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# GENERAL PARTNERSHIP INTERESTS AS SECURITIES UNDER THE FEDERAL SECURITIES LAWS: SUBSTANCE OVER FORM

## INTRODUCTION

One of the central purposes of the federal securities laws<sup>1</sup> was to protect<sup>2</sup> passive, uninformed investors.<sup>3</sup> Accordingly, Congress sought to ensure provision of otherwise unavailable information to these investors.<sup>4</sup> Congress expected that with this information investors would have the tools necessary to protect their interests and would avoid investing in unsound, worthless, or fraudulent securities.<sup>5</sup>

General partners are not usually viewed by courts as needing the protections offered by the federal securities laws<sup>6</sup> because they are assumed

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1. For purposes of this Note the term "federal securities laws" refers to the Securities Act of 1933 (1933 Act), ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a-77aa (1982)) and to the Securities Exchange Act of 1934 (1934 Act), ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78kk (1982)).

2. See *Landreth Timber Co. v. Landreth*, 105 S. Ct. 2297, 2305 (1985); *United States v. Naftalin*, 441 U.S. 768, 775 (1979); *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967); *Wilko v. Swan*, 346 U.S. 427, 431 (1953); *Futura Dev. Corp. v. Centex Corp.*, 761 F.2d 33, 39 (1st Cir.), *cert. denied*, 106 S. Ct. 147 (1985); *Lank v. New York Stock Exch.*, 548 F.2d 61, 65 (2d Cir. 1977); *Zeller v. Bogue Elec. Mfg. Corp.*, 476 F.2d 795, 800 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973); S. Rep. No. 47, 73d Cong., 1st Sess. 1 (1933); H.R. Rep. No. 85, 73d Cong., 1st Sess. 1-4 (1933).

3. See *Slevin v. Pedersen Assocs.*, 540 F. Supp. 437, 441 (S.D.N.Y. 1982) ("securities laws were enacted to provide surveillance for those not in a position to monitor their own investments . . . [and to] protect the integrity of financial interests that unsuspecting investors are incapable of investigating for themselves"); *Sandusky Land, Ltd. v. Uniplan Groups, Inc.*, 400 F. Supp. 440, 445 (N.D. Ohio 1975) (investors usually knew little about the actual operation of companies they were investing in).

4. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976) (1933 Act designed to give investors full disclosure of material information about public offerings of securities and protect investors against fraud); *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967) (a central purpose of the 1934 Act is to protect investors by requiring full disclosure by issuers); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963) (fundamental purpose of securities laws was to substitute full disclosure for the philosophy of caveat emptor); *Kahan v. Rosenstiel*, 424 F.2d 161, 173 (3d Cir.) (1934 Act's goal is to give the investing public the opportunity to make knowing and intelligent decisions), *cert. denied*, 398 U.S. 950 (1970); S. Rep. No. 1455, 73d Cong., 2d Sess. 68 (1934) ("One of the prime concerns of the exchanges should be to make available to the public, honest, complete, and correct information regarding the securities listed."); S. Rep. No. 47, 73d Cong., 1st Sess. 1 (1933) (1933 Act aims "to place adequate and true information before the investor").

5. See *Kahan v. Rosenstiel*, 424 F.2d 161, 173 (3d Cir.) (1934 Act designed to "protect the public from inaccurate, incomplete and misleading information"), *cert. denied*, 398 U.S. 950 (1970); H.R. Rep. No. 1383, 73d Cong., 2d Sess. 2 (1934) (letter from President Franklin Roosevelt to Congressman Sam Rayburn) ("[w]e must eliminate unnecessary, unwise, and destructive speculation [on the stock exchanges]"); S. Rep. No. 47, 73d Cong., 1st Sess. 1 (1933) (1933 Act's aim is to prevent the sale of worthless securities through misrepresentation).

6. See *Goodwin v. Elkins & Co.*, 730 F.2d 99, 108 (3d Cir.), *cert. denied*, 105 S. Ct. 118 (1984); *Odom v. Slavik*, 703 F.2d 212, 215 (6th Cir. 1983) (*per curiam*); *Vincent v. Moench*, 473 F.2d 430, 436 (10th Cir. 1973); *Elson v. Geiger*, 506 F. Supp. 238, 243

to possess powers and responsibilities<sup>7</sup> that would enable them to protect their partnership interests. Such classic general partners should expect to reap profits through their own efforts and active participation<sup>8</sup> in the venture rather than simply through the efforts of others.

Some promoters have sought to take advantage of this judicial position by trying to masquerade a security as a general partnership interest to avoid the regulatory requirements and potential liabilities imposed by the securities laws.<sup>9</sup> Federal courts, recognizing the potential for this type of masquerade in the context of other investment vehicles,<sup>10</sup> have followed a Supreme Court mandate to examine the economic realities of an investment scheme rather than its appearance to determine whether the particular scheme will be considered a security and thus fall within the ambit of the federal securities laws. In the Supreme Court's analysis, the substance rather than the form of the scheme should govern.<sup>11</sup>

A classic general partner trying to prove that his general partnership

(E.D. Mich. 1980), *aff'd*, 701 F.2d 176 (6th Cir. 1982); *Sandusky Land, Ltd. v. Uniplan Groups, Inc.*, 400 F. Supp. 440, 445 (N.D. Ohio 1975); *Hirsch v. duPont*, 396 F. Supp. 1214, 1220 (S.D.N.Y. 1975), *aff'd*, 553 F.2d 750 (2d Cir. 1977); *New York Stock Exch. v. Sloan*, 394 F. Supp. 1303, 1314 (S.D.N.Y. 1975).

7. See *SEC v. Professional Assocs.*, 731 F.2d 349, 356 (6th Cir. 1984); *Goodwin v. Elkins & Co.*, 730 F.2d 99, 103 (3d Cir.), *cert. denied*, 105 S. Ct. 118 (1984); *Odom v. Slavik*, 703 F.2d 212, 215 (6th Cir. 1983) (per curiam); *Williamson v. Tucker*, 645 F.2d 404, 422 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981); *Hirsch v. duPont*, 396 F. Supp. 1214, 1220 (S.D.N.Y. 1975), *aff'd*, 553 F.2d 750 (2d Cir. 1977). See also Uniform Partnership Act (U.P.A.) § 18 (1914) (rules determining rights and duties of partners); *id.* § 19 (giving partner right to inspect and copy partnership records); *id.* § 20 (partners must provide information of anything affecting partnership to any partner or to representative of any deceased or disabled partner). A classic general partner is one who enjoys the rights set out in the U.P.A.

8. *Slevin v. Pederson Assocs.*, 540 F. Supp. 437, 440-41 (S.D.N.Y. 1982) (quoting *R. Jennings & H. Marsh, Securities Regulation* 252 (4th ed. 1977)).

9. See *McConnell v. Frank Howard Allen & Co.*, 574 F. Supp. 781, 783 (N.D. Cal. 1983); *Pfohl v. Pelican Landing*, 567 F. Supp. 134, 136-37 (N.D. Ill. 1983); *Morrison v. Pelican Land Dev.*, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,863, at 94,480 (N.D. Ill. Aug. 20, 1982); *Brodsky, General Partnership Interests as Securities*, 190 N.Y.L.J., Dec. 7, 1983, at 1, col. 1.

10. The federal courts have found the existence of a security in a variety of interesting contexts. See *Smith v. Gross*, 604 F.2d 639, 643 (9th Cir. 1979) (per curiam) (contracts involving the sale of earthworms); *Miller v. Central Chinchilla Group, Inc.*, 494 F.2d 414, 417 (8th Cir. 1974) (chinchilla contracts); *SEC v. MacElvain*, 417 F.2d 1134, 1137 (5th Cir. 1969) (letter offering interests in underwater oil mining claims), *cert. denied*, 397 U.S. 972 (1970); *Continental Mktg. Corp. v. SEC*, 387 F.2d 466, 471 (10th Cir. 1967) (contracts involving sale of beavers), *cert. denied*, 391 U.S. 905 (1968); *Roe v. United States*, 287 F.2d 435, 437 (5th Cir.) (sales of mineral leases on specific pieces of property), *cert. denied*, 368 U.S. 824 (1961); *Penfield Co. v. SEC*, 143 F.2d 746, 750-51 (9th Cir.) (bottling contracts received in exchange for whiskey warehouse receipts), *cert. denied*, 323 U.S. 768 (1944); *McLish v. Harris Farms, Inc.*, 507 F. Supp. 1075, 1080-85 (E.D. Cal. 1980) (purchase of cattle); *SEC v. Western Pac. Gold & Silver Exch. Corp.*, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,064, at 97,730 (D. Nev. Jan. 30, 1975) (sales agreements involving gold coins and silver bars); *Ferland v. Orange Groves of Florida, Inc.*, 377 F. Supp. 690, 703 (M.D. Fla. 1974) (sales of orange grove interests).

11. See *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 558 (1979); *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 851-52 (1975); *Tcherepnin v. Knight*, 389

interest constitutes a security<sup>12</sup> faces a difficult burden<sup>13</sup> because he is presumed able to protect his own investment. To satisfy this burden, some courts have noted that the general partner must prove that despite the partnership form, he was so dependent on the promoter or a third party that he was in fact unable to exercise meaningful partnership powers.<sup>14</sup> In fact, not all courts have given the general partner such an opportunity but have simply held as a matter of law that a general partnership interest cannot be considered a security.<sup>15</sup>

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U.S. 332, 336 (1967); *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298 (1946); *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 349 (1943).

12. Often the complaining general partner will invoke the antifraud provisions of the 1933 Act and/or the 1934 Act, *see, e.g.*, 15 U.S.C. § 771(1), (2) (1982); *id.* § 77q(a); *id.* § 78j(b), and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5, and any rights under state law, *see, e.g.*, *Goodwin v. Elkins & Co.*, 730 F.2d 99, 101 (3d Cir.), *cert. denied*, 105 S. Ct. 118 (1984); *Odom v. Slavik*, 703 F.2d 212, 213 (6th Cir. 1983) (*per curiam*); *Gordon v. Terry*, 684 F.2d 736, 739 & n.2 (11th Cir. 1982), *cert. denied*, 459 U.S. 1203 (1983); *Pfohl v. Pelican Landing*, 567 F. Supp. 134, 135 (N.D. Ill. 1983); *Hirsch v. duPont*, 396 F. Supp. 1214, 1215 (S.D.N.Y. 1975), *aff'd*, 553 F.2d 750 (2d Cir. 1977). In addition, the complaining general partner will be trying to gain all the advantages of being in federal court. For example, the general partner will have broader discovery rights in federal court. *See E. Brodsky*, *Guide to Securities Litigation* 326 (1974). If the general partner is also bringing some state law claims, the federal court will probably exercise pendent jurisdiction over such claims, because the federal and state claims will normally arise from the same operative facts. *See United Mine Workers v. Gibbs*, 383 U.S. 715, 725 (1966).

