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MARC H. MORGENSTERN

REAL ESTATE JOINT VENTURE INTERESTS AS SECURITIES: THE IMPLICATIONS OF *WILLIAMSON V. TUCKER*

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Whether interests in real estate transactions are securities is an intriguing and continually recurring issue. Such transactions rarely are structured in conventional corporate form, and, consequently, interests in real estate seldom bear recognizable security labels such as "stocks" or "bonds." As one commentator has noted, "substance governs rather than form . . . . [J]ust as some things which look like real estate are securities, some things which look like securities are real estate."[1]

Judicial examination of real estate interests as securities typically requires an analysis of whether they are "investment contracts,"[2] one of the defined terms for a security under the federal securities laws.[3] The scope of investment contract analysis is expansive, and under its aegis, courts have found securities in surprising contexts, from investments in scotch whiskey casks,[4] to earthworm farms,[5] to discretionary commodities accounts.[6] Courts are repeatedly called upon to determine "which of the myriad financial transactions in our society come within the cov-

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* Principal, Kahn, Kleinman, Yanowitz & Arnson Co., L.P.A., Cleveland, Ohio. B.A., 1972, Yale University; J.D., 1975, Boston University. The author thanks Thomas Collin, Karl May, Pat Morgenstern-Clarren, and Peter Rubin for their helpful comments.

1. L. Loss, SECURITIES REGULATION 493 (2d ed. 1961).

2. 15 U.S.C. §§ 77b(1) 78c(a)(10) (1976).

3. *See* Securities Act of 1933, § 2(1), 15 U.S.C. § 77b(1) (1976); Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C. § 78a (1976).

4. *See, e.g.*, SEC v. Haffenden-Rimer Int'l, Inc., 496 F.2d 1192 (4th Cir. 1974); SEC v. M.A. Lundy Assocs., 362 F. Supp. 226 (D.R.I. 1973).

5. Smith v. Gross, 604 F.2d 639 (9th Cir. 1979).

6. The federal appellate courts have not treated discretionary commodities accounts uniformly. *See* SEC v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974) (discretionary commodities account is a security); Glen-Arden Commodities, Inc. v. Costantino, 493 F.2d 1027 (2d Cir. 1974) (same). *But see* Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 622 F.2d 216 (6th Cir. 1980) (discretionary commodities account is not a security), *cert. granted*, 101 S. Ct. 1971 (1981); Brodt v. Bache & Co., 595 F.2d 459 (9th Cir. 1978) (same); Milnarik v. M-S Commodities, Inc., 457 F.2d 274 (7th Cir.) (same), *cert. denied*, 409 U.S. 887 (1972). *See also* Hodes & Dreyfus, *Discretionary Trading Accounts in Commodity Futures—Are They Securities?*, 30 PRAC. LAW. 99 (1974); Comment, *Discretionary Commodities Accounts as Securities*, 67 GEO. L.J. 269 (1978).

erage of [the federal securities] statutes."[7]

The Fifth Circuit Court of Appeals in *Williamson v. Tucker*[8] recently explicated the circumstances under which an interest in a real estate joint venture[9] constitutes an investment contract and thus a security. The court also formulated a test for making such a determination. This Article discusses the history of investment contract analysis, critically examines the *Williamson* test, and suggests methods for joint venture promoters and their counsel to respond to the test.

I. Definition of a Security

Section 2(1) of the Securities Act of 1933 defines a security as "any note, . . . evidence of indebtedness, . . . *investment contract*, . . . or, in general any interest or instrument commonly known as a 'security.'"[10] The definition of a security in section 3(a)(10) of the Securities Exchange Act of 1934[11] is identical in operative effect to that contained in the Securities Act of 1933, and for this purpose the two acts are to be construed *in pari materia*.[12]

The definition of a security for state law purposes is substantially the

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7. United Hous. Foundation, Inc. v. Forman, 421 U.S. 837, 848 (1975).

8. 645 F.2d 404 (5th Cir.), *cert. denied*, 102 S. Ct. 396 (1981).

9. A joint venture is commonly defined as a partnership organized for a specific project, or more generally as a "form of partnership." Long, *Partnership, Limited Partnership, and Joint Venture Interests as Securities*, 37 Mo. L. Rev. 581, 587 (1972). There are technical differences between the two forms of entities. The Uniform Partnership Act has been adopted, with some revisions, in all states and delineates the respective rights and obligations of partners in a partnership. There is no statutory counterpart, however, for joint venture partners. Among the more important differences to the practitioner between a general partnership and a joint venture is that a partner has the right contractually to bind the partnership, while a joint venture partner has no such right absent specific authorization in the joint venture agreement.

While these differences may be of practical interest in choosing an entity form, they do not necessitate separate analytical treatment when determining the existence of a security. From a conceptual standpoint, whether an agreement is denominated a general partnership or a joint venture is irrelevant, because both are subject to the same investment contract analysis. Most courts have agreed that interests in joint ventures and general partnerships may be securities under appropriate factual circumstances. This Article, therefore, draws no distinction between the analysis of a joint venture or general partnership interest.

10. 15 U.S.C. § 77b(1) (1976) (emphasis added).

11. 15 U.S.C. § 78c(a)(10) (1976).

12. Tcherepnin v. Knight, 389 U.S. 332, 336 (1967). The term "security" is defined in the following federal securities statutes: Securities Act of 1933, § 2(1), 15 U.S.C. § 77b(1) (1976); Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C. § 78c(a)(10) (1976); Public Utility Holding Company Act of 1935, § 2(a)(16), 15 U.S.C. § 79b(a)(16) (1976); Investment Company Act of 1940, § 2(a)(36), 15 U.S.C. § 80a-2(a)(36) (1976); Investment Advisers Act of 1940, § 202(a)(17), 15 U.S.C. § 80b-2(a)(17) (1976). The Trust Indenture Act of 1939, § 303(17), 15 U.S.C. § 77ccc(1)

same as the federal definitions. The Uniform Securities Act[13] defines a security as "any note; stock; treasury stock; bond; debenture; evidence of indebtedness; . . . *investment contract*; . . . or, in general, any interest or instrument commonly known as a 'security.' "[14]

Neither the federal nor the state definitions of a security expressly include joint venture interests.[15] Such interests are securities when they fall within the elastic category of investment contracts.[16] Investment

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(1976), adopted the same definition as the Securities Act of 1933. There are some differences among these statutory definitions, but none that affect this Article.

For an analysis of the different definitions of the term "security" in the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Advisers Act of 1940, and the Investment Company Act of 1940, see Hannan & Thomas, *The Importance of Economic Reality and Risk in Defining Federal Securities*, 25 HASTINGS L.J. 219, 221 & n.13 (1974).

13. The Uniform Securities Act has been adopted in whole or in part in 35 states, the District of Columbia, Puerto Rico, and Guam.

14. UNIFORM SECURITIES ACT § 401(A) (emphasis added).

The Uniform Act also includes in its definition of securities "any contract or bond for the sale of any interest in real estate or deferred payments or on installment plans when such real estate is not situated in this state or in any state adjoining this state." *Id.* This aspect of state regulation of interests in foreign real estate as securities will not be addressed in this Article.

15. The American Law Institute Federal Securities Code Project also does not define a joint venture interest as a security. Professor Loss, the Reporter of the Code, indicates that the statutory definition should not be substantially changed because "there is now a considerable body of jurisprudence and because it [the statutory definition] was substantially followed in the Uniform Securities Act, so that there is also a degree of uniformity at both state and federal levels." ALI, FED. SEC. CODE § 202(150), Comment 1, at 198 (Official Draft 1980).

Section 202(150) of the proposed Code defines a security as follows:

> (a) General.—"Security" means a bond, debenture, note, evidence of indebtedness, share in a company (whether or not transferable or denominated "stock"), preorganization certificate or subscription, *investment contract*, certificate of interest or participation in a profit-sharing agreement, collateral trust certificate, equipment trust certificate (including a conditional sale contract or similar interest or instrument serving the same purpose), voting trust certificate, certificate of deposit for a security, or fractional undivided interest in oil, gas, or other mineral rights, or in general, an interest or instrument commonly considered to be a "security", or a certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or buy or sell, any of the foregoing.

Id. (emphasis added).

