

1-1-1986

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Recommended Citation

Nathan W. Drage, *Are Limited Partnership Interests Securities? A Different Conclusion under the California Limited Partnership Act*, 18 PAC. L.J. 125 (1986).

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Are Limited Partnership Interests Securities? A Different Conclusion Under the California Limited Partnership Act

*“Under [California Law], a limited partner cannot maintain his limited status and at the same time exercise managerial control over the partnership . . . Accordingly, we conclude that the limited partnership interest offered . . . was a security. . . .”*¹

In January of 1985, the California court of appeal in *People v. Graham*² considered whether a limited partnership³ interest was a security.⁴ In *Graham*, the defendant offered for sale limited partnership interests in a chemical detoxification machine.⁵ The issue was whether the interests were subject to securities regulation.⁶ An answer to this issue required analysis of whether limited partnerships are

1. *People v. Graham*, 163 Cal. App. 3d 1159, 1168-69, 210 Cal. Rptr. 318, 325 (1985).

2. 163 Cal. App. 3d 1159, 210 Cal. Rptr. 318 (1985).

3. A limited partnership is a partnership formed by two or more persons under a limited partnership statute, which has one or more general partners and one or more limited partners as members. H. HENN, *LAW OF CORPORATIONS* § 28, at 85 (1983); *BLACK'S LAW DICTIONARY* 836 (5th ed. 1979). “An unincorporated association, or firm, in which one or more of the partners are, on compliance with the provisions of various state statutes regulating such partnerships, relieved from liability beyond the amount of the capital contributed by them. A partnership formed by two or more persons under the provisions of the Uniform Limited Partnership Act, having as members one or more general partners and one or more limited partners. The limited partners, as such, are not bound by the obligations of the partnership.” *Id.*; *UNIF. LTD. PARTNERSHIP ACT* § 1, 6 U.L.A. 562 (1969) [hereinafter cited as *ULPA*]; *see also REVISED UNIF. LTD. PARTNERSHIP ACT* § 101(7), 6 U.L.A. 216 (Supp. 1986) [hereinafter cited as *RULPA*]. The limited partnership is a form of business which is similar to a corporation because of limited liability, and similar to partnerships because of the tax treatment of the income of the partnership. *See A. BROMBERG, CRANE AND BROMBERG ON PARTNERSHIP* § 23B(K), at 136 (1968). The federal income tax provisions relating to partnerships are set forth in the Internal Revenue Code, §§ 701-761. Section 701 provides for “conduit” or “pass through” income tax treatment: “A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities.” I.R.C. § 701 (1954).

4. *Graham*, 163 Cal. App. 3d at 1164-74, 210 Cal. Rptr. at 322-29.

5. *Id.* at 1164, 210 Cal. Rptr. at 321.

6. Whether an investment must be registered with the state under the securities regulation provisions of the California Corporations Code requires a two-step analysis. *CAL. CORP. CODE* § 25110. The first issue is whether the investment is definable as a security. *Id.* § 25019. The second issue is whether the investment is exempt from registration. *Id.* §§ 25100, 25102, 25103, 25105. This comment is concerned primarily with the first step of analysis for applying securities regulation. *See infra* notes 42-197 and accompanying text (discussing the definition of a security). *See also infra* notes 438-44 (discussing exemption provisions).

securities.⁷ The court initially stated that the limited partnership interests were securities under appropriate circumstances.⁸ Appropriate circumstances exist when an investor places money at risk and expects a benefit largely from the efforts of others.⁹ The court concluded that limited partnerships meet these requirements.¹⁰ As a result, the court held that, by definition, a limited partnership interest meets the appropriate circumstances and, therefore, is a security.¹¹

The *Graham* decision, however, was reached after California enacted¹² a unique¹³ version of the Revised Uniform Limited Partnership Act (RULPA).¹⁴ Unfortunately, application of securities analysis using California's current limited partnership law is absent from the *Graham* decision.¹⁵ The 1984 California version of the RULPA and the 1985 ULPA¹⁶ greatly expand a limited partner's right

7. See *Graham*, 163 Cal. App. 3d at 1164-69, 210 Cal. Rptr. at 322-25.

8. *Id.* at 1164-65, 210 Cal. Rptr. at 322.

9. See *id.* at 1165-69, 210 Cal. Rptr. at 322-25.

10. *Id.* at 1169, 210 Cal. Rptr. at 325.

11. *Id.*

12. The California version of RULPA is found at California Corporation Code §§ 15611-15723. See also *infra* notes 323-58 and accompanying text.

13. See CAL. CORP. CODE § 15632. Two other states have similar statutes. See *infra* note 419 and accompanying text.

14. RULPA §§ 101-1105, *supra* note 3, at 215-83. See also HANDBOOK OF THE NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS (1982) [hereinafter cited as HANDBOOK] (explaining the purpose of the National Conference for drafting uniform laws).

The object of the National Conference, as stated in its constitution, is "to promote uniformity in state laws on all subjects where uniformity is deemed desirable and practicable." The National Conference works through standing and special committees. In recent years proposals of subjects for legislation are referred to a standing Committee on Scope and Program. After due investigation, and sometimes a hearing of parties interested, this committee reports whether the subject is one upon which it is desirable and feasible to draft a uniform law. If the National Conference decides to take up the subject, it refers the same to a special committee with instructions to develop a draft of an act. With respect to some of the more important acts, it has been customary to employ an expert draftsman. Tentative drafts of acts are submitted from year to year and are read and discussed section by section. Each uniform act is thus the reaction, and emendation of the Commissioners, who represent the experience and judgment of a select body of lawyers chosen from every part of the United States. When finally approved by the National Conference, the uniform acts are recommended for general adoption throughout the jurisdiction of the United States and are reported to the American Bar Association.

Id. at 347.

15. See 163 Cal. App. 3d at 1164-69, 210 Cal. Rptr. at 322-25.

16. The Revised Uniform Limited Partnership Act has been superseded by the 1985 Uniform Limited Partnership Act, which was adopted by the National Conference of Commissioners in August 1985. See *infra* notes 299-322 and accompanying text. See also HANDBOOK, *supra* note 14, at 346:

The National Conference of Commissioners on Uniform State Laws is composed of Commissioners from each of the states, the District of Columbia and Puerto Rico. In approximately one-third of these jurisdictions the Commissioners are appointed by the chief executive acting under express legislative authority. In the other jurisdictions the appointments are either made by general executive authority, or appointed

to control the enterprise.¹⁷ The right of control changes the requirement that the limited partner be a passive investor.¹⁸ The limited partner does not need to expect a return on investment solely from the efforts of others.¹⁹ As a result, application of the current California Corporations Code could cause a different result than reached by the court in *Graham*.²⁰

The California Corporations Code and the 1985 ULPA raise important questions about partnership interests being subjected to securities regulation. The initial question to consider is which elements will cause an investment to be defined as a security and, hence, be subject to securities regulation.²¹ Since limited partnership interests are not specifically listed in federal and state securities statutes, the interests may be securities if the definition of an investment contract is met.²² The lack of control is an essential element of an investment contract, which is defined as a security by federal securities regulations.²³ In applying the definition of a security to limited partnerships, the next question is whether a limited partner may participate in control of the business enterprise.²⁴ The ultimate question is whether a limited partnership interest is subject to securities regulation through the appropriate definition of a security.²⁵

Initially, this comment will consider federal and state statutory definitions of securities.²⁶ In addition, definitions of a security made by the United States Supreme Court,²⁷ the Ninth Circuit Court of Appeals,²⁸ and California²⁹ courts will be analyzed. The cases reviewed will illustrate the crucial issue of "control" when deciding whether an investment is a security.³⁰

by the legislature, or by some other means. There are usually four representatives from each jurisdiction. The term of appointment varies. The Commissioners are chosen from the legal profession, being lawyers and judges of standing and experience, legislators and teachers of law in some of the leading law schools.

Id. See also *infra* notes 410-25 and accompanying text.

17. See *infra* notes 323-58 and accompanying text.

18. See *infra* notes 73, 323-58 & 377 and accompanying text.

19. See *infra* notes 323-58 and accompanying text.

20. See *infra* notes 391-408 and accompanying text.

21. See *infra* notes 79-197 and accompanying text.

22. See *infra* notes 97-197 and accompanying text.

23. See *infra* notes 97-114 and accompanying text.

24. See *infra* notes 258-358 and accompanying text.

25. See *infra* notes 359-408 and accompanying text.

26. See *infra* notes 75-77 and accompanying text.

27. See *infra* notes 79-138 and accompanying text.

28. See *infra* notes 139-66 and accompanying text.

29. See *infra* notes 167-97 and accompanying text.

30. See *infra* notes 79-197 and accompanying text.

This comment will examine the history of general³¹ and limited partnership³² law. The nuances of liability, liquidity, and control under general and limited partnerships will be contrasted with those characteristics in corporations.³³ In addition, limited partnerships formed under the California Corporations Code after 1984 and the 1985 ULPA will be analyzed.³⁴ Changes in a limited partner's right to control an enterprise will be emphasized. This comment will conclude that contrary to traditional notions about partnership law, limited partners in California and states adopting the 1985 ULPA may now participate in control of the enterprise without fully losing the protection of limited liability.³⁵ In addition, this comment will conclude that, contrary to traditional notions about securities law, some limited partnership interests will not meet the definition of a security since a limited partner may now participate in control of the enterprise under current California law.³⁶ Therefore, determination of whether the sale of a limited partnership interest is a security will have to be made on a case by case basis.³⁷

Finally, this comment will examine the 1985 ULPA and the 1985 Uniform Securities Act.³⁸ The 1985 ULPA expands limited partner control rights beyond current California partnership law.³⁹ The 1985 Uniform Securities Act specifically includes limited partnership interests in the definition of a security.⁴⁰ This comment will conclude that California should amend the Corporations Code to be consistent with the 1985 ULPA and 1985 Uniform Securities Act.⁴¹

DEFINING A SECURITY

In order to determine whether a particular investment or financial scheme is subject to securities regulation, attorneys should consider

31. See *infra* notes 201-55 and accompanying text; UNIF. PARTNERSHIP ACT § 6(1), 6 U.L.A. 22 (1969) (a partnership is an association of two or more persons to carry on as co-owners a business for profit) [hereinafter cited as UPA]. See also BLACK'S LAW DICTIONARY 1009 (5th ed. 1979). A general partnership is a partnership in which the parties carry on all their trade and business for the joint benefit and profit of all the parties concerned. All the partners share the profits, losses, and management equally. *Id.*

32. See *supra* note 3 and accompanying text; *infra* notes 258-358 and accompanying text.

33. See *infra* notes 212-358 and accompanying text.

34. See *infra* notes 323-58 and accompanying text.

35. See *infra* notes 323-58 & 410-25 and accompanying text.

36. See *infra* notes 391-408 and accompanying text.

37. See *infra* notes 358, 408 & 425 and accompanying text.

38. See *infra* notes 409-44 and accompanying text.

39. See *infra* notes 410-25 and accompanying text.

40. See *infra* note 426-44 and accompanying text.

41. See *infra* notes 423-44 and accompanying text.

both the statutory definition of a security and the governmental goals of security regulation.⁴² Both factors are important because legislative consideration of public policy goals often will control the judicial interpretation of statutes.⁴³ Hence, investments not expressly included in the statutory definition of a security will sometimes be included through case law.⁴⁴

A. Philosophy and Goals of Regulation

Formal securities regulation began in 1911 when the Kansas legislature enacted a statute regulating investment schemes marketed within Kansas.⁴⁵ This statute became known as a "blue sky" law because the purpose of the statute was to protect Kansas farmers from being sold a piece of the blue sky.⁴⁶ Other states followed by enacting similar statutes.⁴⁷ Today all states have blue sky laws.⁴⁸ In addition to requiring the disclosure of information regarding the security, many

42. See *Marine Bank v. Weaver*, 455 U.S. 551, 560 n.11 (1982). The Court stated: It does not follow that a certificate of deposit or business agreement between transacting parties invariably falls outside the definition of a "security" as defined by the federal statutes. Each transaction must be analyzed and evaluated on the basis of the content of the instruments in question, the purposes intended to be served, and the factual setting as a whole.

Id.

43. See *id.* at 558-59. The Supreme Court held that a bank certificate of deposit is not a security. Recognizing that certificate of deposit owners in federally regulated banks are protected by federal banking laws and the Federal Deposit Insurance Corporation, the Court stated:

The definition of "security" in the 1934 Act provides that an instrument which seems to fall within the broad sweep of the act is not to be considered a security if the context otherwise requires. It is unnecessary to subject issuers of bank certificates of deposit to liability under the antifraud provisions of the federal securities laws since the holders of bank certificates of deposit are abundantly protected under the federal banking laws. We therefore hold that the certificate of deposit purchased by the Weavers is not a security.

Id. (footnote omitted). See also *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 848 (1975). The Court held that the stocks sold by the defendant were not securities. The Court stated:

We reject at the outset any suggestion that the present transaction, evidenced by the sale of shares called "stock," must be considered a security transaction simply because the statutory definition of a security includes the words "any . . . stock." Rather we adhere to the basic principle that has guided all the Court's decisions in this area:

[I]n searching for the meaning and scope of the word 'security' in the Act[s], form should be disregarded for substance and the emphasis should be on economic reality.

Id. (footnote omitted, brackets in original) (quoting *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967)). See also *infra* notes 120-38 (discussing *Forman* and *Marine Bank*).

44. See *infra* notes 79-197 and accompanying text.

45. See T. HAZEN, *THE LAW OF SECURITIES REGULATION* § 1.2, at 6 (1985).

46. *Id.*

47. *Id.*

48. See generally L. LOSS, *COMMENTARY ON THE UNIFORM SECURITIES ACT* (1976); H. SOWARDS & N. HIRSCH, *BLUE SKY LEGISLATION* (1977).

blue sky laws demand that the security qualify on a merit basis.⁴⁹ State merit laws require that the security pass minimum state standards of quality.⁵⁰ The purpose of the merit test is to protect the investor by authorizing only securities that have a predetermined degree of merit.⁵¹

Despite the enactment of numerous blue sky laws, securities fraud persisted throughout the United States.⁵² During the two decades following enactment of the Kansas statute, the United States Congress resisted federal legislation regulating securities.⁵³ Fraudulent securities practices, however, may have helped precipitate the stock market crash of 1929 and the ensuing depression.⁵⁴ Consequently, Congress recognized the need for federal regulation of securities and passed the Securities Act of 1933 (1933 Act).⁵⁵ The 1933 Act, also known as the Truth in Securities Act, was directed primarily at the initial distribution of securities.⁵⁶ To achieve the goal of investor protec-

49. See W. PAINTER, PROBLEMS AND MATERIALS IN BUSINESS PLANNING 602 (1975) (the philosophy of many states is that there are some offerings against which the investor needs to be protected whether or not the facts have been disclosed). *But cf.* Campbell, *An Open Attack on the Nonsense of Blue Sky Regulation*, 10 J. CORP. LAW 553-79 (1985) (discussion on whether blue sky merit laws provide protection for investors); Brandi, *Security Practitioners and Blue Sky Laws: A Survey of Comments and Rating of States by Stringency of Regulation*, 10 J. CORP. L. 689-710 (Spring 1985).

