Modern Partnership Interests as Securities: The Effect of RUPA, RULPA, and LLP Statutes on Investment Contract Analysis

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James B. Porter*

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I. Introduction

The evolution of business organization law in recent years is striking. Traditionally, lawyers could consistently rely on certain categorical norms. For example, a clear difference existed between general partnerships and limited partnerships.1 Partners in general partnerships faced unlimited personal liability for partnership obligations and were expected to participate in firm management.2 Alternatively, limited partnerships offered limited liability for those partners who had little desire to participate in firm management.3 Such stark formal differences made application of federal securities law4 to partnership interests relatively simple.5

Although federal securities law does not specifically mention partnership interests in the definition of a "security," courts and commentators agree that partnership interests should be analyzed as investment contracts, a term included in the definition of a "security."6 In SEC v. W. J. Howey Co.,7 the Supreme Court announced an investment contract test that required profits to be derived from the "efforts of others."8 Building on Howey's "efforts of

1. Compare UNIF. PARTNERSHIP ACT (1914) § 15 [hereinafter UPA] (providing that partners are jointly and severally liable for another partner's wrongful act or breach of trust and jointly liable for all other partnership obligations) with UNIF. LIMITED PARTNERSHIP ACT (1916) § 7 [hereinafter ULPA] (providing limited liability for limited partners unless they participate in control of business).


5. See infra Part II.B.1 & 2 (discussing traditional treatment of general and limited partnership interests under securities law).


8. See SEC v. W. J. Howey Co., 328 U.S. 293, 301 (1946) (concluding that interests in question are investment contracts and thus securities). In Howey, the Supreme Court created a test for determining when an investment is an "investment contract" under the federal securities laws. Id. The investors in Howey purchased small tracts of citrus groves consisting of individual rows or portions thereof. Id. at 295. A single row of forty-eight trees constituted one acre, and thirty-one of the forty-two investors bought less than five acres. Id. In addition to a land sales contract, most investors also purchased a service contract from Howey Co. that gave the company full discretion and authority over cultivation, harvesting, and marketing of the investors' crops, with net profits later distributed to the investors. Id. at 296. Most of the
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others" test, lower federal courts developed presumptions that general partnership interests are not securities and that limited partnership interests are securities.\(^9\) These presumptions rely on traditional notions of the roles that general and limited partners play within their respective firms.\(^{10}\)

Recent changes in partnership law have uprooted traditional notions of partnership, causing a blurring of the lines and a collision of categories so that traditional presumptions no longer provide sufficient analytical tools when deciding whether partnership interests are securities. General partnership law no longer guarantees general partners enough control over partnership affairs to protect their investment.\(^{11}\) Statutory norms no longer restrict limited partners to merely passive roles.\(^{12}\) Moreover, the development of limited liability partnerships (LLPs) effectively eliminates the traditional tradeoff between partnership control and limited liability.\(^{13}\) This Note considers whether changes to partnership law and the development of LLPs should alter the effect of federal securities law on partnership interests.

In Part II, this Note discusses the traditional application of federal securities law on general and limited partnership interests. Part III provides a lengthy but necessary discussion of the changes in modern partnership law that make traditional form-based presumptions less reliable. Specifically, Part III discusses the increased freedom of contract available under the Revised Uniform Partnership Act (RUPA) and explains how this freedom enables partnerships to create strong centralized management and stripped general

investors were professionals who lacked the "knowledge, skill and equipment necessary for the care and cultivation of citrus trees." \(^{\text{Id.}}\) Taking the position that substance prevails over form, the Howey Court held that the land sales contract and the service contract taken together constituted investment contracts under the securities laws. \(^{\text{Id. at 299.}}\) In reaching its conclusion, the Court held that an investment contract exists when there is an investment of money in a common enterprise with an expectation of profit to be derived solely through the efforts of others. \(^{\text{Id. at 301. See infra Part II (discussing traditional treatment of general and limited partnership interests under federal securities law).}}\)

9. \(^{\text{See Williamson v. Tucker, 645 F.2d 404, 422 (5th Cir. 1981) (suggesting that general partnership interests presumptively are not securities); SEC v. Murphy, 626 F.2d 633, 640-41 (9th Cir. 1980) (suggesting that limited partnership interests presumptively are securities).}}\)

10. \(^{\text{See Michael J. Garrison & Terry W. Knoepfle, Limited Liability Company Interests as Securities: A Proposed Framework for Analysis, 33 AM. BUS. L.J. 577, 617 (1996) (stating that general partnership interests are usually not securities because owners are active participants who directly control partnership).}}\)

11. \(^{\text{See infra Part III.A (discussing freedom of contract under Revised Uniform Partnership Act).}}\)

12. \(^{\text{See infra Part III.B (discussing change in limited partnership law that allows limited partners to exercise control over business).}}\)

13. \(^{\text{See infra Part III.C (discussing LLPs and elimination of tradeoff between partnership control and limited liability).}}\)
partners. In addition, Part III explains how the Revised Uniform Limited Partnership Act (RULPA) allows limited partners to exercise control without incurring personal liability. Part III concludes with a discussion of LLPs and compares LLPs to general partnerships. Part IV suggests that changes in modern partnership law remove the basis for presuming that partnership interests are or are not securities based solely on formal categories. Furthermore, Part IV proposes a test for determining whether an interest in a general partnership, a limited partnership, or an LLP is a security. Part V concludes that formal categories no longer reflect economic reality and that courts should disregard form-based distinctions when deciding whether partnership interests are securities.

II. Federal Securities Law and the Definition of "Security"

Congress intended the federal securities laws to ensure fair disclosure of financial information to potential investors. The federal securities laws apply to transactions involving "securities" as defined in the Securities Act of 1933 and the Securities Exchange Act of 1934. According to the Supreme

14. See infra Part III.A (discussing RUPA and situation where partner has little or no power). The term "stripped general partners" refers to general partners who lack the traditional attributes normally associated with being a partner (for example, participation in management and control, sharing in partnership profits, and participating in decisions to admit new partners).

15. See infra Part III.A (discussing RUPA).

16. See SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963) (stating that fundamental purpose of statutes was "to substitute a philosophy of full disclosure for the philosophy of caveat emptor"); A.C. Frost & Co. v. Coeur D'Alene Mines Corp., 312 U.S. 38, 40 (1941) (stating that purpose of securities law is to protect investors by requiring disclosure).

17. Section 2(1) of the Securities Act of 1933 provides:

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.


18. Section 3(a)(10) of the Securities Exchange Act of 1934 provides:

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,
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Court, the definitions of the term "security" in the two Acts are essentially the same.\textsuperscript{19} The definitions do not explicitly include either general or limited partnership interests.\textsuperscript{20} Thus, to be deemed securities, partnership interests must fall into one of the general categories enumerated in the definition of a security.\textsuperscript{21}

\textbf{A. SEC v. Howey and the Investment Contract Test}

Courts and commentators generally agree that when deciding whether partnership interests are securities, applying an investment contract analysis is proper.\textsuperscript{22} In the landmark case \textit{SEC v. W. J. Howey Co.}, the Supreme Court developed a four-part test for identifying an investment contract.\textsuperscript{23} According to the \textit{Howey} Court, an investment contract is a contract, transaction, or scheme in which there is an investment of money in a common enterprise with an expectation of profits to be derived solely from the efforts of others.\textsuperscript{24} The Court intended the \textit{Howey} test to protect passive investors who lack the necessary knowledge or power to protect their investments.\textsuperscript{25} In formulating the


21. \textit{See} Everhard, \textit{supra} note 6, at 444 (discussing treatment of partnership interests under federal securities law).

22. \textit{See id.} at 444 & n.22 (discussing investment contract analysis and its application to partnership interests).


24. \textit{Id.}

25. \textit{See id.} at 299 (stating that test embodies flexible principle capable of adaptation to meet various schemes devised by those who seek to use other people's money with promise of profits).
Howey test, the Court clearly stated that the test embodies a flexible principle that courts should adapt to new profit-making schemes when appropriate.26

Howey involved operations by two Florida corporations, W. J. Howey Company (Howey Co.) and Howey-in-the-Hills Service, Inc. (HHS), that were under direct common control and management.27 Howey Co. would plant approximately five hundred acres of citrus groves annually, keep half for itself, and sell the other half to the public in small tracts to finance further development.28 HHS provided services in cultivating, developing, harvesting, and marketing the crops that the citrus groves produced.29 When entering into the land sales contracts with the public, Howey Co. told prospective investors that their investment would not be feasible unless they also signed a service contract with HHS.30 Not surprisingly, HHS acquired service contracts for eighty-five percent of the acreage sold.31 These service contracts gave HHS full discretion and authority over cultivation, harvesting, and marketing of the investors' crops, with net profits later distributed to the investors.32 Most of the investors were not Florida residents.33 Additionally, most were professionals or business people who lacked the necessary knowledge, skill, and equipment required to care for and to cultivate citrus trees.34 According to the Court, the people were "attracted by the expectation of substantial profits."35

The Howey Court began its analysis by noting that the securities issue turned on whether the land sales contract, the deed, and the service contract collectively constituted an investment contract under federal securities law.36 The Court further noted that neither the Securities Act nor its legislative history defined the term investment contract.37 Turning to state blue sky laws that included the term "investment contract" prior to the enactment of federal securities law, the Court found that state courts construed the term broadly "so

26. See id. (stating that Howey test "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 money of others on the promise of profits").

27. Id. at 295.
28. Id.
29. Id.
30. Id.
31. Id.
32. Id. at 296.
33. Id.
34. Id.
35. Id.
36. Id. at 297. The Court noted that the lower courts treated the contracts and deeds as separate transactions and therefore determined that no investment contract existed. Id. at 297-98.
37. Id. at 298.
as to afford the investing public a full measure of protection." State courts placed substance over form and emphasized the economic reality of investments. State law generally defined an investment contract as a "contract or scheme for "the placing of capital or laying out of money in a way intended to secure income or profit from its employment." The Court concluded that adopting the state law interpretation of the term "investment contract" was reasonable and consistent with the purposes of the Securities Act. In restating the test, the Court declared that an investment contract is "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party." This broad definition embodies a flexibility designed to include the numerous profit-making schemes that enterprising individuals might develop.

By cutting through legal terminology and focusing instead on economic reality, the Howey Court found that the transactions involved were clearly investment contracts. The investors relied exclusively on HHS for any profits derived from their investments. Moreover, any attempt by an investor to manage his tract individually would have been economically unfeasible.

Partnerships, like other business organizations, generally involve a for-profit investment in a common enterprise. As a result, the first three parts of Howey's test are almost always satisfied. The primary question when dealing with partnership interests, then, is whether an interest meets Howey's "solely by the efforts of others" test.