16. Numerous commentators have explored the parameters of investment contracts as securities. *See* Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?*, 18 W. RES. L. REV. 367 (1967); Faust, *What Is A Security? How Elastic Is The Definition?*, 3 SEC. REG. L.J. 219 (1975); Hannan & Thomas, *supra* note 12; Long, *An Attempt to Return 'Investment Contracts' to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135 (1971); Long, *Introduction to Symposium: Interpreting the Statutory Definition of a Security: Some Pragmatic Considerations*, 6 ST. MARY L.J. 96 (1974); Long, *supra* note 9; Marx, *What Is A Security?*, 35 WASH. & LEE L. REV. 757 (1978); Mofsky, *The Expanding Definition of 'Security' Under the Blue Sky Laws*, 1 SEC. REG. L.J. 3 (1973); Rapp, *The Role of Promotional Characteristics in Determining the Existence of a Security*, 9 SEC. REG. L.J. 26 (1981); Comment, *Franchise Sales: Are They Sales or*

contract analysis evolved from a series of key decisions, including *SEC v. C.M. Joiner Leasing Corp.*,[17] *SEC v. W.J. Howey Co.*,[18] *Commissioner v. Hawaii Market Center, Inc.*,[19] and *United Housing Foundation, Inc. v. Forman*.[20] An understanding of the implications of *Williamson* first requires a review of these cases.[21]

II. Case Law Development

A. SEC v. C.M. Joiner Leasing Corp.

The first of the investment contract cases was *Joiner*.[22] An oil drilling firm, Joiner Company, offered assignments of oil leases to numerous small investors. The sales literature[23] emphasized that Joiner Company was drilling a test well, the purpose of which was "to test the

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Securities?, 34 Alb. L. Rev. 383 (1970); Note, *The Expanding Definition of 'Security': Sale-Leasebacks and Other Commercial Leasing Arrangements*, 1972 Duke L.J. 1221.

17. 320 U.S. 344 (1943).

18. 328 U.S. 293 (1946).

19. 52 Hawaii 642, 485 P.2d 105 (1971).

20. 421 U.S. 837 (1975).

21. In addition to *Joiner*, *Howey*, and *United Housing*, the Supreme Court has also construed the term "investment contract" in several cases. *See* International Bhd. of Teamsters v. Daniel, 439 U.S. 551 (1979) (noncontributory pension plan was not a security within the meaning of the federal securities acts); Tcherepnin v. Knight, 389 U.S. 332 (1967) (withdrawable capital shares of a savings and loan association were securities under the Exchange Act); SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967) (flexible fund annuity contracts were securities within the meaning of the Securities Act); SEC v. Variable Annuity Life Ins. Co. of America, 359 U.S. 65 (1959) (variable annuity contracts were securities within the meaning of the Securities Act).

For critical evaluations of *Daniel*, see Della Rosa, *Securities Law—Applicability of the Securities Act to Noncontributory, Compulsory Pension Plans*—International Brotherhood of Teamsters v. Daniel, 14 Suffolk U.L. Rev. 159 (1980); Joseph, *Securities Regulation: Implications of the* Daniel *Decision—Involuntary, Noncontributory Pension Plans are not Securities*, 32 Okla. L. Rev. 935 (1979). The Seventh Circuit's opinion was also discussed in Barasch, *Interests in Pension Plans as Securities*: Daniel v. International Brotherhood of Teamsters, 78 Colum. L. Rev. 184 (1978); Emery & Heinzerling, *Federal Securities Laws*: Daniel v. International Brotherhood of Teamsters, 11 Akron L. Rev. 578 (1978); Note, *The Federal Securities Laws and Employee Pension Participants*: *Rating* Daniel, 87 Yale L.J. 1666 (1978).

22. SEC v. C.M. Joiner Leasing Co., 320 U.S. 344 (1943).

23. The following statement appeared on the circulars and selling letters:

> Because these securities are believed exempted from registration, they have not been registered with the Securities and Exchange Commission; but such exemption, if available, does not indicate that the Securities have been either approved or disapproved by the Commission or that the Commission has considered the accuracy or completeness of the statements in this communication.

Id. at 347 n.3.

The Supreme Court, however, gave little consideration in its analysis to whether the assignments were securities to the promoters' own characterization of such interests as securities. 320 U.S. 344 *passim*.

oil-producing possibilities of the offered leaseholds."[24] The literature also emphasized the investment character of the purchase and the opportunity afforded the investor to participate in an "enterprise."[25]

In holding that the assignments were investment contracts, the Supreme Court announced several standards that formed the basis for later investment contract analysis. First, the method by which an offer to sell an interest is communicated may play an important role in determining whether the interest is a security.[26] Second, the name that the interest bears is a starting point for analyzing whether the interest is a security, but the name, by itself, is not dispositive.[27] Finally, although the concept is implicit rather than explicit, "participation in an enterprise"[28] is a prerequisite to the existence of an investment contract.

The Joiner Company's drilling of the test well provided a common enterprise between the seller and buyer of the assignments. The exploration was an integral part of the value of the leasehold interests, and the agreement to drill the well "[ran] through the whole transaction as the thread on which everyone's beads were strung."[29] The exploration provided the inducement to invest, because a successful test for oil could cause the land to appreciate in value and permit the investors to make a profit.

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24. *Id.* at 346.

25. *Id.*

26. "[D]efendants were not, as a practical matter, offering naked leasehold rights. Had the offer mailed by defendants omitted the economic inducements of the proposed and promised exploration well, it would have been a quite different proposition." *Id.* at 348.

For a thorough discussion of the importance of the manner of the offer in determining the existence of a security, see generally Rapp, *supra* note 16.

27. The Court stated:

> In the Securities Act the term "security" was defined to include by name or description many documents in which there is common trading for speculation or investment. Some, such as notes, bonds, and stocks, are pretty much standardized and the name alone carries well settled meaning. Others are of more variable character and were necessarily designated by more descriptive terms such as "transferable share," "investment contract," and "in general any instrument commonly known as a security" . . . . Instruments may be included within any of these definitions, as a matter of law, if on their face they answer to the name or description. However, the reach of the Act does not stop with the obvious and commonplace. Novel, uncommon or irregular devices, whatever they appear to be, are also reached if it be proved as a matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as "investment contracts," or as "any interest or instrument commonly known as a 'security.'"

320 U.S. at 351.

28. *Id.* at 346.

29. *Id.* at 348.

B. SEC v. W.J. Howey Co.

The broad analytic principles articulated in *Joiner* were refined in *Howey*.[30] The W.J. Howey Company offered to sell land in a citrus grove development and its affiliate, Howey-in-the-Hills Service, Inc., offered to manage, cultivate, and market the crops and to remit the proceeds to investors. The company offered each potential investor both a land sales contract and a service contract and advised investors that it was not feasible to invest in a grove unless a service arrangement was made.[31]

The Supreme Court relied heavily on federal and state[32] judicial interpretation of the term "investment contract"and held that four elements predicate the existence of an investment contract: (1) an investment; (2) a common enterprise; (3) the expectation of profits; and (4) profits that result solely from efforts of another.[33] This formulation is referred to as the *Howey* test, and subsequent decisions have subjected virtually every constituent clause and word of the test to judicial interpretation and modification.[34]

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30. SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

31. *Id.* at 295.

32. The author of the *Howey* opinion, Justice Murphy, stated that he relied heavily on state court interpretation of the term "investment contract" in formulating the test. Some commentators have suggested that at least a portion of the *Howey* opinion, however, was created from whole cloth:

> There is considerable support for the view that "solely" did not spring from prior judicial precedent. None of the state cases cited in Justice Murphy's opinion even use the word. Indeed, *State v. Gopher Tire & Rubber Co.*, apparently the principal source of Murphy's definition, placed no such limitation on investment contracts. An investment contract was there held to mean a contract or scheme for "placing of capital or laying out of money in a way intended to secure income or profits from its employment."

Hannan & Thomas, *supra* note 12, at 250.

33. The Court held that "an investment contract, for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party . . . ." 328 U.S. at 298-99.

It should be noted that the Court itself did not divide the test into constituent elements. Professor Loss apparently was the first commentator to do so. *See* L. Loss, *supra* note 1, at 491 (2d ed. 1961). The *Williamson* court also discusses the *Howey* test as a three-part test. This Article, however, treats the test as having four elements.

34. For a discussion of the meaning of "investment of money," see International Bhd. of Teamsters v. Daniel, 439 U.S. 551, 559-61 (1979). For secondary examination of the first element of the *Howey* test, see Long, *An Attempt to Return Investment Contracts' to the Mainstream of Securities Regulation*, *supra* note 16, at 161-62.