50. See Painter, *supra* note 49, at 602 (citing Illinois law, which gives the Secretary of State power to refuse registration of securities if there are "conditions affecting the soundness of the security so that the sale would be inequitable, or would work or tend to work a fraud or deceit"); see also A. CONRAD, CORPORATIONS IN PERSPECTIVE § 22 (1976); *cf.* CAL. CORP. CODE § 25140 (requiring the transaction to be "fair, just and equitable"). "The state blue sky laws frequently empowered the state commissioner not only to require information, but to forbid the issuance of securities that appeared to be unsound." A. CONRAD, *supra*, § 22, at 42.

51. See T. HAZEN, *supra* note 45, at 6.

52. *Id.*

53. *Id.* See Carney, *Defining a Security: The Addition of a Market-Oriented Contextual Approach to Investment Contract Analysis*, 33 EMORY L.J. 311, 352 (1984). "Congress did not believe that markets for information about securities were a total failure. Congress might have felt that the costs of mandatory disclosure were far greater than the possible benefits from such disclosure." *Id.* at 352. The markets for information referred to means information about companies demanded by investors. *Id.* at 347.

54. T. HAZEN, *supra* note 45, at 6. See also Carney, *supra* note 53, at 348 (whether correctly or incorrectly, Congress saw the crash of the securities market as a cause rather than an effect of the Great Depression).

55. 15 U.S.C. § 77a-77bbb (1982). See also *infra* notes 75-77 and accompanying text.

56. See T. HAZEN, *supra* note 45, at 6-7. See also H. HENN, *supra* note 3, at 797 (the Securities Act of 1933 deals mainly with the initial distribution of securities by the issuer rather than with subsequent trading of securities by the owner). See also Message from the President, 77 CONG. REC. 937 (1933).

I recommend to the Congress legislation for Federal supervision of traffic in investment securities in interstate commerce.

In spite of many State statutes the public in the past has sustained severe losses through practices neither ethical nor honest on the part of many persons and corporations selling securities.

Of course, the Federal Government cannot and should not take any action which

tion, Congress eschewed the merit requirements of blue sky laws.⁵⁷ Instead, Congress opted for a policy of full disclosure.⁵⁸ The theory behind the 1933 Act was that investors were protected adequately if all significant aspects of the securities being offered were disclosed fully and fairly.⁵⁹ During legislative debate, proponents of the 1933 Act argued that full disclosure would place the owners of securities on parity with management of the corporations.⁶⁰ By possessing the same information available to management, investors can avoid fraudulent schemes.

Despite the significance of the 1933 Act, some commentators argued that the Act did not protect investors effectively.⁶¹ After initial purchase of the security, investors had no knowledge of the operations of the enterprise.⁶² Consequently, Congress passed the Securities

might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their value will be maintained or that the properties which they represent will earn profit.

There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.

This proposal adds to the ancient rule of caveat emptor, the further doctrine, "Let the seller also beware." It puts the burden of telling the whole truth on the seller. It should give impetus to honest dealing in securities and thereby bring back public confidence.

The purpose of the legislation I suggest is to protect the public with the least possible interference to honest business.

This is but one step in our broad purpose of protecting investors and depositors. It should be followed by legislation relating to the better supervision of the purchase and sale of all property dealt in on exchanges, and by legislation to correct unethical and unsafe practices on the part of officers and directors of banks and other corporations.

What we seek is a return to a clearer understanding of the ancient truth that those who manage banks, corporations, and other agencies handling or using other people's money are trustees acting for others.

Franklin D. Roosevelt,
The White House, March 29, 1933,

Id.

57. T. HAZEN, *supra* note 45, at 7.

58. L. LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 35 (1983).

59. *See* T. HAZEN, *supra* note 45, at 7. *See also* W. PAINTER, *supra* note 49, at 602.

60. L. LOSS, *supra* note 58, at 36 (quoting Representative Rayburn: "The purpose of this bill is to place the owners of securities on a parity, so far as is possible, with the management of the corporations, and to place the buyer on the same plane so far as available information is concerned, with the seller." (footnote omitted)).

61. *Id.* at 33 (quoting Professor William O. Douglas: "[T]hose needing investment guidance will receive small comfort from the balance sheets, contracts, or compilation of other data revealed in the registration statement. They either lack the training or intelligence to assimilate them and find them useful, or are so concerned with a speculative profit as to consider them irrelevant.").

62. *See generally* W. CARNEY, *supra* note 53, at 334-54.

Exchange Act of 1934 (1934 Act).⁶³ The 1934 Act increased investor protection by requiring *periodic* disclosure of all relevant information to investors.⁶⁴ Thus, after the 1934 Act, investors were entitled not only to material information at the time of initial distribution, but also similar information throughout the life of the enterprise.⁶⁵ The continuous disclosure required by the 1934 Act has been recognized as significantly more beneficial to the shareholder than the initial disclosure requirements under the 1933 Act.⁶⁶

The main premise of both the 1933 and 1934 Acts is that investors need information in order to make competent investment decisions.⁶⁷ Regulation through full disclosure laws has two inherent assumptions. First, investors have the right to make investment decisions without approval from the government.⁶⁸ An investor should be free to be

63. 15 U.S.C. § 78-78kk (1982). The 1934 Act also created the Securities and Exchange Commission and included severe antifraud provisions. See 15 U.S.C. §§ 78j, 78r, 78ff (1982).

64. See T. HAZEN, *supra* note 45, at 7. See also *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417 (N.D. Cal. 1968), *modified on other grounds*, 430 F.2d 1202 (9th Cir. 1970). "It has been held that . . . the purpose of the Securities Exchange Act is to protect the innocent investor, as distinguished from one who loses his innocence and waits to see how his investment turns out before he decides to invoke the act. . . ." *Id.* at 428.

65. See T. HAZEN, *supra* note 45, at 238. "Section 13(a)(2) of the Exchange Act requires all issuers of equity securities subject to section 12's registration requirements to file annual and quarterly reports. . . ." *Id.* (footnotes omitted); 15 U.S.C. § 78m(a) (1982).

66. See H. BLOOMENTHAL, *SECURITIES LAW HANDBOOK* § 5.02, at 41 (1986). See also T. HAZEN, *supra* note 45, at 7.

67. See *supra* notes 58-66 and accompanying text.

68. See *Federal Securities Act, 1933: Hearing Before the Committee on Interstate and Foreign Commerce House of Representatives on H.R. 4314*, 73rd Cong., 1st Sess. 40 (1933) (statement of Hon. Huston Thompson, Attorney at Law, Washington, D.C.).

And, furthermore, the Government says to them: We are not taking into consideration the extremely speculative nature of this stock. What we are trying to do is to put you on an equal basis, or as nearly as possible on an equal basis, with the seller. Then it is up to you. If you want to take the speculative risk, all right.

Id. at 40.

MR. WOLVERTON. You say the only thing you can do is inform the purchaser. You mean under the provisions of this bill?

MR. THOMPSON. Under the provisions of this bill, we can compel the issuer, the seller, to do that.

MR. WOLVERTON. The bill could be drawn to go further than that, could it not, so more security could be given to the purchaser than the mere right to issue the stock now?

MR. THOMPSON. If you do that, you are getting over into a phase that is covered by the State blue sky laws. We have tried to keep away from that and have tried to follow the English method and the German method. The great duty that we have to perform or that the Government will have to perform is to, as far as possible, acquaint the purchaser with the speculative phase of the transaction.

MR. WOLVERTON. Then the theory upon which this bill is drawn is not to prevent the issuance of worthless stock, but merely to give such facts as will enable a purchaser to recognize it as worthless stock?

MR. THOMPSON. I think that is pretty near it.

MR. WOLVERTON. If there is a duty on the part of our Government to give information to a purchaser that stock is worthless, why would it not be a duty of

prudent or reckless.⁶⁹ The investor, however, is entitled to information necessary to make that decision.⁷⁰ The second assumption is that, without full disclosure, the investor normally lacks the information necessary to buy, hold, or sell an investment.⁷¹ Requiring disclosure of information about the enterprise also assumes the investor does not have control of the enterprise, since investor control would provide the needed information to make decisions.⁷² An investor not possessing the right to control the enterprise is defined as a passive investor.⁷³ Therefore, the fundamental goals of both the 1933 and 1934 Acts is to provide passive investors with information about the

the Government to stop that stock from going out just the same as you would stop any other fraud from being carried on?

MR. THOMPSON. If you do that, you begin to get into the question of what is speculative and what is not speculative, and that is a very difficult sphere to pick up.

Id. at 53.

MR. PETTENGILL. In other words, if a man wants to invest money in a proposition to make gold out of sea water, we do not want to stop it.

MR. THOMPSON. I should think that is true.

MR. PETTENGILL. As long as he knows what he is putting his money into and wants to take the risk.

MR. THOMPSON. Yes.

Id. at 58.

69. See L. Loss, *supra* note 58, at 35 (“At the same time the law should not try to keep investors from making bad bargains. . . .”); *Id.* at 36. “In short, Congress did not take away from the citizen ‘his inalienable right to make a fool of himself.’ It simply attempted to prevent others from making a fool of him.” *Id.*

70. See 77 CONG. REC. 2910, 2918 (1933) (statement of Rep. Rayburn). “Those who are interested in purchasing these pieces of paper have the right to demand information as to the actual condition of the issuing company.” *Id.*

71. *Id.* at 2916.

As corporations became older, as their founders died, as their operations became more extensive, as they came to demand increasing and frequent additions of capital, their stockholders ceased to be a few fellow adventurers known to each other and became a multitude. The relations between the stockholder and the corporation ceased to be personal and became impersonal.

Id.

[T]oday the owner of shares in a corporation possesses a mere symbol of ownership, while the power, the responsibility, and the substance which have characterized ownership in the past have been transferred to a separate group which holds control. It is for the protection of these 18 million owners of symbols that this bill has been drawn.

Id. at 2918. “The average stockholder cannot tell much about the condition of his company from the statements he receives. The inquiring investor has been able to get little except blurbs.”

Id. See also *id.* at 2982 (1933) (statement of Sen. Fletcher). “People have been persuaded to invest their money in securities without any information respecting them, except the advertisements put forth by the agents or representatives of those issuing the securities, and such advertisements have not given full information to the public.” *Id.*

72. See *id.* at 2918 (1933) (statement by Rep. Rayburn). “We have, on the one hand, 18,000,000 passive citizens having no actual contact with their companies; on the other hand, a few hundred powerful managers directing and controlling the destinies of the companies and the physical properties which they own.” *Id.* See also *Frazier v. Manson*, 651 F.2d 1078, 1080 (5th Cir. 1981) (“an investor does not need the extensive protection of the federal securities laws when he or she has partial control of an enterprise”).

73. 3 H. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW § 2.12 (1985).

enterprise that is available to those persons actively controlling the business.⁷⁴

By enacting the 1933 and 1934 Acts, Congress recognized the need for securities regulation and decided upon a regulatory policy of full disclosure. Having decided how to protect the investor, Congress next had to decide which investments should be subject to regulation. Examination of the statutory language of the 1933 and 1934 Acts is a necessary step in defining a security.

B. Statutory Definition

In the 1933 Act Congress listed the types of investments subject to federal regulation. Section 2 of the 1933 Act states:

The 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, 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.⁷⁵

Although the 1933 and 1934 Acts differ slightly in their definitions of securities, the Acts have been interpreted as being essentially identical.⁷⁶ Consequently, nearly all opinions involving securities begin with the definition found in the 1933 Act.⁷⁷ Since the 1933 Act specifically

74. See *supra* note 60 and accompanying text.

75. 15 U.S.C. § 77(b)(1) (1982). Consistent with the philosophy of protecting investors who lack necessary investment information, Congress established exemptions to the registration requirements. Section 3(b), known as the "small issue" exemption, exempts securities issues when the aggregate value of the offering does not exceed \$5,000,000. 15 U.S.C. § 77c(b) (1982). Pursuant to § 3(b), the Securities and Exchange Commission promulgated Regulation A. 17 C.F.R. §§ 230.251-.264 (1985). Regulation D exempts offerings of any amount to accredited investors and offerings under \$5,000,000 if the investors are nonaccredited. *Id.* §§ 230.501-.506 (1985). Rule 506 exempts offerings regardless of dollar amount, when no more than 35 non-accredited persons purchase the shares from the issuer. *Id.* § 230.506 (1985). See also H. HENN, *supra* note 3, at 799-805. See also *infra* note 439 and accompanying text.

76. *Tcherepnin v. Knight*, 389 U.S. 332, 335-36 (1967). In addition to the items listed in the 1933 Act, the 1934 Act includes "any oil, gas or other mineral royalty or lease," rather than the 1933 Act's "fractional undivided interest in oil, gas or other mineral rights." The 1934 Act excludes from the list "currency or any note, draft bill of exchange, or bankers acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited." See 15 U.S.C. § 78c(a)(10) (1982).

77. See, e.g., *Landreth Timber Co. v. Landreth*, 105 S. Ct. 2297, 2302 (1985); *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 556 (1979); *United Hous. Found., Inc. v.*

states what constitutes a security, the remaining question is whether an investment not listed in the Act could also be a security. The judicial definition of securities has developed primarily from the statutory phrase "investment contracts."⁷⁸

C. Judicial Interpretation

1. The Supreme Court

In *S.E.C. v. Joiner Leasing Corp.*,⁷⁹ the United States Supreme Court struggled with the definition of a security found in the 1933 Act.⁸⁰ *Joiner Leasing* involved the public sale of oil leases.⁸¹ The defendant promoters marketed the leaseholds through a mass mailing campaign to prospects throughout the country.⁸² The SEC sought an injunction against further sales because the defendant promoters failed to register the investment with the SEC.⁸³

The Court was confronted with the issue of whether an investment could be subject to securities regulation if the investment was not specifically included in the 1933 Act definition of a security.⁸⁴ The Court recognized that state courts had given liberal construction to blue sky laws in order to prevent and punish fraudulent sales of securities.⁸⁵ The Court felt the 1933 Act should be given a similar liberal interpretation.⁸⁶ Consequently, the Court relied on the practical goals of the 1933 Act to analyze the issue.⁸⁷ The Court concluded that novel or uncommon investment devices were subject to the 1933 Act if the devices were similar to investment contracts or to any interest commonly known as a security.⁸⁸ The rationale was that if an investment is similar to a security as defined by the 1933 Act, the goals supporting regulation bring the investment within the section 2 definition of a security.⁸⁹ For example, an investment pro-

Forman, 421 U.S. 837, 847 (1975); *S.E.C. v. Howey Co.*, 328 U.S. 293, 297 (1946); *S.E.C. v. Glenn Turner Enterprises*, 474 F.2d 476, 480 (9th Cir. 1973); *Bank of Am. Nat'l Trust & Sav. Ass'n v. Hotel Rittenhouse Assocs.*, 595 F. Supp. 800, 806 (E.D. Pa. 1984); *Hirsch v. duPont*, 396 F. Supp. 1214, 1218 (S.D.N.Y. 1975), *aff'd*, 553 F.2d 750 (2d Cir. 1977).