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38. Id.
39. Id.
40. Id. (quoting State v. Gopher Tire & Rubber Co., 177 N.W. 937, 938 (Minn. 1920)).
41. Id.
42. Id. at 298-99.
43. Id. at 299.
44. Id.
45. Id. at 300.
46. Id. The Court explained that to make a profit in the citrus industry, one must take advantage of economies of scale because care, cultivation, harvesting, and marketing expenses for a small tract would be cost prohibitive. Id.
48. BROMBERG & RIBSTEIN, LLPs, supra note 47, at 234.
Use of the word "solely" in Howey's test is problematic. If interpreted literally, the term "solely" creates a significant loophole for those wishing to avoid the securities laws and undermines protection of investors and the spirit of flexibility embodied in Howey.⁴⁹ In SEC v. Glenn W. Turner Enterprises, Inc.,⁵⁰ the United States Court of Appeals for the Ninth Circuit applied a liberal interpretation to Howey's "solely by the efforts of others" test.⁵¹ The Glenn Turner court declared that Howey's "efforts of others" test is satisfied when those other than the investor make the essential managerial efforts that affect the success or failure of the enterprise.⁵² The Glenn Turner interpretation of Howey has been adopted by several other federal circuit courts⁵³ and apparently approved by the Supreme Court.⁵⁴ Glenn Turner and subsequent cases

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⁵⁰. 474 F.2d 476 (9th Cir. 1973).

⁵¹. See SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 476, 482 (9th Cir. 1973) (stating that adherence to "solely" requirement would create unduly restrictive definition of investment contract). Glenn Turner involved the sale of self-help plans by Dare To Be Great, Inc. (Dare), a wholly owned subsidiary of Glenn W. Turner Enterprises (GWT). Id. at 477-78. Dare sold five different plans varying in price and in contents, all of which purported to improve the self-motivation and sales ability of the purchaser. Id. at 478. If a buyer purchased one of the three most expensive plans, he obtained the right to sell plans to others and to retain a portion of the purchase price. Id. The SEC brought suit seeking to enjoin Dare from selling the plans on the ground that Dare was allegedly violating federal securities law. Id. at 477. The district court granted the injunction and GWT appealed, arguing that the plans were not securities. Id. at 476. The Glenn Turner court, after reciting the fraudulent excesses Dare employees would undertake to pressure prospective purchasers into buying, noted that the remedial nature of federal securities law called for broad interpretation of the term security. Id. at 482. The court found that Dare's plans easily satisfied the first three parts of the investment contract test established in Howey, but that the "solely" requirement in the "efforts of others" test was problematic. Id. In noting that strict interpretation of the word "solely" would result in an "unduly restrictive" interpretation of what is or is not an investment contract, the court opted for a more "realistic test." Id. Thus, the court decided that the "efforts of others" test is satisfied where 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." Id. With the test restated, the court deemed plans sold by Dare to be investment contracts, and thus securities. Id.

⁵². Id. at 482.

⁵³. See Sobel, supra note 49, at 1325 n.59 (citing numerous cases adopting Glenn Turner analysis).

⁵⁴. See International Bhd. of Teamsters v. Daniel, 439 U.S. 551, 561 (1979) (citing United Hous. Found. v. Forman, 421 U.S. 837, 852 (1975) and stating that "touchstone of the Howey test is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others"); Forman, 421 U.S. at 852 (stating that "touchstone [of cases defining securities] is the presence of an investment in a common venture premised on a reasonable expectation of profits to be
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suggest that an investment contract exists when there is an investment in a common venture with a reasonable expectation that profits will come primarily or substantially from the entrepreneurial or managerial efforts of others.  

B. Traditional Securities Law Analysis of Partnership Interests

1. General Partnership Interests as Securities

The Supreme Court has never addressed whether general partnership interests or joint venture interests are securities; however, several other courts have discussed the issue.  

In Williamson v. Tucker, the United States Court of Appeals for the Fifth Circuit found that certain joint venture interests were not securities under federal securities law. The investors in Williamson purchased interests in real estate development projects in the form of three joint ventures. Although the promoter agreed to perform all management duties with respect to the property, the joint venture agreements granted each investor some managerial power. The Williamson court stated that joint venture interests derived from the entrepreneurial or managerial efforts of others. Note that both Forman and Daniel omit the word "solely" in their restatements of the Howey test. Daniel, 439 U.S. at 561; Forman, 421 U.S. at 852. However, the Forman Court expressed no opinion as to the holding in Glenn Turner. Forman, 421 U.S. at 852 n.16.

55. See Garrison & Knoepfle, supra note 10, at 616 (stating that question is whether investors are relying "primarily" on efforts of others); Elaine A. Welle, Limited Liability Companies as Securities: An Analysis of Federal and State Actions Against Limited Liability Companies Under the Securities Laws, 73 DENY. U. L. REV. 425, 446 (1996) (declaring that interest may be security if profits come "substantially" from efforts of others).


57. 645 F.2d 404 (5th Cir. 1981).

58. See Williamson v. Tucker, 645 F.2d 404, 421 (5th Cir. 1981) (stating that courts ruling on issue of whether general partnership interests are securities have held that such interests generally are not investment contracts under securities laws). The Williamson court explained that general partnership interests are traditionally not securities because general partners and joint venturers "have the sort of influence which generally provides them with access to important information and protection against a dependence on others." Id. at 422. Furthermore, an "investor who is offered an interest in a general partnership or joint venture should be on notice . . . that his ownership rights are significant, and that the federal securities acts will not protect him from a mere failure to exercise his rights." Id.

59. Id. at 408.

60. Id. at 408-09. Each agreement required unanimous consent of the venturers to confess a judgment; to make execute, or deliver any commercial paper; to borrow money in the joint venture's name; to use joint venture property as collateral; and to amend the joint venture agreement. Id. Joint venturers also had power to remove the manager by a vote of 60% or 70%
and general partnership interests are presumptively not securities because investors in such entities normally have broad managerial powers. The court cautioned, however, that substance might prevail over form in some cases. In focusing on the "efforts of others" part of Howey's test, the Williamson court found that a general partnership or joint venture interest might be an investment contract, and thus a security, if the investor can establish that:

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

In finding that none of the factors from this disjunctive test were present, the court held that the joint venture interests in question were not securities.

The Williamson court placed great importance on the power that the agreement granted to the joint venturers. The joint venturers purportedly purchased their interests with the expectation that they would not exercise managerial control, but the agreement nonetheless authorized such control. In addition, the court stressed the high degree of business acumen possessed by the joint venturers as evidence of their ability to exercise genuine managerial control over the enterprise. Finally, in reference to the third alternative of its test, the court noted that the plaintiffs did not assert that the promoter in interest. It is not clear whether the joint venturers ever actually exercised their powers. The court provided three examples of when partnership powers may be inadequate to protect a partner from dependence on others:

61. Id. at 409.
62. Id. at 422.
63. Id. at 424.
64. Id. at 425-26.
65. See id. at 424 (explaining that agreement granted joint venturers ultimate control even though they did not expect to exercise control).
66. Id.
67. See id. at 425 (noting high degree of business experience and knowledge of joint venturers). The court noted that among the joint venturers were three top executives, including the Chairman of the Board and the President of Frito-Lay, Inc. Id.
68. Id. at 424. The third alternative for determining whether a joint venture (or partner-
had unique entrepreneurial or managerial skills or that their dependence on the promoter was so great that they could not reasonably replace him.\footnote{69} Thus, the interests in \textit{Williamson} were not securities.\footnote{70}

\textit{Williamson} created a workable but somewhat rigid test for determining when partnership interests are securities.\footnote{71} Although widely regarded as authoritative, \textit{Williamson} has been modified by some circuits\footnote{72} and rejected by the United States Court of Appeals for the Third Circuit in \textit{Goodwin v. Elkins \& Co.}.\footnote{73} The \textit{Goodwin} court relied on state partnership law and the

\begin{itemize}
  \item \textit{Goodwin v. Elkins \& Co.}, 730 F.2d 99, 100 (3d Cir. 1984) (holding that general partnership interest involved therein was not investment contract). Although the three judge panel in \textit{Goodwin} was unanimous in its decision that the partnership interests involved were not securities, each judge penned a separate opinion. \textit{Id.} at 100, 111, 113. Goodwin, a former general partner of defendant Elkins \& Co., brought suit alleging a violation of the Securities Exchange Act of 1934. \textit{Id.} at 100. Goodwin asserted that the partnership agreement gave him so little power that he was in effect a limited partner. \textit{Id.} at 103. In the opinion announcing the judgment of the court, Judge Garth held that even if Goodwin could prove the partnership
powers given to the partners in the partnership agreement to find that the partnership interest at issue was not a security.\textsuperscript{74} Although the three judge panel in \textit{Goodwin} unanimously agreed that the general partnership interest involved was not a security, the judges differed in their reasoning. Judge Garth, delivering the opinion of the court, decided that general partnership interests are never securities because of the inherent power that state partnership law vests in partners.\textsuperscript{75} In separate concurrences, Chief Judge Seitz and Judge Becker confined their analyses to the power distribution in the partnership agreement.\textsuperscript{76} Other federal courts have not adopted Judge Garth's per se rule that general partnership interests are not securities, but instead employ either all or part of the \textit{Williamson} test and apply a rebuttable presumption that general partnership interests are not securities.\textsuperscript{77}

\section{Limited Partnership Interests as Securities}

In contrast to general partnership interests, courts generally presume that limited partnership interests are securities.\textsuperscript{78} The rationale for this presumption is simple. A limited partnership, like most other business entities (including general partnerships), almost always involves an investment of money in agreement restricted his powers, his partnership interest would not be a security. \textit{Id.} Judge Garth reasoned that because state partnership law endows general partners with certain "powers, rights, and responsibilities," their interests cannot be securities under the Securities Act. \textit{Id.} at 104. In separate concurring opinions, Chief Judge Seitz and Judge Becker disagreed with the breadth of Judge Garth's opinion and based their decisions that Goodwin was not a security holder solely on power granted in the partnership agreement. \textit{Id.} at 112. Chief Judge Seitz and Judge Becker agreed they "need not decide here whether a general partner's rights and responsibilities under the Pennsylvania Uniform Partnership Act are sufficient to prevent a general partner's interest from being treated as a security for purposes of federal law." \textit{Id.}

\textsuperscript{74} \textit{See supra} note 73 (discussing \textit{Goodwin} and differences in judges' opinions).

\textsuperscript{75} \textit{See Goodwin}, 730 F.2d at 103 (declaring that law extends role of general partner well beyond permitted role of passive investor); \textit{see also} Ribstein, \textit{Private Ordering, supra} note 71, at 41-45 (arguing for per se rule that general partnership interests are not securities so as to promote private ordering).

\textsuperscript{76} \textit{Goodwin}, 730 F.2d at 111-13 (Seitz, C.J., concurring); \textit{id.} at 113-14 (Becker, J., concurring).