A divergence of judicial opinion has developed with respect to the concept of "common enterprise." One approach is to analyze the relationship between the investor and promoter, while the other approach analyzes the relationships among the investors. The former is referred to as the

The Howey Company contended that the transaction was merely the sale of a fee simple interest in land, an interest clearly not a security. It argued that the sale of land was completely distinct from the service contract. The Court disagreed, however, and held that the investors were actually offered an opportunity "to contribute money and to share in the profits of a large citrus fruit enterprise managed and partly owned by respondents."[35] This arrangement made the investors dependent on the managerial services of the service company to secure profits, and the interests were therefore investment contracts.[36]

Although the Court stated that the investors were dependent upon management by the service company, some investors did not enter into a separate service contract,[37] indicating that they thought they could manage their interest without the service company. The potential importance of this fact was minimized by the Court, which addressed the issue of the independent investors by noting that the Securities Act prohibits the offer as well as the sale of unregistered, nonexempt securities. "Hence, it is enough that the respondents merely *offer* the essential ingredients of an investment contract."[38]

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vertical approach, while the latter is referred to as the horizontal approach. The horizontal approach has been adopted by the Third, Sixth, and Seventh Circuits. *See* Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 622 F.2d 216 (6th Cir. 1980), *cert. granted*, 101 S. Ct. 1971 (1981); Milnarik v. M-S Commodities, Inc., 457 F.2d 274 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972); Wasciowic v. Chicago Bd. of Trade, 352 F. Supp. 1066 (M.D. Pa. 1972), *aff'd without opinion*, 491 F.2d 752 (3rd Cir. 1973), *cert. denied*, 416 U.S. 994 (1974). The Fifth Circuit has championed the vertical approach. *See* SEC v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974).

Under the horizontal approach, Florida courts have held that more than a single investor is required to constitute a common enterprise. Le Chateau Royal Corp. v. Pantaleo, 370 So. 2d 1155 (Fla. Dist. Ct. App. 1979); Brown v. Raleigh, 363 So. 2d 590 (Fla. Dist. Ct. App. 1978). *See also* Moreno, *Discretionary Accounts*, 32 U. MIAMI L. REV. 401 (1978); 8 FLA. ST. U.L. REV. 129 (1980).

For a discussion of the fourth element of the *Howey* test and the limitations of the word "solely," see Hannan & Thomas, *supra* note 12, at 233-35, 249-52. *See also* note 39 *infra*.

35. 328 U.S. at 299.

36. The District Court in *Howey* noted that 51 purchasers acquired property from the Howey Company during the time period that was examined in the litigation. Only 42, however, entered into contracts with the service company. SEC v. W.J. Howey Co., 60 F. Supp. 440, 441 (S.D. Fla. 1945). The Supreme Court decision in *Howey* emphasized the inability of the investors to manage their land interests by themselves. The trial court's opinion, however, makes it clear that, in fact, almost 20% of the investors were able to manage, or cause to be managed, their interest in the land. *Id.*

37. 328 U.S. at 300.

38. *Id.* at 301 (emphasis added). The Supreme Court apparently held that investors who purchased land but did not enter into service contracts were offered a security but purchased a commodity. Investors who purchased land and entered into a service contract were offered, and

In *Howey* the investment contract and service contract were separate documents. A major focus of the Court's inquiry was whether there were two separate transactions or merely a single, integrated transaction effected by two documents. Inquiry into the integration of ownership and management is frequently unnecessary in a real estate joint venture agreement. Customarily, both the ownership rights and the services to be performed with respect to joint venture property by each joint venturer are delineated in the joint venture agreement. Existence of a security under the *Howey* test, however, is unaffected by the number of documents involved in a transaction. The critical inquiry concerns the offeree's characteristics, particularly his ability to perform the managerial services upon which the success of the enterprise will depend, and the economic dependence and interrelationship between the offeror and the offeree.

C. Commissioner v. Hawaii Market Center, Inc.

The primary alternative to the *Howey* test is the "risk capital" test enunciated by the Supreme Court of Hawaii in *Hawaii Market*.[39] The court chose not to follow *Howey* in construing the term investment contract under state law. In determining whether a "Founder-Member Purchasing Contract Agreement" was a security within the meaning of the Hawaii Uniform Securities Act,[40] the court dismissed the *Howey*

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purchased, a security. The distinction is that investors who either managed their land or caused it to be managed actively participated in the making of profits. As a result of their active participation, they failed to meet the requirement that an investment contract exists only when the investor anticipates profits solely from the efforts of another.

39. Commissioner v. Hawaii Market Center, Inc., 52 Hawaii 642, 485 P.2d 105 (1971).

In addition to certain state courts' rejection of *Howey*, some federal courts have also deviated from application of the *Howey* test. The Ninth Circuit held that "the word 'solely' should not be read as a strict or literal limitation on the definition of an investment contract, but rather must be construed realistically, so as to include within the definition those schemes which involve in substance, if not form, securities." SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476, 482 (9th Cir. 1973), *cert. denied*, 414 U.S. 821 (1973). *See also* SEC v. Koscot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974); Miller v. Central Chinchilla Group, Inc., 494 F.2d 414 (5th Cir. 1974); Nash & Assocs. v. Lum's of Ohio, Inc., 484 F.2d 392 (6th Cir. 1973). The Supreme Court in United Hous. Foundation, Inc. v. Forman, 421 U.S. 837 (1975), explicitly avoided ruling on this aspect of the *Howey* definition. *See* notes 44-56 *infra* and accompanying text.

40. The Hawaii statute provides:

> "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, certificate of interest in an oil, gas, or mining title or lease, or, *in general, any interest or instrument commonly*

test as too mechanical to protect the investing public adequately. The principal weakness of the *Howey* test, in the court's view, was its overemphasis on investor participation in the enterprise and the unduly restrictive requirement that the investors' expectations of profit must derive *solely* from the efforts of another. Noting that the fundamental policy of the securities laws is to afford broad protection to investors, the court held that securities exist "even in those situations where an investor is not inactive, but [instead] participates to a limited degree in the operation of the business."[41]

The *Hawaii Market* court adopted a "risk capital" test, which states that an investment contract is created whenever:

> (1) An offeree furnishes initial value to an offeror;
>
> (2) A portion of this initial value is subjected to the risks of the enterprise;
>
> (3) The furnishing of the initial value is induced by the offeror's promises or representations which give rise to a reasonable understanding that a valuable benefit of some kind, over and above the initial value, will accrue to the offeree as a result of the operation of the enterprise; and
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> (4) The offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise.[42]

Although each element of the risk capital test differs from its *Howey* counterpart, the fourth element of the test represents a major departure from the *Howey* formula. Rather than focusing on whether the investor reasonably expects to make profits based solely on the efforts of others, the risk capital test looks to the quality, not the quantity, of the investor's participation in and control over the common enterprise. "[I]n order to negate the finding of a security the offeree should have

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known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

HAWAII REV. STAT. § 485-1(12) (1976) (emphasis added).

41. 52 Hawaii at 647, 485 P.2d at 108.

42. *Id.* at 649, 485 P.2d at 109. The court acknowledged its debt to Professor Coffey as the source of this definition. *Id. See* Coffey, *supra* note 16.

Perhaps the earliest proponent of the "risk capital" theory was the court in Silver Hills Country Club v. Sobieski, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961), in which Justice Traynor employed the phrase but did not define it. The court held that charter memberships in a country club were within the regulatory purpose of the California Blue Sky Law. "[I]ts [the California blue sky law's] objective is to afford those who risk their capital at least a fair chance of realizing their objectives in legitimate ventures whether or not they expect a return of their capital in one form or another." *Id.* at 815, 361 P.2d at 908-09, 13 Cal. Rptr. at 188-89. *See also* 50 CAL. L. REV. 156 (1962); 14 HASTINGS L.J. 181 (1962).

practical and actual control over the managerial decisions of the enterprise. For it is this control which gives the offeree the opportunity to safeguard his own investment, thus obviating the need for state intervention."[43]

The *Hawaii Market* and *Howey* courts agree that the nature of the investor's participation in the enterprise is critical in determining whether a security exists. Under a literal application of *Howey*, even a modicum of investor participation would remove the arrangement from the definition of a security. Under the "risk capital" test, identifying the investor participation is only a preliminary step in analyzing the quality of the participation. Only actual and practical control of the enterprise by each investor would remove the arrangement from the definition of security. Although no federal courts appear formally to have adopted the "risk capital" test, several, including the *Williamson* court, analyze investor participation in terms similar to those that would apply had they adopted the fourth element of the "risk capital" test.

