the partnership and sale-of-business cases became particularly clear in *Rivanna*,²⁴⁶ where Justice Powell (who also wrote *Forman*, *Landreth* and *Gould*), rejected the *Williamson* approach directing courts to examine each partner’s knowledge and business expertise.²⁴⁷

Indeed, the approach in the sale-of-business cases is not only analogous to that in the partnership cases, but is also complementary to the partnership approach. Investors in closely held firms — a context in which application of the securities laws is at least debatable²⁴⁸ — can choose coverage of the securities laws by selecting between the general partnership and close corporation forms.

2. Contrasting Partnership and Non-Partnership Cases

This section focuses on cases decided during the last ten years, the same period over which the partnership cases evolved from the *Williamson* rule. It shows that, where the parties do not adopt the general partnership or joint venture form, courts continue to apply the *Howey* “efforts of others” analysis. Thus, the federal securities laws have been applied in situations similar, from the standpoint of mandatory disclosure policy, to partnership investments character-

244. *Adena*, 860 F.2d at 1253. On the other hand, even where, as in *Forman*, the parties use “stock,” the securities laws do not apply if their application would frustrate the parties’ expectations. In the words of one court: “A lizard with a sign around its neck reading ‘dog’ does not change the lizard into a Labrador retriever.” *Slevin v. Pedersen Assoc.*, 540 F. Supp. 437, 440 (S.D.N.Y. 1982) (holding that calling a joint venture an “investment contract” does not make it a “security”).

245. See Dennis S. Karjala, *Realigning Federal and State Roles in Securities Regulation Through the Definition of a Security*, 1982 U. ILL. L. REV. 413, 428.

246. *Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.*, 840 F.2d 236 (4th Cir. 1988).

247. See *supra* text accompanying notes 213-15.

248. See *supra* text accompanying notes 66-75.

ized as non-“securities.” The difference is best explained by the private ordering hypothesis. In the cases discussed in this section, unlike the non-partnership cases, there is no clear adoption of a non-“security” form, and therefore no basis for holding that the parties contracted around the securities laws.

A prominent example of the contrast between partnership and non-partnership investment contract cases is *SEC v. Aqua-Sonic Products Corp.*²⁴⁹ In a leading application of *Howey* decided shortly after *Williamson*, the court, in an opinion by Judge Friendly, affirmed an injunction against an unregistered offering of licenses to sell a new dental product.²⁵⁰ Each licensee received a territory in which to promote the product and was offered a sales agency agreement with the promoter.²⁵¹ The court held that the package was an investment contract even though the sales agency agreement was optional and even though the agreement offered important rights to the licensee, including the power to direct control over pricing and other matters, access to information, and the right to terminate.²⁵² The court relied on several facts indicating that the investors would necessarily accept the sales agency and would not actively exercise their rights under that contract: the promoter recruited investors unsophisticated in dental supplies; territories were remote from the residences of the licensees; and for tax reasons the entire fee for the eight-year agency was payable up front.²⁵³

Significantly, the court explicitly rejected *Williamson*'s stated emphasis on the investor's right to control rather than actual control.²⁵⁴ The *Williamson* rule might have supported characterization as an investment contract since the facts suggested actual dependence on the promoter. But the licensees' contract rights almost certainly would have precluded characterization as an investment contract under the reasoning of *Goodwin*, *Matek* and *Rivanna* if the promoter had employed the partnership form.

A second important, contrasting case is *Hocking v. DuBois*, a recent *en banc* decision by the Ninth Circuit — the same court

249. 687 F.2d 577 (2d Cir.), cert. denied sub. nom., Hecht v. SEC, 459 U.S. 1086 (1982).

250. *Aqua-Sonic*, 687 F.2d at 585.

251. *Id.* at 578.

252. *Id.* at 582-83.

253. *Id.* at 583-84.

254. *Id.* at 584.

that recently decided *Matek*.²⁵⁵ The court held in favor of characterizing as a "security" an investment in a condominium rental pool run like a hotel.²⁵⁶ Although the participants had significant powers, including authority to replace the developer, the court found material fact issues regarding the investors' effective control, including their level of sophistication, the fact that they lived far from the condominium, and the difficulty of replacing the manager.²⁵⁷ Significantly, the court relied on *Williamson* rather than on *Matek*, and emphasized the investors' dependence on the promoter instead of the investors' powers under the agreement.²⁵⁸ This article's analysis supports the conclusion, contrary to that in *Koch*,²⁵⁹ that *Hocking's* failure to rely on *Matek* was not a mere oversight, and that *Hocking* left *Matek* undisturbed.

A third category of contrasting cases deals with cattle-feeding arrangements in which passive investors buy cattle but leave fattening and slaughter to a feedyard. The courts commonly characterize these transactions as "securities" because they doubt the investors' practical ability to exercise their important contractual rights. For example, in *McLish v. Harris Farms, Inc.*, the court found that a "security" existed even though the investor had the rights to sell or move the cattle and to consent to sale by the feedlot.²⁶⁰ The court noted that the plaintiff had to arrange financing to exercise these rights.²⁶¹ But had the investment been structured as a general partnership between the investor and the feedyard, the partnership cases suggest that the court probably would not have held in favor of a "security" even if the partner had little practical alternative to abiding by the promoter's decisions.²⁶²

The foregoing discussion is not intended to suggest that all "investment contract" cases would be non-securities if the promoters had simply selected the partnership form without substantive change. For example, participants in cattle feeding investments

255. 885 F.2d 1449 (9th Cir. 1989) (*en banc*), *cert. denied*, 110 S. Ct. 1805 (1990).

256. *Id.* at 1462.

257. *Id.* at 1460-61.

258. *Id.* (noting the court's previous acceptance of *Williamson*).

259. See *supra* text accompanying notes 205-07 (discussing *Koch*).

260. 507 F. Supp. 1075, 1085 (E.D. Cal. 1980).

261. *Id.* at 1082.

262. See *Goodwin*, 730 F.2d at 103 (holding that, as a matter of law, a limited partnership interest is not a security); *Matek*, 860 F.2d at 729-31 (holding that a *bona fide* general partnership is not a security); *Rivanna*, 840 F.2d at 241 (finding that the partners' possession of information and voting rights created a presumption that the general partnership was not a security). See also *supra* text accompanying notes 199-216.

may, in theory, have power to participate in the management decisions of the feedlot with respect to care and sale of the cattle, but significantly could not "fire" the manager by moving the cattle to another feedlot.²⁶³ The point is only that the partnership cases are virtually alone in stressing the investors' formal powers under the agreement even where the investors may actually be relying on the promoters' efforts.

IV. CONCLUSION

Strong policy considerations support permitting parties to enter into agreements that effectively waive application of the securities laws in some situations. Moreover, such a rule is not inconsistent with the securities statutes. This is so even if the policies and factors relating to the scope of mandatory disclosure would justify application of the securities laws in the absence of a private agreement to the contrary.

This article has shown that, consistent with this proposition, courts recognize a limited role for private ordering with respect to application of the securities laws. In particular, this analysis explains why the courts have moved toward a rule that *per se* excludes general partnership interests from the definition of a "security."

263. See *Long v. Shultz Cattle Co.*, 881 F.2d 129 (5th Cir. 1989); *Waterman v. Alta Verde Indus.*, 643 F. Supp. 797 (E.D.N.C. 1986).