\textsuperscript{77} \textit{See} Bailey v. J.W.K. Properties, Inc., 904 F.2d 918, 924-25 (4th Cir. 1990) (applying \textit{Williamson} factors and finding that interest is security when investor was "practically dependent" on manager); \textit{Hocking}, 885 F.2d at 1460-61 (effectively overruling \textit{Matek v. Murat} and adopting three-prong test set out in \textit{Williamson}). \textit{But see Banghart}, 902 F.2d at 808 (adopting only part one of \textit{Williamson} test, which focuses simply on whether partnership agreement grants sufficient power to partners, and not on whether partners actually exercise those powers). For a general discussion of the approaches that courts take when deciding whether general partnership interests are securities, see Sobel, \textit{supra} note 49, at 1327-44.

\textsuperscript{78} \textit{See SEC v. Murphy}, 626 F.2d 633, 640-41 (9th Cir. 1980) (stating that limited partnership interest is generally security because, by definition, limited partnerships involve investments where profits are derived from efforts of others).
a common enterprise with an expectation of profit, and thus a limited partnership interest usually satisfies the first three parts of Howey. General and limited partnerships are, however, distinguished by the fourth part of Howey's test—whether profits derive primarily from the efforts of others. In general partnerships, partners expect to participate equally in the management and in the conduct of the business. Typically, however, a limited partner does not participate in management and, historically, could lose his limited status and incur personal liability for partnership obligations by participating in control of the enterprise. Therefore, limited partners usually do not participate in control of the business and thus rely on the efforts of others for a return on their investment.

According to the United States Court of Appeals for the Fifth Circuit in Youmans v. Simon, limited partners simply do not have the kind of authority

79. See supra note 8 (discussing Howey). The first three parts of Howey's test require (1) an investment of money (2) in a common enterprise (3) with an expectation of profits. SEC v. W. J. Howey Co., 328 U.S. 293, 298 (1946).

80. See supra notes 48-55 and accompanying text (discussing original "solely" requirement in Howey's fourth part, subsequent liberal interpretations by lower courts, and apparent approval by Supreme Court).

81. See UPA (1914) § 18(e) (providing default rule that partners share equally in management); REVISED UNIF. PARTNERSHIP ACT (1996) § 401(f) [hereinafter RUPA] (providing default rule that partners share equally in management). RUPA incorporates the limited liability partnership amendments adopted in 1996. Note, however, that both UPA and RUPA provide that an agreement among the partners may alter the general rule regarding management rights. UPA § 18; RUPA § 103(a). See also POSNER, supra note 2, at 291 (suggesting that unlimited liability encourages general partners to participate in firm management).

82. See ULPA (1916) § 7 (providing that limited partner may become liable as general partner if he "takes part in the control of the business"); REVISED UNIF. LIMITED PARTNERSHIP ACT (1976) § 303(a) [hereinafter RULPA] (providing that limited partner is not liable for partnership obligations unless he participates in control of business). RULPA did, however, significantly increase the ability of limited partners to participate in the control of the business. Under RULPA, a limited partner participating in control is only liable "to persons who transact business with the limited partnership reasonably believing, based upon the limited partner's conduct, that the limited partner is a general partner." RULPA § 303(a). Limited partners may now participate in management with impunity so long as they disclose to third parties their limited partner status. Id; see RULPA § 303 (Tentative Draft No. 2, 1998) (eliminating all language in current Section 303 and providing limited liability for limited partners "even if" they participate in management and control). The tentative draft for RULPA Section 303 provides in part: "(a) A limited partner is not liable for a debt, obligation or other liability of the limited partnership solely by reason of being a limited partner, even if the limited partner participates in the management and control of the limited partnership." RULPA § 303 (Tentative Draft No. 2, 1998).

83. See Garrison & Knoepfle, supra note 10, at 626 (stating that limited partnership interests generally are securities because limited partners generally are passive investors). As a result, a limited partnership interest is generally a security.

84. 791 F.2d 341 (5th Cir. 1986).
that general partners possess. The Youmans court stated that limited partners' positions are analogous to those of corporate stockholders because limited partners have limited liability, cannot dissolve the partnership, cannot bind other partners, and have no authority to actively manage the partnership. Supported by the weight of judicial authority, the principle that limited partnership interests are presumptively securities is very strong.

In Rodeo v. Gillman, the United States Court of Appeals for the Seventh Circuit provided an example of investment contract analysis of limited partnership interests. In Gillman, the plaintiffs purchased limited partnership interests in several apartment buildings. A few years later, the plaintiffs brought suit against the managing general partners alleging, among other things, federal securities law violations. The trial court granted the defendants' motion for summary judgment. On appeal, the defendants contended

85. See Youmans v. Simon, 791 F.2d 341, 346 (5th Cir. 1986) (suggesting that limited partnership interests are securities within statutory definition). In Youmans, a physician who participated in several real estate joint ventures brought suit alleging federal securities law violations. Id. at 343-44. After discussing Howey and the Williamson factors, the court looked to the economic reality of the investments to determine whether the joint venture interests were securities. Id. at 345-47. Of the two joint ventures discussed, the court found the Dickinson Apartment Project Venture was not a security because the investors held a 63% interest and could terminate the joint venture by majority vote. Id. at 346. The Bidco-Tomball Joint Venture was a security because the investors lacked management power, had no power to dissolve the venture, and could not remove the managing venturer. Id. at 347. The court drew a clear distinction between treatment of general partnership interests and limited partnership interests, and suggested that limited partnership interests are always securities because limited partners are passive investors. Id. at 346. But see supra note 82 (discussing impact of RULPA Section 303 and increased power for limited partners if they disclose limited status).

86. Youmans, 791 F.2d at 346.

87. See Garrison & Knoepfle, supra note 10, at 626-27 (discussing treatment of limited partnership interests under federal securities law).

88. 787 F.2d 1175 (7th Cir. 1986).

89. See Rodeo v. Gillman, 787 F.2d 1175, 1177-79 (7th Cir. 1986) (deciding that limited partnership interest is security even if accompanied with option to purchase enterprise). In Gillman, the plaintiffs purchased limited partnership interests in apartment buildings and later brought securities fraud allegations when the deal went sour. Id. at 1175. The plaintiffs held an option to buy the general partners' interests, but never executed that option. Id. at 1176. In deciding that the plaintiffs' limited partnership interests were securities, the court drew a distinction between potential control and actual control. Id. at 1177. The court stated that potential managerial control is not enough to take a limited partnership interest outside the reach of securities law. Id. at 1178.

90. Id. at 1175. The investors, in addition to their limited partnership interest, obtained an option to buy out the general partners. Id. The trial court granted summary judgment for the defendants after concluding that such an option gave plaintiffs enough control over the investment to remove their interest from protection under the securities laws. Id.

91. Id.

92. See id. (granting defendant's summary judgment motion because plaintiffs' option to
that the plaintiffs' limited partnership interests were not securities because the plaintiffs held an option to buy the general partners' interests and thus had ultimate control over management of the apartments. The Seventh Circuit rejected the defendants' argument and noted that complete passivity is not a requirement for an individual to be a security holder. The court, in finding that the investors' limited partnership interests were securities, noted a difference between potential control and actual control. According to the court, "[p]otential managerial control – even if easily assumed – is not enough to take a limited partnership [interest] out of the reach of the securities laws."

In contrast, the United States Court of Appeals for the Third Circuit in Steinhardt Group Inc. v. Citicorp found that a limited partnership interest was not a security. Steinhardt involved a highly structured securitization transaction that required defendant Citicorp to create a limited partnership, Bristol Oaks, L.P. (Bristol), that would serve as an investment vehicle for issuance of both debt and equity securities to investors. Bristol issued equity securities in the form of limited partnership interests. Bristol had one
general partner and two limited partners. Steinhardt, the party alleging securities laws violations, was a limited partner with a 98.79% ownership interest in Bristol. In deciding whether Steinhardt's limited partnership interest in Bristol constituted an investment contract, and thus a security, the court focused on the Limited Partnership Agreement (LPA) to determine who exercised control in generating profits. The LPA restricted the managing partner's right to take material actions without the consent of a majority of the partners. Because the LPA defined "Majority of the Partners" as partners holding more than a fifty percent interest in Bristol, Steinhardt alone constituted a majority. Thus, Steinhardt had to consent before Bristol could take any material action. Steinhardt also had the power to remove and to replace the general partner without notice. Given these facts, the court held that Steinhardt's powers under the LPA "were not nominal, but rather, were significant and, thus, directly affected the profits it received from the Partnership." Therefore, Steinhardt's limited partnership interest was not an investment contract.

III. Modern Partnership Law

As illustrated above, specific factual circumstances are very important in determining whether a partnership interest is a security. Some courts, however, invariably approach securities cases with preconceived notions that a partnership interest is or is not a security based solely on the type of partnership involved. This Part discusses the minutiae of modern partnership law and demonstrates that changes in the law provide significant flexibility in forming partnerships. This flexibility masks formal categories such that distinctions based solely on form have little basis. Thus, courts should re-examine whether traditional notions of partnership provide an adequate framework for securities law analysis.

101. Id.
102. Id. at 145.
103. Id. at 153-54.
104. Id. at 153.
105. Id. at 154.
106. Id.
107. Id.
108. Id. at 155.
109. Id.
110. See Goodwin v. Elkins & Co., 730 F.2d 99, 103 (3d Cir. 1984) (suggesting that general partnership interests are per se not securities because of power provided in state partnership law).
MODERN PARTNERSHIP INTERESTS AS SECURITIES

A. General Partnerships Under RUPA

Until recently, the Uniform Partnership Act (UPA) provided the basic format from which states derived their partnership statutes. Adopted in 1994, the Revised Uniform Partnership Act (RUPA) is in many ways similar to UPA. There are, however, some significant differences. UPA Section 18 contains default rules that establish the rights and duties of partners in relation to the partnership and makes those rules subject to modification by the partnership agreement. Under UPA Section 18, only certain rights and duties are subject to change by the partnership agreement and other duties, such as a partner's fiduciary duty, are nonwaivable. In contrast, RUPA Section 103 clearly grants broad contractual freedom followed by a short, exhaustive list of rights and duties that the partnership agreement may not modify.

111. Similarities between UPA and RUPA include the following: (1) the definition of "partnership" in UPA Section 6 and in RUPA Section 101(6), (2) rules governing partnership formation in UPA Section 7 and in RUPA Section 202, and (3) characterization of partner's interest as personal property in UPA Section 26 and in RUPA Section 502.

112. See UPA (1914) § 18 (providing that "[t]he rights and duties of the partners in relation to the partnership shall be determined, subject to any agreement between them," by rules in Section 18).

113. See Wartski v. Bedford, 926 F.2d 11, 20 (1st Cir. 1991) (stating that fiduciary duty of partners is integral part of partnership and that words of partnership agreement cannot negate fiduciary duty).

114. RUPA (1996) § 103. Section 103 provides in pertinent part:

(a) Except as otherwise provided in subsection (b), relations among the partners and between the partners and the partnership are governed by the partnership agreement. To the extent the partnership agreement does not otherwise provide, this [Act] governs relations among the partners and between the partners and the partnership.