D. United Housing Foundation, Inc. v. Forman

In *United Housing*,[44] the first Supreme Court case involving investment contracts after *Hawaii Market*, the Court faced the converse of the factual situation present in *Joiner*, *Howey*, and *Hawaii Market*. The earlier cases involved financial arrangements not normally regarded as securities. In *United Housing*, the issue was whether stock in a corporation, an interest that is almost invariably denominated a security, was outside the purview of the federal securities laws.[45]

Ownership of stock in a nonprofit housing cooperative entitled the holders to lease an apartment in buildings owned by the cooperative. The Court held that the stock was not a security because it had none of the normal indicia of "stock." The stockholder had neither the right to receive dividends[46] nor the expectation of earning profits.[47] As a conse-

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43. 52 Hawaii at 652, 485 P.2d at 111 (citations omitted).

44. United Hous. Foundation, Inc. v. Forman, 421 U.S. 837 (1975).

45. The *United Housing* decision generated comment from the legal community. *See, e.g.*, Deacon & Prendergast, *Defining a "Security" After the Forman Decision*, 11 PAC. L.J. 213 (1980); 9 LOY. L.A.L. REV. 206 (1975); 29 SW. L.J. 987 (1976); 53 TEX. L. REV. 623 (1975).

46. 421 U.S. at 851.

47. *Id.*

quence, the stock did not satisfy the definition of an investment contract.

In reaching its holding, the Court reaffirmed the *Howey* test as the basis for distinguishing a securities transaction from other commercial dealings and quoted the entire formula in full.[48] The Court introduced a certain analytical ambiguity, however, by paraphrasing the original *Howey* language in what may be referred to as the "touchstone" test. The Court stated that "[t]he touchstone is [1] the presence of an investment [2] in a common venture [3] premised on a reasonable expectation of profits [4] to be derived from the entrepreneurial or managerial efforts of others."[49] The touchstone test omits the word "solely" from the fourth element of the *Howey* test.

The Fifth Circuit in *Williamson* makes much of this omission and suggests that it has great significance.[50] A careful reading of *United Housing*, however, suggests that the omission of the word "solely" in the touchstone test has minimal significance. First, the central issue in *United Housing* was the meaning of the word "profits." The Court found no profit inducement in purchasing the cooperative stock and, as a consequence, no investment contract. It had no need, therefore, to examine the fourth element of the *Howey* test. Second, the Court carefully noted that it was expressing no view whatsoever as to the correct interpretation of the word "solely."[51] When the Supreme Court next considered the term "investment contract" in *International Brotherhood*

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48. *Id.* at 852.

49. *Id.*

50. In Williamson v. Tucker, 645 F.2d 404 (5th Cir.), *cert. denied*, 102 S. Ct. 396 (1981), the Fifth Circuit stated:

> Moreover, the Supreme Court has altogether omitted the word "solely" in its most recent formulation of the investment contract definition. In *United Housing Foundation, Inc. v. Forman*, . . . the Court quoted the investment contract definition from Howey and restated it as 'an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.'

Id. at 418-19.

51. The Court stated:

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

421 U.S. at 852 n.16 (citations omitted) (emphasis added).

of Teamsters v. Daniel,[52] it again quoted with approval the original *Howey* test[53] and the touchstone test[54] created in *United Housing*. This would appear to rebut the *Williamson* court's suggestion that the word "solely" has been deleted from the *Howey* test by the Supreme Court.

The *United Housing* Court also rejected a request that it adopt the risk capital test,[55] although it did not directly repudiate the doctrine. The Court stated: "Even if we were inclined to adopt such a 'risk capital' approach we would not apply it in the present case. Purchasers of apartments in Co-op City take no risk in any significant sense. If dissatisfied with their apartments, they may recover their initial investment in full."[56]

The holding in *United Housing* emphasized clearly that in determining the existence of an investment contract, the substance of the arrangement, and not its form or name, governs. As a gloss on the analysis of investment contracts, it added an explication of the term "profits" and tacitly acknowledged the lower federal courts' growing concern over the limitations of the word "solely" in the fourth element of the *Howey* test. The preceding discussion depicts the state of the law at the time the Fifth Circuit decided *Williamson*.

III. *WILLIAMSON V. TUCKER*

In *Williamson*, the Fifth Circuit Court of Appeals focused on joint venture interests as securities. The court specifically considered whether the retention of meaningful managerial powers by investor joint venturers excluded the joint venture interest from the category of investment contracts. The court held that absent certain "limited circumstances," the possession of those powers precludes a finding that such interests are securities.[57] The court's discussion of the genesis and

52. 439 U.S. 551 (1979).

53. *Id.* at 558.

54. *Id.* at 561.

55. 421 U.S. at 857. The Court in *United Housing* attributed the risk capital test to the California Supreme Court's opinion in *Silver Hills Country Club* rather than to *Hawaii Market*. *See* note 42 *supra* and accompanying text.

56. *Id.* at 857 n.24.

57. The procedural posture of *Williamson* is unusual but does not diminish the importance of the court's holding and analysis. Appellants alleged violations of the Securities Act of 1933 and the Securities Exchange Act of 1934, contending that the joint venture interests were securities within the meaning of both. Appellees filed motions for summary judgment under Rule 56 of the Federal Rules of Civil Procedure, or, in the alternative, to dismiss for lack of subject matter jurisdiction under Rule 12(b)(1). The district court dismissed the suit without indicating upon which

meaning of the phrase "investment contract" and its explicit formulation of the appropriate investment contract test for a joint venture interest have unusual importance because of the limited amount of federal law in this area.[58]

Williamson concerned development of a 160 acre tract of land (the "Venture Property") located between Dallas and Fort Worth, Texas, near the then proposed Dallas-Fort Worth airport. Through a series of four sales that occurred between 1969 and 1971, three separate joint ventures (Reg Air I, Reg Air II, and Reg Air IV) each came to own an undivided one-third interest in the Venture Property.

M.L. Godwin Investments, Inc., or its employees, executed contracts to purchase an interest in the Venture Property, formed each joint venture, and then attracted potential investors to participate in the ventures. The offering materials for each venture described, in similar terms, the management expertise of Godwin and the investment potential of the Venture Property. Godwin managed the Venture Property

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Rule it was relying. The Fifth Circuit concluded that the district court's dismissal was for lack of subject matter jurisdiction and was improper. After remand to the district court for substantive determination, the Fifth Circuit had no reason to reach the merits of the case. In the interests of judicial economy, however, the Fifth Circuit dealt with the substantive issues and formulated the *Williamson* test. 645 F.2d 404 (5th Cir.), *cert. denied*, 102 S. Ct. 396 (1981).

58. Federal case law on joint venture or general partnership interests as investment contracts is relatively sparse. For some of the more important cases, see Andrews v. Blue, 489 F.2d 367, 371 (10th Cir. 1973) (when a joint owner of real property invested money and devoted substantial time to the development of the property, but was "not given the right to share in the management or in any decision to sell, mortgage, or dispose of the property," his interest was a security); Nor-Tex Agencies, Inc. v. Jones, 482 F.2d 1093, 1099 (5th Cir. 1973) (when the promoter was to take the initiative and the joint venture investor in an oil and gas transaction was to remain "comparatively passive," the joint venture interest was a security), *cert. denied*, 415 U.S. 977 (1974); Sandusky Land, Ltd. v. Uniplan Groups, Inc., 400 F. Supp. 440, 445 (N.D. Ohio 1975) (no security when a general partner was "actively . . . involved in the decision-making process"); Hirsch v. du Pont, 396 F. Supp. 1214, 1221 (S.D.N.Y. 1975) (when general partners had a degree of managerial control that afforded them access to information about the issuer, the partnership interests were not securities), *aff'd*, 553 F.2d 750 (2d Cir. 1977); New York Stock Exch., Inc. v. Sloan, 394 F. Supp. 1303, 1314-15 (S.D.N.Y. 1975) (when a general partner chooses to delegate his day-to-day managerial responsibilities to a committee, his retained ability to vote and responsibility for partnership acts compel a conclusion that his interest was not a security); Oxford Finance Cos. v. Harvey, 385 F. Supp. 431, 433-34 (E.D. Pa. 1974) (when a joint venturer had authority over many decisions, including approval of all plans and specifications and all expenditures in excess of $10,000, there was no security); Bryant v. Uhand, 327 F. Supp. 439, 442 (S.D. Tex. 1971) (a joint venture interest in undivided, working interests was conceded to be a security by the defendant-promoter); Pawgan v. Silverstein, 265 F. Supp. 898, 900 (S.D.N.Y. 1967) (when a general partnership agreement gave controlling power to three managing partners, the partnership interests of other general partners were securities).