78. See T. HAZEN, *supra* note 45, at 15.

79. 320 U.S. 344 (1943).

80. *Id.* at 350-51.

81. *Id.* at 346.

82. *Id.*

83. *Id.* at 345.

84. *Id.* at 348-55.

85. *Id.* at 353.

86. *Id.* at 353-54.

87. *Id.* at 349.

88. *Id.* at 351.

89. *Id.*

ven functionally similar to a stock will be defined as a security regardless of the label given by the promoter.⁹⁰

In *Joiner Leasing*, the defendant promoters utilized mass marketing to reach investors who had no prior business association with the defendants.⁹¹ Therefore, informal access to investment information did not exist.⁹² Additionally, the prospective investors would not take part in management.⁹³ The Court found the *Joiner Leasing* investment offer was the type of scheme from which investors need protection through full disclosure.⁹⁴ As a result, the Court held that the oil leases fit within the remedial purposes of the 1933 Act and therefore, were securities.⁹⁵ The *Joiner Leasing* Court, however, did not establish a test that could be utilized by other courts faced with the same issue.⁹⁶

Three years after *Joiner Leasing*, the Supreme Court enunciated the first definition of an "investment contract" in *S.E.C. v. Howey Co.*⁹⁷ The case involved the public sale of subdivided citrus groves.⁹⁸ Offers were made throughout the country.⁹⁹ Each investor purchased an average of 1.33 acres.¹⁰⁰ The purchases included a service contract with Howey-in-the-Hills Service, Inc.¹⁰¹ This company would plant, harvest, and market the crops.¹⁰² The net profit would be distributed to the investors.¹⁰³ As with *Joiner Leasing*, the Court was confronted with an investment that was not expressly included in the 1933 Act.¹⁰⁴ The Court framed the issue as being whether the land sales contract, the warranty deed, and the service contract together constituted an investment contract within the meaning of section 2(1) of the 1933 Act.¹⁰⁵

The Court in *Howey* stressed the importance of broad construction of the 1933 Act to afford the investing public a full measure

90. *Id.* at 352-53.

91. *Joiner Leasing*, 320 U.S. at 346.

92. Informal access to information means that the investors lacked valuable information about the venture because they had no prior association with the promoters or their enterprise. Cf. CAL. CORP. CODE § 25102(f)(2).

93. See 320 U.S. at 346.

94. See *supra* notes 45-74 and accompanying text.

95. 320 U.S. at 351.

96. See Long, *Partnership, Limited Partnership, and Joint Venture Interests as Securities*,

37 Mo. L. REV. 581, 598 (1972).

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

98. *Id.* at 294-95.

99. *Id.* at 299-300.

100. *Id.* at 295.

101. *Id.* at 295-96.

102. *Id.*

103. *Id.* at 296.

104. *Id.* at 297.

105. *Id.*

of protection.¹⁰⁶ Additionally, the Court stated that form should be disregarded in favor of substance, and that economic reality should be considered.¹⁰⁷ The Court reasoned that the actual mechanics of the investment are controlling, not the label applied by promoters.¹⁰⁸ With this premise, the Court held that an investment contract is a contract, transaction, or scheme whereby money is invested in a common enterprise and the investor is led to expect profits solely from the efforts of the promoter or a third party.¹⁰⁹ As applied to the facts of *Howey*, investors contributed money to a common enterprise in which profits were anticipated. Since most investors would not farm the citrus acreage,¹¹⁰ or participate in management of the enterprise,¹¹¹ the Court concluded the expected return on investment was based solely on the efforts of others.¹¹²

The Court in *Howey* viewed the new definition as a fulfillment of congressional intent and an embodiment of a flexible rather than a static principle.¹¹³ Although forty years have passed since the *Howey* decision, the *Howey* definition of an investment contract and the supporting rationale of the case remain the beginning point of security analysis involving investment contracts.¹¹⁴

Although the Supreme Court has repeatedly affirmed the *Howey* definition, an additional factor has been discussed by the Court. The inability of investors to inspect products and verify company or

106. *Id.* at 298.

107. *Id.*

108. *Id.* at 300. See also *Slevin v. Pedersen Assocs., Inc.*, 540 F. Supp. 437, 440 (S.D.N.Y. 1982). In deciding whether an investment is an investment contract security, Judge Duffy applied an economic realities analysis and remarked: "A lizard with a sign around its neck reading 'dog' does not change the lizard into a Labrador retriever." *Id.* Cf. *In re Deborah C.*, 30 Cal. 3d 125, 141, 635 P.2d 446, 455, 177 Cal. Rptr. 852, 861 (1981) (Mosk, J., concurring) (Speaking on an entirely different subject than securities, Justice Mosk stated "I would invoke the folk wisdom that if an object looks like a duck, walks like a duck and quacks like a duck, it is likely to be a duck.").

109. 328 U.S. at 298-99. The holding became known as the *Howey* test. The test has four elements for finding an investment contract: (1) Investment of money, (2) presence of a common enterprise, (3) expectation of profits, and (4) the profits will result solely from the efforts of others. *Id.*

110. *Id.* at 300.

111. *Id.*

112. *Id.*

113. *Id.* at 299.

114. See Deacon & Prendergast, *Defining a "Security" After the Forman Decision*, 11 PAC. L.J. 213, 217-18 (1980). "[I]n evaluating investment contract securities under Section 2(1) of the Securities Act, the *Howey* test becomes the accepted methodology." *Id.* at 217. See also *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 852 (the *Howey* test embodies the essential attributes that permeate all the Court's decisions defining a security); see also Carney, *supra* note 53, at 320 (with minor changes, the *Howey* test has dominated the definitional approach to investment contract analysis).

promoter representations has been considered by the Court since *Joiner Leasing*.¹¹⁵ The Court has expressed this concern by discussing the plan of distribution of an investment.¹¹⁶ In *Joiner Leasing*, the Court noted that sales literature was sent to over one thousand prospective investors.¹¹⁷ The Court stated that a security may be identified by the plan of distribution,¹¹⁸ which includes whether the scheme was offered to a wide range of investors.¹¹⁹

The Supreme Court in two recent decisions has opined that the absence of widespread solicitation could negate the application of securities law. In *United Housing Foundation v. Forman*,¹²⁰ the Court held that shares of stock in a nonprofit housing cooperative were not securities.¹²¹ To acquire an apartment in the housing development a purchaser was required to buy eighteen shares of Riverbay stock for twenty-five dollars per share, for each room.¹²² The stock was not transferable, could not appreciate in value, and did not pay dividends.¹²³ The court stated that the primary purpose of the 1933 and 1934 Acts was to eliminate serious abuses in a largely unregulated market.¹²⁴ The focus of both acts was the capital market of the enterprise system.¹²⁵ The Court implied that since the inducement was merely to acquire subsidized "living space,"¹²⁶ the investment was not the type that was likely to be widely traded on the securities exchanges or elsewhere.¹²⁷

In *Marine Bank v. Weaver*,¹²⁸ the Court strengthened the inference in *Forman*¹²⁹ that the plan of distribution is a factor to consider.¹³⁰ In *Marine Bank*, a couple purchased a \$50,000 certificate of deposit from a bank.¹³¹ The certificate then was pledged to the same bank

115. See Carney, *supra* note 53, at 355.

116. See Rapp, *The Role of Promotional Characteristics in Determining the Existence of a Security*, 9 SEC. REG. L.J. 26, 31 (1981) (the presence of promotional characteristics in finding a security is unmistakable).

117. *Joiner Leasing*, 320 U.S. at 346.

118. *Id.* at 353.

119. See *id.* at 351.

120. 421 U.S. 837 (1975).

121. *Id.* at 859-60.

122. *Id.* at 842.

123. *Id.* at 851.

124. *Id.* at 849.

125. *Id.*

126. *Id.* at 851.

127. See *id.* at 849.

128. 455 U.S. 551 (1982).

129. See *supra* notes 120-27 and accompanying text.

130. See Carney, *supra* note 53, at 356.

131. *Marine Bank*, 455 U.S. at 552.

to guarantee a \$65,000 loan by the bank to a third party.¹³² In exchange for the guarantee, the certificate owner received an agreement from the third party that entitled the certificate owners to fifty percent of the third party's business and one-hundred dollars per month for the balance of the loan guarantee.¹³³ The Court held the certificate of deposit and third party agreement were not securities.¹³⁴ The Court stated the unusual instruments held to be securities in prior cases involved offers to many potential investors, rather than a private transaction as in the case before the court.¹³⁵ The Court also noted that the investments in *Howey* and *Joiner Leasing* clearly were not private transactions.¹³⁶

Although the *Forman* and *Marine Bank* decisions have yet to be formulated into a concise test, an inference may be drawn that the courts should examine the surrounding circumstances closely to determine whether the investor needs protection through securities regulation.¹³⁷ One of the circumstances courts should consider is the plan of distribution.¹³⁸ Since the Supreme Court is a court of last resort, opportunities to refine the law are more likely at the appellate level. Thirteen years ago the Ninth Circuit Court of Appeals refined the *Howey* test.

2. The Ninth Circuit

The *Howey* decision has resulted in controversy and criticism.¹³⁹ The use of the word "solely" by the Court when describing the investor's reliance on the efforts of others resulted in confusion among

132. *Id.* at 553.

133. *Id.*

134. *Id.* at 560.

135. *Id.* at 559.

136. *See id.* at 559-60.

137. *See Carney, supra* note 53, at 356-57.

138. *Id.* at 355-57.

139. *See Long, supra* note 96, at 601 (cases since 1967 show a growing dissatisfaction with the *Howey* test since the court failed to make clear in *Howey* what type of efforts it meant). *See also* Comment, *Recent Ninth Circuit Developments in Securities Law*, 13 *LOY. L.A.L. REV.* 985 (1980).

Many critics contended that the courts had created an arbitrary definition of investment contract that had become rigid and fixed through judicial interpretation, and had failed to expand with the financial schemes of the day. It soon became readily apparent that some modifications in the application of the test would be required if the test were to remain a useful tool in defining securities.

Id. at 988; *see also Coffey, The Economic Realities of a "Security": Is There a More Meaningful Formula?*, 18 *CASE W. RES. L. REV.* 367 (1967) (courts were dissatisfied with the *Howey* test).

the lower courts.¹⁴⁰ Courts in subsequent cases disagreed whether “solely” should be construed strictly or broadly.¹⁴¹

In *S.E.C. v. Glenn W. Turner Enterprises, Inc.*,¹⁴² the Ninth Circuit Court of Appeals specifically considered the meaning of the word “solely.” *Glenn Turner* involved a pyramid sales scheme¹⁴³ in which self-improvement contracts were offered to buyers who then could sell contracts to other buyers and receive a commission.¹⁴⁴ After paying an initial investment, the buyer was obligated to find other prospective buyers to bring to the sales meetings.¹⁴⁵ In *Glenn Turner*, the defendants were officers, directors, and employees of the defendant corporation.¹⁴⁶ The defendants argued if the “solely from the efforts of others” criterion from *Howey* were applied, the investment could not be a security.¹⁴⁷ The investor could only obtain a profit through personal efforts.¹⁴⁸ The Court recognized the word “solely” as the only question to be resolved in *Glenn Turner* since all the other prongs of the *Howey* test had been met.¹⁴⁹ The court emphasized economic reality and substance over form in holding the word “sole-

140. See generally *State Comm’r of Sec. v. Hawaii Mkt. Center, Inc.*, 485 P.2d 105, 108 (Hawaii 1971) (stating that “courts become entrapped in polemics over the meaning of the word ‘solely’”).

141. *Id.* See also Long, *supra* note 96, at 602.

142. 474 F.2d 476 (9th Cir. 1973), *cert. denied*, 414 U.S. 821 (1973).

143. A pyramid sales scheme is a “device, illegal in many states, in which a buyer of goods is promised a payment for each additional buyer procured by him.” BLACK’S LAW DICTIONARY 1113 (5th ed. 1979).

144. 474 F.2d 478-79.

145. The court described these sales meetings as follows:

These meetings are like an old time revival meeting, but directed toward the joys of making easy money rather than salvation. Their purpose is to convince prospective purchasers, or “prospects,” that Dare is a sure route to great riches. At the meetings are employees, officers, and speakers from Dare, as well as purchasers (now “salesmen”) and their prospects. The Dare people, not the purchaser-“salesman,” run the meetings and do the selling. They exude great enthusiasm, cheering and chanting; there is exuberant handshaking, standing on the chairs, shouting, and “money-humming.” The Dare people dress in expensive, modern clothes; they display large sums of cash, flaunting it to those present, and even at times throwing it about; they drive new and expensive automobiles, which are conspicuously parked in large numbers outside the meeting place. Dare speakers describe, usually in a frenzied manner, the wealth that awaits the prospects if they will purchase one of the plans. Films are shown, usually involving the “rags-to-riches” story of Dare founder Glenn W. Turner. The goal of all of this is to persuade the prospect to purchase a plan. . . . After the meeting, pressure is applied to the prospect by Dare people, in an effort to induce him to purchase one of the Adventures or plans. The sale is sometimes closed by the purchaser who brought the prospect to the meeting, but primarily, by Dare salesmen, specialists in the “hard sell.”

Id. at 479 (footnotes omitted).

146. *Id.* at 477-78.

147. See *id.* at 481-82.

148. *Id.* at 482.

149. *Id.* at 181.

ly” should not be read as a strict or literal limitation on the definition of an investment contract.¹⁵⁰

By abandoning literal interpretation of the word solely,¹⁵¹ the court adopted an “expanded efforts” test. This test involves whether the efforts made by those other than the investor are undeniably significant and are essential managerial efforts which affect the failure or success of the enterprise.¹⁵² The court in *Glenn Turner* emphasized the significance of the presence or absence of investor control when deciding if an investment scheme is a security.¹⁵³ The court recognized that if the *Howey* test is applied strictly, the fundamental goals of investor protection can be circumvented.¹⁵⁴ Requiring a modicum of effort from the investor would mean that the investor no longer has to rely solely on the efforts of others for a profit and, therefore, the investment would not meet the *Howey* test of a security.¹⁵⁵ For example, requiring investors to stuff envelopes once a year for the business might be enough effort to fall outside the *Howey* definition of an investment contract.¹⁵⁶ This strict interpretation, however, would be contrary to the spirit of both *Joiner Leasing*¹⁵⁷ and *Howey*.¹⁵⁸ Therefore, recognizing the economic realities of the pyramid scheme in *Glenn Turner*, the court used a managerial test.¹⁵⁹ As applied to the facts in *Glenn Turner*, the Court held that providing a business with prospects is not an essential managerial effort by the investor.¹⁶⁰

The application of the managerial test in *Glenn Turner* reemphasizes the philosophy and goals of Congress in enactment of 1933 and 1934 Acts.¹⁶¹ If an investor possesses the right to perform essential managerial

150. *Id.* at 481-82.