If the general partner's interests are considered securities, the promoter or issuer may be required to register as a broker or dealer under § 15 of the 1934 Act, 15 U.S.C. § 78o (1982), if he is not exempt from registration. The promoter may also have to consider the possibility of registering the initial offering under § 5 of the 1933 Act, 15 U.S.C. § 77e (1982), if he is unable to find an exemption.

This issue will often arise in the context of either a motion to dismiss for lack of subject matter jurisdiction, Fed. R. Civ. P. 12(b)(1), a motion to dismiss for failure to state a claim, Fed. R. Civ. P. 12(b)(6), or a motion to dismiss on summary judgment, Fed. R. Civ. P. 56. *See, e.g.*, *Goodwin v. Elkins & Co.*, 730 F.2d 99, 101 (3d Cir.) (Rule 12(b)(6)), *cert. denied*, 105 S. Ct. 118 (1984); *Odom v. Slavik*, 703 F.2d 212, 214 (6th Cir. 1983) (*per curiam*) (Rule 12(c) motion turned into Rule 56 motion); *Williamson v. Tucker*, 645 F.2d 404, 409 (5th Cir.) (Rules 12(b)(1) and 56), *cert. denied*, 454 U.S. 897 (1981); *McConnell v. Frank Howard Allen & Co.*, 574 F. Supp. 781, 782 (N.D. Cal. 1983) (Rules 12(b)(1) and 56); *Morrison v. Pelican Land Dev.*, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,863, at 94,480 (N.D. Ill. Aug. 20, 1982) (Rule 12(b)).

13. *See Gordon v. Terry*, 684 F.2d 736, 742 (11th Cir. 1982), *cert. denied*, 459 U.S. 1203 (1983); *Williamson v. Tucker*, 645 F.2d 404, 424 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981); *cf. Odom v. Slavik*, 703 F.2d 212, 216 (6th Cir. 1983) (*per curiam*) (defendant did not overcome burden of showing that his partnership interest was a limited one).

14. *See Odom v. Slavik*, 703 F.2d 212, 215 (6th Cir. 1983) (*per curiam*); *Gordon v. Terry*, 684 F.2d 736, 742 (11th Cir. 1982), *cert. denied*, 459 U.S. 1203 (1983); *Williamson v. Tucker*, 645 F.2d 404, 424 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981); *Morrison v. Pelican Land Dev.*, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,863, at 94,481 (N.D. Ill. Aug. 20, 1982).

15. *See Goodwin v. Elkins & Co.*, 730 F.2d 99, 103 (3d Cir.), *cert. denied*, 105 S. Ct. 118 (1984); *Hirsch v. duPont*, 396 F. Supp. 1214, 1220 (S.D.N.Y. 1975), *aff'd*, 553 F.2d 750 (2d Cir. 1977); *New York Stock Exch. v. Sloan*, 394 F. Supp. 1303, 1314 (S.D.N.Y. 1975); *cf. Elson v. Geiger*, 506 F. Supp. 238, 243 (E.D. Mich. 1980) (federal securities jurisdiction should not be extended to general partners where duties have been delegated), *aff'd*, 701 F.2d 176 (6th Cir. 1982).

This Note argues that an investment should not lose the protections of the federal securities laws simply because it is in the form of a general partnership interest. Rather, the economic realities of the scheme should govern. Part I will analyze the *Howey* test,<sup>16</sup> the current formula used to determine whether a particular scheme classifies as an investment contract and thus a security, and the *Howey* test's relevance to general partnership interests. Part II will describe the present controversy concerning whether general partnership interests should ever be considered securities. Part III will conclude that under certain circumstances general partnership interests should be treated as securities. Part III will also set forth a proposed sequence of analysis for determining the securities status of general partnership interests on a case-by-case basis.

## I. *HOWEY* AND ITS RELEVANCE TO GENERAL PARTNERSHIP INTERESTS

### A. *The Howey Test*

The Securities Act of 1933<sup>17</sup> (1933 Act) and the Securities Exchange Act of 1934<sup>18</sup> (1934 Act) both include within their definitions of a security<sup>19</sup> the terms "certificate of interest or participation in any profit shar-

16. See *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946). There has been much scholarly discussion of *Howey*. See, e.g., FitzGibbon, *What Is a Security?—A Redefinition Based on Eligibility to Participate in the Financial Markets*, 64 Minn. L. Rev. 893 (1980) [hereinafter cited as *What is a Security?*]; Hannan & Thomas, *The Importance of Economic Reality and Risk in Defining Federal Securities*, 25 Hastings L.J. 219 (1974) [hereinafter cited as *Importance of Risk*]; Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 Okla. L. Rev. 135 (1971) [hereinafter cited as *Securities Regulation*]; Newton, *What is a Security?: A Critical Analysis*, 48 Miss. L.J. 167 (1977); Tew & Freedman, *In Support of SEC v. W.J. Howey Co.: A Critical Analysis of the Parameters of the Economic Relationship Between an Issuer of Securities and the Securities Purchaser*, 27 U. Miami L. Rev. 407 (1973); Comment, *Catch-All Investment Contracts: The Economic Realities Otherwise Require*, 14 Cum. L. Rev. 135 (1984).

17. Ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a-77aa (1982)).

18. Ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78kk (1982)). The issue of whether a general partnership interest can be considered a security has also arisen in the context of The Investment Company Act of 1940 (1940 Act), ch. 686, 54 Stat. 789 (codified as amended at 15 U.S.C. §§ 80a-1 to 80a-64 (1982)). If a company is considered an investment company under § 3(a) of the 1940 Act, 15 U.S.C. § 80a-3(a) (1982), it must either register under the Act or qualify for an exemption. See, e.g., FCA Realty Fund, No-Action Letter, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,841, at 79,233 (available Nov. 13, 1984) (whether a realty fund was an investment company turned on whether the general partnership interests the fund was acquiring were securities); Realex Capital Corp., No-Action Letter, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,611, at 78,843 (available Mar. 19, 1984) (exemption under § 3(c)(5)(C) of 1940 Act not available to issuer if underlying partnership was a general partnership because general partnership interests would be investment contracts and thus securities); MSA Realty Corp., No-Action Letter, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,610, at 79,839-40 (available Mar. 19, 1984) (real estate investment trust planning to invest in a shopping center as a general partner granted exemption under § 3(c)(5)(C) of the 1940 Act).

19. Section 2 of the Securities Act of 1933 provides:

ing agreement” and “investment contract.”<sup>20</sup> Neither Act refers directly to partnership interests. The Uniform Partnership Act<sup>21</sup> (U.P.A.), however, defines a partnership as “an association of two or more persons to carry on as co-owners a business for profit.”<sup>22</sup> This definition appears to bring partnership agreements within the definition of securities in that they entail certificates of interest or participations in a profit-sharing agreement.<sup>23</sup> The Supreme Court has stated, however, that a profit-shar-

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[U]nless the context otherwise requires—(1) 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, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a “security,” or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

15 U.S.C. § 77b(1) (1982) (emphases added).

Section 3(a) of the Securities Exchange Act of 1934 provides:

[U]nless the context otherwise requires—. . . (10) The term “security” means any note, stock, treasury stock, bond, debenture, *certificate of interest or participation in any profit-sharing agreement* or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, *investment contract*, voting-trust certificate, certificate of deposit, for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a “security”; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker’s 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.

15 U.S.C. § 78c(a)(10) (1982) (emphases added).

20. The Supreme Court has stated repeatedly that the definition of a security in § 2(1) of the 1933 Act, 15 U.S.C. § 77b(1) (1982), is virtually identical to the definition of a security in § 3(a)(10) of the 1934 Act, 15 U.S.C. § 78c(a)(10) (1982). See *Marine Bank v. Weaver*, 455 U.S. 551, 555 n.3 (1982); *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 556 n.7 (1979); *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 847 & n.12 (1975); *Tcherepnin v. Knight*, 389 U.S. 332, 335-36, 342 (1967); see also S. Rep. No. 792, 73d Cong., 2d Sess. 14 (1934) (definition of security in 1934 Act substantially same as 1933 Act). Therefore, for purposes of this Note the two definitions will be regarded as the same.

21. The U.P.A. has been adopted in 48 states and the District of Columbia. The only states that have not adopted the Act are Georgia and Louisiana. The Act has also been adopted in Guam and the Virgin Islands. See 6 U.L.A. 1-2 (Supp. 1985).

22. U.P.A. § 6 (1914).

23. 15 U.S.C. §§ 77b(1), 78c(a)(10) (1982).

ing agreement alone is not sufficient to make an agreement a security.<sup>24</sup>

Courts confronted with the issue of whether a general partnership interest constitutes a security have considered whether the interest satisfies the definition of an investment contract<sup>25</sup> set forth in the seminal case

24. See *Marine Bank v. Weaver*, 455 U.S. 551, 560 (1982); *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 558 n.11 (1979).

25. See, e.g., *Goodwin v. Elkins & Co.*, 730 F.2d 99, 102 (3d Cir.), cert. denied, 105 S. Ct. 118 (1984); *Odom v. Slavik*, 703 F.2d 212, 214 (6th Cir. 1983) (per curiam); *Wagner v. Bear, Stearns & Co.*, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,032, at 94,913 (N.D. Ill. Sept. 17, 1982); *Hirsch v. duPont*, 396 F. Supp. 1214, 1218 (S.D.N.Y. 1975), aff'd, 553 F.2d 750 (2d Cir. 1977).

Some courts have considered whether the partnership was a bona fide partnership or a partnership in the accepted sense. See *Vincent v. Moench*, 473 F.2d 430, 436 (10th Cir. 1973); *Hirsch v. duPont*, 396 F. Supp. 1214, 1226 (S.D.N.Y. 1975), aff'd, 553 F.2d 750 (2d Cir. 1977); *Pawgan v. Silverstein*, 265 F. Supp. 898, 900 (S.D.N.Y. 1967); *Solomont v. Polk Dev. Co.*, 245 Cal. App. 2d 488, 498, 54 Cal. Rptr. 22, 28-29 (1966); *Rivlin v. Levine*, 195 Cal. App. 2d 13, 23, 15 Cal. Rptr. 587, 594 (1961); *Garbo v. Hilleary Franchise Sys.*, 479 S.W.2d 491, 500-01 (Mo. Ct. App. 1972). This test was initially discussed in the context of the California Corporate Securities Act. See *Dahlquist, Regulation and Civil Liability Under the California Corporate Securities Act*, 33 Calif. L. Rev. 343, 361-65 (1945). The test is based on the view that a bona fide partnership is not a security.