(b) The partnership agreement may not:

1. vary the rights and duties under Section 105 except to eliminate the duty to provide copies of statements to all of the partners;
2. unreasonably restrict the right of access to books and records under Section 403(b);
3. eliminate the duty of loyalty under Section 404(b) or 603(b)(3), but:
   (i) the partnership agreement may identify specific types or categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable; or
   (ii) all of the partners or a number or percentage specified in the partnership agreement may authorize or ratify, after full disclosure of all material facts, a specific act or transaction that otherwise would violate the duty of loyalty;
4. unreasonably reduce the duty of care under Section 404(c) or 603(b)(3);
5. eliminate the obligation of good faith and fair dealing under Section 404(d), but the partnership agreement may prescribe the standards by which the performance of the obligation is to be measured, if the standards are not manifestly unreasonable; . . .
RUPA's break from the statutory regime of UPA is subtle, yet important. The provisions in UPA Section 18 were clearly subject to change by the partnership agreement. Other sections, such as UPA Section 20, which deals with a partner's right to demand information concerning the partnership, did not mention the partnership agreement. UPA's silence about whether some provisions were subject to change resulted in inconsistent court decisions. RUPA attempts to correct this flaw by clearly identifying provisions the partnership agreement may modify. This clarity confirms the ability to create partnerships with strong centralized management where some partners have virtually no power to participate in management. This lack of power reduces the ability of partners to protect adequately their investments and thus implicates securities law because insufficient power suggests reliance on the efforts of others.

One primary safeguard protecting partners under the UPA regime was the requirement of unanimous consent for undertaking extraordinary matters. Extraordinary matters include amending the partnership agreement and other matters outside the ordinary course of the partnership's business. Although UPA did not specifically provide rules regarding extraordinary matters, courts routinely required the partners' unanimous consent for extraordinary actions. RUPA allows partnerships to eliminate completely the unanimous consent requirement for extraordinary matters. Eliminating a general partner's

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(10) restrict rights of third parties under this [Act].

Id.

115. See supra note 112 (providing language from UPA Section 18).

116. UPA § 20. Section 20 provides: "Partners shall render on demand true and full information of all things affecting the partnership to any partner or the legal representative of any deceased partner or partner under legal disability." Id.

117. See ROBERT W. HILLMAN ET AL., GENERAL AND LIMITED LIABILITY PARTNERSHIPS UNDER THE REVISED UNIFORM PARTNERSHIP ACT 21 (1996) (stating that UPA silence held to preclude modification in some situations but not in others).

118. Id.

119. See infra notes 121-159 and accompanying text (discussing creation of stripped general partners).

120. See supra notes 48-55 and accompanying text (discussing "efforts of others" test).

121. See RUPA (1996) § 401 cmt. 11 (discussing extraordinary matters and general treatment under UPA).

122. See id. (equating "extraordinary matters" with matters outside ordinary course of partnership business and amendments of partnership agreement).

123. Id. (citations omitted).

124. See id. § 401(j) (providing that "act outside the ordinary course of business of a partnership and an amendment to the partnership agreement may be undertaken only with the
ability to halt extraordinary matters is the first step toward creating a stripped
general partner.

In addition to the unanimous consent rule for extraordinary matters, all
other rights and duties enumerated in RUPA Section 401 are subject to modi-

fication or complete elimination.\textsuperscript{125} Applying the broad freedom of contract

granted in RUPA Section 103 to the rights and duties in RUPA Section 401,
a partnership agreement may, among other things, eliminate a partner's right
to share in partnership profits,\textsuperscript{126} eliminate a partner's right to participate in
the management and conduct of the business,\textsuperscript{127} and eliminate the unanimous
consent requirement for adding new partners.\textsuperscript{128} RUPA clearly provides tools
that allow a partnership to eliminate the essential attributes normally associ-
ated with general partners. Indeed, under RUPA, a partnership can completely
strip a partner of meaningful partnership powers and yet the partner could
remain personally liable for partnership obligations.\textsuperscript{129}
In addition to allowing the partnership agreement to restrict a partner's power, RUPA allows restrictions on a partner's right to access information. RUPA Section 403(b) provides that a partnership shall provide its partners access to the partnership's "books and records." A partnership may not unreasonably restrict such access to "books and records." RUPA Section 403(c) provides partners with rights to access any information concerning the partnership's "business and affairs" unless the demand or information requested is unreasonable or improper. However, RUPA Section 403(c) is conspicuously absent from the RUPA Section 103(b) list of provisions not subject to change by the partnership agreement. Although the common law may independently provide partners with the right to access business information, RUPA, on its face, clearly allows elimination of a partner's right to access information concerning the partnership's business and affairs.

Partnerships may also restrict a partner's power by filing statements of partnership authority pursuant to RUPA Section 303. The purposes of

(5) liability is imposed on the partner by law or contract independent of the existence of the partnership.

Id. § 307(c)-(d).

130. Id. § 103(b). Section 103(b) expressly prohibits an unreasonable restriction on a partner's right to access "books and records" under RUPA Section 403(b), but does not prohibit restrictions on a partner's right to access information concerning the partnership's "business and affairs" under RUPA Section 403(c).

131. Id. § 401(b). Section 401(b) also provides access to a partner's agents and attorneys, and former partners and their agents and attorneys for the period during which they were partners. Id. For a discussion of what the term "books and records" includes, see HILLMAN ET AL., supra note 117, at 130-31 (concluding that "books and records" includes records beyond mere financial records).


133. Id. § 403(c). The partner or partnership subject to the demand for information bears the burden of showing that the demand is unreasonable or improper. Id. § 403 cmt. 3.

134. See id. § 103(b) (omitting RUPA Section 403(c) from list of provisions not subject to modification by partnership agreement).


136. See RUPA § 403(c) (providing that partnership shall furnish partner with information concerning partnership business and affairs). But see RUPA § 103 (providing broad rule that all default rules in RUPA are subject to change or elimination if not included in Section 103(b)). The information rights provision in Section 403(c) is not among those provisions enumerated in Section 103(b). Id.

137. See id. § 303(a)(2) (providing that partnership may file statement of partnership authority that states authority or limitations on authority of its partners to enter into transactions
RUPA Section 303 are threefold: it creates a system for filing standard business documents,\textsuperscript{138} it binds the partnership to extraordinary grants of authority to partners in real property transfers,\textsuperscript{139} and it binds third parties to restrictions on authority of partners.\textsuperscript{140} A partnership may file a statement that grants or limits the authority of some or all of its partners to transact with third parties on behalf of the partnership.\textsuperscript{141} Statements of partnership authority memorialize grants or restrictions of authority so as to provide certainty to third parties.\textsuperscript{142} Statements of authority also impact the rights and remedies of third parties who transact with partners named in a statement. In real property transfers, statements of authority, if properly filed, provide third parties with constructive notice that certain partners have no authority to transfer real property on behalf of the partnership.\textsuperscript{143} In all other transactions with partners, a third party's remedy is curtailed only if he has actual notice of a limitation contained in a filed statement.\textsuperscript{144}

One might think it unlikely that a prospective general partner would sign a partnership agreement providing almost no power with which to protect his partnership interest. In some very large partnerships in which prospective partners have weak bargaining positions, they must agree, however, to have limited power if they want to become a partner. The partnership agreement

\textsuperscript{138} See HILLMAN ET AL., supra note 117, at 94 (noting that filing system allows third parties to record instruments to protect themselves when dealing with partnerships and provides assurance to third parties that partner has actual authority to act on behalf of partnership).

\textsuperscript{139} See id. (noting that third parties have statutory right to rely on statements granting partners extraordinary authority to act for partnership).

\textsuperscript{140} Compare RUPA (1996) § 303(e) (providing that third parties have constructive notice of limitation on partner's right to transfer real property if statement of authority is properly filed) with RUPA § 303(f) (providing general rule that statement of authority does not impart constructive notice on third parties).

\textsuperscript{141} RUPA § 303(a)(2).

\textsuperscript{142} See HILLMAN ET AL., supra note 117, at 94 (stating that third parties (for example, lenders, landlords, and sellers) often require partnerships to submit names of all partners with authority to bind partnership and that filing system eliminates this step and binds partnership to authority granted in statement).

\textsuperscript{143} RUPA § 303(e). Section 303(e) provides:

A person not a partner is deemed to know of a limitation on the authority of a partner to transfer real property held in the name of the partnership if a certified copy of the filed statement containing the limitation on authority is of record in the office for recording transfers of that real property.

\textit{Id.}

\textsuperscript{144} See id. § 303(f) (providing general rule that third parties are "not deemed to know of a limitation on the authority of a partner merely because the limitation is contained in a filed statement").
in *Simpson v. Ernst & Young*[^145] provides a particularized example of how a partnership can strip a partner of the essential attributes traditionally associated with general partners.[^146]

The *Simpson* case involved the merger of two large accounting firms, Ernst & Whinney and Arthur Young & Co., forming a 2200 partner mega-firm styled Ernst & Young.[^147] Simpson, a former managing partner of Arthur Young’s Cincinnati office, became a partner in Ernst & Young and served as Director of Entrepreneurial Services in Cincinnati.[^148] The partnership structure of Ernst & Young involved a highly centralized management scheme and included general partners with little or no voice in the firm.[^149] The court held that for the purposes of the Employee Retirement Income Security Act (ERISA) and the Age Discrimination in Employment Act (ADEA), Simpson was in economic reality an employee and not a partner.[^150]

Of particular interest to the court was the firm’s Management Committee.[^151] The Management Committee consisted of ten to fourteen members who exercised exclusive control over the firm’s business and affairs, including the

[^145]: 100 F.3d 436 (6th Cir. 1996).
[^146]: See *Simpson v. Ernst & Young*, 100 F.3d 436, 443-44 (6th Cir. 1996) (comparing partnership agreement to principles codified in UPA and concluding that lack of indicia of ownership qualifies partner as employee for purposes of Employee Retirement Income Security Act and Age Discrimination in Employment Act claims). In *Simpson*, the Sixth Circuit determined relevant factors for distinguishing between an "employee" and a "partner" for purposes of the Employee Retirement Income Security Act (ERISA) and the Age Discrimination in Employment Act (ADEA). *Id.* at 444. The plaintiff, a general partner at Ernst & Young, brought suit alleging damages pursuant to ERISA and ADEA. *Id.* at 438. Ernst & Young raised as a defense Simpson’s status as a "partner." *Id.* Although Simpson signed a document titled "Partnership Agreement," he argued that in reality he was merely an employee entitled to protection under federal law. *Id.* at 440. The *Simpson* court engaged in a behind-the-documents analysis in determining whether Simpson qualified as an employee. *Id.* at 444. In reaching its conclusion, the court enumerated several common law attributes of partners as codified in the Uniform Partnership Act. *Id.* These attributes included the following: (1) the right to participate in management, (2) the right to act as an agent of other partners, (3) personal liability, (4) a fiduciary relationship among partners, (5) using the term "co-owners" to indicate each partner’s "power of ultimate control," (6) participating in firm profits and losses, (7) an investment in the firm, (8) part ownership of the firm’s assets, (9) meaningful voting rights, (10) the ability to control and operate the business, (11) compensation calculated as a percentage of the firm’s profits, (12) employment security, and (13) other similar indicia of ownership. *Id.* After finding most of these attributes missing, the court decided that Simpson qualified as an employee and could bring suit under ERISA and ADEA. *Id.*

[^147]: *Id.* at 440, 445.
[^148]: *Id.* at 440.
[^149]: *Id.* at 441.
[^150]: *Id.* at 444.
[^151]: *Id.* at 441-42.
admission and discharge of all personnel.\textsuperscript{152} In addition, the Management Committee was a self-perpetuating entity, with the Committee appointing its chairman and, in turn, the chairman appointing its new members.\textsuperscript{153}

In addition to creating a strong centralized management scheme, the partnership agreement also curtailed almost all "meaningful attributes" of Simpson's status as a partner.\textsuperscript{154} For example, the trial judge found that Simpson had no authority to participate in decisions to admit or discharge new partners,\textsuperscript{155} participate in decisions regarding partner compensation,\textsuperscript{156} vote for members or the chairman of the Management Committee,\textsuperscript{157} or share in the firm's profits.\textsuperscript{158} Clearly, Simpson lacked the kind of authority that general

\textsuperscript{152} Id. A centralized management structure is permissible under RUPA because the default rule that provides partners with equal management rights is subject to change by the partnership agreement. RUPA (1996) § 103.