151. See Rapp, *supra* note 116, at 38.

152. 474 F.2d at 482.

153. *Id.* at 481-83.

154. *Id.* See also Long, *supra* note 96, at 601; Arnold, “When Is a Car a Bicycle?” and Other Riddles: The Definition of a Security Under the Federal Securities Laws, 33 CLEV. ST. L. REV. 449, 452 (1985); Comment, *Is a Limited Partnership Interest a “Security?”: The Current State of the California and Federal Definitions Add a Legal Dimension to Economic Speculation*, 16 SANTA CLARA L. REV. 311, 332 (1976).

155. See *supra* note 154 and accompanying text.

156. Cf. *Gallion v. Alabama Mkt. Centers, Inc.*, 282 Ala. 679, 213 So. 2d 841 (1968) (distribution of 100 cards to potential customers of a membership-only discount department store was sufficient to fail the *Howey* test); *Georgia Mkt. Centers v. Forston*, 225 Ga. 854, 171 S.E. 2d 620 (1969) (distribution of cards to potential customers of a membership-only discount department store was sufficient to fail the *Howey* test). See also Comment, *Catch-All Investment Contracts: The Economic Realities Otherwise Require*, 14 CUM. L. REV. 135, 150-53 (1984).

157. See *supra* notes 79-96 and accompanying text.

158. See *supra* notes 97-114 and accompanying text.

159. 474 F.2d at 482 (“those essential managerial efforts which affect the failure or success of the enterprise”).

160. *Id.* at 482-83.

161. See *supra* notes 45-74 and accompanying text.

duties that affect the failure or success of the enterprise, the investment is not merely an investment contract.¹⁶² This type of investor does not need protection of the 1933 and 1934 Acts.¹⁶³ Since the investor can protect an investment through personal efforts and access to information, full disclosure requirements are superfluous.¹⁶⁴ The *Glenn Turner* modification of the *Howey* test has not yet been approved by the United States Supreme Court,¹⁶⁵ despite the large number of courts following the decision.¹⁶⁶

Unlike the federal courts, some state courts took a different approach in deciding if an investment, contract, or scheme was a security. Unfortunately, state court definitions can be more ambiguous than the federal court decisions. In California, two tests have been applied to decide if investments not mentioned in the applicable statute are securities.¹⁶⁷

3. California

In *People v. Syde*,¹⁶⁸ the Supreme Court of California applied a "participation" test to state securities analysis.¹⁶⁹ The *Syde* case involved contracts between Milton Syde Films, Inc. and parents of various child actors.¹⁷⁰ The contracts required down payments of fifteen dollars and five dollars per rehearsal until ninety-eight dollars was paid.¹⁷¹ The contracts also provided that upon sale of the film sixty percent of the gross receipts would be distributed equally to the

162. *Glenn Turner*, 474 F.2d at 482.

163. See *supra* notes 45-74 and accompanying text.

164. *Id.*

165. However, the Supreme Court has acknowledged the holding in *Glenn Turner*. See *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 852 n.16 (1975). The Court stated:

This test speaks in terms of "profits to come *solely* from the efforts of others." (Emphasis supplied). Although the issue is not presented in this case, we note that the Court of Appeals for the Ninth Circuit has held that "the word 'solely' should not be read as a strict or literal limitation on the definition of an investment contract, but rather must be construed realistically, so as to include within the definition those schemes which involve in substance, if not form, securities." We express no view, however, as to the holding of this case.

Id. (citations omitted).

166. See, e.g., *S.E.C. v. Goldfield Deep Mines Co.*, 758 F.2d 459 (9th Cir. 1985); *S.E.C. v. Koscot Interplanetary, Inc.*, 497 F.2d 473 (5th Cir. 1974); *Miller v. Central Chinchilla Group, Inc.*, 494 F.2d 414 (8th Cir. 1974); *Securities Adm'r v. College Assistance Plan, Inc.*, 533 F. Supp. 118 (D. Guam 1981), *aff'd*, 700 F.2d 548 (9th Cir. 1983).

167. Comment, *Limited Partnerships and the California Securities Law: Restricting the Public Sale of Limited Partnership Interests*, 13 U.C.D. L. Rev. 618, 624 (1980).

168. 37 Cal. 2d 765, 235 P.2d 601 (1951).

169. *Id.* at 769, 235 P.2d at 603.

170. *Id.* at 766-67, 235 P.2d at 602.

171. *Id.* at 767.

cast members.¹⁷² The court concluded the film could not be produced without the actual participation of the cast members.¹⁷³ By holding that the contracts with the parents were not securities, the court stated that securities law was not intended to regulate investments in which persons expect to reap a profit from active participation in a business venture.¹⁷⁴ One commentator has argued that the court in *Syde* essentially applied the elements of the *Howey* test, although *Howey* was not cited.¹⁷⁵

In *Silver Hills Country Club v. Sobieski*,¹⁷⁶ the California Supreme Court interpreted the California statutory definition of a security.¹⁷⁷ *Silver Hills* involved the sale of memberships in a country club under development.¹⁷⁸ The memberships were offered to the public and proceeds were used for acquiring the necessary property.¹⁷⁹ The court held the memberships were securities and emphasized that state securities laws were designed to protect the public against spurious schemes devised to attract risk capital.¹⁸⁰ Furthermore, the court held the purpose of the law was "to afford those who risk their capital at least a fair chance of realizing their objectives in legitimate ven-

172. *Id.*

173. *Id.* at 769, 235 P.2d at 603.

174. *Id.*

175. 2 H. BALLANTINE & G. STERLING, CALIFORNIA CORPORATION LAWS § 444.02 (1985); see also Deacon & Prendergast, *supra* note 114, at 222 (citing *Syde*, the authors state that California has adopted the *Howey* test). See also *People v. Davenport*, 13 Cal. 2d 681, 687, 91 P.2d 892, 895-96 (1939). While explaining the meaning of "securities," the California Supreme Court in *Davenport* stated "It means the investment of funds in a designated portion of the assets and capital of a concern, with a view of receiving a profit through the efforts of others than the investor; and in this sense includes what are termed 'security' or 'investment' contracts or 'speculative securities.'" (emphasis by the court). *Id.* The *Davenport* case is particularly interesting because it predates *Howey*.

176. 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961).

177. CAL. CORP. CODE § 25019 (defines "security" as "any note; stock; treasury stock; membership in an incorporated or unincorporated association; 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; certificate of interest or participation in an oil, gas or mining title or lease or in payments out of production under such a title or lease; 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; any beneficial interest or other security issued in connection with a funded employees' pension, profit sharing, stock bonus, or similar benefit plan; 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.").

178. 55 Cal. 2d at 812-13, 361 P.2d at 906-07, 13 Cal. Rptr. at 186-87.

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

180. *Id.* at 814, 361 P.2d at 907, 13 Cal. Rptr. at 187.

tures whether or not they expect a return on their capital in one form or another."¹⁸¹

The amorphous definition¹⁸² of a security stated by the California Supreme Court is known as the risk capital test.¹⁸³ The risk capital approach permits the finding of a security if capital is sought to be risked in the initiation of a business venture.¹⁸⁴ Unlike the *Howey* test, however, an investor is not required to have an expectation of receiving a monetary profit from the investment.¹⁸⁵ Thus, the court in *Silver Hills* found a security when the benefit sought was country club memberships rather than financial gain.¹⁸⁶

The risk capital test creates problems, however, because the test focuses on the risk of the investment. The investor's ability to control the enterprise through active participation is not expressly relevant.¹⁸⁷ As a result, a venture in which the investor participated in management in addition to risking capital could still be defined as a security. This result does not appear consistent with the philosophy of protecting only passive investors. Yet, thirteen years later, a California court of appeal redeclared the risk capital test to be the law in California.¹⁸⁸ Some commentators have argued that this declaration is incorrect.¹⁸⁹

Lower courts in California eventually ignored the risk capital test and applied the *Howey* test. In 1978, the court in *People v. Park*¹⁹⁰ held the *Howey* decision as the applicable test in security analysis.¹⁹¹ The court also cited *Glenn Turner* for the proposition that the in-

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

182. See Comment, *supra* note 154, at 322 (the risk capital test provides uncertain guidance for identification of a security); see also Hirsch v. duPont, 396 F. Supp. 1214, 1222 (S.D.N.Y. 1975) (stating under the risk capital test "virtually every conceivable investment, including the general partnership interests in the present case, would qualify as securities.").

183. See Deacon & Prendergast, *supra* note 114, at 220. The risk capital standard was first employed by the California Supreme Court in *Sobieski*. *Id.*

184. H. BALLANTINE & G. STERLING, *supra* note 175, § 444.02, at 21-19.

185. *Id.* at 21-20.

186. 55 Cal. 2d at 815-16, 361 P.2d at 909, 12 Cal. Rptr. at 189.

187. See T. HAZEN, *supra* note 45, at 23; H. Ballantine, *supra* note 175, at § 444.02.

188. See Hamilton Jewelers v. Department of Corps., 37 Cal. App. 3d 330, 335, 112 Cal. Rptr. 387, 390 (1974). "Thus California follows the 'risk capital' approach in ascertaining whether a transaction involves a 'security' within the meaning of the Corporate Securities Law." *Id.* (citation omitted).

189. Deacon & Prendergast, *supra* note 114, at 222. But see Comment, *supra* note 154, at 320. "The major test used by California courts to define 'security' is commonly referred to as the 'risk capital test.'" *Id.*

190. 87 Cal. App. 3d 550, 151 Cal. Rptr. 146 (1984).

191. *Id.* at 563, 151 Cal. Rptr. at 152. "Under widely accepted judicial interpretation and definition, an investment contract for the purposes of securities laws 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." *Id.*

vestor's power to control the enterprise is a crucial issue in deciding whether an investment is a security.¹⁹² Similarly, in *People v. Coster*,¹⁹³ another California court of appeal held the *Howey* test applicable to both federal and California securities law.¹⁹⁴ Finally, the court in *People v. Graham*¹⁹⁵ also applied the *Howey* test with the *Glenn Turner* modification. The court stated that the holding has the effect of merging elements of both the *Howey* test and the risk capital test.¹⁹⁶ Additionally, like the court in *Glenn Turner*, the court found that resolving the right of control issue was an essential element of security analysis.¹⁹⁷

The California Supreme Court, however, has yet to merge the *Howey* and risk capital tests. Most refinement of securities analysis has occurred at the trial and appellate court levels. Consequently, security analysis in California is currently unsettled. Before any application of security tests to limited partnerships can be analyzed, an examination of the nature of partnership interests must be made.

PARTNERSHIP INTERESTS

To fully understand the characteristics of a limited partnership, a distinction should be made between general partners and limited partners. Two reasons exist for making this distinction. First, the distinction illustrates the type of investor attracted by various forms of business. This distinction identifies the relationship between the investor and management, which becomes crucial when analyzing securities.¹⁹⁸ The second reason for the comparison is to determine how rights and liabilities of general and limited partners compare to those of corporate shareholders, who are readily recognized as owning securities.¹⁹⁹ If an investment is similar to corporate stock, then the policies supporting securities regulation of stocks should also apply to the investment. Therefore, similarity, or dissimilarity to corporate stock alters the established need for securities regulation through full disclosure.²⁰⁰

192. *Id.*; see *S.E.C. v. Glenn W. Turner Enters., Inc.*, 474 F.2d 476 (9th Cir. 1973), *cert. denied*, 414 U.S. 821 (1973).

193. 151 Cal. App. 3d 1188, 199 Cal. Rptr. 253 (1984).

194. *Id.* at 1193, 199 Cal. Rptr. at 256.

195. 163 Cal. App. 3d 1159, 210 Cal. Rptr. 318 (1985). See also *supra* notes 1-11 and accompanying text.

196. *Graham*, 163 Cal. App. 3d at 1168, 210 Cal. Rptr. at 324.

197. *Id.* at 1168, 210 Cal. Rptr. at 325.

198. See *supra* notes 56-74 and accompanying text.

199. See *supra* note 75 and accompanying text (treatment of a stock).

200. See *supra* notes 45-74 and accompanying text (discussing policy of protecting passive investors such as stockholders).

A. General Partnerships

Partnerships are as old as cooperative activity.²⁰¹ Partnerships can be traced from Babylonian sharecropping through Greek and Roman trading enterprises of the Renaissance.²⁰² The partnership form of business organization was established as an informal method of conducting business. Informality was a natural requirement due to the personal relationship between the partners.²⁰³ This type of relationship was also a natural result of the partners' direct involvement in the venture. All partners were involved in the enterprise because combining financial, material, and managerial resources was the basis for developing a partnership.²⁰⁴ Through early Mercantile Courts, England accepted the partnership form, designated as Societas.²⁰⁵ As the law developed, England eventually passed the Partnership Act of 1890.²⁰⁶ In 1914, drafting of the Uniform Partnership Act (UPA) was completed in the United States.²⁰⁷ Though subject to some variations, the UPA has been adopted by nearly all jurisdictions in the United States.²⁰⁸ Consistent with common law development, however, the partnership remains the simplest form of business association for two or more persons. Under the UPA, a partnership can be created by an oral agreement,²⁰⁹ generally does not require a filing with the state,²¹⁰ and may be dissolved by any of the partners.²¹¹ In addition to these basic principles of partnership law, the following three factors should be analyzed to distinguish this business organization from others: liability, transferability, and control.

201. See generally A. BROMBERG, CRANE AND BROMBERG ON PARTNERSHIP 10 (1968); R. HAMILTON, CASES AND MATERIALS ON CORPORATIONS 41-44 (1981).

202. See generally A. BROMBERG, *supra* note 201, at 10; R. HAMILTON, *supra* note 201, at 41-44.

203. See C. ROHRlich, ORGANIZING CORPORATE AND OTHER BUSINESS ENTERPRISES § 2.03[2], at 2-13 (5th ed. 1975 & Supp. 1985) (the partnership relation is personal and consensual). See also Long, *supra* note 96, at 586 (partnership relations are usually spawned by an acquaintanceship or business association).

204. 1 WEST'S SYMBIOLEOGRAPHY § 27 (1590).

It may be that the one (partner) only conferreth the goods, and the other no goods, but bestoweth only his and diligence, which then is instead of goods. For labor is oftentimes of as good regard as money, yea, and sometimes much better, which causeth that even the poor being industrious, may have fellowship with the rich.

Id.