The most important consideration in determining whether a partnership is bona fide is the presence of the right of *delectus personae*, the right to determine membership. *Id.* at 363. This notion was codified in the U.P.A.: "no person can become a member of a partnership without the consent of all the partners." U.P.A. § 18(g) (1914). Thus, to be a bona fide partnership, all the partners must have the right to select all the other partners. In addition, if partnership interests are offered to the public, the partnership cannot be bona fide. *Dahlquist, supra*, at 363. Lastly, if the holders of the interests have no personal relationship with one another, the partnership will not be bona fide since most partners, it is said, have a close personal relationship. *Id.*

*Dahlquist's* bona fide partnership test has been severely criticized. See, e.g., *Long, Partnership, Limited Partnership and Joint Venture Interests as Securities*, 37 Mo. L. Rev. 581, 606-11 (1972). The criticism notes that a partnership that allows people to become partners without the consent of the other partners is not merely a non-bona fide partnership, but actually not a partnership at all, although nothing in partnership law prevents the public solicitation of new partners. *Id.* at 609. Thus, the factors considered by the bona fide partnership test will not help distinguish between the passive investor and the active general partner.

This kind of test has not often been used in the federal courts, and when it has been mentioned the courts have also relied on the *Howey* test. See, e.g., *Vincent v. Moench*, 473 F.2d 430, 436 (10th Cir. 1973); *Holmes v. Bateson*, 434 F. Supp. 1365, 1386-87 (D.R.I. 1977), aff'd in part and rev'd in part, 583 F.2d 542 (1st Cir. 1978); *Hirsch v. duPont*, 396 F. Supp. 1214, 1226-27 (S.D.N.Y. 1975), aff'd, 553 F.2d 750 (2d Cir. 1977); *Pawgan v. Silverstein*, 265 F. Supp. 898, 900-01 (S.D.N.Y. 1967).

Some courts that have considered whether an investor's interest constitutes a security have also employed a risk capital analysis. Such an analysis was initially used in *Silver Hills Country Club v. Sobieski*, 55 Cal. 2d 811, 815-16, 361 P.2d 906, 908-09, 13 Cal. Rptr. 186, 188-89 (1961) (en banc) where the California Supreme Court held that membership interests in a country club were securities because the investors risked their capital in an enterprise managed by others. *Id.* at 815, 361 P.2d at 908, 13 Cal. Rptr. at 188. It was irrelevant whether they expected a return on their capital as long as the investors received some benefit. This test focuses on what an investor stands to lose retrospectively and not what he expects to gain.

The Supreme Court of Hawaii, in *Commissioner of Sec. v. Hawaii Mkt. Center, Inc.*, 52 Hawaii 642, 648-49, 485 P.2d 105, 109 (1971) also adopted a risk capital test. This

defining that term, *SEC v. W.J. Howey Co.*<sup>26</sup>

In *Howey*, the Howey Company offered investors interests in approximately 250 acres of a citrus grove development, along with a service contract to harvest, cultivate and market the crop.<sup>27</sup> In holding that the offering was an investment contract the Supreme Court set forth a four part test to determine whether an investment scheme was an investment contract.<sup>28</sup> To be considered an investment contract, the contract, transaction or scheme under scrutiny must be one in which a person 1) invests his money 2) in a common enterprise and 3) is led to expect profits 4) solely from the efforts of a promoter or a third party.<sup>29</sup>

The *Howey* test seems mechanical on its face, but the Supreme Court emphasized that the term investment contract "embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the

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test was originally set forth in Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?*, 18 W. Res. L. Rev. 367, 377 (1967). Noting that the *Howey* test was too mechanical to protect the investing public, the court stated that

an investment contract is created whenever:

- (1) An offeree furnishes initial value to an offeror, and
- (2) a portion of this initial value is subjected to the risks of the enterprise, and
- (3) the furnishing of the initial value is induced by the offeror's promises or representations which give rise to a reasonable understanding that a valuable benefit of some kind, over and above the initial value, will accrue to the offeree as a result of the operation of the enterprise, and
- (4) the offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise.

*Hawaii Mkt. Center*, 52 Hawaii at 648-49, 485 P.2d at 109 (footnote omitted).

While risk capital tests have been supported by other commentators, see, e.g., *What Is a Security?*, *supra* note 16, at 908-12; *Importance of Risk*, *supra* note 16, at 244-49; *Securities Regulation*, *supra* note 16, at 167-70; *Securities Regulation: "Beneficial Interest in Title to Property" as a Security*—*Silver Hills Country Club v. Sobieski* (Cal. 1961), 50 Calif. L. Rev. 156 (1962); Note, *Securities Regulation: Risk Capital—Twenty Years After Silver Hills*, 35 Okla. L. Rev. 436 (1982), they have not been frequently employed by the federal courts. Such tests have been used in the context of deciding whether certain debt instruments are securities. See *Great W. Bank & Trust v. Kotz*, 532 F.2d 1252, 1257 (9th Cir. 1976); *El Khadem v. Equity Sec. Corp.*, 494 F.2d 1224, 1228-30 (9th Cir.), *cert. denied*, 419 U.S. 900 (1974). It does appear, however, that the fourth prong of this approach was influential in the Ninth Circuit's interpretation of the "efforts" prong of *Howey* in *SEC v. Glenn W. Turner Enters.*, 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973). See *infra* notes 39-44 and accompanying text.

26. 328 U.S. 293 (1946).

27. See *id.* at 295.

28. See *id.* at 298-99. In defining the term "investment contract," the Court did not specifically refer to the test as a four part test. The federal courts in interpreting *Howey*, however, have broken the test down into distinct elements. See, e.g., *Hunssinger v. Rockford Bus. Credits, Inc.*, 745 F.2d 484, 489 (7th Cir. 1984) (breaking down the *Howey* test into four parts); *Kansas State Bank v. Citizens Bank*, 737 F.2d 1490, 1494 (8th Cir. 1984) (same); *American Bank & Trust Co. v. Wallace*, 702 F.2d 93, 96 (6th Cir. 1984) (same); *United Am. Bank v. Gunter*, 620 F.2d 1108, 1114 (5th Cir. 1980) (same); see also *Odom v. Slavik*, 703 F.2d 212, 214 (6th Cir. 1983) (*per curiam*) (breaking down the *Howey* test into three parts); *Gordon v. Terry*, 684 F.2d 736, 740 (11th Cir. 1982) (same), *cert. denied*, 459 U.S. 1203 (1983); *Smith v. Gross*, 604 F.2d 639, 642 (9th Cir. 1979) (same).

29. See *Howey*, 328 U.S. at 298-99.



money of others on the promise of profits."<sup>30</sup> This construction has led the federal courts to interpret the elements of the *Howey* test broadly.<sup>31</sup>

### B. *The Significance of the Howey Test to General Partnership Interests*

A general partnership interest will normally satisfy the first three prongs of the *Howey* test.<sup>32</sup> In most cases the general partner will have made an investment into the partnership in the form of a capital contribution,<sup>33</sup> expecting to receive profits.<sup>34</sup> In addition, a general partnership will normally be considered a common enterprise.<sup>35</sup>

30. *Id.* at 299.

31. See *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967); *Williamson v. Tucker*, 645 F.2d 404, 418 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981); *SEC v. Glenn W. Turner Enters.*, 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973). See *infra* notes 32-44 and accompanying text.

32. See *Wagner v. Bear, Stearns & Co.*, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,032, at 94,913 (N.D. Ill. Sept. 17, 1982).

33. See J. Mulder, M. Volz & A. Berger, *The Drafting of Partnership Agreements* 12 (1967); *cf.* U.P.A. § 18(a), (c) (1914). This contribution will usually be in the form of money, although a contribution of goods or services will satisfy the *Howey* test as long as it is not designed to enhance the profitability of the investment. See *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 560 & n.12 (1979); *Sandusky Land, Ltd. v. Uniplan Groups, Inc.*, 400 F. Supp. 440, 445 (N.D. Ohio 1975).

The Ninth Circuit has gone so far as to hold that the use of investors' credit in the form of a promissory note was sufficient to satisfy the "investment of money" prong of the *Howey* test. See *Hector v. Wiens*, 533 F.2d 429, 432-33 (9th Cir. 1976) (*per curiam*); *El Khadem v. Equity Sec. Corp.*, 494 F.2d 1224, 1228-29 (9th Cir.), *cert. denied*, 419 U.S. 900 (1974).

34. An enterprise cannot be considered a partnership unless it was organized to make a profit for its members. See generally J. Crane & A. Bromberg, *Law of Partnership* § 13, at 63-65 (1968). The Supreme Court has noted that this prong of the *Howey* test may be satisfied either by profits generated through a capital appreciation resulting from the development of the initial investment or by having the investors participate in the earnings that have resulted from the use of their funds. See *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 852 (1975) (citing *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943) and *Tcherepnin v. Knight*, 389 U.S. 332 (1967)). It is also possible that potential tax benefits could satisfy the requirement of profits. This issue can be very important in determining whether partnership interests can qualify as securities, because investors frequently choose to invest in a partnership mainly because of its potential tax benefits. Since the expectation of a tax saving may have actually induced the investment, it is arguable that this potential tax benefit should be considered an investor's expected profit satisfying the third prong of the *Howey* test. See *SEC v. International Mining Exch., Inc.*, 515 F. Supp. 1062, 1069 (D. Colo. 1981); *Stowell v. Ted S. Finkel Inv. Servs., Inc.*, 489 F. Supp. 1209, 1221 (S.D. Fla. 1980), *aff'd*, 641 F.2d 323 (5th Cir. 1981); *Sharp v. Coopers & Lybrand*, 457 F. Supp. 879, 889 (E.D. Pa. 1978), *aff'd in part and vacated in part*, 649 F.2d 175 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982).

The Supreme Court noted in *Forman*, 421 U.S. at 855 (1975), that certain tax benefits did not qualify as profits. These tax benefits were of the type available to all homeowners. *Id.* at 855. In a footnote, the Court stated that even if tax deductions were considered profits, they could not be said to derive from a "security investment" if they did not result from the managerial efforts of others. See *id.* at 855 n.20.