on behalf of each of the joint ventures. Each joint venture acquired its one-third undivided interest at a different time and paid a different purchase price. Each joint venture financed its purchase with a promissory note to the seller with several, but not joint, liability among the joint venturers. Despite numerous other similarities in the transaction, the actual ownership of each joint venture was not identical. Although there were differences in the specific provisions of the various joint venture agreements, the court concluded that "[n]evertheless, the transactions were all arranged by Godwin Investments and are identical in all other relevant respects."[59]

Because of the factual setting, the *Williamson* court had no reason to comment extensively about the first three elements of the *Howey* test. The first element was satisfied because of the joint venturer's liability under the promissory notes. There was no dispute about the existence of a common enterprise, so satisfaction of the second element was not raised. As to the third element, the investors reasonably anticipated making profits, and the promotional literature emphasized that such profits would occur.

Only the fourth element of the *Howey* test, the managerial efforts from which the investor expected to receive profits, was an open issue. In the Fifth Circuit, however, this element has been modified from the original *Howey* test. In *SEC v. Koscot Interplanetary, Inc.*,[60] the Fifth Circuit expressly adopted the standard articulated by the Ninth Circuit in *SEC v. Glenn W. Turner Enterprises, Inc.*,[61] in which the Ninth Circuit held that the salient factor to be considered was whether the efforts that most critically determined the success or failure of the enterprise were those made by persons other than the investor.[62] This modifica-

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59. 645 F.2d at 408.

60. 497 F.2d 473, 483 (5th Cir. 1974).

61. 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973). *See* 52 N.C.L. Rev. 476 (1973); 51 Tex. L. Rev. 788 (1973); 27 U. Miami L. Rev. 487 (1973).

62. 474 F.2d at 482. The court stated:

> [I]n light of the remedial nature of the legislation, the statutory policy of affording broad protection to the public, and the Supreme Court's admonitions that the definition of securities should be a flexible one, the word "solely" should not be read as a strict or literal limitation on the definition of an investment contract, but rather must be construed realistically, so as to include within the definition those schemes which involve in substance, if not form, securities.
>
> . . . *[W]e adopt a more realistic test, whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.*

Id. (emphasis added).

tion permits finding an investment contract when none may have existed under the original test. Under a literal application of *Howey*, even a scintilla of managerial involvement by the investor arguably would be sufficient to preclude a finding of an investment contract. The Fifth Circuit's modification provides that even a finding of a scintilla of investor involvement would still require further analysis as to who provided the essential managerial services, the promoter or the investor.

The *Williamson* court articulated a three-part factual test to determine whether the fourth element of the *Howey* test was satisfied for a joint venture interest. The court stated that such a characterization required

> 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.[63]

One troublesome aspect of the *Williamson* test is the premise that joint venture or general partnership interests are properly subject to a specific investment contract analysis different from any other investment. A joint venture agreement results from negotiation, and the parties to the agreement establish their own rules for governing their relationship. There is no standard or statutory distribution of power. The consistent teaching of the Supreme Court from *Joiner* through *Daniel* is that the name of an interest does not alone establish whether it is a security. The *Williamson* test offers an alluring formula that purports to delineate the investment contract inquiry for a joint venture interest. The test, however, should not be taken as an independent formulation removed from conventional investment contract analysis. It is properly only a specific application of, and not a replacement for, the broader principles of *Howey*.

The *Williamson* test directs judicial inquiry, in turn, to (1) the enterprise's document, (2) the investor, and (3) the promoter.[64] An analysis

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63. 645 F.2d at 424.

64. The *Williamson* court specifically noted that these factors should not be considered ex-

of each variable reveals the existence and reasonableness of the investors' managerial expectations. The conclusion that the investor reasonably expected to receive profits derived from essential managerial services of another can be based upon (1) the formal, documentary, distribution of power; (2) the fact that the investors' efforts could not conceivably give rise to any profits; or (3) the fact that the promoter's talents are so remarkable or unique that the investors' efforts could not have any significant effect on making profits.

The test must be applied to each investor. One possible analytical anomaly is that a joint venture interest could be a security as to some investors and not to others. Investors' abilities to participate in the enterprise vary. A real estate developer who invests in another developer's enterprise may have the reasonable expectation that he will participate in management and help make profits. His joint venture interest might not constitute an investment contract. Conversely, the same ownership interest and the same right to vote owned by a doctor with little or no management expertise might constitute an investment contract under the *Williamson* test, because no reasonable expectation of managerial involvement may exist.

The Fifth Circuit's statement that a joint venture interest can be a security "only" if it satisfies one of the three elements of the *Williamson* test suggests a judicial presumption that ordinarily such interests are not securities. This implicit presumption has support from commentators.[65] Even while articulating the formidable barriers to finding that a joint venture interest is a security, the *Williamson* court acknowledged the possibility that the test might be satisfied.[66]

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hanstive: "[T]his is not to say that other factors could not also give rise to such a dependence on the promoter or manager that the exercise of partnership powers would be effectively precluded." *Id.* at 424 n.15.

65. JENNINGS & MARSH, SECURITIES REGULATION 252 (4th ed. 1977). The authors state:

> An interest in a joint venture or general partnership normally is the antithesis of an "investment contract" or "profit-sharing agreement." The Uniform Partnership Act defines a partnership to be "an association of two or more persons to carry on as *co-owners* a business for profit." Thus the right to participate in the management and control of the business is a fundamental characteristic of the partnership. The general partners of a partnership are not passive investors who place money in an enterprise with the expectation of deriving profits *solely* from the efforts of others. Rather, they expect to reap profits through their own active participation in the control and management of the business.

Id.

66. 645 F.2d at 424.

The court had stated earlier:

> It should be clear from the content of the cases discussed above, however, that the mere

The court's premise that the distribution of power of the enterprise "as in a limited partnership" necessarily leads to a conclusion that the agreement is an investment contract warrants some discussion. Certain courts have held that interests in limited partnerships are investment contracts[67] as a matter of law. The Securities and Exchange Commission routinely treats limited partnership interests as securities.[68] The better view, however, was expressed in *Stowell v. Ted S. Finkel Investment Services, Inc.*,[69] in which the Florida District Court referred to the economic reality tests enunciated by the Supreme Court in *Tcherepnin v. Knight*,[70] *United Housing*, and *Daniel* and held that the crucial issue

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fact that an investment takes the form of a general partnership or joint venture does not inevitably insulate it from the reach of the federal securities laws.

. . . .

A scheme which sells investments to inexperienced and unknowledgeable members of the general public cannot escape the reach of the securities laws merely by labeling itself a general partnership or joint venture. Such investors may be led to expect profits to be derived from the efforts of others in spite of partnership powers nominally retained by them.

Id. at 422-23.

67. *See, e.g.*, Goodman v. Epstein, 582 F.2d 388 (7th Cir. 1978), *cert. denied*, 440 U.S. 939 (1979); Doran v. Petroleum Management Corp., 545 F.2d 893 (5th Cir. 1977); Nor-Tex Agencies, Inc. v. Jones, 482 F.2d 1093 (5th Cir. 1973), *cert. denied*, 415 U.S. 977 (1974).

68. In 17 C.F.R. § 240.3(a)11-1 (1981), for example, the Securities and Exchange Commission expressly includes interests in limited partnerships and joint ventures in the definition of "equity security" for purposes of §§ 12(g) and 16 of the Securities Exchange Act of 1934. The Commission states:

The term "equity security" is hereby defined to include any stock or similar security, certificate of interest or participation in any profit sharing agreement, preorganization certificate or subscription, transferable share, voting trust certificate or certificate of deposit for an equity security, *limited partnership interest, interest in a joint venture*, or certificate of interest in a business trust; or any security convertible, with or without consideration into such security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any put, call, straddle, or other option or privilege of buying such a security from or selling such a security to another without being bound to do so.