205. See generally A. Bromberg, *supra* note 201, at 10-13.

206. *Id.*

207. See generally Commissioner's Prefatory Note, UPA, *supra* note 31, at 5-8.

208. Table of Jurisdictions, UPA, *supra* note 31, at 1-2 (Supp. 1986) (only Louisiana is not listed).

209. See H. HENN, *supra* note 3, at 66.

210. *Id.* at 67.

211. UPA § 31(1), *supra* note 31, at 376.

1. Liability

In accordance with principles of agency law,²¹² each partner is liable for the actions of the other partners.²¹³ Liability exists whether those actions are based upon actual or apparent authority.²¹⁴ Unlimited liability is well established under principles of common law.²¹⁵ By statute, if the partnership assets cannot satisfy a claim by tort victims or creditors, a partner's personal assets are available to satisfy partnership obligations.²¹⁶ Consequently, since actions by one partner can greatly affect the personal assets of another partner, a personal relationship of trust generally exists before the formation of a partnership or admittance of a new partner.²¹⁷ Additionally, with the risk of unlimited liability, a general partner demands control of the enterprise to guard against financial ruin.²¹⁸

The treatment of liability for general partners is in sharp contrast to corporate shareholder liability, which is limited to the initial investment.²¹⁹ Limitations on liability allow shareholders to be more concerned about investment performance, rather than potential liability. Consequently, the corporate shareholder is less concerned about possessing a right to control the enterprise. In addition to limited liability, limitations on transferability distinguish partnerships from other business organizations.

2. Transferability

The rights of a partner are generally nontransferable.²²⁰ Under the doctrine of *delectus personae*,²²¹ a person cannot be made a partner

212. See H. HENN, *supra* note 3, at 66.

213. UPA § 4(3), *supra* note 31, at 16.

214. See *id.* § 9, at 132.

215. See C. BATES, 1 LAW OF PARTNERSHIP 475-506 (1888).

216. See UPA § 15, *supra* note 31, at 174.

217. See R. JENNINGS & R. BUXBAUM, CORPORATIONS, CASES AND MATERIALS 17 (1979).

"The mutual agency relation of the partners is so personal, and carries the potential for such far-reaching consequences to each partner because of the unlimited liability of each for partnership debts, that any change in the originally-constituted group ends the relationship." *Id.* See also Long, *supra* note 96, at 586 (stating partnership relationships "are usually spawned by an acquaintanceship or business association that allows each of the prospective partners to observe the talents and shortcomings of the others. Thus, the traditional partnership was a relationship of mutual respect and trust.").

218. See R. POSNER, ECONOMIC ANALYSIS OF LAW § 14.2, at 291 (2d ed. 1977) (since each partner is personally liable for the debts of the partnership, a prospective investor will want to participate in the actual management of the firm to make sure the firm does not incur large debts).

219. H. HENN, *supra* note 3, at 130-31.

220. *Id.* at 76.

221. Literally translated, *delectus personae* means choice of the person. See BLACK'S LAW DICTIONARY 383 (5th ed. 1979). "By this term is understood the right of a partner to exercise

without unanimous consent of the partners.²²² The doctrine of *delectus personae* is logical because partners are liable for the actions of new partners.²²³ Therefore, existing partners must choose very carefully the prospective partners since these partners could have a large impact on the partners' personal finances. Although partners are free to sell partnership interests, not all partnership rights vest in the assignee.²²⁴ The assignee may not vote on partnership matters or otherwise participate in control of the enterprise.²²⁵ Essentially, the assignee's rights are limited to receipt of profits and the right to request an accounting.²²⁶ These provisions force the partnership to attract investors willing to forego liquidity.²²⁷ A reduction in liquidity increases the risk to the investor, due to an inability to limit losses through sale of the investment.²²⁸ To offset the increased risk, an investor is likely to want some right to control the enterprise.²²⁹ Relatively few investors, however, have the time and talent to protect investments through active participation in management of the business. The prac-

his choice and preference as to the admission of any new members to the firm, and as to the persons to be so admitted, if any." *Id.*

222. H. HENN, *supra* note 3, at 76.

223. See 1 J. BARRETT & E. SEAGO, PARTNERS AND PARTNERSHIPS LAW AND TAXATION § 2.1 (1956) (the doctrine is the very cornerstone of the partnership relationship).

Logically one can fully understand the reason for this doctrine if he will but contemplate the full scope of the legal effects of the partnership relation. Lord Kenyon has said, "When a man enters into a partnership he certainly commits his dearest rights to the discretion of everyone who forms a part of that partnership in which he engages. . . ."

Id. (quoting *Wells v. Masterman*, 2 Esp. 731 (1799)).

224. H. HENN, *supra* note 3, at 76.

225. *Id.* See also UPA § 27(1), *supra* note 31, at 353. An assignee may, however, vote on partnership matters and participate in management if the partners have consented in the partnership agreement. *Id.*

226. *Id.*

227. Liquidity is defined as "the status or condition of a person or a business in terms of his or its ability to convert assets into cash." BLACK'S LAW DICTIONARY 839 (5th ed. 1979); See also Van Camp, *Securities Regulation of Real Estate Investments: The California Model*, 35 OHIO ST. L.J. 309, 311 (1974). "[A] partnership investment generally lacks liquidity, perhaps the single most important feature of a corporate security. In the usual case a partnership investment cannot be readily and conveniently converted to cash through the sale or transfer of the partnership interest." *Id.*

228. R. POSNER, *supra* note 218, at 291 (a reduction in liquidity places the investor at the mercy of the partners). See also F. REILLY, INVESTMENT ANALYSIS & PORTFOLIO MANAGEMENT 17-18 (1979).

The greater the uncertainty regarding whether the investment can be bought or sold or the greater the price concession required to buy or sell it, the greater the liquidity risk. An example of an asset with almost no liquidity risk would be a United States Government Treasury Bill. A treasury bill can be bought or sold in minutes at a price almost identical to the quoted price. Purchase or conversion into cash is almost instantaneous and the price is known with almost perfect certainty.

Id.

229. See R. POSNER, *supra* note 218, at 291.

tical effect of these compensating factors is a reduction in the value of public solicitation.²³⁰ This reduction reemphasizes the close relationship between partners that is necessary for organizing a partnership.²³¹

Corporate shareholders, alternatively, may transfer interests freely²³² with all rights vesting in the assignee.²³³ Millions of corporate shares are transferred daily through regional and national stock exchanges.²³⁴ Unlike a partnership investment, approval from the other shareholders is not necessary.²³⁵ Liquidity is enhanced because the seller does not have to find a buyer willing to purchase an investment with unlimited liability. Consequently, the shareholder is less likely to be interested in controlling the enterprise.²³⁶ In addition to limited liability and transferability, rights of control distinguish partnerships from other forms of business.

3. Rights of Control

Unless otherwise stated in the partnership agreement, all partners have equal rights to control and manage the partnership.²³⁷ The right of control ranges from making day to day operational decisions to amending the partnership agreement.²³⁸ This fundamental right is a significant reason for choosing a partnership as the enterprise form.²³⁹ In addition, the right to control the business is a counter balance to unlimited personal liability and lack of liquidity.²⁴⁰

In contrast, shareholders of a corporation are usually not involved

230. Public solicitation is a factor considered by the courts when applying regulatory protection through full disclosure laws. *See supra* notes 117-37 and accompanying text.

231. *See supra* notes 203 & 217 and accompanying text.

232. *See Van Camp, supra* note 227, at 311 (liquidity is the single most important feature of a corporate security). *See also* H. HENN, *supra* note 3, at 757. Transferability may be limited pursuant to a contract between shareholders and the corporation. *Id.* As a practical matter, however, large corporations seldom restrict share transfer in order to maintain the marketability of the stock. H. BALLANTINE, *supra* note 175, at § 60.01(1).

233. Transferability is, however, subject to any restrictions placed in the bylaws or articles of incorporation. *See generally* H. HENN, *supra* note 3, at 451.

234. *See* STATISTICAL ABSTRACT OF THE UNITED STATES 507 (105th ed. 1985) (the New York Stock Exchange traded an average of 85.3 million shares per day in 1983).

235. *See* H. HENN, *supra* note 3, at 451.

236. *See supra* note 229 and accompanying text.

237. A partnership agreement is an agreement of the partners concerning the affairs of the partnership and the conduct of its business. *See* RULPA § 101, *supra* note 3, at 216. *See generally* H. HENN, *supra* note 3, at 70-72 (all partners have an equal right to manage).

238. *See* H. HENN, *supra* note 3, at 70-72.

239. *Cf.* Estate of Foreman, 269 Cal. App. 2d 180, 189, 74 Cal. Rptr. 699, 706 (1969). "Some degree of participation by partners in management and control of the business is one of the primary elements of partnership." *Id.* (citations omitted).

240. *See supra* note 229 and accompanying text.

in the operational aspects of the enterprise.²⁴¹ Shareholders do not possess a fundamental right to engage in managerial control.²⁴² Control of the business is generally limited to the right to elect and release members of the board of directors.²⁴³ The directors are in turn responsible for supervising corporate officers.²⁴⁴

The exception to noninvolvement by corporate shareholders is found in closely held corporations. A closely held corporation may be a very large business entity and yet not exceed the statutory limit of thirty-five shareholders.²⁴⁵ In closely held corporations, the shareholders are often personally involved in management of the enterprise.²⁴⁶ Despite this exception, as a general rule, a corporate business form is more amenable to attracting passive investors.²⁴⁷

In conclusion, differences in liability, liquidity, and management distinguish one form of business from another. Partners sacrifice liquidity and limited liability in exchange for participation in management of the business.²⁴⁸ Since most investors do not have time to avoid liability through active control, public offers of partnership interests would yield few investors.²⁴⁹ Thus, public solicitation is of little value to the partnership form of business.²⁵⁰ In addition, since a partner

241. H. HENN, *supra* note 3, at 490-92. See also L. RIBSTEIN, BUSINESS ASSOCIATIONS § 1.04 (1983) (unlike partners, corporate shareholders generally are passive owners, not co-equal managers).

242. See H. HENN, *supra* note 3, at 490-92.

243. See generally L. RIBSTEIN, *supra* note 241, at § 104 (stating "the day-to-day management of the corporation is left to the directors, while shareholders merely approve or disapprove of certain of the directors' decisions.").

244. See generally H. HENN, *supra* note 3, at 564.

245. See *id.* at 694-95.

246. *Id.* at 696. See also Berger, *Statutory Close or Closely-Held Corporations*, 11 PAC. L.J. 699, 699-700 (1980).

The kind of corporation referred to generically as "close," "closely held" or "closed" typically possesses the following characteristics:

- (1) the shareholders are few in number, often only two or three;
- (2) they usually live in the same geographical area, know each other, and are well acquainted with each other's business skills;
- (3) all or most of the shareholders are active in the business, usually serving as directors or officers or as key men in some managerial capacity; and
- (4) there is no established market for the corporate stock, the shares not being listed on a stock exchange or actively dealt in by brokers; little or no trading takes place in the shares.

Id. (footnotes omitted).

247. See R. POSNER, *supra* note 218, at 301.

248. See *supra* notes 213-29 and accompanying text.

249. See A. BROMBERG, *supra* note 201, at 126. "It is normally impracticable to market widely a non-corporate ownership interest because of the liability potential it carries." *Id.* See also *supra* note 230 and accompanying text.

250. See *supra* note 230 and accompanying text.

is normally involved actively in business operations, the possibility of defrauding the partner is lessened.²⁵¹

In contrast, the corporate shareholder has significant liquidity²⁵² and no risk beyond the initial investment.²⁵³ In addition, involvement in management is limited to the appointment of directors.²⁵⁴ As a result of this arrangement, the shareholder is more passive in relation to the enterprise than a partner in a partnership.²⁵⁵ Therefore, legislators have recognized a greater need to protect the corporate investor through regulation that requires full disclosure and provides remedies for fraud.

A general partnership is a form of business that predominantly attracts investors desiring personal involvement in the partnership.²⁵⁶ Corporations, predominantly attract passive investors.²⁵⁷ A detailed examination of limited partnerships will answer questions regarding whether an investor in a limited partnership is allowed active participation in management.

B. Limited Partnerships

1. History and the Uniform Limited Partnership Act

Despite the existence of partnerships as a business form, a need arose for an association permitting capital investment without management responsibilities or financial liability beyond the amount invested.²⁵⁸ From inception, the fundamental principles behind this form of business enterprise were limited liability and noninvolvement by the investor.²⁵⁹ In 1822, New York enacted the first U.S. statute permitting the organization of a similar noncorporate enterprise.²⁶⁰ The statute designated this business organization a "limited partnership."²⁶¹

Following the novel legislation of New York, other states enacted

251. Self protection through managerial control reduces the need for governmental protection. See *supra* notes 150-64 and accompanying text.

252. See *supra* notes 232-34 and accompanying text.

253. See *supra* note 219 and accompanying text.

254. See *supra* notes 241-44 and accompanying text.

255. See *supra* note 241 and accompanying text.

256. See *supra* notes 237-40 and accompanying text.

257. See R. POSNER, *supra* note 218, at 292, 301; H. HENN, *supra* note 3, at 490-92.

258. J. CRANE, HANDBOOK ON THE LAW OF PARTNERSHIP 113 (1952).

259. *Id.* The "commenda" satisfied the need for another business form during the middle ages. The commendator supplied money to commendatarius to finance trade. In return, the commendator received a majority of the profits. Additionally, the commendator could not be held accountable for losses exceeding the capital invested. This type of business association was statutorily recognized as "en commandite" in the French Commercial Code of 1807. *Id.*

260. Comment, *The Limited Partnership*, 45 YALE L.J. 895, 895-96 (1936).

261. *Id.* at 896.

similar statutes.²⁶² These laws generally provided that a limited partner must contribute cash, file a partnership certificate, amend any false statements in the certificate, and renew the certificate when expiration occurs.²⁶³ In addition to technical formalities, the statutes generally provided a limitation on limited partner participation to business record inspections and consultation with the general partner.²⁶⁴ Any further interference would result in general partner classification.²⁶⁵

When the early statutes were enacted, the prevailing viewpoint was that investors who enjoyed profits of a successful enterprise also should share losses upon failure.²⁶⁶ This viewpoint made the courts uncomfortable with the limited partnership privileges created by the legislature.²⁶⁷ Consequently, these statutes received strict interpretation.²⁶⁸ Strict interpretation by the courts resulted in a loss of limited partnership status for any deviations from the statutory provisions, despite proper formation of the limited partnership.²⁶⁹ The environment of strict interpretation threatened the attractiveness and continued use of limited partnerships.²⁷⁰

To correct problems associated with limited partnerships,²⁷¹ the

262. *Id.* See also Basile, *Limited Liability for Limited Partners: An Argument for the Abolition of the Control Rule*, 38 VAND. L. REV. 1199, 1202 (1985) (stating "[w]ithin the following 60 years, all the states adopted limited partnership acts based generally on the New York model.").

263. See Comment, *supra* note 260, at 897-98.

264. *Id.* at 898.