35. Another issue arises as to what degree of commonality must be present in order for the *Howey* test to be satisfied. Some courts require the presence of horizontal commonality, which is a comingling of the various funds or a private sharing of profits. See

The determination of whether a general partnership interest is an investment contract will turn on one of the most litigated aspects of the *Howey* test: whether profits are expected *solely from the efforts of others*. A literal reading of the word "solely" would almost always prevent a general partnership interest from being an investment contract because general partners, given their participatory role in the enterprise, will not depend solely on the efforts of others for profits. Promoters of investment schemes would be able to evade the securities laws<sup>36</sup> by creating investments in the form of general partnership interests and by requiring the investing general partners to "contribute a modicum of effort" to the scheme.<sup>37</sup> Such schemes would thwart the remedial purposes behind the securities laws.<sup>38</sup>

Realizing this potential for abuse, the Ninth Circuit, in *SEC v. Glenn W. Turner Enterprises*,<sup>39</sup> noted that it would adopt a more realistic approach to investment contract analysis.<sup>40</sup> The Ninth Circuit stated that a court must determine "whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."<sup>41</sup>

This interpretation of the *Howey* test recognizes that even when an

*Salcer v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 682 F.2d 459, 460 (3d Cir. 1982) (investment did not satisfy *Howey* test because it was not part of a pooled group of funds); *Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 622 F.2d 216, 222-24 (6th Cir. 1980) (a relationship that ties the fortunes of each investor to the success of the overall venture is required), *aff'd on other grounds*, 456 U.S. 353 (1982); *Hirk v. Agri-Research Council, Inc.*, 561 F.2d 96, 101 (7th Cir. 1977) ("a sharing or pooling of funds is required by *Howey*"). Other courts require the presence of vertical commonality for the investor and promoter to be engaged in a common enterprise. See *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 478 (5th Cir. 1974) ("[t]he critical factor is . . . the uniformity of impact of the promoter's efforts"); *SEC v. Glenn W. Turner Enters.*, 474 F.2d 476, 482 n.7 (9th Cir.) (the fortunes of the investor must be "interwoven with and dependent upon the efforts . . . of those seeking the investment or of third parties"), *cert. denied*, 414 U.S. 821 (1973). See generally Note, *Discretionary Commodity Accounts as Securities: An Application of the Howey Test*, 53 Fordham L. Rev. 639, 646-50 (1984) (discussing the circuit courts' differing analyses of the common enterprise requirement).

36. See *Odom v. Slavik*, 703 F.2d 212, 214-15 (6th Cir. 1983) (per curiam); *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 480 (5th Cir. 1974); *Lino v. City Investing Co.*, 487 F.2d 689, 692-93 (3d Cir. 1973); *SEC v. Glenn W. Turner Enters.*, 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973); *Rogers v. Cowley*, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. ¶ 99,178, at 95,684 (N.D. Ga. Mar. 14, 1983).

37. See *SEC v. Glenn W. Turner Enters.*, 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

38. See *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967); *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 480 (5th Cir. 1974); *Nor-Tex Agencies, Inc. v. Jones*, 482 F.2d 1093, 1098 (5th Cir. 1973), *cert. denied*, 415 U.S. 977 (1974); *SEC v. Glenn W. Turner Enters.*, 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973); *Rogers v. Cowley*, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,178, at 95,684 (N.D. Ga. Mar. 14, 1983); cf. *In re Caesars Palace Sec. Litig.*, 360 F. Supp. 366, 382-83 (S.D.N.Y. 1973) (court adopted liberal interpretation of privity requirement under § 12(2) of 1933 Act in recognition of Act's remedial nature).

39. 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

40. See *id.* at 482.

41. *Id.*

investor performs some very minor, nominal services for an investment scheme,<sup>42</sup> the investor may still lack access to the information necessary to enable him to protect his investment.<sup>43</sup> Most circuits have accepted this interpretation of *Howey*.<sup>44</sup>

## II. THE CONTROVERSY

There is disagreement on whether a general partnership interest can ever be considered a security for purposes of the federal securities laws. Under one view general partnership interests cannot be securities as a matter of law because general partners possess certain statutory powers.<sup>45</sup> The other view focuses on the factual reality of the given case and analyzes the actual rights and abilities of the general partner.<sup>46</sup> Both approaches purport to place central importance on the "efforts" or "solely" prong of the *Howey* test.<sup>47</sup>

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42. For example, while the investors in *Glenn W. Turner* (who were considered security holders) were required to lure other potential investors to the scheme, the people in charge of the enterprise actually sold the investments. See *Glenn W. Turner Enters.*, 474 F.2d at 482-83.

43. See *Hirsch v. duPont*, 396 F. Supp. 1214, 1219 (S.D.N.Y. 1975), *aff'd*, 553 F.2d 750 (2d Cir. 1977).

44. See, e.g., *SEC v. Professional Assocs.*, 731 F.2d 349, 357 (6th Cir. 1984); *Goodwin v. Elkins & Co.*, 730 F.2d 99, 103 (3d Cir.), *cert. denied*, 105 S. Ct. 118 (1984); *SEC v. Aqua-Sonic Prods. Corp.*, 687 F.2d 577, 582 (2d Cir.), *cert. denied*, 459 U.S. 1086 (1982); *Kim v. Cochenour*, 687 F.2d 210, 213 n.7 (7th Cir. 1982); *Williamson v. Tucker*, 645 F.2d 404, 418 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981); *Aldrich v. McCulloch Properties, Inc.*, 627 F.2d 1036, 1040 n.3 (10th Cir. 1980); *Fargo Partners v. Dain Corp.*, 540 F.2d 912, 914-15 (8th Cir. 1976). The First and Fourth Circuits have not had the opportunity to decide this issue; the Eleventh Circuit has refrained from doing so. See *Phillips v. Kaplus*, 764 F.2d 807, 816 & n.9 (11th Cir. 1985) *cert. denied*, 54 U.S.L.W. 3460 (U.S. Jan. 14, 1986).

The Supreme Court has on occasion omitted the word "solely" in discussion of the *Howey* test. See *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 561 (1979). Nonetheless, the Court has explicitly declined to express a view on whether "solely" should be interpreted literally or whether the essential managerial efforts test of *Glenn W. Turner* should be used when applying *Howey*. See *United House Found., Inc. v. Forman*, 421 U.S. 837, 852 n.16 (1975). If the Supreme Court were to decide this issue, however, it would be very unlikely to follow a mechanical reading of this prong of the *Howey* test in light of its mandate that the substance and not the form of an investment scheme should govern and that the factual economic realities behind the scheme should be scrutinized. See *supra* note 11 and accompanying text.

45. See *Goodwin v. Elkins & Co.*, 730 F.2d 99, 103-04 (3d Cir.) (opinion of Garth, J.) (citing 59 Pa. Cons. Stat. Ann. §§ 301-365 (Purdon Supp. 1983)), *cert. denied*, 105 S. Ct. 118 (1984); *Hirsch v. duPont*, 396 F. Supp. 1214, 1220 (S.D.N.Y. 1975) (adopting much of the reasoning of *New York Stock Exch. v. Sloan*, 394 F. Supp. 1303, 1314 (S.D.N.Y. 1975) (citing N.Y. Partnership Law §§ 10-11, 26 (Mc Kinney 1948)), *aff'd*, 553 F.2d 750 (2d Cir. 1977).

46. See *SEC v. Professional Assocs.*, 731 F.2d 349, 357 (6th Cir. 1984); *Williamson v. Tucker*, 645 F.2d 404, 424 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981); *McConnell v. Frank Howard Allen & Co.*, 574 F. Supp. 781, 786 (N.D. Cal. 1983); *Morrison v. Pelican Land Dev.*, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,863, at 94,480-81 (N.D. Ill. Aug. 20, 1982); see also *Pfohl v. Pelican Landing*, 567 F. Supp. 134, 137 (N.D. Ill. 1983) (quoting *Williamson*, 645 F.2d at 424).

47. See, e.g., *Goodwin v. Elkins & Co.*, 730 F.2d 99, 103 (3d Cir.), *cert. denied*, 105 S.

### A. *The Matter of Law Approach*

A proponent of the matter of law approach will often look to the statutory rights of a general partner<sup>48</sup> and assume that a general partner possesses the ability to exercise those rights and therefore has a voice in managing partnership affairs.<sup>49</sup> The Third Circuit recently used this analysis in *Goodwin v. Elkins & Co.*,<sup>50</sup> holding, as a matter of law, that one who holds a general partnership interest does not possess a security for purposes of the federal securities laws.<sup>51</sup>

The plaintiff, Mr. Goodwin, was a general partner in a brokerage and securities limited partnership.<sup>52</sup> Goodwin brought an action alleging violations of Section 10(b) of the 1934 Act<sup>53</sup> and Rule 10b-5.<sup>54</sup> He claimed that based on the defendants' false representations made to him, including the misrepresentation that the firm was not planning to merge or to be sold, he resigned from the company.<sup>55</sup> Shortly thereafter, the company was acquired by Bache, Halsey, Stuart and the value of the partnership interest he had relinquished rose considerably.<sup>56</sup>

Judge Garth, announcing the judgment of the court, held that plaintiff's interest in the partnership could not qualify as a security because "the role of a general partner, *by law*, extends well beyond the permitted role of a passive investor."<sup>57</sup> This holding would apparently prevent any general partner<sup>58</sup> from ever having an opportunity to prove that he

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Ct. 118 (1984); *SEC v. Professional Assocs.*, 731 F.2d 349, 357 (6th Cir. 1984); *Williamson v. Tucker*, 645 F.2d 404, 418 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981); *Hirsch v. duPont*, 396 F. Supp. 1214, 1218-19 (S.D.N.Y. 1975), *aff'd*, 553 F.2d 750 (2d Cir. 1977).

48. See *supra* note 45 and accompanying text.

49. See *Goodwin v. Elkins*, 730 F.2d 99, 103 (3d Cir.) (opinion of Garth, J.), *cert. denied*, 105 S. Ct. 118 (1984); *Hirsch v. duPont*, 396 F. Supp. 1214, 1220 (S.D.N.Y. 1975), *aff'd*, 553 F.2d 750 (2d Cir. 1977); *New York Stock Exch. v. Sloan*, 394 F. Supp. 1303, 1314 (S.D.N.Y. 1975); *cf. Elson v. Geiger*, 506 F. Supp. 238, 243 (E.D. Mich. 1980), *aff'd*, 701 F.2d 176 (6th Cir. 1982).

50. 730 F.2d 99 (3d Cir.), *cert. denied*, 105 S. Ct. 118 (1984). While Judge Garth announced the judgment of the court, his analysis with regard to the matter of law approach was not shared by his colleagues. *Id.* at 103.