\textsuperscript{153} Simpson v. Ernst & Young, 100 F.3d 436, 442 (6th Cir. 1996).

\textsuperscript{154} Id.

\textsuperscript{155} Id. at 441. This runs contrary to the default rule in RUPA Section 401(i) which provides that all partners must consent to admission of new partners. RUPA § 401(i). This default rule is, however, subject to modification or elimination pursuant to RUPA Section 103. See id. § 103(b) (providing exhaustive list of things partnership agreement may not do and not including RUPA Section 401(i)).

\textsuperscript{156} Simpson, 100 F.3d at 441. Participating in decisions regarding partner compensation might be among the powers normally given to partners to participate in the firm's management and control. See RUPA § 401(f) (providing each partner with equal rights in management and conduct of partnership's business). The rule in RUPA Section 401(f) is, however, subject to modification or elimination pursuant to RUPA Section 103. See id. § 103(b) (omitting RUPA Section 401(f)).

\textsuperscript{157} Simpson, 100 F.3d at 441. There is nothing inherently suspect about a management committee controlling firm operations. In large law and accounting firms with hundreds of partners, requiring each partner to vote on every management decision would be impractical. Administrative feasibility and economic efficiency problems force some centralization of management in large firms. Often in these cases, partners vote for management committee members and thus participate in management through their representatives. In Simpson, however, the partnership agreement even removed Simpson's power to vote for management. Id. at 441-42. RUPA Section 103(b) places no restrictions on the degree to which the partnership agreement may curtail a partner's right to participate in management and control. RUPA § 103(b).

\textsuperscript{158} Simpson, 100 F.3d at 441. The default rule in RUPA Section 401(b) entitles each partner to an equal share of the firm's profits. RUPA (1996) § 401(b). This rule is, however, subject to modification pursuant to RUPA Section 103. Id. § 103(b). In large partnerships, there are inevitably some partners with more seniority than others, and thus some partners earn a greater share of the firm's profits. Modifying a partner's share of profits is common, but entirely eliminating a partner's right to profits is problematic. At least one commentator has questioned the Simpson court's factual determination that Simpson did not share in the firm's profits. See Sixth Circuit Holds that Partners in an Accounting Firm are Employees for Purposes of ERISA and the ADEA, 6 No. 1 ERISA Litig. Rep. 16, 18 (1997) (discussing Simpson's compensation scheme and suggesting that he did share in firm profits). According to this article, Simpson received a fixed "salary" and an additional "allocation" at year's end based on firm profits. Id.
partners traditionally hold. Although *Simpson* may be an extreme case, the degree to which the Ernst & Young partnership agreement restricted Simpson's authority provides a clear example of a stripped general partner.

In summary, this section illustrates the subtle changes in modern general partnership law that enable partnerships to modify drastically or to even eliminate those essential attributes traditionally associated with being a general partner. For example, a partnership agreement may eliminate a partner's right to vote on important business decisions, eliminate his right to share in profits, and eliminate his access to information concerning the partnership's business and affairs. General partnership law provides partnerships with maximum flexibility to shape management and organizational structure in almost any way imaginable. Flexibility, however, may solve some problems while creating others not imagined.159

**B. Limited Partnerships Under RULPA**

Limited partnerships developed to allow noncorporate profit-sharing investors to limit their liability to the amount they contributed to the firm.160 Initially, limited partnership statutes permitted limited partners to obtain limited liability and to participate in management.161 Thereafter, courts looked toward limited partnerships with skepticism because conventional wisdom suggested that those participating in profits during prosperity should likewise suffer losses upon failure.162 To provide some certainty in this area, the Committee on Commercial Law drafted the Uniform Limited Partnership Act (ULPA) in 1916.163 ULPA clarified limited partnership law significantly, but its control provision proved somewhat vague.164 ULPA provided that a limited partner exercising control might be treated as a general partner, but did not define the word "control."165

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159. Potential problems might include actions under employment discrimination laws or actions for securities fraud under federal or state securities laws.  
160. See Comment, supra note 3, at 895-96 (providing brief history of limited partnerships).  
161. See id. (discussing first limited partnership statute, which was enacted in New York in 1822).  
162. See id. (discussing degree to which courts scrutinized limited partnership formation and required strict adherence to statutory provisions to maintain limited partnership status).  
163. 3 ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG AND RIBSTEIN ON PARTNERSHIP 11:20 (1988) [hereinafter BROMBERG & RIBSTEIN, PARTNERSHIP]. The Committee on Commercial Law wrote ULPA and the National Conference of Commissioners on Uniform State Laws presented it. Id.  
164. ULPA (1916) § 7. Section 7 provides: "A limited partner shall not become liable as a general partner unless, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business." Id.  
165. Id. For an in-depth discussion of activities that may or may not result in loss of
The Revised Uniform Limited Partnership Act of 1976 and the 1985 amendments thereto (collectively RULPA) clarify the meaning of control. Under RULPA, a limited partner may still be treated as a general partner if he participates in control of the firm, but the limited partner is only liable to those third parties who reasonably believe that the limited partner is a general partner. Furthermore, for the limited partner to lose limited status, third parties must base their reasonable beliefs upon the limited partner’s conduct. Thus, the clear import of RULPA is that a limited partner may control the business without incurring personal liability so long as he notifies third parties with whom he is dealing that he is not a general partner.

The latest proposed revision to RULPA would further encourage limited partners to participate in firm management. A proposed draft of RULPA Section 303 entirely eliminates previous language and provides instead that a limited partner is not liable for partnership obligations "even if" he participates in management and control. The current trend of allowing limited partners to participate actively in firm management undermines the traditional tradeoff between control and liability and serves to blur distinctions between general and limited partnerships. Blurred distinctions between general and limited partnerships suggest that traditional presumptions applied in securities law analysis may no longer be valid.

C. Limited Liability Partnerships Under RUPA

1. Background

The recent advent of limited liability partnerships (LLPs) coupled with the freedom of contract permitted under RUPA effectively eliminate the traditional tradeoff between control and liability. Both the corporate and traditional limited partnership forms exemplify this tradeoff. A corporation’s
shareholders have limited personal liability and risk nothing beyond their initial investment.\textsuperscript{172} Traditionally, in exchange for limited liability, the shareholders give up their right to manage directly corporate affairs and instead must exercise their power by electing directors.\textsuperscript{173} Limited partners obtain limited liability by giving up management rights in the business.\textsuperscript{174} Traditionally, if a limited partner went beyond his rights and participated in the control of the business, he lost limited status and became personally liable for partnership obligations.\textsuperscript{175} In contrast to corporations and limited partnerships, LLPs provide partners with limited liability\textsuperscript{176} without restricting management rights.\textsuperscript{177}

\begin{enumerate}
\item \textsuperscript{172} See \textit{Model Bus. Corp. Act} § 6.22(b) (1984) [hereinafter MBCA] (providing that shareholder is not personally liable for corporate obligations, but may become liable by reason of his own acts or conduct).
\item \textsuperscript{173} See \textit{Douglas M. Branson, Corporate Governance} 2 (1993) (stating that power to elect directors is power most central to shareholder's role). The MBCA allows corporations to change this traditional separation between shareholders and managers in a corporation. MBCA § 7.32. The MBCA authorizes shareholder agreements among the shareholders that eliminate entirely the board of directors, thereby permitting direct shareholder management. \textit{Id.} § 7.32(a)(1). Obviously, administrative feasibility limits such a management scheme to closely held corporations.
\item \textsuperscript{174} \textit{ULPA} (1916) § 7; \textit{RULPA} (1976) § 303(a). Modern limited partnership statutes further erode the traditional tradeoff between control and liability in limited partnerships. See supra notes 166-71 and accompanying text (discussing degree to which limited partner may participate in control of firm).
\item \textsuperscript{175} See \textit{ULPA} § 7 (providing for loss of limited status if limited partner participates in control of business). \textit{But see RULPA} § 303 (replacing \textit{ULPA} Section 7). RULPA Section 303 adopted the idea that a limited partner forfeits limited status by participating in control of the business. \textit{Id.} § 303(a). However, RULPA Section 303 declares that a limited partner participating in control of the business "is liable only to persons who transact business with the limited partnership reasonably believing, based upon the limited partner's conduct, that the limited partner is a general partner." \textit{Id.} This language takes much of the bite out of the traditional tradeoff between control and liability and suggests that a limited partner may engage in unlimited control without fear of losing limited status as long as he discloses to third parties that he is a limited partner and not a general partner. Furthermore, a proposed revision to RULPA Section 303 would provide limited liability for a limited partner "even if" he participates in the management and control of the firm. \textit{RULPA} § 303(a) (Tentative Draft No. 2, 1998).
\item \textsuperscript{176} \textit{RUPA} (1996) § 306(c) provides:

An obligation of a partnership incurred while the partnership is a limited liability partnership, whether arising in contract, tort, or otherwise, is solely the obligation of the partnership. A partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for such a partnership obligation solely by reason of being or so acting as a partner. This subsection applies notwithstanding anything inconsistent in the partnership agreement that existed immediately before the vote required to become a limited liability partnership under Section 1001(b).

\textit{Id.}
\item \textsuperscript{177} See \textit{id.} § 401(f) (providing that each partner has equal rights in management and conduct of partnership). This rule, however, is merely a default rule and is subject to modifica-
LLPs originated in Texas in response to the savings and loan crisis and several lawsuits imposing personal liability on partners in various law and accounting firms.\textsuperscript{178} Although styled as "limited liability partnerships," LLPs are simply general partnerships that obtain limited liability for their partners by filing a registration in their respective state.\textsuperscript{179} Proving to be very popular among state legislatures, LLP provisions have been enacted in almost every state and in the District of Columbia.\textsuperscript{180} In most of these states, any general partnership may register as an LLP, but California, Nevada, New York, and Oregon limit LLP election to partnerships that provide professional services.\textsuperscript{181} Because LLP statutes may vary from state to state, this Note focuses its discussion on the 1996 Limited Liability Partnership amendments to RUPA.