Id. (emphasis added). *See* SEC Rel. No. 33-4877 (Aug. 8, 1967), 32 Fed. Reg. 11,705 (1967), which states in pertinent part:

Under the federal securities laws, an offering of limited partnership interests and interests in joint or profit sharing real estate ventures generally constitutes an offering of a "profit sharing agreement" or an "investment contract" which is a "security" within the meaning of Section 2(1) of the Securities Act of 1933.

. . . [I]f the promoters of a real estate syndication offer investors the opportunity to share in the profits of real estate syndications or similar ventures, particularly when there is no active participation in the management and operation of the scheme on the part of the investors, the promoters are, in effect, offering a "security."

[1973] 1 FED. SEC. L. REP. (CCH) ¶ 1046, at 2062. *See also* SEC Rel. No. 34-14273 (Dec. 15, 1977), [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,387.

69. 489 F. Supp. 1209 (S.D. Fla. 1980).

70. 389 U.S. 332 (1967).

in each case was whether the partnership agreement entered into by the parties met established investment contract criteria. Resolution of the issue is only possible on a case-by-case inquiry.[71] It cannot be overemphasized that the name of an interest, including any implications arising from the standard distribution of power for such an interest, does not establish whether the interest is an investment contract. Interests in limited partnerships, general partnerships, or joint ventures may or may not constitute investment contracts. The decision can be made only by reviewing the precise facts of each transaction.

The Fifth Circuit's initial inquiry under the *Williamson* test required an examination of how the joint venture agreement distributed power among the joint venturers. The promoter and manager, Godwin, was a party to the joint venture agreements.[72] In the offering materials, Godwin represented that it would ultimately pursue the sale or development of the Venture Property, and "would perform all management duties, including efforts to have the land rezoned from single-family residential to its best uses."[73] The materials emphasized: "OUR FIRM AGGRESSIVELY PURSUES ALL ZONING AND PROPER LAND PLANNING EFFORTS TO ASSURE THE MAXIMUM PROFIT POTENTIAL OF EACH INVESTMENT."[74] Based solely on these facts, which indicated that Godwin would play an active management role, an investor joint venturer might reasonably have believed that Godwin would supply the essential managerial efforts from which the enterprise would realize its profits.

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71. 489 F. Supp. at 1220.

72. Although the *Williamson* court does not refer to Godwin as a joint venturer, an examination of the Reg Air I joint venture agreement shows that Godwin was a signatory. The agreement is attached as Appendix Number 1, Brief for Appellees James F. Mason, L.R. Polan, Jr., and M.L. Godwin Investments, Inc. The agreement for Reg Air I provided that:

> Subject to the reservation of control in the Joint Venturers as specified in this Article VIII and until further action by the Joint Venturers, the Joint Venturers hereby designate M.L. Godwin Investments, Inc. as manager of the Venture Property to do all things necessary and proper to carry out the purposes of this Joint Venture. So long as the Venture Property remains undeveloped, M.L. Godwin Investments, Inc. shall not be entitled to receive any compensation for its services as manager of the Venture Property other than the compensation to be received at the closing of the purchase of the Venture Property. As space becomes available for rent, M.L. Godwin Investments, Inc. shall be entitled to compensation as manager and the Joint Venture shall enter into a management contract with M.L. Godwin Investments, Inc.

Reg Air I Joint Venture Agreement § 8.03, at 6, Brief for Appellees, app. 1, Williamson v. Tucker, 645 F.2d 404 (5th Cir.), *cert. denied*, 102 S. Ct. 396 (1981).

73. 645 F.2d at 408.

74. *Id.*

The *Williamson* court, however, did not stop its inquiry after discovering those facts. Even if Godwin were to provide those managerial services, the court made further examination of whether the investor retained control over the manager. The difficulty of answering this critical question was magnified because each joint venture had approximately fifteen venturers.[75] As the court stated, "[A] complication is added where the investment asset is not owned directly, but is held instead through a joint venture or general partnership. While the partnership per se may have full ownership powers over the asset, each individual partner has only his proportionate vote in the partnership."[76]

Each joint venture agreement gave the venturers the right to control certain areas of management. Decisions to borrow money or to deliver any bonds, mortgages, or deeds required the affirmative vote of all joint venturers.[77] Any development proposal for the Venture Property likewise required the approval of a significant number of venturers.[78] Regardless of whether the Venture Property was developed, a significant number of the venturers could remove Godwin as manager and "make any other decision regarding the Property."[79] The joint venturers, in the aggregate, thus had significant opportunity to control the management of the joint venture and the development of the Venture Property.

Although the venturers, in the aggregate, had significant management control, there remained the further question of whether each investor also had significant control. Each joint venture consisted of approximately fifteen venturers. The four plaintiffs, Blake, Lilley, Williamson, and Wilson, each held minority interests in the ventures. Williamson had the largest individual interest, with a twenty percent interest in Reg Air I, II and IV, while Wilson and Blake each held only

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75. *Id.* Reg. Air I had 13 venturers, Reg Air II had 17 venturers, and Reg Air IV had 10 venturers. Brief for Appellees Trustees of the Home Interiors and Gifts Employees Profit Sharing Trust at 4, Williamson v. Tucker, 645 F.2d 404 (5th Cir.), *cert. denied*, 102 S. Ct. 396 (1981).

76. 645 F.2d at 421.

77. Each joint venture agreement requires unanimous consent of the venturers to confess a judgment; to make, execute or deliver any bond, mortgage, deed of trust, guarantee, indemnity bond, surety bond or accommodation paper or accommodation endorsement; to borrow money in the name of the joint venture or use joint venture property as collateral; and to amend the agreement to modify the rights of the venturers.

Id. at 408-09.

78. *Id.* at 409.

79. *Id.* Depending upon the joint venture, the vote of 60% or 70%, in interest, of the venturers was required.

five percent interests in Reg Air II.[80] Although the court noted the dilutive effect on management control created by selling interests to numerous investors, it drew no adverse conclusions on the basis of the sale of venture interests by Godwin to an average of fifteen investors.[81]

Having fifteen investors actively participate in or simply control management presents significant practical problems. Conflicts arise in scheduling and attending meetings. Even when the investors in the aggregate retain latent management control, the logistical inertia created by a group of otherwise unconnected investors may prevent their actual exercise of those powers.

The facts in *Williamson* support this conclusion. From the time the joint ventures were formed, between 1969 and 1971, until at least late 1975, the plaintiffs relied entirely on Godwin "and made no attempt to oversee or participate in the management of the Property."[82] It was not until late 1975, when the plaintiffs claimed they first became aware of alleged securities laws violations, that any of the plaintiffs participated in joint venture meetings.[83] There is no bright-line test for determining when an enterprise has so many investors that their individual vote is meaningless to safeguard their investment or to control either the enterprise or the manager. The results in *Williamson*, however, support a conclusion that when an enterprise has fifteen otherwise unrelated investors, none of them may possess meaningful rights to control the enterprise.

An issue not raised by the litigants or addressed by the *Williamson* court is whether the offerings in the three joint ventures should have been integrated and considered as a single offering of interests. The ventues may have involved a single plan of financing, class of securities, and type of consideration. Within broad parameters, the agreements were executed at approximately the same time for the general purpose of developing the Venture Property.[84] Although not free from

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80. *Id.* at 407. *See* note 92 *infra*.

81. *Id.* at 423. The court stated:

> [O]ne would not expect partnership interests sold to large numbers of the general public to provide any real partnership control; at some point there would be so many partners that a partnership vote would be more like a corporate vote, each partner's role having been diluted to the level of a single shareholder in a corporation. Such an arrangement might well constitute an investment contract.

Id.

82. *Id.* at 409.

83. *Id.* at 424.

84. In SEC Rel. No. 33-4552 (Nov. 6, 1962), 27 Fed. Reg. 11,316 (1962), the SEC enunciated

doubt, the offerings could have been integrated, thereby increasing considerably the total number of investors even after allowing for some duplication of investors. Whether the presence of twenty or thirty investors would have prompted the *Williamson* court to address directly the issue of the meaningfulness of the powers retained by an individual investor under those circumstances is conjectural.