51. See *id.* at 108 (Garth, J.).

52. *Id.* at 101 (Garth, J.).

53. 15 U.S.C. § 78j(b) (1982).

54. 17 C.F.R. § 240.10b-5 (1985).

55. *Goodwin*, 730 F.2d at 101 (Garth, J.).

56. *Id.*

57. *Id.* at 103 (Garth, J.) (emphasis in original). Judge Garth went a step further, characterizing as dicta the parts of *Williamson v. Tucker*, 645 F.2d 404 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981), which stated that some forms of general partnership interests could be securities. See *Goodwin*, 730 F.2d at 106 n.11 (Garth, J.). In his view *Williamson* only stands for the proposition that for a case to be dismissed for lack of subject matter jurisdiction the plaintiff's claims must be made solely to obtain federal jurisdiction. *Id.* Regardless of the accuracy of this argument, the *Williamson* analysis has been quoted and adopted by many other courts. See *infra* note 88 and accompanying text.

58. Although Judge Garth's conclusion that Mr. Goodwin's general partnership interest was not a security was probably correct even under *Williamson*, his analysis was overinclusive.

owned a security in the form of an investment contract by satisfying the requirements of the *Howey* test.

Judge Garth based his opinion on the statutory rights and powers granted the general partner,<sup>59</sup> reasoning that a partnership agreement could not so diminish these statutory powers as to make the general partnership interest a security.<sup>60</sup> His opinion discussed many provisions of the Pennsylvania Partnership Act<sup>61</sup> to demonstrate the extensive powers of a general partner and to conclude that one who has such powers cannot have expected to receive profits solely from the efforts of others.<sup>62</sup>

The partnership rights and duties emphasized by Judge Garth's opinion are those of the general partners with respect to third parties,<sup>63</sup> not the rights of the partners among themselves to control and manage the business of the partnership. Hence, these rights do not necessarily give the general partner access to the kind of information that would help the general partner protect himself. The fourth prong of the *Howey* test, as interpreted by *Glenn W. Turner*, considers the partner's actual control over the management of the enterprise to determine whether profits are expected from the efforts of others.<sup>64</sup> The Garth analysis, however, does not acknowledge the relevance of the actual functioning and managing of

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59. See *Goodwin v. Elkins*, 730 F.2d 99, 103-04 & n.7 (3d Cir.) (Garth, J.) (citing 59 Pa. Cons. Stat. Ann. §§ 301-365 (Purdon Supp. 1983)), *cert. denied*, 105 S. Ct. 118 (1984).

60. *Id.* at 104. Other courts at times have followed an analysis similar to Judge Garth's opinion in *Goodwin*. In *New York Stock Exch. v. Sloan*, 394 F. Supp. 1303 (S.D.N.Y. 1975) the court stated that general partners are not passive investors and therefore could not be considered investors in securities. See *id.* at 1314. The court emphasized that a partner's responsibility under New York partnership law for acts of the partnership could not be diminished even if the general partner chose to delegate his duties. See *id.* The court did not extensively analyze the fourth prong of the *Howey* test, but stated that whether a general partnership interest is a security "does not and should not hinge on the particular degree of responsibility he assumes within the firm." *Id.*; see also *Hirsch v. duPont*, 396 F. Supp. 1214, 1220 (S.D.N.Y. 1975) (adopting the *Sloan* reasoning), *aff'd*, 553 F.2d 750 (2d Cir. 1977). The court in *Hirsch* noted that the rights and duties granted by the partnership articles were not a sham designed to evade the strictures of the *Howey* test.

61. 59 Pa. Cons. Stat. Ann. §§ 301-365 (Purdon Supp. 1983). Judge Garth particularly noted certain rights under this act, including: each general partner can bind the partnership while conducting business with third parties; each partner has unlimited liability for partnership losses; the partnership is liable for wrongful acts or breaches of trust by partners; and notice to one general partner is equal to notice to the entire partnership. See *Goodwin*, 730 F.2d at 104.

62. See *Goodwin*, 730 F.2d at 104 (Garth, J.). Judge Garth noted that even if the Elkins partnership agreement contained the most draconian restrictions on the rights of the nonmanaging general partners, these partners would still have enough legal power and responsibility to preclude such interests from being considered securities. See *id.* at 107.

63. See *supra* note 61.

64. See *SEC v. Glenn W. Turner Enters.*, 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

the partnership.<sup>65</sup>

### B. *The Factual Reality Approach*

Courts employing the factual reality approach<sup>66</sup> look beyond the rights of a general partner as set forth by statute or by the partnership agreement to scrutinize the partner's ability to manage the partnership.<sup>67</sup> These courts seek to determine whether the investing general partner actually depends on the managing efforts of others to control partnership affairs.<sup>68</sup>

This approach was initially set forth in *Williamson v. Tucker*,<sup>69</sup> in which the Fifth Circuit described three sets of circumstances under which a general partnership interest could appropriately be treated as a security.<sup>70</sup> These circumstances were referred to by the court as examples of situations that would give rise to an investor's dependence on the promoter.<sup>71</sup> These examples were not considered exhaustive.<sup>72</sup>

The Fifth Circuit's analysis requires an evaluation of the capabilities of the general partner to determine whether the investing general partner

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65. See *Goodwin v. Elkins & Co.*, 730 F.2d 99, 100-08 (3d Cir.) (Garth, J.), *cert. denied*, 105 S. Ct. 118 (1984).

In contrast, the concurring opinions of Chief Judge Seitz and Judge Becker were not based on the statutory rights afforded general partners but on the particular partnership agreement at hand. See *id.* at 111-13 (Seitz, C.J., concurring); *id.* at 113-14 (Becker, J., concurring). They both stop short of the broad sweep of the opinion announcing the judgment of the court, reasoning that it was unnecessary to decide whether the statutory rights granted to general partners were substantial enough to preclude a general partner from claiming that his interest was a security. See *id.* at 112 (Seitz, C.J., concurring); *id.* at 114 (Becker, J., concurring).

66. See, e.g., *SEC v. Professional Assocs.*, 731 F.2d 349 (6th Cir. 1984); *Gordon v. Terry*, 684 F.2d 736 (11th Cir. 1982), *cert. denied*, 459 U.S. 1203 (1983); *Williamson v. Tucker*, 645 F.2d 404 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981); *McConnell v. Frank Howard Allen & Co.*, 574 F. Supp. 781 (N.D. Cal. 1983); *Rogers v. Cowley*, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,178 (N.D. Ga. Mar. 14, 1983); *Morrison v. Pelican Land Dev.*, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,863 (N.D. Ill. Aug. 20, 1982).

67. See, e.g., *McConnell v. Frank Howard Allen & Co.*, 574 F. Supp. 781, 786 (N.D. Cal. 1983); *Rogers v. Cowley*, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,178, at 95,684 (N.D. Ga. Mar. 14, 1983); *Morrison v. Pelican Land Dev.*, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,863, at 94,481 (N.D. Ill. Aug. 20, 1982).

68. See, e.g., *Odom v. Slavik*, 703 F.2d 212, 216 (6th Cir. 1983) (per curiam); *Gordon v. Terry*, 684 F.2d 736, 742 (11th Cir. 1982), *cert. denied*, 459 U.S. 1203 (1983); *Williamson v. Tucker*, 645 F.2d 404, 424 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981); *Pfohl v. Pelican Landing*, 567 F. Supp. 134, 137 (N.D. Ill. 1983).

69. 645 F.2d 404 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981).

70. See *id.* at 424. The Fifth Circuit's analysis is applicable to joint venture interests as well. The two business forms are quite similar, and most states apply many of the rules of partnership law to joint ventures. The joint venture, however, is normally established to perform a particular undertaking and is usually dissolved on completion while the partnership is a more permanent entity. See generally J. Crane & A. Bromberg, *supra* note 34, § 35, at 189-95; H. Henn & J. Alexander, *Law of Corporations* § 49, at 105-09 (1983); H. Reuschlein & W. Gregory, *Agency & Partnership*, § 266, at 441-46 (1979).

71. See *Williamson*, 645 F.2d at 424.

72. *Id.* at 424 n.15.

expected to rely on the efforts of others for profits.<sup>73</sup> This scrutiny would be appropriate even though the actual partnership agreement seemed to provide all general partners with the power to control the business.<sup>74</sup> One aim of the *Williamson* analysis is to determine whether the partnership agreement accurately reflects the behavior and abilities of the general partners.<sup>75</sup>

Under *Williamson*, a general partnership interest can be considered a security if

- (1) an agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership; or
- (2) the partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or
- (3) the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers.<sup>76</sup>

The Fifth Circuit thus seems to acknowledge that a general partnership

73. *See id.* at 423.

74. *Id.* at 424.

75. *See id.*

76. *Id.* The first example may be of questionable validity because it assumes that all limited partnership interests qualify as securities and therefore a partnership agreement that distributes power as would a limited partnership should also be construed as creating a security. For cases holding that limited partnership interests are not securities, see *Bank of Am. Nat'l Trust & Sav. Ass'n v. Hotel Rittenhouse Assoc.*, 595 F. Supp. 800, 807 (E.D. Pa. 1984) (since partnership agreement gave limited partner partnership powers, hotel developers' limited partnership agreement was not a security for purposes of federal securities laws); *Darrah v. Garrett*, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,472, at 98,365 (N.D. Ohio Mar. 14, 1984) (because they exercised control over the profit and loss potential of their investments limited partners' interests were not securities).

A more precise analysis, however, would determine whether the specific partnership interest, limited or general, meets the four criteria of an investment contract as set forth in *Howey*. This is necessary because the limited partner label does not always accurately reflect the powers of the investor, just as the general partner label does not always accurately reflect the powers of a general partner. *See Gordon v. Terry*, 684 F.2d 736, 740-41 & n.5 (11th Cir. 1982), *cert. denied*, 459 U.S. 1203 (1983).