A general partnership may become an LLP pursuant to RUPA Section 1001 by filing a statement of qualification.\textsuperscript{182} Upon filing the statement of qualification, the LLP must include in its name words identifying its limited liability status.\textsuperscript{183} Although uniform in name, the nature of the liability shield afforded partners in LLPs varies from state to state.\textsuperscript{184} Over the past five years, three generations of LLP statutes have evolved with ever broadening by the partnership agreement; \textit{see also id.} § 103(a) (providing that relations among partners and between partners and partnership are governed by partnership agreement); \textit{supra} Part III.A (discussing provisions under RUPA subject to modification or elimination).

\textsuperscript{178} See \textit{HILLMAN ET AL., supra} note 117, at 301 (stating that LLPs developed in response to Resolution Trust Corporation and Federal Deposit Insurance Corporation holding lawyers and accountants liable for losses caused by failed savings and loan associations).

\textsuperscript{179} See RUPA § 1001 (authorizing statements of qualification enabling partnerships to become LLPs).

\textsuperscript{180} As of January 1998, Arkansas, Vermont, and Wyoming were the only states that had not adopted limited liability partnership provisions.

\textsuperscript{181} See \textit{CAL. CORP. CODE} §16101(6) (West 1991 & Supp. 1998) (providing that only accounting firms, law firms, and firms related to registered accounting or law firms may register as limited liability partnerships); \textit{NEV. REV. STAT.} § 87.020(7) (1997) (providing that only firms formed for purpose of rendering professional services may register as limited liability partnerships); \textit{N.Y. PARTNERSHIP LAW}, § 121-1500(a) (McKinney 1988 & Supp. 1997) (providing that only firms authorized to render professional services in New York may register as limited liability partnerships); \textit{OR. REV. STAT.} § 68-110(3) (1995) (providing that registration as limited liability partnership is permissible if firm provides professional services or is affiliated with domestic or foreign limited liability partnership that provides related or complementary services).

\textsuperscript{182} See RUPA (1996) § 1001 (providing rules for filing and content requirements for statements of qualification).

\textsuperscript{183} See \textit{id.} § 1002 (providing that name of LLP must end with "Registered Limited Liability Partnership," "Limited Liability Partnership," "R.L.L.P.," "L.L.P.," "RLLP," or "LLP").

\textsuperscript{184} See Carol J. Miller, \textit{LLPs: How Limited is Limited Liability?}, 53 J. Mo. B. 154, 154 (1997) (discussing nature of limited liability shield and noting evolution from narrow to broad shield).
ing liability shields. RUPA includes the third generation comprehensive liability shield giving partners protection from direct or indirect liability for partnership debts and obligations whether arising from tort, contract or otherwise. This broad liability shield does not, however, protect a partner from liability stemming from his own negligence, malpractice, misconduct, or wrongful acts.

2. Comparison of LLPs to General Partnerships

RUPA defines an LLP explicitly as a "partnership" that has achieved limited liability by filing a statement of qualification. Thus, RUPA's default rules for general partnerships apply equally to LLPs and provide for many similarities between general partnerships and LLPs. There are, however, some important differences. Unlike a general partnership, forming an LLP requires certain formalities and thus formation cannot occur inadvertently. The most important difference between general partnerships and LLPs, however, is the limited liability shield, which may affect other aspects of the partnership.

Obtaining limited liability will likely affect the distribution of partners' management rights in the partnership agreement. Conventional wisdom suggests that partners with limited liability are less concerned with active participation in the management and in the control of the business. Thus, becoming an LLP may encourage centralization of management.

185. Id. First generation statutes provided a liability shield for non-negligent partners who had no notice or knowledge of the misconduct that created the liability for the partnership. Id. Thus, these first generation statutes did not entirely shield partners from others' negligence. Id. at 155. Second generation statues broadened the liability shield to protect partners from liability stemming from another partner's misconduct. Id. These statutes also included protection from indirect liability by way of contribution or indemnification. Id. Third generation statutes provide an even broader shield protecting partners from personal liability for all partnership debts and obligations. Id.

186. See RUPA § 306(c) (providing for broad limited liability shield). For the exact language of RUPA Section 306(c), see supra note 176.

187. See id. § 306 cmt. 3 (stating that partners remain personally liable for their own misconduct).

188. Id. § 101(5).

189. See BROMBERG & RIBSTEIN, LLPs, supra note 47, at 17 (discussing formalities such as registration and name requirements).

190. See id. at 22 (noting that express statutory differences may support other differences between general partnerships and LLPs).

191. See id. at 77-85 (suggesting changes partners should consider making to partnership agreement upon obtaining LLP status).

192. See id. at 82 (noting that LLP registration does not require restructured management rights but may justify judicial enforcement of centralized management schemes). Professors Bromberg and Ribstein point out, however, that an LLP should be careful to not jeopardize its status as a partnership under employment discrimination, tax, and securities law. Id. at 82-83.
registration may also encourage partnerships to reallocate profit distribution plans to reflect increased risk to partners in more liability-prone practice areas. The increased flexibility provided in modern partnership law and the development of limited liability partnerships serves to blur form-based distinctions between business entities. It is now possible to have general partners with almost no power and limited partners exercising pervasive control without incurring personal liability. Part IV discusses the effect this flexibility has on investment contract analysis.

IV. Investment Contract Analysis Under Modern Partnership Law

A. Diminished Importance of Formal Categories

The Supreme Court often emphasizes the importance of economic reality in defining the word "security." In carrying out the Supreme Court's directions, the Fifth Circuit, in Williamson v. Tucker, developed a test designed to allow substance to prevail over form in some situations. However, the

Providing partners with strong management and voting rights will likely preserve treatment as a partnership under these other statutes. Id.

193. See id. at 83 (discussing impact of LLP election on profit sharing ratios).

194. See supra Part III.A (discussing freedom of contract under RUPA and creation of general partners with little or no managerial control); see also supra Part III.B (discussing changes to RULPA that allow limited partners more ability to exercise control without losing limited liability).

195. See supra Parts III.A-III.B (discussing changes in law that affect traditional tradeoff between control and liability in partnerships).

196. See Tcherepnin v. Knight, 389 U.S. 332, 336 (1967) (stating that in defining security, "form should be disregarded for substance and the emphasis should be on economic reality"); SEC v. W. J. Howey, Co., 328 U.S. 293, 298 (1946) (discussing definition of investment contract under state law and stating that "[f]orm was disregarded for substance and emphasis was placed upon economic reality").

197. 645 F.2d 404 (5th Cir. 1981). As discussed above in Part II.B.1, Williamson involved the purchase of joint venture interests in real estate development projects. Id. at 408. For a discussion of the facts and the result in Williamson, see supra notes 57-70 and accompanying text.

198. See Williamson v. Tucker, 645 F.2d 404, 424 (5th Cir. 1981) (providing three part test). The Williamson court found that a general partnership or joint venture interest might be deemed an investment contract, and thus a security, if the investor can establish that:

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

Id.
Williamson court explicitly acknowledged the importance it placed on form.\textsuperscript{199} The court stated that a general partner who claims his interest is a security has a "difficult burden to overcome" because the general partner retains substantial control over his investment.\textsuperscript{200} But general partners do not always retain substantial control because RUPA permits a partnership agreement to strip a general partner of power and to thus provide the partner with no control over his investment.\textsuperscript{201} A partner with no power should not face a "difficult burden" in proving his interest is a security. Furthermore, the first part of Williamson's test provides that a general partnership interest might be a security if the partnership agreement distributes power "as would a limited partnership."\textsuperscript{202} But limited partnerships do not distribute power according to any one particular management scheme. Instead, power distribution depends on the terms of the limited partnership agreement, and RULPA permits limited partners to exercise significant control over partnership affairs.\textsuperscript{203} The Williamson court clearly placed significant importance on formal categories, but Part III of this Note demonstrates that form has little meaning.\textsuperscript{204}

To support the assertion that the labels general partnership and limited partnership now have little meaning, compare the underlying general partnership in Simpson \textit{v.} Ernst \& Young\textsuperscript{205} with the limited partnership in Steinhardt Group Inc. \textit{v.} Citicorp.\textsuperscript{206} In Simpson, the typical general partner could not vote for management committee members, could not participate in compensation decisions, could not share in firm profits, and had no part in decisions to admit new partners.\textsuperscript{207} In contrast, the limited partner in Steinhardt held a 98.79\% ownership interest and retained pervasive control over the partnership.\textsuperscript{208}

\textsuperscript{199} See Ribstein, Private Ordering, supra note 71, at 49-50 (suggesting that Williamson comes close to establishing per se test that general partnership interests are not securities).

\textsuperscript{200} Williamson, 645 F.2d at 424.

\textsuperscript{201} See supra Part III.A (discussing RUPA and flexibility provided to create stripped general partners).

\textsuperscript{202} Williamson, 645 F.2d at 424.

\textsuperscript{203} See supra Part III.B (discussing RULPA and ability of limited partners to exercise control over partnership affairs).

\textsuperscript{204} See Park McGinty, The Limited Liability Company: Opportunity for Selective Securities Law Deregulation, 64 U. Cin. L. Rev. 369, 374 (1996) (stating that formal categories become less useful when they mask substantive economic reality); see also supra Part III (discussing effect of modern partnership statutes).

\textsuperscript{205} 100 F.3d 436 (6th Cir. 1996); see supra notes 145-158 and accompanying text (discussing Simpson).

\textsuperscript{206} 126 F.3d 144 (3d Cir. 1997); see supra notes 97-109 and accompanying text (discussing Steinhardt).

\textsuperscript{207} See supra notes 154-158 and accompanying text (discussing degree to which partnership agreement curtailed Simpson's power).

\textsuperscript{208} See Steinhardt Group Inc. \textit{v.} Citicorp, 126 F.3d 144, 154 (3d Cir. 1997) (stating that
These cases demonstrate that the words general partnership and limited partnership have lost much of their descriptive value and now are merely labels. Courts should abandon presumptions based entirely on these labels.

Form-based presumptions are convenient, but they make little sense. Congress designed the securities laws to provide protection for investors who lack the ability to protect themselves. Focusing on form rather than substance undermines investor protection by providing protection to savvy entrepreneurs who possess the knowledge to choose the favored form. When elevating substance over form, it is necessary to determine which factors are most important. The following section addresses this issue.