265. *Id.*

266. *Id.* at 896.

267. *Id.*

268. *Id.*

269. *Id.* at 899.

270. *Id.*

271. See Basile, *supra* note 262, at 1202-03. Drafters of the early statutes made no attempt to define the type of conduct that would constitute interference by the limited partner. Consequently early cases were mixed. Limited partner liability was not found in *Madison County Bank v. Gould*, 5 Hill 309, 315 (N.Y. Sup. Ct. 1843) (title to real estate was taken in the name of two general partners and a limited partner, but the evidence did not show that the limited partner participated in the conveyance or knew that he was named as a grantee in the deed); *Lawson v. Wilmer*, 3 Phila. 122, 15 Leg. Int. 133, 133 (Phila. Common Pl. 1858) and *Outcalt & Co. v. Burnet & Brother*, 1 Handy 404, 405 (Ohio 1855) (a limited partner conducted the sale of partnership assets after dissolution); *Lachaise v. Marks*, 4 E.D. Smith 610, 619 (N.Y. Common Pl. 1855) (a limited partner agreed to the proposed terms of the partnership's dissolution); *McKnight v. Ratcliff*, 44 Pa. 156, 162-63 (1863) (a limited partner purchased goods from and sold goods to the partnership and performed an occasional errand for the partnership); *Ulman & Co. v. Briggs, Payne & Co.*, 32 La. Ann. 655, 662 (1880) (a limited partner on one occasion "consulted with one of the general partners" and telegraphed persons who requested information about the partnership to the effect that the firm was "all right"). For cases in which limited partners were liable, see *Richardson v. Hogg*, 38 Pa. 153, 156 (1861) (the partnership agreement provided that the partnership was to employ a son of the limited partner as a bookkeeper and that the general partner could not sign notes, checks, or contracts on behalf of the partnership without the bookkeeper's approval); *Farnsworth v.*

Uniform Limited Partnership Act (ULPA) was drafted in 1916,²⁷² two years after the Uniform Partnership Act.²⁷³ Despite the overall clarity of the ULPA, provisions dealing with a limited partner's ability to participate in management without incurring general liability were vague.²⁷⁴ A limited partner could inspect the partnership books²⁷⁵ and force a dissolution by court decree.²⁷⁶ Beyond these two privileges, few rights were articulated.²⁷⁷ Section 7 of the ULPA, however, provided that a limited partner becomes liable as a general partner "when in addition to the exercise of his rights and powers as a limited partner, he takes part in control of the business."²⁷⁸ Unfortunately, the term "control" was never defined by the ULPA. Thus, a major controversy regarding limited partnership liability law began.²⁷⁹ Courts faced with the question whether a limited partner should be liable for the obligations of the partnership had to decide if a limited partner's involvement had become too extensive.²⁸⁰ Two California cases illustrate the subtle distinctions in court analysis of control by limited partners.

In *Holzman v. de Escamilla*,²⁸¹ a limited partnership engaged in the business of growing vegetables.²⁸² The business consisted of one general partner and two limited partners.²⁸³ The three partners always conferred regarding which crops to plant.²⁸⁴ The limited partners sometimes dictated the choice of crops over the dissent of the general partner.²⁸⁵ The partnership maintained two bank accounts upon which checks could be drawn with the signature of two partners.²⁸⁶ Therefore, the general partner could draw a check only with the signature of a limited partner.²⁸⁷ Finally, the limited partners replaced the general

Boardman, 131 Mass. 115, 120 (1881) (a limited partner was a party to a contract transferring all the assets of an insolvent partnership to a creditor and made a contract with the creditor regarding disposal of the assets and payment of the partnership's debts); *Strang v. Thomas*, 114 Wis. 599, 601, 91 N.W. 237, 238 (1902) (a partnership agreement provided that the business of the partnership would be managed by directors elected by the limited partners).

272. See Comment, *supra* note 260, at 899.

273. See *supra* notes 206-57 and accompanying text.

274. See Comment, *supra* note 260, at 902.

275. ULPA § 10, *supra* note 3, at 590.

276. *Id.*

277. See *id.*

278. *Id.* at 582.

279. See generally Comment, *supra* note 260, at 902-07.

280. Basile, *supra* note 262, at 1205-06.

281. 86 Cal. App. 2d 858, 195 P.2d 833 (1948).

282. *Id.* at 859, 195 P.2d at 833-34.

283. *Id.* at 833.

284. *Id.* at 834.

285. *Id.* at 860, 195 P.2d at 834.

286. *Id.*

287. *Id.*

partner with a new general partner.²⁸⁸ Based upon these facts, the court held the circumstances clearly showed that the limited partners took part in control of the partnership.²⁸⁹

In *Grainger v. Antoyan*,²⁹⁰ a California court considered the status of a limited partnership engaged in the business of selling automobiles.²⁹¹ The partnership consisted of one general partner and two limited partners.²⁹² The limited partner defendant was the sales manager of the limited partnership and was in charge of the new car sales department.²⁹³ Additionally, the limited partner was authorized to cosign checks drawn on the checking account of the partnership in addition to the general partner and employees.²⁹⁴ The limited partner, however, only cosigned checks when the general partner was not available.²⁹⁵ The limited partner had no authority to maintain the partnership books, extend credit to customers, set prices, hire or fire employees, or purchase new cars.²⁹⁶ On these facts, the California Supreme Court held the limited partner's actions did not result in a loss of limited partner status.²⁹⁷ The court stated that the case was distinguishable from *Holtzman* because in that case the limited partner exercised control over the enterprise.²⁹⁸

Cases like *Holtzman* and *Grainger* illustrate the problems confronted by courts in deciding the issue of control under the ULPA. These cases also demonstrate that under the ULPA, one or two actions by the limited partner can result in a loss of limited partner status. As will be seen, despite subsequent drafting and amending of the uniform laws, the issue of control remains unsettled.

2. *The Revised Uniform Limited Partnership Act*

Sixty years after ULPA, the Revised Uniform Limited Partnership Act (RULPA) was drafted to modernize the prior uniform law.²⁹⁹ As of January 1, 1986, thirty states had adopted RULPA.³⁰⁰ To com-

288. *Id.*

289. *Id.*

290. 48 Cal. 2d 805, 313 P.2d 848 (1957).

291. *Id.* at 807, 313 P.2d at 849.

292. *Id.* at 806-07.

293. *Id.* at 808, 313 P.2d at 850.

294. *Id.*

295. *Id.*

296. *Id.*

297. *Id.* at 813, 313 P.2d at 853.

298. *Id.*

299. See Prefatory Note, RULPA, *supra* note 3, at 202.

300. See Table of Jurisdictions, RULPA, *supra* note 3, at 201 (states adopting the RULPA are: Alabama, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, Idaho, Iowa,

pare limited partnerships under RULPA with general partnerships and corporate shareholders, the factors of liability, liquidity, and control again must be considered.

Liability of limited partners is confined to the amount of the investor's original investment.³⁰¹ Should tort judgments or creditor obligations exceed the assets of the limited partnership, debts may be satisfied only with assets of the general partner.³⁰² Limited liability historically³⁰³ and modernly³⁰⁴ is the fundamental basis for this form of business.³⁰⁵ The liability of limited partners is similar to corporate shareholders³⁰⁶ and unlike general partnership interests.³⁰⁷

In contrast to a general partner, a limited partner may assign the interest without approval of the other partners.³⁰⁸ The assignment provision increases the liquidity of a limited partnership interest.³⁰⁹ By agreement, partners may limit the right to assign the interest, but as a practical matter, the general partner is concerned more with the limited partner's capital than managerial contribution.³¹⁰ As a result, a change in limited partners is unimportant to the general partner. Therefore, the transferability rights generally will not be proscribed in the partnership agreement, in order to enhance the attractiveness of the investments.³¹¹

With regard to the issue of control, the RULPA expanded the rights of limited partners by creating certain "safe harbors."³¹² Safe harbors

Kansas, Maryland, Massachusetts, Michigan, Minnesota, Missouri, Montana, Nebraska, Nevada, New Jersey, North Dakota, Ohio, Oklahoma, Oregon, Rhode Island, South Carolina, Virginia, Washington, West Virginia, Wisconsin, and Wyoming).

301. See H. HENN, *supra* note 3, at 93.

302. *Id.*

303. See *supra* note 259 and accompanying text.

304. H. HENN, *supra* note 3, at 93.

305. *Id.* See also R. JENNINGS, *supra* note 217, at 33; L. RIBSTEIN, *supra* note 241, at § 2.03; Basile, *supra* note 262, at 1199.

306. See *supra* note 219 and accompanying text.

307. See *supra* notes 213-16 and accompanying text.

308. H. HENN, *supra* note 3, at 94.

309. See *id.* See also *supra* note 220-28 and accompanying text.

310. Cf. R. POSNER, *supra* note 218, at § 14.2 (partnerships and sole proprietorships seek contributions of labor, while corporations seek capital contributions).

311. See *id.*

312. RULPA § 303(b) & (c), *supra* note 3, at 241.

A limited partner does not participate in the control of the business within the meaning of subsection (a) solely by doing one or more of the following: (1) being a contractor for or an agent or employee of the limited partnership or of a general partner; (2) consulting with and advising a general partner with respect to the business of the limited partnership; (3) acting as surety for the limited partnership; (4) approving or disapproving an amendment to the partnership agreement; or (5) voting on one or more of the following matters: (i) the dissolution and winding up of the limited partnership; (ii) the sale, exchange, lease, mortgage, pledge, or other transfer of all or substantially all of the assets of the limited partnership other than in the ordinary

are activities in which the limited partner may engage without incurring general partner liability.³¹³ One significant safe harbor provision is the right of limited partners to remove the general partner.³¹⁴ This right is similar to the right conferred upon corporate shareholders and indirectly involves the limited partner in controlling the enterprise.

In addition to safe harbors, the RULPA gives an expanded definition of the type of control that results in liability for limited partners beyond initial investment.³¹⁵ The RULPA states if the limited partner engages in control of the enterprise which is *not* substantially similar to the control exercised by a general partner, the limited partner is liable only to those who transact business with the partnership with actual knowledge of the limited partner's control.³¹⁶ The RULPA implies that if a limited partner engages in conduct substantially similar to a general partner, the limited partner will lose the limited liability and be treated as a general partner.³¹⁷ Hence, under the RULPA, a limited partner cannot participate in managerial control of the enterprise. Except for the safe harbor provisions, which allow some control, a limited partner is a passive investor.³¹⁸

In exchange for the relinquishment of managerial control, the limited partner receives limited³¹⁹ liability and greater liquidity than a general partner.³²⁰ This treatment is strikingly similar to that of a corporate

course of its business; (iii) the incurrence of indebtedness by the limited partnership other than in the ordinary course of its business; (iv) a change in the nature of the business; or (v) the removal of a general partner. (c) The enumeration in subsection (b) does not mean that the possession or exercise of any other powers by a limited partner constitutes participation by him in the business of the limited partnership.

Id.

313. See Basile, *supra* note 262, at 1212 (safe harbors are activities in which a limited partner may engage without being deemed to have participated in the control of the business).

314. RULPA § 303(b)(5)(v), *supra* note 3, at 241.

315. *Id.*

316. *Id.* Revised Uniform Limited Partnership Act § 303(a) states:

Except as provided in subsection (d), a limited partner is not liable for the obligations of a limited partnership unless he is also a general partner or, in addition to the exercise of his rights and powers as limited partner, he takes part in the control of the business. However, if the limited partner's participation in the control of the business is not substantially the same as the exercise of the powers of a general partner, he is liable only to persons who transact business with the limited partnership with actual knowledge of his participation in control.

Id.

317. Unfortunately the "substantially similar" test presents the same interpretive problems as § 7 of the ULPA. See Basile, *supra* note 262, at 1213 (the commissioners have created a new concept without providing any guidance for judges and lawyers regarding the meaning of that concept).

318. *Id.* at 1212-13.

319. See A. BROMBERG, *supra* note 201, at 147 (stating "limited partners are exempt from personal liability on condition they do not participate in management.").

320. See *supra* notes 308-09 and accompanying text.

shareholder.³²¹ As a result, public policy reasons for protecting corporate shareholders should also apply to limited partnerships formed under the RULPA.³²² An understanding of the RULPA, as adopted by California, is necessary before applying substantive partnership law to securities analysis.

3. *The California Corporations Code*

The RULPA became effective in California in July of 1984.³²³ The RULPA was adopted as part of the California Corporations Code (California Code).³²⁴ Section 15632 of the California Code, however, is a unique provision. Although the RULPA greatly extended allowable limited partner involvement in the enterprise, the California Code exceeded even that standard.³²⁵

The extension of limited partner involvement is partly a result of an expansion of the RULPA safe harbor provisions.³²⁶ Like the RULPA, the California provisions allow the limited partner to be a contractor, agent, or employee of the general partner;³²⁷ consult with the general partner;³²⁸ act as a surety to the limited partnership;³²⁹ approve or disapprove an amendment to the partnership agreement;³³⁰ and vote on dissolution and winding up of the limited partnership,³³¹ the transfer of all or substantially all limited partnership assets,³³² incurrance of debt,³³³ change in the nature of the business,³³⁴ and the removal of the general partner.³³⁵ In addition to the RULPA safe harbors, the California Code explicitly allows a limited partner to be an officer, director, or shareholder of a corporate general partner;³³⁶ vote on transactions when the general partner may have a con-

321. See Comment, *A Tax Comparison of the Limited Partnership and the Subchapter S Corporation*, 43 MINN. L. REV. 964, 967 (1959) ("In many respects the status of a limited partner is similar to that of a corporate stockholder. . .").

322. See *supra* notes 42-164 and accompanying text.

323. See generally *Review of Selected 1983 California Legislation*, 15 PAC. L.J. 411, 482 (1984).

324. CAL. CORP. CODE §§ 15611-15723.

325. See *infra* notes 326-53 and accompanying text.

326. See *supra* notes 312-14 and accompanying text.

327. CAL. CORP. CODE § 15632(b)(1).

328. *Id.* § 15632(b)(2).

329. *Id.* § 15632(b)(3).

330. *Id.* § 15632(b)(4).

331. *Id.* § 15632(b)(5)(A).

332. *Id.* § 15632(b)(5)(B).

333. *Id.* § 15632(b)(5)(C).

334. *Id.* § 15632(b)(5)(D).

335. *Id.* § 15632(b)(5)(F).

336. *Id.* § 15632(b)(1).

flict of interest,³³⁷ to continue the business,³³⁸ admission of a general partner,³³⁹ to continue the business of a limited partnership after a general partner ceases to be a general partner,³⁴⁰ to wind up the partnership;³⁴¹ to file certificates of amendment or dissolution;³⁴² to serve on an audit committee or perform the functions of an audit committee.³⁴³ These additional safe harbor provisions are illustrative of the increased control rights of a limited partner under the California Code.