If instead, this first example were reworded to state that a general partnership interest should be considered a security if "an agreement among the parties distributes power as would normally be possessed by a classic limited partner," the *Howey* requirements would definitely be satisfied because classic limited partnership interests will pass the *Howey* test. *See Mayer v. Oil Field Sys. Corp.*, 721 F.2d 59, 65 (2d Cir. 1983) (limited partnership interests are generally securities under *Howey*); *SEC v. Holschuh*, 694 F.2d 130, 137 (7th Cir. 1982) (limited partnership interests were securities); *SEC v. Murphy*, 626 F.2d 633, 640-41 (9th Cir. 1980) (same); *Goodman v. Epstein*, 582 F.2d 388, 406-09 (7th Cir. 1978) (court held as a matter of law that limited partnership interest was a security because on its face the interest met all the requirements of *Howey*), *cert. denied*, 440 U.S. 939 (1979); *McGregor Land Co. v. Meguiar*, 521 F.2d 822, 824 (9th Cir. 1975) (limited partnership interests were securities); *Stowell v. Ted S. Finkel Inv. Serv., Inc.*, 489 F. Supp. 1209, 1224 (S.D. Fla. 1980) (undisputed facts of case allowed court to conclude that limited partnership interests were securities), *aff'd*, 641 F.2d 323 (5th Cir.

interest is denied securities protection only if the partner possesses both the designated right and the actual ability to control his investment in the partnership.<sup>77</sup>

Unfortunately for the joint venturers in *Williamson*, the court was unable to find investor dependence sufficient to qualify the interests as securities. Three people each owned undivided one-third interests in a 160-acre tract of land near the proposed site of the Dallas-Fort Worth airport.<sup>78</sup> As a result of a series of transactions, three separate joint venture groups bought new undivided one-third interests in the property.<sup>79</sup> The transactions were arranged by Godwin Investments, which had purchased an interest in the property and then attracted potential investors to participate in the joint venture.<sup>80</sup> As part of its scheme, Godwin Investments represented that it would perform all management duties to "assure the maximum profit potential of each investment."<sup>81</sup>

In its analysis, the court noted that the partnership agreement allocated powers sufficient to give the venturers the right to control their investment.<sup>82</sup> In addition, the plaintiffs were capable of exercising such control because of their considerable business experience and the knowl-

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1981). The SEC has also supported this view. See Securities Act Release No. 33-4877, 1 Fed. Sec. L. Rep. (CCH) ¶ 1046, at 2062-63 (Aug. 8, 1967).

If a general partner acquires a limited partnership interest before he becomes a general partner, it is arguable that his limited partnership interest should be considered a security even though he participates in the management of the business because he may have expected profits to be generated through the efforts of others at the time of the purchase. Compare *Hirsch v. duPont*, 396 F. Supp. 1214, 1228 (S.D.N.Y. 1975) (plaintiffs' limited partnership interests were considered separately from their general partnership interests because both were purchased at the same time and fraudulent inducements to purchase the limited partnership interests were allegedly made before plaintiffs became general partners), *aff'd*, 553 F.2d 750 (2d Cir. 1977) with *Frazier v. Manson*, 651 F.2d 1078, 1080-81 (5th Cir. 1981) (a partner in a general partnership which later became the general partner of limited partnerships was not allowed to isolate his general and limited partnership interests and therefore his limited partnership interest was not a security).

Section 7 of the Uniform Limited Partnership Act (U.L.P.A.) provides that a limited partner will lose his limited liability if he takes part in the control of the business. See U.L.P.A. § 7 (1916). What constitutes control, however, is not clear. See *Feld*, *The "Control" Test for Limited Partnerships*, 82 Harv. L. Rev. 1471 (1969) (arguing that under the U.L.P.A. no adequate standard of control has emerged). The Revised Uniform Limited Partnership Act (R.U.L.P.A.) takes the same view, but provides that certain acts of a limited partner will not be considered control. For example, § 303(2) states that a limited partner will not be deemed to participate in the control of the partnership if he consults with and advises a general partner with respect to the business of the limited partnership. See R.U.L.P.A. § 303(2) (1976). This notion may not be consistent with the general rule that a classic limited partnership interest will be considered a security under the *Howey* test.

77. See *Williamson v. Tucker*, 645 F.2d 404, 424 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981).

78. *Id.* at 407.

79. *Id.* at 407-08.

80. *Id.* at 408.

81. *Id.* (capitalization omitted).

82. See *id.* at 424.



edge they had acquired as real estate venturers.<sup>83</sup> Last, the court found that since the plaintiffs were capable of replacing the management of Godwin Investments, they were not solely dependent on that management to operate the scheme.<sup>84</sup>

*Williamson* thus precludes finding a general partnership interest to be a security if the investor's right to control the enterprise is accompanied by the actual ability to control the enterprise.<sup>85</sup> It recognizes that if the general partner retains substantial power and the capacity to exercise it, his general partnership interest will not be deemed a security. Thus, the *Williamson* approach is consistent with the view that the securities laws were not enacted to protect against all fraud<sup>86</sup> and would not provide federal securities laws protection to classic general partners. *Williamson* will, however, protect the truly passive investor even though he is termed a general partner.

The Securities and Exchange Commission<sup>87</sup> and many federal courts<sup>88</sup> have endorsed the *Williamson* approach. Courts that employ it do so as an extension of the "efforts" or "solely" prong of the *Howey* test. For example, in *Morrison v. Pelican Land Development*,<sup>89</sup> the District Court for the Northern District of Illinois relied on the second<sup>90</sup> and third<sup>91</sup>

83. *Id.* at 424-25.

84. *See id.* at 425.

85. The investor's right to control the enterprise refers to a de jure right while his actual ability to do so refers to a de facto condition.

86. *See Landreth Timber Co. v. Landreth*, 105 S. Ct. 2297, 2303 (1985); *Marine Bank v. Weaver*, 455 U.S. 551, 556 (1982); *Odom v. Slavik*, 703 F.2d 212, 215 (6th Cir. 1983) (per curiam); *Gordon v. Terry*, 684 F.2d 736, 744 (11th Cir. 1982), *cert. denied*, 459 U.S. 1203 (1983); *Elson v. Geiger*, 506 F. Supp. 238, 243 (E.D. Mich. 1980), *aff'd*, 701 F.2d 176 (6th Cir. 1982); *cf. Bellah v. First Nat'l Bank*, 495 F.2d 1109, 1114 (5th Cir. 1974) ("We doubt that Congress intended by these Acts to render federal judges the guardians of all beguiled makers or payees.").

87. *See, e.g.*, FCA Realty Fund, No-Action Letter, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,841, at 79,234 (available Nov. 13, 1984); Realex Capital Corp., No-Action Letter, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,611, at 78,843 (available Mar. 19, 1984); Riverbottom Land Co., No-Action Letter (Available Dec. 27, 1982, on LEXIS Fedsec Library, Noact file).

While the opinion of an administrative agency such as the SEC can be quite persuasive and is often given great weight, it is not binding on the courts. *See International Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 566 n.20 (1979).

88. *See, e.g.*, SEC v. Professional Assocs., 731 F.2d 349, 357 (6th Cir. 1984); *Odom v. Slavik*, 703 F.2d 212, 216 (6th Cir. 1983) (per curiam); *Kim v. Cochenour*, 687 F.2d 210, 213 n.7 (7th Cir. 1982); *Gordon v. Terry*, 684 F.2d 736, 741-42 (11th Cir. 1982), *cert. denied*, 459 U.S. 1203 (1983); *McConnell v. Frank Howard Allen & Co.*, 574 F. Supp. 781, 785-86 (N.D. Cal. 1983); *Pfohl v. Pelican Landing*, 567 F. Supp. 134, 137 (N.D. Ill. 1983); *Rogers v. Cowley*, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,178, at 95,684 (N.D. Ga. Mar. 14, 1983); *Morrison v. Pelican Land Dev.*, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,863, at 94,480-81 (N.D. Ill. Aug. 20, 1982); *Fund of Funds, Ltd. v. Arthur Andersen & Co.*, 545 F. Supp. 1314, 1348-49 (S.D.N.Y. 1982).

89. [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,863 (N.D. Ill. Aug. 20, 1982).

90. *Id.* at 94,481; *see Williamson*, 645 F.2d at 424 ("the partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers").

examples of the *Williamson* analysis. The plaintiff, a Chicago police officer with a high school education,<sup>92</sup> became one of nineteen general partners in Pelican Land Development by investing over \$100,000.<sup>93</sup> He claimed he decided to invest in the development after the defendant, his lawyer, lied to him about it.<sup>94</sup> The defendants argued that plaintiff's general partnership interest gave him a right to control the partnership equal to that of the other general partners.<sup>95</sup> Plaintiff contended that he could exercise no real control over the venture because he lacked the expertise,<sup>96</sup> and that he actually depended on the managing partners, to whom the partnership agreement gave the power to control the day-to-day affairs of the partnership.<sup>97</sup> The court denied defendant's motion for summary judgment because it was a disputed issue of fact whether the second and third examples of *Williamson* were satisfied.<sup>98</sup>

### III. THE SECURITIES STATUS OF GENERAL PARTNERSHIP INTERESTS: A PROPOSED SEQUENCE OF ANALYSIS

The alternative approaches to determining the securities status of general partnership interests vary markedly in their sensitivity to the substance of the investment at issue. The matter of law approach<sup>99</sup> rigidly refuses to inquire beyond the face of an investment agreement which takes the general partnership form. It makes only a truncated inquiry, correctly commencing with scrutiny of form, but failing to pierce beyond it. The factual reality approach<sup>100</sup> articulated in *Williamson* recognizes that despite the appearance of the general partnership agreement, a general partner, because of his lack of expertise or ability, or because of his dependence on others may actually be a passive investor who merits the

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91. *Morrison*, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH), at 94,481; see *Williamson*, 645 F.2d at 424 ("the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers") (footnote omitted).

92. *Morrison*, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH), at 94,480.

93. *Id.*

94. *Id.*

95. *Id.*

96. *Id.*

97. *Id.* at 94,480 & n.1.

98. See *id.* at 94,481. In a similar context, the District Court for the Northern District of California used the *Williamson* analysis to deny a motion for summary judgment. See *McConnell v. Frank Howard Allen & Co.*, 574 F. Supp. 781, 786-87 (N.D. Cal. 1983). The plaintiffs, who were designated as nonmanaging general partners of a real estate venture, claimed that they were defrauded, and sued under the 1934 Act (appending many state law claims). *Id.* at 782-83. In denying the motion, the court noted that both the contract and the factual necessity must be scrutinized to determine whether the partners were able to exercise some control over the management of the venture. *Id.* at 786; see also *Gordon v. Terry*, 684 F.2d 736, 742-43 (11th Cir. 1982) (whether defendant's skills created dependency as set forth in *Williamson* was an issue of fact), *cert. denied*, 459 U.S. 1203 (1983).