B. Modified Williamson Proposal

This Note proposes that courts should disregard formal categories and adopt a modified Williamson test when determining whether an interest in a general, limited, or limited liability partnership is a security. The proposed test adopts the second and third factors from Williamson, modifies Williamson's first factor to eliminate reference to a limited partnership, and adds a fourth factor focusing on the partnership's size. Thus, under this proposed modified Williamson test, a general, limited, or limited liability partnership interest might be a security if the investor establishes that: (1) the partnership agreement leaves so little power in the hands of the partner that the partner

limited partnership agreement defined majority of partners as partners holding more than 50% interest in limited partnership and thus provided Steinhardt with power to approve or disapprove any material action). With a 98.79% ownership interest, Steinhardt alone constituted a majority of the partners. Id. See also supra notes 103-08 and accompanying text (discussing power given to Steinhardt under Limited Partnership Agreement).

209. At least one commentator proposes a "private ordering" approach that would adopt a per se rule that general partnership interests are not securities. See Ribstein, Private Ordering, supra note 71, at 41-42 (stating that under private ordering approach, general partnerships would be per se non-securities whether or not partners need protection of securities laws). The convenience of Professor Ribstein's approach is apparent in that it provides much certainty in this field of law. Although certainty is an important consideration, it is not the only consideration. Placing so much emphasis on the general partnership label may eviscerate protections provided by securities law to unwary investors.

210. See SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963) (stating that fundamental purpose of statutes was "to substitute a philosophy of full disclosure for the philosophy of caveat emptor"); A.C. Frost & Co. v. Coeur D'Alene Mines Corp., 312 U.S. 38, 40 (1941) (stating that purpose of securities law is to protect investors by requiring disclosure).

211. See Williamson v. Tucker, 645 F.2d 404, 424 (5th Cir. 1981) (providing three part test). Part two of the Williamson test deals with a partner's knowledge or experience concerning partnership business. Id. Part three deals with a partner's reliance or dependence on the unique entrepreneurial ability of a manager or promoter. Id.

212. See id. (providing in first part of test that partner may be security holder if partnership agreement distributes power as would limited partnership).
cannot adequately protect his partnership interest; or (2) the partner has so little knowledge or experience with the partnership’s business that he is incapable of intelligently exercising his partnership powers; or (3) the partner is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that the partner cannot reasonably replace the manager or otherwise exercise meaningful partnership powers; or (4) the partnership is so large and the partner’s interest so small that he effectively has no influence over essential managerial functions. The following subsections discuss each modified Williamson factor separately.

1. Partnership Agreement

Part one of the proposed modified Williamson test states that a partnership interest might be a security if the investor establishes that the partnership agreement leaves so little power in the hands of the partner that the partner cannot adequately protect his partnership interest. Looking to the power given to partners in the partnership agreement is the logical starting point in a securities analysis because the partnership agreement provides the law for that partnership. Consider the partnership agreement in Simpson v. Ernst &

213. See Bromberg & Ribstein, LLPS, supra note 47, at 239 (stating that relevant factor in securities analysis is whether partnership agreement restricts partners’ rights too tightly).

214. See SEC v. W. J. Howey Co., 328 U.S. 293, 300 (1946) (suggesting that lack of partner expertise in partnership’s business is factor weighing in favor of finding that interest is security); see also SEC v. Telecom Mktg., Inc., 888 F. Supp. 1160, 1166 (N.D. Ga. 1995) (finding that general partnership interests are securities where evidence suggests defendants targeted investors because of their ignorance of law, accounting, and wireless cable television industry); Williamson, 645 F.2d at 422-23 (stating that when partner "is so dependent on the particular expertise of the promoter or manager that he has no reasonable alternative to reliance on that person, then his partnership powers may be inadequate to protect him from dependence on others" and therefore implicate securities law); Bromberg & Ribstein, LLPS, supra note 47, at 239 (stating that whether partner’s lack of knowledge of partnership’s business is too great is relevant factor in securities analysis).


216. See Williamson, 645 F.2d at 423 (stating that sale of interests to large numbers dilutes single partner’s role to level similar to shareholder in corporation); see also Bromberg & Ribstein, LLPS, supra note 47, at 239 (stating that whether "partners are too numerous" and whether their "interests are too small" are relevant factors in securities analysis); Chris Walters, Comment, Application of Investment Contract Analysis to Partnership Interest and Dual Regulation Under Federal and Kansas Securities Laws, 45 Kan. L. Rev. 1275, 1291 (1997) (asserting that large number of partners reduces ability of single partner to influence firm management).

217. See RUPA (1996) § 103(a) (providing that relations among partners and between partners and partnership are governed by partnership agreement).
Young. Simpson provides a clear example of a partnership agreement that would satisfy the first part of the modified Williamson test.

The partnership agreement in Simpson severely restricted Simpson's power and hampered his ability to protect his partnership interest. Three key factors support classifying Simpson's partnership interest as a security. First, the agreement established a very strong centralized management structure in which a management committee exercised exclusive control over the firm's business and affairs. Generally, using a management committee in a large firm is not problematic because economic efficiency and administrative feasibility require some centralization of management. But in Simpson, the Management Committee was a self-perpetuating entity in which members of the committee appointed its chairman and the chairman, in turn, appointed its members. Because partners did not vote for Management Committee members, the committee was hardly a representative body. Second, the partnership agreement gave Simpson no right to participate in decisions to admit or discharge new partners. This factor is important because admission of new partners impacts the success of the enterprise and thus supports the assertion that Simpson relied on others to make essential managerial decisions that affected the success of the firm. Third, the partnership agreement curtailed Simpson's right to inspect partnership books and records. Re-

218. 100 F.3d 436 (6th Cir. 1996). See supra notes 145-158 and accompanying text (discussing Simpson and power held under partnership agreement).

219. See Simpson v. Ernst & Young, 100 F.3d 436, 441 (6th Cir. 1996) (discussing Simpson's lack of power within partnership). According to the trial judge, Simpson had no authority to (1) participate in admission or discharge of partners, (2) participate in determining partner compensation, (3) vote for Management Committee members or its chairman, (4) participate in firm profits or losses, (5) examine books and records unless authorized by the Management Committee, (6) sign promissory notes for the firm or pledge, assign, or transfer his partnership interest, (7) access various client accounts, or (8) participate in annual performance reviews. Id.

220. See id. at 441 (discussing Ernst & Young's Management Committee).

221. See 3 BROMBERG & RIBSTEIN, PARTNERSHIP, supra note 163, at 6:60 (stating that centralization of management is common in large partnerships where there are too many partners for each to participate effectively in daily decision making).

222. See Simpson, 100 F.3d at 441 (discussing Ernst & Young's Management Committee).

223. See id. (reiterating trial court's findings of fact).

224. See SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 476, 482 (9th Cir. 1973) (restating "efforts of others" test and providing that interest is security where those other than investor make undeniably significant and essential managerial efforts that affect success of enterprise).

225. See Simpson v. Ernst & Young, 100 F.3d 436, 441 (6th Cir. 1996) (stating that Simpson had no right to "examine books and records of the firm except to the extent permitted by the Management Committee"). Under RUPA, a partnership may restrict its partners' rights to access books and records as long as the restriction is reasonable. RUPA (1996) § 103(b)(2).
stricting a partner's right to information hampers his ability to protect adequately his partnership interest.

In contrast to the agreement in Simpson, a general or limited liability partnership agreement that largely adopts the RUPA default provisions easily satisfies the first part of the modified Williamson test. Such a partnership agreement provides each partner with equal voice in management and unfettered access to partnership information. In addition, all partners have to consent to admitting new partners into the partnership. An interest in this partnership is probably not a security because a partnership agreement that gives its partners significant powers provides persuasive evidence that partners are not relying primarily on the efforts of others for their profit.

Like general and limited liability partnership interests, a limited partnership interest will likely not be a security when the partnership agreement provides the limited partner with power sufficient to protect his investment. One of the most extreme examples of this power is when the partnership agreement gives a limited partner the right to remove and to replace a general or managing partner without cause. Such power provides limited partners with significant control because managers must be responsive to the limited partners or face removal. In small limited partnerships, removal power is probably enough to take the limited partnership interests outside securities law protection. But in large limited partnerships, the right to remove a general partner becomes attenuated and has little practical effect and thus should not rule out classification of limited partnership interests as securities. In some

226. See RUPA § 401 (providing default rules regarding partners' rights and duties).
227. See id. § 401(f) (providing that each partner has equal rights in management and conduct of partnership); see also id. § 403 (providing partner with right to access partnership books and records and other information concerning partnership's business and affairs).
228. See id. § 401(i) (providing that person may become partner only with consent of all partners).
229. If a partner does not rely on the efforts of others to obtain profit, his partnership interest is not an investment contract and, thus, not a security. See SEC v. W. J. Howey Co., 328 U.S. 293, 298-99 (1946) (announcing investment contract test and including "efforts of others" prong).
230. See Steinhardt Group Inc. v. Citicorp, 126 F.3d 144, 154 (3d Cir. 1997) (finding that partnership agreement provided limited partner with pervasive control over partnership management and determining that limited partnership interest was not security). For an in-depth discussion of Steinhardt, see supra notes 97-109 and accompanying text.
231. See 3 BROMBERG & RIBSTEIN, PARTNERSHIP, supra note 163, at 12:147 (discussing effects of limited partner's right to exercise control).
232. Id.
233. See id. (discussing removal power and its effect on securities law analysis).
234. See id. at 12:147-48 (discussing effect of removal power in large firms).
cases, limited partners are so reliant on the managing partner that removal, even if authorized by the partnership agreement, is not a realistic option.\textsuperscript{235} In those cases, removal power should not preclude securities law protection.\textsuperscript{236}