In addition to the safe harbor provisions, section 16532(a) of the California Code further expands permissible involvement by a limited partner. The first sentence is essentially the same as section 7 of the ULPA³⁴⁴ and section 303 of the RULPA.³⁴⁵ The second sentence of section 15632(a), however, is significantly different than the second sentence of the RULPA section 303.³⁴⁶ The California Code states:

If a limited partner participates in the control of the business without being named as a general partner, that partner is nevertheless not liable to persons who transact business with the limited partnership unless they do so with actual knowledge of the partner's participation in control and reasonably believing that partner to be a general partner.³⁴⁷

Stated differently, if a limited partner participates in control of the enterprise the partner will *not* be liable unless the person seeking liability has (1) transacted business with the partnership, (2) had actual knowledge of the limited partner's control at the time of the transaction, *and* (3) reasonably believed the limited partner was a general

337. *Id.* § 15632(b)(1)(E).

338. *Id.* § 15632(b)(1)(G). Implied in the Revised Uniform Limited Partnership Act. *See* RULPA § 801(3), *supra* note 3, at 262.

339. CAL. CORP. CODE § 15632(b)(1)(H). Implied in the Revised Uniform Limited Partnership Act. *See* RULPA § 401, *supra* note 3, at 246.

340. CAL. CORP. CODE § 15632(b)(1)(J). Implied in the Revised Uniform Limited Partnership Act. *See* RULPA § 801(3), *supra* note 3, at 262.

341. CAL. CORP. CODE § 15632(b)(6).

342. *Id.* § 15632(b)(7).

343. *Id.* § 15632(b)(8).

344. "A limited partner shall not become liable as a general partner unless, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business." ULPA § 7, *supra* note 3, at 582.

345. "Except as provided in subsection (d), a limited partner is not liable for the obligations of a limited partnership unless he is also a general partner or, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business." RULPA § 303(a), *supra* note 3, at 241.

346. "However, if the limited partner's participation in the control of the business is not substantially the same as the exercise of the powers of a general partner, he is liable only to persons who transact business with the limited partnership with actual knowledge of his participation in control." RULPA § 303(a), *supra* note 3, at 241.

347. CAL. CORP. CODE § 15632(a).

partner.³⁴⁸ This language of the California Code significantly varies from the RULPA. One commentator has concluded that California confines a limited partner's liability to reliance creditors and tort victims.³⁴⁹

Thus, under the California Code a limited partner can participate fully in management, while retaining significant protection from liability.³⁵⁰ Alone, the safe harbor provisions of the California Code extend a limited partner's power to control the enterprise far beyond the early New York statute and the ULPA.³⁵¹ Section 15632(a) further extends the limited partner's power to control.³⁵² Absent provisions to the contrary in the partnership agreement, a limited partner no longer is forced to rely solely on the managerial skills of others and may actively protect investments.³⁵³

The newly sanctioned powers of control distinguish the limited partner's right from corporate shareholder rights and identify the limited partner more closely with a general partner.³⁵⁴ Generally, the limited partner in California will now have the right to control the enterprise without fully losing protection from liability. Exercise of some control will be fully protected from liability by the safe harbor provisions.³⁵⁵ Other types of participation in control will exceed the safe harbor provisions and result in partial liability.³⁵⁶ Finally, rights of control may be circumscribed in the partnership agreement.³⁵⁷ Therefore, in California, whether a limited partner can participate in control of the enterprise is an issue that must be decided on a case by case basis.³⁵⁸

LIMITED PARTNERSHIPS AS SECURITIES

A. *The ULPA and RULPA*

Since limited partnerships are not listed as securities in either the

348. See Buxbaum, *Understanding California's New Limited Partnership Act*, CALIF. L. REV. 13, 14 (May 1984).

349. Tort victims are included because the liability provision in the first sentence is not excepted in the second sentence. See generally Buxbaum, *supra* note 348, at 13-15.

350. The limited partner remains potentially liable to reliance creditors and tort victims. See *supra* notes 347-49 and accompanying text.

351. See *supra* notes 260-98 and accompanying text.

352. See *supra* notes 346-50 and accompanying text.

353. See generally Buxbaum, *supra* note 348, at 13-15. See also *supra* notes 325-50 and accompanying text.

354. See *supra* notes 198-240 and accompanying text.

355. See *supra* notes 326-43 and accompanying text.

356. Participation in control exposes limited partners to liability to tort victims and reliance creditors. See *supra* notes 347-50 and accompanying text.

357. RULPA § 3.02, *supra* note 3, at 240.

358. See *infra* note 408 and accompanying text.

1933 Act or the 1934 Act, deciding whether a limited partnership interest is a security requires application of judicial interpretation.³⁵⁹ The *Howey* definition of an investment contract provides the structure for analyzing partnership interests.³⁶⁰ The first three prongs of the *Howey* definition are easily met.³⁶¹ First, the investor usually will invest money³⁶² in the partnership. Second, the investment involves a common enterprise.³⁶³ Third, partnership interests are designed to return a profit to the investor.³⁶⁴ Therefore, few partnership interests would not meet the first three prongs of the *Howey* test.³⁶⁵

The fourth prong distinguishes general partnerships from limited partnerships.³⁶⁶ The fourth prong of *Howey* requires the investor to rely solely upon the efforts of others for a return on investment. The right of a partner to control the enterprise is fundamental to general partnerships.³⁶⁷ Consequently, general partnerships fail the control prong of *Howey* and, therefore, generally are held not to be securities.³⁶⁸

Limited partnerships under the ULPA and RULPA, however, are treated differently than general partnerships. Violation of the fourth prong is almost impossible. Under the ULPA a limited partner would lose limited status if the partner participated in control of the enterprise.³⁶⁹ Under RULPA the limited partner can exert a greater amount of control.³⁷⁰ Limited partners, however, lose limited status if participation in control of the enterprise is substantially the same as that exercised by the general partner.³⁷¹ Therefore, under both the ULPA and RULPA, a limited partner cannot participate in control of the business. Consequently, if the interest is a true limited partnership,

359. See *supra* notes 78-197 and accompanying text.

360. See *supra* notes 97-112 and accompanying text.

361. See *supra* note 109 and accompanying text.

362. *Id.*

363. *Id.*

364. *Id.*

365. See Long, *supra* note 96, at 612. "Classifying a general partnership interest as a security depends upon the last element of the proposed test, managerial control. The other elements are clearly present." *Id.*

366. See *supra* note 109 and accompanying text.

367. See *supra* notes 204 & 237-38 and accompanying text.

368. See 1 H. MARSH & R. VOLK, PRACTICE UNDER THE CALIFORNIA SECURITIES LAWS § 5.11(1) (1985). "In the case of a partnership . . . the legal right of the general partner directly to exercise control over the operations of the business has been considered to negative the existence of any security. . . ." *Id.* See also H. BLOOMENTHAL, *supra* note 73, at § 2.12 (stating "[t]he view that general partnership interests are not securities appears now to be well entrenched.").

369. See *supra* notes 271-98 and accompanying text.

370. See *supra* notes 299-318 and accompanying text.

371. *Id.*

and limited partners do not participate in control of the enterprise, the fourth prong of the *Howey* test is satisfied because the investor relies upon the efforts of others for a return on the investment. As a result, limited partnership interests are generally held to be securities.³⁷²

In addition to the result reached under *Howey*, the goals of securities regulation distinguish general partnerships from limited partnerships.³⁷³ Full disclosure laws protect investors who lack access to information available to management. In general partnerships, partners can personally influence the enterprise and obtain all information that would be available through full disclosure requirements.³⁷⁴ Therefore, neither federal nor California case law would support application of securities law to protect a general partner.³⁷⁵ One caveat exists, however. If the partnership agreement limits the general partner's right to control the enterprise and access to information, application of securities regulations would be justified for the same reason that securities law applies to corporate shares.³⁷⁶

Applying the same policy to limited partnerships results in regulatory protection for these investments as securities. Since the limited partner cannot protect the investment through participation in management, the investor is forced into passivity.³⁷⁷ When the investor is passive, full disclosure requirements aid the investor in deciding whether to buy, hold, or sell.³⁷⁸ Under both the ULPA and the RULPA, the

372. See Long, *supra* note 96, at 611 (limited partnership interests are always securities); T. HAZEN, *supra* note 45, at 22 (limited partnership interest meets the definition of a security); H. BLOOMENTHAL, *supra* note 73, at § 2.12(2) (limited partnerships ordinarily meet the investment-contract approach to securities analysis); H. MARSH & R. VOLK, *supra* note 368, at § 5.11[2] (limited partnerships restricting a limited partner's control have always been held securities). See also *Kroungold v. Triester*, 407 F. Supp. 414, 416-17 (E.D. Pa. 1975) (sale of a limited partnership interest in apartment development was sale of an investment contract, and therefore sale of securities within the meaning of the Securities Act); *Murphey v. Hillwood Villa Associates*, 411 F. Supp. 287, 290 (S.D.N.Y. 1976) (interest of limited partner, who was a party to agreement that enterprise was to be managed wholly by general partners, was investment contract and therefore security within meaning of the Securities Act).

373. See *supra* notes 45-74 and accompanying text.

374. See *supra* notes 203 & 237-38 and accompanying text.

375. See *supra* notes 79-197 and accompanying text.

376. See H. MARSH & R. VOLK, *supra* note 368, at § 5.11(1).

If the actual arrangement is such that persons who are given the legal status of general partners are nevertheless merely passive investors and the direction and control of the enterprise is concentrated in the hands of only one or a few of the ostensible general partners, the interest of the other partners may be a "security" within the regulatory purpose of the statute.

Id. (footnote omitted). See also Long, *supra* note 96, at 613 (for purposes of securities laws, little difference exists between a general and limited partnerships if the general partners concentrate management in the hands of a few partners through the partnership agreement).

377. See *supra* notes 274-322 and accompanying text.

378. See *supra* notes 45-74 and accompanying text.

limited partner is a passive investor.³⁷⁹ Full disclosure laws would protect the limited partner from fraudulently being induced to invest in the partnership. As a result, limited partnership interests should be subject to securities regulation under the policy of protecting passive investors.³⁸⁰

As an economic reality, investment in most limited partnerships is very similar to purchasing corporate stock.³⁸¹ The limited partner under the ULPA and RULPA has the ability to transfer the interest in the enterprise, has the benefit of limited liability, and has limited control rights.³⁸² Congress has expressly recognized the need to regulate the sale of corporate shares.³⁸³ Two investments with similar characteristics should be regulated in the same manner.

Finally, the manner of soliciting investors, as discussed in *Joiner*, *Howey*, *Forman*, and *Marine Bank*, is often different for general and limited partnerships.³⁸⁴ Promoters will not publicly solicit investors to become general partners due to the risk to both the original and prospective partners.³⁸⁵ Furthermore, most investors would not have sufficient time to participate in management. Limited partnerships, however, tend to attract passive investors.³⁸⁶ The investor in a limited partnership will not be an active participant in the enterprise,³⁸⁷ since control is limited. Moreover, most investors in limited partnerships do not desire active involvement.³⁸⁸ Therefore, promoters are more likely to publicly solicit investors for limited partnership interests than a general partnership interest. Public solicitation is another reason for application of securities regulation to limited partnerships.³⁸⁹ Therefore, the remedial purposes of securities regulation support the definition of limited partnership interests formed under the ULPA or RULPA as securities.³⁹⁰ Because legislatures may alter the RULPA, the limited partnership statute of each state must be examined to determine whether securities regulations are applicable to limited partnerships formed under the laws of the state. The modification made by

379. See *supra* notes 258-322 and accompanying text.

380. See *supra* notes 45-74 and accompanying text.

381. See *supra* notes 301-22 and accompanying text.

382. *Id.*

383. See *supra* note 75 and accompanying text.

384. See *supra* notes 115-38 and accompanying text.

385. See *supra* notes 249-50 and accompanying text.

386. See L. RIBSTEIN, *supra* note 241, at § 2.03.

387. See *supra* notes 274-320 and accompanying text.

388. See *supra* notes 301-20 and accompanying text.

389. See *supra* notes 115-38 and accompanying text.

390. See *supra* notes 45-74 and accompanying text.

the California Legislature of the RULPA has significant impact when applying securities analysis.

B. California Limited Partnerships

Application of the *Howey* test to California limited partnerships can cause a different result than under the ULPA or RULPA. While the first three prongs of the *Howey*³⁹¹ test have the same application as described above,³⁹² the effect of control is altered. The California version of the RULPA allows the investor to control the business and maintain status as a limited partner.³⁹³ The absence of control found critical to the definition of an investment contract in *Howey*,³⁹⁴ *Glenn Turner*,³⁹⁵ *Park*,³⁹⁶ *Coster*,³⁹⁷ and *Graham*,³⁹⁸ is allowed under California Corporations Code section 15632.³⁹⁹ Therefore, the fourth prong of the *Howey* test for finding a security is not satisfied.

In addition to the definitional approach of *Howey*, public policy reasons for securities regulation preclude the definition of some California limited partnerships as securities.⁴⁰⁰ Since the limited partner in California now may protect an investment through managerial control,⁴⁰¹ protection through full disclosure is unnecessary.⁴⁰² Applying securities regulation would, in essence, disregard the economic realities of the investment.⁴⁰³ Expansion of the limited partner's control distinguishes limited partners from corporate shareholders.⁴⁰⁴ Limited partners who control the partnership resemble general partners in a general partnership.⁴⁰⁵

Although the limited partner has the ability to control the enter-

391. The four prongs of the *Howey* test are (1) an investment of money, (2) presence of a common enterprise, (3) expectation of profits, and (4) the profits will result solely from the efforts of others. *Howey*, 328 U.S. at 298-99. See also *supra* notes 97-113 and accompanying text.

392. See *supra* notes 360-65 and accompanying text.

393. See *supra* notes 323-58 and accompanying text.

394. See *supra* notes 97-112 and accompanying text.

395. See *supra* notes 142-64 and accompanying text.

396. See *supra* notes 190-92 and accompanying text.

397. See *supra* notes 193-94 and accompanying text.

398. See *supra* notes 195-97 and accompanying text.

399. See *supra* notes 324-54 and accompanying text.

400. See *supra* notes 45-74 and accompanying text.

401. See *supra* notes 324-54 and accompanying text.

402. See *supra* notes 45-74 and accompanying text. See also Long, *supra* note 96, at 613.

"If a partner is active in the partnership business and shares in management and control, his interest is not a security. Even registration under the security act could not give him more complete access to information." *Id.*

403. See *supra* notes 107-08 and accompanying text.

404. See *supra* notes 241-44 and accompanying text.

405. See *supra* note 354 and accompanying text.

prise in California, the right of control can be circumscribed in the partnership agreement.⁴⁰⁶ As a result, the limited partnership agreement essentially will determine the necessity for investor protection through securities regulation and satisfaction of the *Howey* control test.⁴⁰⁷ Therefore, courts now must analyze application of securities regulation to limited partnership interests on a case-by-case basis.⁴⁰⁸ The recent drafting of two uniform laws raise questions about the *future* treatment of limited partnership interests as securities in California.