99. See *supra* Part II.A.

100. See *supra* Part II.B.

protections of the securities laws.<sup>101</sup>

### A. *The Three Stage Analysis*

To ensure that the true relationship between the general partner and the partnership is revealed, an examination of the partnership interest should proceed well beyond the face of the agreement.<sup>102</sup> Accordingly, this Note proposes a three stage analysis.<sup>103</sup>

Each stage focuses on a different kind of evidence, with each stage serving as a threshold to the next.<sup>104</sup>

*Stage One. The partnership agreement.* Inquiry should begin with an assessment of the balance of powers within the partnership,<sup>105</sup> scrutinizing the partnership agreement to determine whether the powers, rights and responsibilities granted the general partner would enable him to exercise a voice in the management and control of the partnership, thus helping to further its goals.<sup>106</sup> This scrutiny helps determine the intent or expectation of the general partners.

*Stage Two. Conduct and behavior of general partner.* The conduct and behavior of the general partner should be examined to determine whether his actions are consistent with the partnership agreement.<sup>107</sup>

*Stage Three. Sophistication of general partner.* The general partner's level of sophistication regarding the particular business of the partnership should be evaluated to determine whether his experience and knowledge would provide him with the ability to make an independent

101. *Williamson v. Tucker*, 645 F.2d 404 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981).

102. *Id.* at 424; *see Lino v. City Investing Co.*, 487 F.2d 689, 693 (3d Cir. 1973) ("It would seem that only through examining all the facts and circumstances surrounding the agreement could the Supreme Court's mandate to emphasize economic reality be given full effect."); *McConnell v. Frank Howard Allen & Co.*, 574 F. Supp. 781, 786 (N.D. Cal. 1983) ("Although an enterprise may be a partnership or a joint venture in form, it may be considered the equivalent of a limited partnership under *Williamson* because by contract or factual necessity certain partners have little or no control over the management of the enterprise.").

103. The proposed test adopts many of the ideas behind the *Howey* test and the *Williamson* analysis. It should be employed only after the first three prongs of the *Howey* test have been satisfied.

104. For discussion of the rationale supporting this analysis, see *infra* Part III.B.

105. U.P.A. § 18 (1914), which sets forth the rules that determine the rights and duties of partners, assumes that the rights and duties of the partners "shall be determined, subject to any agreement between them." *Id.*

While a written agreement will be strong evidence of the general partner's intent, the partnership agreement need not be in writing. *See Bailes v. Bailes*, 261 Ark. 389, 391, 549 S.W.2d 69, 71 (1977); *Stein v. Jung*, 492 S.W.2d 139, 144 (Mo. App. 1973). A security might exist even without a written agreement. *See SEC v. Addison*, 194 F. Supp. 709, 722 (N.D. Tex. 1961).

106. *See infra* notes 109-14 and accompanying text.

107. *See infra* notes 115-20 and accompanying text.

contribution toward the management and control of the partnership.<sup>108</sup>

### 1. Establishing the Rebuttable Presumptions: Stage One

The proposed analysis begins<sup>109</sup> under Stage One with a facial scrutiny of the partnership agreement to assess the powers granted to the complaining general partner.<sup>110</sup> Stage One will set up one of two presumptions, while Stages Two and Three will afford the opportunity to rebut that presumption.

If, in the partnership agreement, the complaining general partner is found to have no powers<sup>111</sup> or only nominal or ministerial powers,<sup>112</sup> he will be presumed to be a security holder<sup>113</sup> and the burden will be on the

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108. See *infra* notes 121-28 and accompanying text.

109. Under the proposed analysis, the determination of whether a general partnership interest is a security is a mixed question of law and fact. If the material facts are undisputed, the issue may be resolved summarily by the court. If there are disputed issues of fact material to the determination of whether a security exists, the court will not resolve the issue summarily. See *Gordon v. Terry*, 684 F.2d 736, 742 (11th Cir. 1982), *cert. denied*, 459 U.S. 1203 (1983); *McConnell v. Frank Howard Allen & Co.*, 574 F. Supp. 781, 786-87 (N.D. Cal. 1983); *Morrison v. Pelican Land Dev.*, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,863, at 94,481 (N.D. Ill. Aug. 20, 1982); *cf. SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943) (" [n]ovel, uncommon, or irregular devices, whatever they appear to be, are also reached [by the 1933 Act] if it be proved as a matter of fact that they [are] . . . investment contracts") (emphasis added).

110. See *Gordon v. Terry*, 684 F.2d 736, 742 (11th Cir. 1982) (beginning analysis with partnership agreement), *cert. denied*, 459 U.S. 1203 (1983).

In the absence of any agreement to the contrary, all partners shall have equal rights in the management and conduct of the partnership business. U.P.A. § 18(e) (1914).

111. The partnership agreement may, in rare instances, vest all the managerial authority in a distinct group of partners or explicitly deny certain partners the right to any voice in partnership affairs. See *McConnell v. Frank Howard Allen & Co.*, 574 F. Supp. 781, 783 (N.D. Cal. 1983) (agreement granting managing partners exclusive management authority over operations); *Hirsch v. duPont*, 396 F. Supp. 1214, 1221 (S.D.N.Y. 1975) (partnership agreement may provide that certain general partners have no legal right to a voice in partnership matters), *aff'd*, 553 F.2d 750 (2d Cir. 1977); *Pawgan v. Silverstein*, 265 F. Supp. 898, 900 (S.D.N.Y. 1967) (general partnership agreement vested all managerial and controlling authority in hands of managing partners) (incorporating facts of *United States v. Silverstein*, 237 F. Supp. 446 (S.D.N.Y.), *aff'd*, 344 F.2d 1016 (2d Cir.), *cert. denied*, 382 U.S. 828 (1965)). This should not be confused with the situation in which a general partner chooses to delegate some of the managerial control of the partnership to a managing or executive committee or to a managing partner. *Cf. J. Mulder, M. Volz & A. Berger, supra* note 33, at 73 (management is frequently delegated to some partners).

112. *Cf. SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 484-85 (5th Cir. 1974) (investor agreed to do certain minimal tasks in exchange for a share in proceeds); *SEC v. Glenn W. Turner Enters.*, 474 F.2d 476, 482-83 (9th Cir.) (same), *cert. denied*, 414 U.S. 821 (1973).

Even if it is found under Stage Two that the general partner is performing some partnership task that was not reflected in the partnership agreement he will still be presumed a security holder if the task was only nominal or ministerial.

113. The intent and good faith of the promoter may also be considered as part of the assessment of the partnership agreement. Evidence that the promoter intended to avoid the securities laws by granting either illusory or inconsequential powers and responsibilities should figure in the court's initial characterization of the partnership interest at issue. Such evidence, however, may be difficult to establish.

defendant, under Stage Two, to rebut that presumption by proving that the general partner actually exercised or expected to exercise real partnership power. If the complaining general partner does possess significant power on the face of the partnership agreement,<sup>114</sup> he will be presumed to be a classic general partner and therefore not a security holder. It will be his burden to overcome this presumption. The general partner will be able to satisfy his burden if he can prove under Stage Two that he did not exercise his powers and under Stage Three that he did not have the capacity to exercise this power independently.

## 2. Comparing the Partnership Agreement to the Complaining General Partner's Behavior: Stage Two

If defendant can prove under Stage Two that the complaining partner's behavior does not truly reflect the apparently powerless position defined in the partnership agreement and that in fact the general partner participated in the management or control of the partnership, the partnership agreement will be deemed waived or modified, and no security will exist.<sup>115</sup> This may be shown, for example, if the defendant can prove

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114. See, e.g., *Goodwin v. Elkins & Co.*, 730 F.2d 99, 105 (3d Cir.) ("[T]he Partnership Agreement provides that any general partner may participate in the nomination, election, or removal of the Executive committee and the Managing Partner. . . . The general partners as a group also maintain ultimate managerial control through oversight of the Executive Committee and the Managing Partner. . . . General partners must approve new admissions into the partnership and involuntary terminations of the partnership."), *cert. denied*, 105 S. Ct. 118 (1984); *Gordon v. Terry*, 684 F.2d 736, 741 n.5 (11th Cir. 1982) (agreement permits partners to control, by majority vote, decisions regarding partnership property), *cert. denied*, 459 U.S. 1203 (1983); *Williamson v. Tucker*, 645 F.2d 404, 424 (5th Cir.) (partnership agreement allowed investors to exercise ultimate control), *cert. denied*, 454 U.S. 897 (1981); *Morrison v. Pelican Land Dev.*, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,863, at 94,480 n.1 (N.D. Ill. Aug. 20, 1982) (partnership agreement clearly gave the complaining general partner a right to control the partnership affairs equal to that of all other partners subject only to the managing partners' "day to day" control over the partnership); *Bank of Am. Nat'l Trust & Sav. Ass'n v. Hotel Rittenhouse Assocs.*, 595 F. Supp. 800, 806 & n.1 (E.D. Pa. 1984) (general partners were not authorized to act unless their acts had first been approved); *Hirsch v. duPont*, 396 F. Supp. 1214, 1221 (S.D.N.Y. 1975) (disputes resolved by a majority in interest of the general partners, with the interest of each general partner based on the number of voting units he held); *Oxford Fin. Cos. v. Harvey*, 385 F. Supp. 431, 434 (E.D. Pa. 1974) (joint venture agreement showed that most managerial decisions must be approved by both parties).

115. Because the relevant portions of the partnership agreement have been waived or modified, the partnership agreement can no longer be looked at as prime evidence of the general partner's intent or expectations. On the contrary, the general partner's present behavior may now become persuasive evidence of his expectation regarding management. Thus, if a general partner exercises partnership powers, it will usually be justifiable to conclude that he expected to exercise these powers.