Whether the offerings are considered as separate or integrated, the sheer number of investors in *Williamson* significantly diluted voting power and created logistical complications. The presence of many investors would appear directly and negatively to affect an individual investor's ability to exercise meaningful management control. Given the court's emphasis on the significance of the distribution of power and the investor's actual ability to exercise power, the court's failure to provide guidance by stating what importance, if any, should be attached to the actual number of joint venturers is unfortunate and disappointing.

The first element of the *Williamson* test calls for a probe of the power retained by the investor. The thrust of the inquiry is whether the investor has power to manage the enterprise, or, at a minimum, to control the manager of the enterprise. This latter aspect of the *Williamson* test is consistent with a series of cases decided by the Eighth and Tenth Circuits[85] and relied on by the Fifth Circuit, which held that investors

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the principles to be considered in determining whether purportedly separate offerings should be integrated and treated as a single offering:

> A determination whether an offering is public or private would also include a consideration of the question whether it should be regarded as a part of a larger offering made or to be made. The following factors are relevant to such question of integration: whether (1) the different offerings are part of a single plan of financing, (2) the offerings involve issuance of the same class of security, (3) the offerings are made at or about the same time, (4) the same type of consideration is to be received, (5) the offerings are made for the same general purpose.
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> What may appear to be a separate offering to a properly limited group will not be so considered if it is one of a related series of offerings. A person may not separate parts of a series of related transactions, the sum total of which is really one offering, and claim that a particular part is a non-public transaction. Thus, in the case of offerings of fractional undivided interests in separate oil or gas properties where the promoters must constantly find new participants for each new venture, it would appear to be appropriate to consider the entire series of offerings to determine the scope of this solicitation.

Id.

85. *See, e.g.*, Schoitz v. Dain Corp., 568 F.2d 612, 615 (8th Cir. 1978) (when the purchasers of an apartment complex executed a non-revocable three year management agreement with the seller, the purchaser retained "ultimate control" over the apartment complex, and there was no security); Ballard & Cordell Corp. v. Zeller & Dannenberg Exploration, Ltd., 544 F.2d 1059, 1065-66 (10th Cir. 1976) (when an oil drilling operating agreement permitted the investor to approve certain expenses and to leave the enterprise under certain circumstances, there was no security), *cert. denied*, 431 U.S. 965 (1977); Fargo Partners v. Dain Corp., 540 F.2d 912, 915 (8th Cir.

possessing potential control over management did not purchase securities.[86]

Based on *Williamson*, possession, rather than exercise, of power determines whether an interest is an investment contract. This concept is consistent with the consequences of holding that an interest is an investment contract. If a joint venture interest is a security, then the promoter, as issuer, is subject to the full panoply of registration and disclosure requirements of the federal securities laws. Either the joint venture interest must be registered pursuant to the provisions of section 5[87] of the Securities Act of 1933 or it must be exempt. The issuer must fully and fairly disclose all material facts and is accountable under sections 12[88] and 17[89] of the Securities Act of 1933 and section 10(b)[90] of the Securities Exchange Act of 1934 for failure to comply.

Compliance with the registration and disclosure provisions can occur only if the offeror can determine that the joint venture interest is a security prior to the offer and sale. As a consequence, when determining the existence or nonexistence of a security, only those facts determinable when the offer and sale occurred should be considered. Otherwise, an interest that appeared to be a nonsecurity on the basis of facts that existed at the time of sale could become a security on the basis of events that transpired subsequent to sale. Promoters can comply with the federal securities laws only if the determinative control is the control apparently exercisable by the investor when he purchases the interest.

Although the *Williamson* test is based on the potential control avail-

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1976) (when the purchasers of an apartment complex executed a management agreement with the seller that permitted the purchaser to terminate the management agreement upon 30 days notice, there was no security); Mr. Steak, Inc. v. River City Steak, Inc., 460 F.2d 666, 669-70 (10th Cir. 1972) (when a franchise agreement envisioned substantial operation by the franchisor but left some meaningful control in the hands of the franchisee, there was no security).

86. *Williamson*, 645 F.2d at 421.

> These cases from the Tenth and Eighth Circuits—dealing in turn with the purchase of franchise, oil and gas, and real estate interests—are consistent in their treatment of latent investor control. *In each case the actual control exercised by the purchaser is irrelevant.* So long as the investor has the right to control the asset he has purchased, he is not dependent on the promoter or on a third party for "those essential managerial efforts which affect the failure or success of the enterprise."

Id. (emphasis added).

87. 15 U.S.C. § 77e (1976).

88. *Id.* § 77*l* (1976).

89. *Id.* § 77q (1976).

90. *Id.* § 78j (1976).

able to the investor, the opinion does not preclude judicial examination of the powers actually exercised by the investors. Examination of this power may assist the trier of fact in determining whether the control expectations of the parties were realistic when the interest was purchased.

An examination of the joint venture agreements in *Williamson* reveals that the investors were not precluded from participating in management. They retained numerous controls, including the right to replace the manager. Therefore, under the first element of the *Williamson* test, the joint venture agreements were not investment contracts.

The joint venture document provided investors theoretical rights to control. The second and third elements of the *Williamson* test mandate a critical examination of the investor, the promoter, and the relationship of the investor to the promoter to confirm whether the investor could have had the reasonable expectation or capacity to exercise those rights. This feasibility inquiry was crucial, in the *Williamson* court's view, because "[i]nsofar as the power retained by the investors is a real one which they are in fact capable of exercising, courts have uniformly refused to find securities in such cases."[91]

If the joint venture document provides the investors with certain latent management powers, investment contract analysis compels two additional investigations respecting those powers. The first line of inquiry is whether the power is real. The second is whether the investors are capable of exercising that power.

The *Williamson* court made no independent statement concerning the reality of the plaintiffs' retained powers. The court did, however, analyze the background and abilities of the investors to determine whether the investors could exercise their latent management power.

The four plaintiffs were executives with Frito-Lay, Inc., a subsidiary of Pepsico, Inc. Williamson was Chairman of the Board during Lilley's tenure as President. The plaintiffs owned differing percentages of the joint ventures.[92] Williamson and Lilley had participated in other joint

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91. 645 F.2d at 419.

92. The holdings of the plaintiffs in the Joint Ventures were as follows:

Reg Air I	Reg Air II		Reg Air IV	
Williamson 20%	Williamson	20%	Williamson	20%
	Lilley	10%	Lilley	10%
	Wilson	5%		
	Blake	5%		

ventures organized by Godwin.[93] The court concluded without further inquiry that "it is clear that plaintiffs had the business experience and knowledge adequate to the exercise of partnership powers in a real estate joint venture."[94] This conclusion, however, is not as "clear" as the court assumed.

The issue of the standard for investor sophistication, knowledge, and competence is a recurring one in securities analysis. Broker/dealers must evaluate investor sophistication to sell securities that are "suitable" to an investor's individual circumstances.[95] Investor sophistication is also raised specifically when evaluating an investor as an offeree for a private placement conducted under the Rule 146 exemption.[96]

Id. at 407.

93. *Id.* at 425.

94. *Id.*

95. New York Stock Exchange Rule 405 provides:

> Every member organization is required through a general partner, a principal executive officer or a person or persons designated under the provisions of Rule 342(b)(1) to
>
> (1) Use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization and every person holding power of attorney over any account accepted or carried by such organization.

[1978] 2 NYSE GUIDE (CCH) 3697.

Article III, § 2 of the Rules of Fair Practice of the National Association of Securities Dealers provides:

> In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.

NASD MAN. (CCH) ¶ 2152 (1976).

17 C.F.R. § 240.15(b)10-3 (1981) provides:

> Every non-member broker or dealer and every associated person who recommends to a customer the purchase, sale or exchange of any security shall have reasonable grounds to believe that the recommendation is not unsuitable for such customer on the basis of information furnished by such customer after reasonable inquiry concerning the customer's investment objectives, financial situation and needs, and any other information known by such broker or dealer or associated person.

Id.

96. 17 C.F.R. § 230.146(d) (1981) provides:

> (d) Nature of offerees. The issuer and any person acting on its behalf who offer, offer to sell, offer for sale or sell the securities shall have reasonable grounds to believe and shall believe:
>
> (1) Immediately prior to making any offer, either:
>
> (i) That the offeree has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or
>
> (ii) That the offeree is a person who is able to bear the economic risk of the investment, and
>
> (2) Immediately prior to making any sale, after making reasonable inquiry, either:
>
> (i) That the offeree has such knowledge and experience in financial and busi-

An investor has the requisite sophistication only when he has "sufficient investment, business, and other experience, education, and actual knowledge to understand the mechanics and risks of the investments."[97] General business sophistication is not sufficient.[98] Rather, investor sophistication is a product of the investor's experience and knowledge. Williamson, Lilley, Blake, and Wilson were executives of a national snack food corporation. Despite that status, however, they may have lacked any knowledge relevant to the development of the Venture Property. Mastery of zoning, building codes, and construction costs and methods is not a prerequisite to success as a purveyor of food. Sophistication and expertise in one business arena, without more, does not imply sophistication or knowledge in another.