2. Partner's Knowledge and Expertise

Part two of the proposed modified Williamson test states that a partnership interest might be a security if the investor can establish that the partner has so little knowledge or experience with the partnership's business that he is incapable of intelligently exercising his partnership powers. To some extent, the powers provided to a partner in the partnership agreement mean very little if the partner lacks the sophistication to use those powers.\textsuperscript{237} Consider, for example, a lawyer who is a general partner in two separate partnerships. One partnership is a law firm in which the partner and his colleagues perform legal services. The efforts of others generate a portion of the partner's profits, but assuming the partner has sufficient voice and access to information, he is probably not a security holder. His expertise as a lawyer provides him with the knowledge and ability to evaluate adequately and to exercise some control over his investment.\textsuperscript{238} In the second partnership, the partner is one of several professionals who purchased an interest in a wireless cable television business.\textsuperscript{239} He has no intention of actively participating in the management or operation of the business but merely expects to fund partially a startup venture with the expectation of future profits. He also lacks knowledge of the cable television industry and has none of the necessary equipment to perform the required work. Even though his interest is called a general partnership interest, in economic reality it is an investment, and federal securities laws should protect it.\textsuperscript{240}

\begin{itemize}
  \item \textsuperscript{235} See id. (discussing effect of removal right where limited partners depend on special expertise of managing partner).
  \item \textsuperscript{236} Id.
  \item \textsuperscript{237} See SEC v. W. J. Howey Co., 328 U.S. 293, 299-300 (1946) (placing emphasis on fact that partners lacked equipment or knowledge to successfully operate citrus groves).
  \item \textsuperscript{238} See id. at 300 (suggesting that lack of partner expertise in partnership's business is factor weighing in favor of finding that interest is security); see also SEC v. Telecom Mktg., Inc., 888 F. Supp. 1160, 1166 (N.D. Ga. 1995) (finding that general partnership interests were securities where partnership agreement indicated that partners possessed real power, but evidence suggested that defendants targeted investors because of their ignorance of law, accounting, and wireless cable television industry).
  \item \textsuperscript{239} See generally Telecom Mktg., 888 F. Supp. 1160 (involving securities fraud violations and finding that general partnership interests in wireless cable television business are securities).
  \item \textsuperscript{240} See id. at 1166 (finding that similar general partnership interest was security when investors lacked knowledge and equipment to successfully operate partnership's business).
\end{itemize}
The wireless cable television example above demonstrates that courts must look not only to the investor's general business acumen, but also to the investor's knowledge of the partnership's particular business—especially when the partnership's business is highly specialized. In Bailey v. J.W.K. Properties, Inc., the court's decision turned on the specialized nature of the investment. Bailey involved a cattle crossbreeding venture in which the investors purchased cattle embryos from the promoter and the promoter agreed to raise and to market the resulting calves. The court decided that the investors' interests were investment contracts because practical limitations hindered the plaintiffs' ability to protect their investments. First, although the agreements gave the investors significant powers, the investors lacked the technical knowledge needed to successfully operate the business. Second, an economies of scale problem existed in that no single investor owned enough cattle to make crossbreeding profitable. Thus, the investors' dependence on each other and on the promoter limited the investors' ability to protect their investment. The court, therefore, found that the investors' interests were securities.

241. 904 F.2d 918 (4th Cir. 1990).

242. See Bailey v. J.W.K. Properties, Inc., 904 F.2d 918, 924-25 (4th Cir. 1990) (finding investment contract when lack of expertise of plaintiffs in cattle crossbreeding venture imposed practical limitations on plaintiffs' ability to protect their interests). In Bailey, the plaintiffs invested in a cattle crossbreeding program in which the plaintiffs bought embryos from the promoter and the promoter agreed to raise the resulting calves and to market them as they matured. Id. at 919. Although no formal partnership agreement existed, the court apparently considered the "Purchase Agreement" and the "Management Contract" together as a single joint venture, and thus applied a Williamson-type analysis focusing on investor sophistication and reliance on the promoter (parts two and three of the Williamson test). Id. at 924-25. The two agreements purportedly gave the investors significant control over the investment, but the court stated that "limiting the examination to the contract itself would provide an easy loophole through which sellers could circumvent federal securities law." Id. at 920, 922 n.6. The court based its decision that the interests were securities on two practical limitations. First, the plaintiffs had no experience in selecting embryos and had an extremely limited range of alternative sources of information. Id. at 924. Second, economies of scale prevented an individual investor from running a successful breeding operation and required the investors to pool their herds. Id. Based on the plaintiffs' lack of sophistication concerning cattle crossbreeding and their reliance on the promoter, the court found that the plaintiffs' interests were investment contracts and thus securities. Id. at 925.

243. Id. at 919.

244. See id. at 920 & n.4 (discussing plaintiffs' "substantial rights" and providing language from "Management Contract"). The investors' substantial rights included the right to direct the promoter's activities, to choose embryos, to terminate the management agreement, and to direct the sale of herds. Id. at 920.

245. See id. at 924 (stating that investors lacked expertise to make embryo selections and had limited access to other sources of information).

246. See id. at 924-25 (noting that case is similar to Howey in that program required participation of other investors with centralized coordination by promoter).

247. Id. at 925.
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The investors' lack of expertise made them dependent on the promoter. This dependence is demonstrative of the interrelatedness between parts two and three of the modified Williamson test.

3. Partner's Dependence

Part three of the proposed modified Williamson test states that a partnership interest might be a security if the investor can establish that the partner is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot reasonably replace the manager or otherwise exercise meaningful partnership powers. Note that this phrasing is slightly different than the test that Williamson originally stated. The Williamson court did not include the word "reasonably" in its test, but elsewhere in its opinion the court indicated that the words "cannot replace" should be construed broadly. In discussing part three of its test, the court stated that the investors must allege that they were "incapable, within reasonable limits," of replacing the promoter. Such language indicates that the court intended its test to be interpreted realistically rather than rigidly. Thus, this Note inserts the word "reasonably" into its modified Williamson test.

Consider the facts in Bailey v. J.W.K. Properties, Inc. The investors in Bailey had the actual power to remove the promoter, but lacked the knowledge or expertise to operate the business effectively. A rigid application of part three of Williamson would have removed the protection of the securities laws. The Bailey court, however, recognized that although the investors had the power to remove the promoter, they could not reasonably replace him because of his special expertise and his knowledge of cattle cross-breeding.

248. See Williamson v. Tucker, 645 F.2d 404, 424 (5th Cir. 1981) (providing part three of test and not including word "reasonably"). Part three of the original Williamson test stated that an interest might be a security if the partner is so dependent on the manager that "he cannot replace" him or otherwise exercise meaningful partnership powers. Id.

249. Id.

250. See id. at 425 (stating that plaintiffs must allege that partners were "incapable, within reasonable limits, of finding a replacement manager").

251. Id.

252. See supra note 215 and accompanying text (stating part three of modified Williamson test); see also Sobel, supra note 49, at 1349-51 (arguing for nonliteral interpretation of part three of Williamson and suggesting use of word "practically").

253. 904 F.2d 918 (4th Cir. 1990). See supra note 242 (providing facts and result in Bailey).

254. See Bailey v. J.W.K. Properties, Inc., 904 F.2d 918, 920 (4th Cir. 1990) (noting that investors had power to terminate management agreement).

255. See id. at 925 (stating that under circumstances, investors could not meaningfully exercise rights "theoretically available to them").
4. Partnership Size

Part four of the proposed modified *Williamson* test states that a partnership interest might be a security if the investor can establish that the partnership is so large and the partner's interest is so small that he effectively has no influence over essential managerial functions. Although it did not include this factor in its test, the *Williamson* court recognized that firm size may be a factor in an investment contract analysis. According to the *Williamson* court, at some point a partnership becomes so large that a partner's vote is more like a shareholder's vote in a corporation. As the number of partners in a partnership increases, each partner's vote becomes very attenuated, thus causing partners to rely substantially on others to make managerial decisions. This implicates *Howey*’s "efforts of others" test and suggests that the partners' interests are securities.

C. General Comments Concerning Treatment of Limited Liability Partnership Interests

No federal courts have addressed the treatment of LLP interests under federal securities law. Surprisingly, commentators have written very little concerning this topic. The consensus among those broaching the issue is that courts should treat LLP interests like general partnership interests because LLPs are simply general partnerships that elect to obtain limited liability for their partners. But the freedom of contract provided in modern partnership...
law makes such categorical grouping based entirely on form an inappropriate classification. With the addition of limited personal liability, one could fashion a partnership agreement that makes an LLP more analogous to a closely held corporation than to a traditional general partnership.

As with general and limited partnership interests, deciding whether an LLP interest is a security should depend on the facts and circumstances of each case. Some might suggest that the mere presence of limited liability creates a presumption that securities law ought to apply. Clearly, limited personal liability may encourage partners to take a less active role in managing partnership affairs, thus leading to centralization of management—a factor in investment contract analysis. It is true that limited personal liability may have an impact on a partner’s conduct with respect to the partnership, but it is the partner’s conduct—whether he has the power and ability to protect his interest—that should factor into the securities analysis, not the mere presence or absence of limited liability.

Some might suggest that courts should treat LLPs and limited liability companies (LLCs) similarly because they are both unincorporated limited liability entities. This argument has merit because LLP and LLC enabling statutes provide enough flexibility so that the two entities may sometimes appear functionally equivalent. However, this same flexibility permits entrepreneurs to create LLPs and LLCs that are drastically different. Thus, a strict comparison to LLCs is also not appropriate. The ability to alter significantly entity attributes undermines categorical form-based classifications and counsels for fact-sensitive case-by-case analysis.

V. Conclusion

In analyzing whether a partnership interest is a security, courts apply the investment contract test announced in Howey and its progeny. Generally, a partnership interest is a security if an expectation exists that profits will derive primarily or substantially from the efforts of others. In applying

259. See supra Parts III.A-B (discussing features of RUPA and RULPA that permit flexibility and blur distinctions between business forms).

260. See Walters, supra note 216, at 1292 (discussing structure of management as factor in investment contract analysis).

261. See generally Ribstein, Futures, supra note 258 (providing discussion of differences and similarities between LLPs and LLCs).

262. See id. at 321-27 (discussing differences between LLPs and LLCs).

263. See supra Part II.A (discussing development and interpretation of Howey's "efforts of others" test).

264. See supra notes 48-55 and accompanying text (discussing liberal interpretation of "efforts of others" test).
Howey’s test, courts developed presumptions that general partnership interests are not securities and that limited partnership interests are securities. Modern partnership law removes the foundation upon which courts based these presumptions.  RUPA permits the partnership agreement to change or to eliminate most of the default partnership rules thereby creating partners that have little or no power to participate meaningfully in firm management.  RULPA permits limited partners to become more active in firm management without sacrificing limited liability.  Formal categories now mask economic realities and diminish the appropriateness of form-based distinctions.

This Note proposes that with regard to general, limited, and limited liability partnerships, courts should diminish the importance of formal categories when conducting an investment contract analysis. In doing so, courts should apply the proposed modified Williamson test as discussed above in Part IV. Under the modified Williamson test, a general, limited, or limited liability partnership interest might be a security if the investor can establish that: (1) the partnership agreement leaves so little power in the hands of the partner that the partner cannot adequately protect his interest in the partnership, or (2) the partner has so little knowledge or experience with the partnership’s business that he is incapable of intelligently exercising his partnership powers, or (3) the partner is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot reasonably replace the manager or otherwise exercise meaningful partnership powers, or (4) the partnership is so large and the partner’s interest is so small that he effectively has no influence over essential managerial functions. By implementing this test and by placing economic substance over formal categories, courts can more readily achieve the purposes of federal securities law.

265. See Williamson v. Tucker, 645 F.2d 404, 422 (5th Cir. 1981) (suggesting that general partnership interests presumptively are not securities); SEC v. Murphy, 626 F.2d 633, 640-41 (9th Cir. 1980) (suggesting that limited partnership interests presumptively are securities).

266. See supra Parts III.A-B (discussing flexibility of RUPA and RULPA).

267. See RUPA (1996) § 103(a) (providing general rule that partnership agreement may modify or eliminate default rules provided in RUPA). See supra Part III.A for detailed discussion of freedom to contract provided in RUPA.

268. See supra Part III.B (discussing changes in limited partnership law that allow limited partners to exercise control over partnership affairs without incurring personal liability).

269. See supra Part IV.B (discussing application of modified Williamson test).
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