FUTURE LEGISLATIVE ACTION

The California Legislature expanded the control rights of limited partners to control the limited partnership to an extent that alters the traditional notions of limited partnership interests as securities.⁴⁰⁹ Two uniform laws, the 1985 ULPA and 1985 Uniform Securities Act, that affect securities regulation of limited partnerships have recently been approved by the National Conference of Commissioners. The California Legislature should amend the Corporations Code to be consistent with the 1985 ULPA and 1985 Uniform Securities Act.

A. *The 1985 ULPA*

Based on current partnership law in California, a limited partner may participate in control of the partnership to a greater degree than under the RULPA provisions, without losing status as a limited partner.⁴¹⁰ In California, the limited partner's right to control is neither completely granted, nor completely circumscribed.⁴¹¹ Instead, the right to control exists somewhere in between those two extremes. In California and other states, partnership law is changing from a requirement of no interference with management to an accommodation of increased managerial control of the partnership by the limited partner.⁴¹² Reduction of restraints on limited partnership participation continues to be recommended by the commissioners of the uniform laws.⁴¹³

406. CAL. CORP. CODE § 15621(a).

407. See Long, *supra* note 96, at 613.

408. *People v. Syde*, 37 Cal. 2d 765, 768, 235 P.2d 601, 602-03 (1951). "Whether a particular instrument is to be considered a security within the meaning of the statute is a question to be determined in each case." *Id.*

409. See *supra* notes 392-408 and accompanying text.

410. See *supra* notes 326-58 and accompanying text.

411. See *supra* notes 345-57 and accompanying text.

412. See *supra* notes 258-407 and accompanying text.

413. See *supra* note 16 and accompanying text.

In August 1985, the RULPA was superceded by the 1985 ULPA.⁴¹⁴ Section 303(a), the provision relevant to the issue of control, was significantly modified. The new act relaxed, but did not abolish, the control rule.⁴¹⁵ The ambiguous “substantially the same as” test introduced in the RULPA was deleted.⁴¹⁶ The second sentence of section 303(a) now states that a limited partner who participates in control of the enterprise is liable only to persons transacting business with the limited partnership with a reasonable belief, based on the limited partner’s conduct, that the limited partner is a general partner.⁴¹⁷ Thus, under the Amended RULPA, only reliance creditors can sue the limited partner for participation in the enterprise.⁴¹⁸

The 1985 ULPA reinforces a trend for limited partnerships toward liberalization of the control rule.⁴¹⁹ Many actions by limited partners that would have resulted in a loss of limited liability under the ULPA or the RULPA will not result in liability if the limited partnership is formed in California or under the 1985 ULPA.⁴²⁰ In addition, unlike

414. ULPA §§ 101-1106, *supra* note 3, at 284-99.

415. Basile, *supra* note 260, at 1214.

416. *Id.*

417. The second sentence of the new § 303(a) provides: “However, if the limited partner participates in the control of the business, he [or she] is liable only to persons who transact business with the limited partnership reasonably believing, based upon the limited partner’s conduct, that the limited partner is a general partner.” ULPA § 303(a), *supra* note 3, at 290.

418. *See id.*

419. *See, e.g.*, TEX. REV. CIV. STAT. ANN. art. 6132a, § 8(a) (in Texas a limited partner who takes part in control of the business is liable only to “a person who transacts business with the partnership reasonably believing that the limited partner is a general partner”); DEL. CODE ANN. tit. 6, § 17-303(a) (Delaware law provides that “if the limited partner does participate in the control of the business, he is liable only to persons who transact business with the limited partnership reasonably believing, based upon the limited partner’s conduct, that the limited partner is a general partner.”). *See supra* notes 323-58 and accompanying text (California law).

420. *See Basile, supra* note 262, at 1218-19.

Consider the following three hypothetical partnership agreement provisions: (1) a written partnership agreement for a real estate limited partnership providing that the general partners may not, without the consent of the holders of two-thirds of the limited partnership interests, enter into a long-term lease for more than twenty-five percent of the partnership’s rental space; (2) a written partnership agreement providing that the partnership is to be managed by a committee of three persons who may, but need not be, partners and further providing that the management committee is to be elected by vote of all the partners; (3) a written partnership agreement providing that the general partners may not make any charitable contributions without the consent of the holder of fifty-one percent of the limited partnership interests.

If the limited partners exercised the right to consent or to vote under any of these provisions, the limited partners literally would be “taking part” or “participating” in the control of the business and presumptively would incur liability for the partnership’s obligations under section 7 of the ULPA or former or new section 303(a) of the RULPA . . . If the limited partnerships were organized in California, Delaware, Texas, or a state that adopts new § 303(a), the limited partners would be liable, if at all, only “to persons who transact business with the limited partnership reasonably

the California version of the RULPA, the 1985 ULPA protects the limited partners from potential tort victims.⁴²¹ The limited partner is protected from tort victims because a tort is not “transacting business” with the limited partnership.

Decreasing restrictions on limited partner control is consistent with the original philosophy of the ULPA. When the ULPA was drafted in 1916, the act was drafted in accordance with a basic assumption regarding control rights of the limited partner.⁴²² The assumption stated in the Official Comment was:

No public policy requires a person who contributes to the capital of a business, acquires an interest in the profits, and some degree of control over the conduct of the business, to become bound for the obligations of the business; provided creditors have no reason to believe at the time their credits were extended that such person was so bound.⁴²³

California followed the assumption of the National Conference of Commissioners by adopting a version of the RULPA that limits liability of limited partners to reliance creditors and tort victims.⁴²⁴ To be consistent with past legislative action in California, the legislature should further expand a limited partner’s right to control the enterprise by adopting section 303(a) of the 1985 RULPA.

Expansion of the limited partner’s control rights has a substantial impact on securities analysis. The result is greater reliance on the *Howey* test for defining a security through investment contract analysis. Therefore, determining whether a particular partnership interest is an investment contract will have to be made on a case-by-case basis.⁴²⁵ The 1985 Uniform Securities Act provides a solution to the practical problems of applying the *Howey* test to limited partnership interests on a case-by-case basis.

B. The 1985 Uniform Securities Act

Despite the trend to increase the control rights of limited partners, and a corresponding decrease in the need to protect the active limited

believing, based upon the limited partner’s conduct, that the limited partner is a general partner.”

Id. (footnote included).

421. See *supra* note 349 and accompanying text.

422. See Commissioner’s Official Comment, ULPA, *supra* note 3, at 564.

423. *Id.*

424. See *supra* notes 323-58 and accompanying text.

425. See *supra* notes 358 & 408 and accompanying text.

partner, drafting of the 1985 Uniform Securities Act⁴²⁶ has taken an unexpected direction. In August of 1985, the 1985 Uniform Securities Act was adopted by the National Conference of Commissioners and specifically includes limited partnership interests within the definition of a security.⁴²⁷ Applying securities regulation to an investment that increasingly provides for investor participation appears to be inconsistent. The inclusion of limited partnership interests in the definition of a security, however, is logical upon a closer examination.

The amendment is logical for two reasons. The first is practical considerations for the practicing attorneys. Although the limited partner's rights of control have been expanded, the definition of control remains elusive.⁴²⁸ Attempting to apply the definition in order to advise a client whether a limited partnership is a security could be extremely difficult. Prior to the California version of the RULPA, the practitioner could assume that a limited partnership interest was a security and then comply with the applicable securities regulation.⁴²⁹ Currently in California, the attorney must make the very difficult determination whether the partnership agreement provides the limited partner with enough involvement to preclude a finding of an investment contract under the *Howey* test.⁴³⁰

A second reason for defining a limited partnership interest as a security is the economic reality of the investment in *most* cases. The liquidity and limited liability offered by limited partnerships attract passive investors who need protection through full disclosure laws.⁴³¹ As discussed in this comment, however, some limited partners will be able to protect investments through participation in the enterprise.⁴³²

426. UNIF. SEC. ACT §§ 101-807, 7B U.L.A. 16-51 (West Supp. 1986) [hereinafter cited as *Securities Act*].

427. *Id.* § 101(18), *supra* note 426, at 19.

428. *See* Basile, *supra* note 262, at 1221.

Both academicians and practitioners have bemoaned the control rule's uncertainty. Professor Alan Feld has observed that "[t]he control test . . . presents substantial interpretive problems in cases falling between the extreme of the wholly passive investor and the partner who manages the business on a day-to-day basis." Messrs. George Coleman and David Weatherbie of the Texas bar have stated that in their experience "[p]robably the most serious problem encountered in drafting and carrying out a limited partnership agreement is that of determining what constitutes taking part 'in the control of the business' of a limited partnership . . . [S]ome recent cases in attempting to solve the issue have only made it worse."

Id. (quoting Feld, *The "Control" Test for Limited Partnerships*, 82 HARV. L. REV. 1471, 1473 (1969) and Coleman & Weatherbie, *Special Problems in Limited Partnership Planning*, 30 Sw. L.J. 887, 897 (1976)).

429. *See supra* note 372 and accompanying text.

430. *Cf.* Long, *supra* note 96, at 610-13 (the partnership agreement can expand management rights, and therefore, there is "no need for the protection of the securities act").

431. *See supra* notes 319-22 and accompanying text.

432. *See supra* notes 323-58 and accompanying text.

As a result of the increased control rights of the limited partner, a limited partnership interest is analogous to shares in a closely held corporation. A limited partner, like a corporate shareholder, enjoys the advantages of limited liability and liquidity.⁴³³ A limited partner, like a corporate shareholder, can now participate in control of the enterprise without losing limited liability.⁴³⁴ In closely held corporations most investors participate in control of the enterprise.⁴³⁵ Despite the shareholder's participation, the interest owned by the investor is still a security.⁴³⁶ However, while the interest is defined as a security, society recognizes the investor in a closely held corporation does not need protection through full disclosure laws.⁴³⁷ Therefore, state⁴³⁸ and federal⁴³⁹ statutes provide an exemption from registration and qualification if the transaction meets certain requirements.

To be exempted from securities registration and qualification in California, an investment must be offered to fewer than thirty-five persons.⁴⁴⁰ Additionally, the prospective investors must have either a preexisting relationship with the offeror, or have a substantial degree of personal business sophistication or be represented by a professional investment advisor.⁴⁴¹ Finally, the sale cannot be accomplished through public advertising.⁴⁴² The goal of registration and merit requirements is to protect ignorant investors.⁴⁴³ When an investment transaction is exempt from securities registration, the investor has enough knowledge, information, and personal involvement to decrease the need of regulatory protection.⁴⁴⁴

Thus, through securities regulation society recognizes most corporate shareholders will be passive investors and therefore need protection. Additionally, society recognizes that some corporate shareholders will be actively involved in controlling the corporation and, therefore, registration requirements would be of little value. Hence, some trans-

433. See *supra* notes 301-22 and accompanying text.

434. See *supra* notes 324-58 and accompanying text.

435. H. HENN, *supra* note 3, at 696.

436. CAL. CORP. CODE § 15631.

437. See Long, *supra* note 96, at 613.

438. See *infra* notes 440-44 and accompanying text.

439. Rule 505 exempts securities from registration when no more than 35 unaccredited persons purchase the share from the issuer. 17 C.F.R. § 230.505 (1985). See also *supra* note 75 and accompanying text.

440. CAL. CORP. CODE § 25102(f)(1).

441. *Id.* § 25102(f)(2).

442. *Id.* § 25102(f)(4).

443. See *supra* notes 46-74 and accompanying text.

444. See *supra* note 441 and accompanying text. See also *supra* notes 245-46 and accompanying text.

actions involving the sale of stock are entitled to registration exemptions.

As a result of the similarities between limited partnership interests and corporate stock, California should follow the 1985 Uniform Securities Act by including limited partnership interests within the definition of a security in the Corporations Code. By defining a limited partnership interest as a security, California will be able to protect passive investors, allow exemptions for investors not needing protection, and provide greater certainty of securities regulation for practitioners.

CONCLUSION

Protection of ignorant investors is the goal of securities regulation. Federal securities laws seek to achieve this goal by requiring full disclosure of information regarding the investment. Under securities laws, full disclosure is required upon solicitation of investors and throughout the life of the enterprise. California securities laws protect ignorant investors by requiring the investment to meet the fair, just, and equitable standard. When an investment scheme is not specifically listed in a securities statute the scheme may nonetheless meet the definition based upon an investment contract definition. The *Howey* case provides a definition of investment contract that is applied in both federal and California courts. The *Howey* definition establishes four factors for finding an investment contract, the most crucial being reliance upon the efforts of others. If investors are allowed to participate in control of an enterprise, the investment fails the *Howey* test and therefore is not a security.

Traditionally, limited partners have not possessed the right to participate in management of the partnership. Beginning with the RULPA, however, a trend toward relaxing the control rule has developed. The RULPA started the trend by establishing safe harbor provisions and introducing the "substantially the same" test. California further expanded protection of limited partner control by limiting liability to reliance creditors and tort victims. Compared to previous statutes, the California Corporations Code now allows limited partners significant ability to participate in management.

Because of the historical inability of limited partners to participate in management, limited partnership interests have traditionally been treated as securities. Limited partnerships satisfied the *Howey* test of an investment contract as being, (1) an investment of money, (2) in a common enterprise, (3) for profit, and (4) reliance upon the efforts

of others for a return on investment. Increased control rights of limited partners, however, allow the limited partnership interest to fail the *Howey* test. In addition, since the rights may be circumscribed by the partnership agreement, practitioners cannot automatically treat limited partnership interests as meeting, or failing to meet, the definition of a security. Instead, whether a limited partnership interest is a security must be determined on a case-by-case basis.

Recent additions of the 1985 ULPA and the 1985 Uniform Securities Act illustrate an apparent inconsistency in the law. The 1985 ULPA seeks to expand limited partner control. The 1985 Uniform Securities Act seeks to formally recognize limited partnership interests as securities. Analyzing the economic realities of the limited partnership, as well as public policy behind securities regulation, can harmonize the two Acts.

Public policy seeks to protect investors from making investment decisions without the necessary information. Investors who participate in management of an enterprise have access to the necessary information and do not need disclosure and merit laws. Some limited partners will be active and not need regulatory protection. The economic realities of limited partnerships, however, indicate that most limited partners will be passive, since limited partnerships attract passive investors. Therefore, as with corporate shares, limited partnership interests should be treated as securities and should include exemption provisions for situations when the investor is likely to be self protected.

The practitioner must carefully consider the control issues, for both limited partner liability and securities regulation purposes, under current California law. The 1985 ULPA and the 1985 Uniform Securities Act are a standing recommendation to California. The California Legislature should eliminate the partnership law-securities law tug-of-war by amending the Corporations Code to include provisions consistent with the 1985 ULPA and 1985 Uniform Securities Act.

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