The investing general partner should be on notice that he has significant rights and the potential to exercise a voice in the control of partnership affairs because he purchased a general partnership interest. See *Williamson v. Tucker*, 645 F.2d 404, 422 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981). Therefore, if he chooses to exercise his partnership powers, he will be deemed to have expected that he had these powers and was waiting for the opportunity to exercise them, unless he can prove otherwise.

that the complaining partner was actually involved in the day-to-day managing of the business<sup>116</sup> or was consulted and gave his advice and opinions on the management and control of the partnership.<sup>117</sup> This may also be shown if it can be proved that the general partner actually had some significant decision making responsibility not reflected in the partnership agreement.<sup>118</sup>

Most partnership agreements will grant general partners more than negligible powers and responsibilities.<sup>119</sup> When this is the case, Stage One makes it necessary to determine whether these distributed powers and responsibilities would enable the general partner to have a voice in the management and control of the partnership. Where Stage One finds that voice, the complaining general partner will be required to rebut the presumption that he is a classic general partner and not a security holder. To do this, he will have to prove under Stage Two that he did not exercise his apportioned<sup>120</sup> powers and under Stage Three that his nonuse of apparent powers arose from a lack of personal ability to do so.<sup>121</sup>

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116. See *Slevin v. Pedersen Assocs.*, 540 F. Supp. 437, 440 (S.D.N.Y. 1982) (joint venture interest not considered an investment contract even though it may not have been foreseen at time of original agreement that plaintiff would contribute to management of the business because when he saw that the venture was not being run correctly, he rendered his services to the scheme); *Goodman v. DeAzoulay*, 539 F. Supp. 10, 14-15 (E.D. Pa. 1981) (joint venturer who actively participated in company activities and paid personal bills with company funds was not a security holder); *Sandusky Land, Ltd. v. Uniplan Groups, Inc.*, 400 F. Supp. 440, 445 (N.D. Ohio 1975) (because plaintiff was to be actively involved in the operation of the business no security was found to exist); *Romney v. Richard Prows, Inc.*, 289 F. Supp. 313, 315 (D. Utah 1968) ("it clearly appears that plaintiff . . . was a participant in a joint venture, the success of which depended to an important degree upon his services and activity in the venture"). *But see* *Rogers v. Cowley*, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,178, at 95,684 (N.D. Ga. Mar. 14, 1983) (although plaintiff was a minority director and worked as the manager of a racquetball facility, he had no ultimate control over the significant managerial policies and decisions and therefore his stock purchases were considered investment contracts and thus securities).

117. *Cf. Andrews v. Blue*, 489 F.2d 367, 375 (10th Cir. 1973) (joint venture interest was found to be a security even though contract referred to plaintiff as a consultant, because he had no real managerial status).

118. *Cf. SEC v. Professional Assocs.*, 731 F.2d 349, 356-57 (6th Cir. 1984) (while joint venture agreement stated all joint venturers were to have a voice in major decisions affecting the venture, evidence showed that some investors were entirely passive); *Schultz v. Dain Corp.*, 568 F.2d 612, 615 (8th Cir. 1978) (plaintiff retained ultimate control over apartment complex and continued to exercise supervisory rights).

119. See *supra* notes 7, 114 and accompanying text.

120. See, e.g., *SEC v. Professional Assocs.*, 731 F.2d 349, 357 (6th Cir. 1984) (evidence demonstrated that some investors were entirely passive); *Andrews v. Blue*, 489 F.2d 367, 375 (10th Cir. 1973) (plaintiff's consultant role was purely nominal as he had no managerial status and was treated as an outsider); *Morrison v. Pelican Land Dev.*, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,863, at 94,480 (N.D. Ill. Aug. 20, 1982) (partner claimed that in reality he exercised no control over the development).

121. See *Odom v. Slavik*, 703 F.2d 212, 216 (6th Cir. 1983) (*per curiam*); *Gordon v. Terry*, 684 F.2d 736, 741-42 (11th Cir. 1982), *cert. denied*, 459 U.S. 1203 (1983); *Williamson v. Tucker*, 645 F.2d 404, 424 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981); *McConnell v. Frank Howard Allen & Co.*, 574 F. Supp. 781, 785-86 (N.D. Cal. 1983); *Pfohl v. Pelican Landing*, 567 F. Supp. 134, 137 (N.D. Ill. 1983); *Morrison v. Pelican Land Dev.*,

### 3. Sophistication of the Complaining General Partner: Stage Three

When previous analysis finds an agreement that gives power, but also that the plaintiff exhibited only passive behavior, the reason for this discrepancy must be determined. In such cases Stage Three will determine whether the general partner simply chose not to exercise his powers<sup>122</sup> or whether his powers were illusory because he was unable to exercise them.<sup>123</sup>

Under Stage Three,<sup>124</sup> the general partner's level of sophistication regarding the particular business of the partnership will be evaluated. Such scrutiny will determine whether the general partner is sophisticated enough to be able to exercise a meaningful voice in controlling and managing the affairs of the partnership or whether he is actually dependent on others to exercise this power.

The second and third examples of *Williamson* suggest the nature of the inquiry needed here to penetrate the factual reality behind the operation of the partnership. *Williamson* instructs us to evaluate the general partner's past experience and knowledge in the particular business of the partnership as an indicator of his potential influence on partnership affairs.<sup>125</sup> Overall investment knowledge will not be a factor sufficient to establish classic general partner status unless such knowledge is significant to the management and control of the particular partnership.

Alternatively, *Williamson* suggests that the court inquire into the general partner's dependence on the promoter.<sup>126</sup> If the promoter possesses such unique, irreplaceable skills that the general partner is at his mercy

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[1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,863, at 94,481 (N.D. Ill. Aug. 20, 1982).

122. See *Elson v. Geiger*, 506 F. Supp. 238, 243 (E.D. Mich. 1980) (plaintiffs possessed significant managerial roles under the partnership documents but chose not to exercise any managerial functions), *aff'd*, 701 F.2d 176 (6th Cir. 1982); *New York Stock Exch. v. Sloan*, 394 F. Supp. 1303, 1314 (S.D.N.Y. 1975) (even though a general partner chose to delegate his managerial responsibilities to a committee, he still had the right to a voice in partnership matters); see also *Schultz v. Dain Corp.*, 568 F.2d 612, 615 (8th Cir. 1978) (investor retained ultimate control over apartment complex but chose to delegate his responsibility to an agent); *Ballard & Cordell Corp. v. Zoller & Danneberg Exploration, Ltd.*, 544 F.2d 1059, 1065 (10th Cir. 1976) (agreement gave defendants considerable operating power and defendants were skilled and should have been able to use this power), *cert. denied*, 431 U.S. 965 (1977); *Fargo Partners v. Dain Corp.*, 540 F.2d 912, 915 (8th Cir. 1976) (investor had power to control business and whether it was exercised was irrelevant); *Mr. Steak, Inc. v. River City Steak Co.*, 460 F.2d 666, 669-70 (10th Cir. 1972) (franchise agreement was not an investment contract where franchisee retained certain powers but simply chose to let franchisor operate the restaurant).

123. See *supra* note 121 and accompanying text.

124. Since Stage Three calls for a subjective inquiry into the background of the complaining general partners involved in the scheme, it is possible for some general partners to possess securities while others do not, within the confines of the same investment scheme. See *Brodsky, General Partner's Interest as a Security*, 189 N.Y.L.J., Feb. 2, 1983, at 1, col. 1.

125. See *Williamson v. Tucker*, 645 F.2d 404, 424-25 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981).

126. See *id.* at 424.

and unable to replace him, the general partner may be deemed to hold a security.<sup>127</sup>

If it is determined under Stage Three that a general partner has the sophistication and ability to contribute to the management and control of the partnership independently but simply chose not to exercise this power or decided to delegate it, he will not have overcome the presumption that he is a classic general partner in fact, and his interest will not be a security. If it is found, however, that he does not have the capacity to exercise his partnership power, he will have met his burden and his interest will be considered a security.<sup>128</sup>

### B. *Williamson and the Three Stage Analysis*

The factual reality approach set forth in *Williamson* points out certain issues to be considered when analyzing the security status of general partnership interests. The three stage analysis proposed here adopts many of the ideas of *Williamson* but also presents a concrete sequence of analysis to determine the factual realities behind each partnership.

By adopting the proposed three stage analysis, courts would put promoters on notice that the regulatory requirements and the potential liabilities imposed by the federal securities laws may be applicable to their investment enterprises even when couched in the form of a general partnership.<sup>129</sup> Those promoters who want to use the general partnership form of business will be forewarned that immunity from securities protection is only available if investors are reasonably sophisticated in the particular business of the partnership and have the knowledge and capacity necessary to protect their interests without the aid of the federal securities laws. The specific multistage analysis will give promoters standards and predictability regarding acceptable and unacceptable arrangements and the potential consequences and liabilities of establishing an investment venture in the form of a general partnership.<sup>130</sup> Requiring

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127. It must be emphasized that *Williamson* does not require the general partner to prove that the promoter possesses such irreplaceable skills. Rather, offer of such proof will be one way the general partner may establish his dependency on the promoter.

128. Merely because a general partner is not able to control the outcome of partnership affairs because he has a minority vote will not automatically make him a security holder. The classic general partner's vote coupled with his level of sophistication in dealing with the business affairs of the partnership would give him influence over the partnership and sufficient control to allow him to protect his interest.

129. The Supreme Court is reluctant to find the existence of a security where an investment is already comprehensively regulated on the federal level. See *Marine Bank v. Weaver*, 455 U.S. 551, 557-59 (1982) (bank certificate of deposit regulated by federal banking laws); *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 569-70 (1979) (employee pension plans regulated by ERISA); see also *Wolf v. Banco Nacional de Mexico, S.A.*, 739 F.2d 1458, 1463 (9th Cir. 1984) (expanding idea to include a foreign government's regulatory structure where this structure provided certificate holders with same degree of protection against insolvency as does U.S. banking system), *cert. denied*, 105 S. Ct. 784 (1985).

130. To protect themselves, promoters should draft a warranty and indemnity agreement wherein the general partner represents his degree of knowledge and experience re-



that all three elements of the analysis be satisfied will also offer promoters protection from inappropriate liability by making the elevation of the partnership contract to securities status difficult.

To the bona fide passive investors who have been defrauded by unscrupulous promoters, the proposed three stage factual reality test provides an opportunity to use the remedies provided by the securities acts even though the investments at issue are nominally in the general partnership form. The would-be plaintiff is provided with standards for evaluating the potential of his lawsuit.

The proposed test would be consistent with the Supreme Court's mandate that the form of an investment vehicle should not be allowed to camouflage the actual substance and economic reality of the scheme.<sup>131</sup> It would also further the congressional intent behind the securities laws: "[t]o define the term 'security' in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security."<sup>132</sup>

### CONCLUSION

When a general partner does not have the power or ability to have any voice in the management of partnership affairs, his general partnership interest should be considered a security. If it is not, promoters may be encouraged to create investment vehicles in the form of general partnership interests in an effort to bypass the federal securities laws. While most general partners will not be able to overcome the high burden of proof necessary to establish that their partnership interest constitutes a security, those general partners who truly are passive investors should not be deprived of the protections to which they are entitled.

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garding the particular business of the partnership. Cf. *Morgenstern, Real Estate Joint Venture Interests as Securities: The Implications of Williamson v. Tucker*, 59 Wash. U.L.Q. 1231, 1265 (1982) (promoters should document investors' capabilities).

131. See *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 558 (1979); *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 851-52 (1975); *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967); *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298 (1946); *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 349-51 (1943).

132. H.R. Rep. No. 85, 73d Cong., 1st Sess. 11 (1933).