The *Williamson* court may have been correct in concluding that the plaintiffs were capable of exercising their latent control. Reaching that conclusion, however, solely by reason of the plaintiffs' executive status with Frito-Lay and the investment by two of the plaintiffs in other real estate joint ventures requires an awe-inspiring leap of faith. Meaningful exercise of control requires both the substantive knowledge to evaluate problems and sufficient leverage to effect the decision making process. The Court apparently accepted a substitution of sophistication standard. This concept should be rejected, because an apparently sophisticated investor who lacks the relevant experience may in fact be so dependent on the promoter or manager that he satisfies the fourth element of the *Howey* test.

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ness matters that he is capable of evaluating the merits and risks of the prospective investment, or

(ii) That the offeree and his offeree representative(s) together have such knowledge and experience in financial and business matters that they are capable of evaluating the merits and risks of the prospective investment and that the offeree is able to bear the economic risk of the investment.

Id.

97. For an excellent article discussing these factors, see Scraghan, *Private Offerings: Determining "Access," "Investment Sophistication," and "Ability to Bear Economic Risk,"* 8 SEC. REG. L.J. 3, 24 (1980).

98. As Scraghan explains the problem:

Business experience, or success in a business occupation, will suffice in place of actual investment experience only when such business or occupational experience establishes general knowledge of financial and other risk concepts applicable to businesses generally, not only the risks of the business of the investor. General business sophistication will not suffice; the occupation should be one in which the investor deals regularly with financial matters, such as that of an accountant or a corporate attorney actually dealing with such affairs.

Id. at 25.

After the court concluded that the joint venture interests were not investment contracts under either of the first two elements of the *Williamson* test, it examined the third element of the test: whether the promoter has talents so unique that either (1) he cannot be replaced, or (2) as a consequence of the importance of his talents to the venture, the investor, as a practical matter, cannot exercise the latent or nominal powers that he possesses.[99] To the extent that the standards under the third test are absolute, this portion of the *Williamson* test goes beyond the boundaries of *Howey*. Nothing suggested that the talents of the service company in *Howey* were unique or irreplaceable, only that those talents were the ones that would produce profits for the investors.

As an example of a theoretical application of this statement, the court noted that investors may enter a venture on the promise that the manager has a unique understanding of the local market.[100] The agreement may provide the investors with the legal right to fire the manager. Exercise of that right would, however, forfeit the management ability upon which the success of the venture depends. When the putative right is effectively nonexercisable, the illusion of power to remove will not preclude a finding that an investment contract exists. The court concluded that this theoretical statement did not apply to the facts in *Williamson*. Plaintiffs alleged a generalized argument that they were dependent on Godwin. They did not, however, raise "the possibility of a dependence on the unique or irreplaceable expertise of Godwin Investments as an issue in this case."[101]

Judicial determination as to the satisfaction of the second element of the *Williamson* test does not necessarily mean that a similar conclusion will be reached with respect to the third element. Inquiry under the second element focuses on what may be characterized as "investor dependence," while inquiry under the third element seeks "promoter independence." Although the concepts are similar, they are not necessarily corollary. An otherwise qualified investor under the second element may still hold an investment contract if, under the third ele-

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99. The court stated:

> The plaintiffs must allege that Godwin Investments was uniquely capable of such tasks or that the partners were incapable, within reasonable limits, of finding a replacement manager. *Godwin Investments' promise must be more than a binding contract enforceable under state law; it must create the sort of dependence implicit in an investment contract.*

Williamson, 645 F.2d at 425 (emphasis added).

100. *Id.* at 423.

101. *Id.* at 425.

ment, the manager is deemed to have unique talents. The *Williamson* court, however, failed to find either "investor dependence" or "promoter independence" in the facts before it, so it did not explore the subtle distinctions between the second and third elements of the test.

The Fifth Circuit's articulation of investment contract theory as applied to a joint venture is comprehensive. Owing to the relative dearth of federal appellate statements on this issue, *Williamson* apparently now stands as the standard for future analysis. The remainder of this Article accordingly examines the analytical problems faced by joint venture promoters and their counsel in light of the newly announced joint venture test.

IV. After *Williamson v. Tucker*

The consistent theme of *Howey* and its progeny, including *Williamson*, is that although investors have a difficult burden to sustain, joint venture interests can be securities. When organizing a joint venture, therefore, the real estate promoter and his counsel must make three initial determinations: (1) whether an interest in the joint venture is a security; (2) what compliance with state and federal securities law is required if the interest is a security; and (3) what compliance with state and federal securities law is possible without conceding that the interest is a security. The factual analysis that determines the existence of an investment contract is sensitive and subject to error. Even a good faith determination that under the *Williamson* and *Howey* tests an interest is not a security should not prevent consideration of the consequences of the alternative conclusion that the interest is a security.

Section 5 of the Securities Act[102] makes unlawful the selling of any security unless a registration statement is in effect as to the security. Sale of the interest either must be registered under the Securities Act and the relevant state "blue sky" laws, or an exemption from registration under such laws must be obtained. Similarly, the seller of the security either must be registered as a broker/dealer under the Exchange Act and the applicable "blue sky" laws, or an exemption from registration under such laws must be available. Under all circumstances, full, fair, and complete disclosure of material information so as to permit the investor to make an informed decision must be provided to each investor.

102. 15 U.S.C. § 77e (1976).

If the joint venture promoter and his counsel conclude that the interest is a security, their course of action is clear. A disclosure document will be prepared and the security will be registered with the appropriate state and federal regulatory agencies, or the available registration exemptions will be secured. Similar precautions will be effected with respect to the seller of the interests.

If counsel concludes, however, that the interest is not a security, there is no reason to register either the joint venture interest or the seller of the interests with the state or federal regulatory agencies. The joint venture promoter, however, may not be certain that an interest is not a security. Because of the possibility of a subsequent adverse judicial determination that the interest is a security, the conservative promoter and his counsel may explore the circumstances, if any, under which an interest can be sold in compliance with state and federal securities law without taking affirmative action with the regulatory agencies. The following discussion will explore both the laws to be complied with and the degree of compliance that is possible without concluding or declaring that the joint venture interest is a security.

A. *Federal Exemption from Registration*

The preliminary inquiry is whether an exemption from the registration provisions of the Securities Act exists. The primary exemptions are the intrastate exemption and the private placement exemption. These exemptions, however, exempt the interest only from the registration provisions of the Securities Act. They do not exempt an issuer from compliance with the antifraud and antimisstatement requirements.[103]

If the joint venture, its partners, and its property are all located within one state, then the "intrastate" exemption may be available as per section 3(a)(11)[104] of the Securities Act and Rule 147[105] promulgated thereunder. Section 3(a)(11) provides that the registration provisions of the Securities Act do not apply to a class of securities when the security "is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident, and doing business within, or if a corporation, incorpo-

103. *See* text accompanying notes 88-90 *supra*.
104. 15 U.S.C. § 77c(a)(11) (1976).
105. 17 C.F.R. § 230.147 (1981).

rated by and doing business within, such State or Territory."[106] Rule 147 delineates the "safe harbor" provisions of section 3(a)(11).[107]

If the intrastate exemption is available, the joint venture agreement should detail the facts supporting that conclusion. The same representations that would be obtained from the investor in an acknowledged intrastate offering should be procured. The investor should represent that (1) he is a bona fide resident of the state; (2) he will remain such for at least nine months following his purchase of the joint venture interest; and (3) he is purchasing his interest with an investment intent and without a view to the resale or redistribution of his interest. Transfers by the investor of his interest to nonresidents of the state should be subject to an opinion of counsel that the transfer is lawful.

The second major exemption from the registration provisions of the Securities Act is the so-called "private placement" exemption provided by section 4(2)[108] and Rule 146[109] promulgated thereunder. If the joint venture partners are limited to a small number of investors who possess the requisite investment sophistication to qualify as "private placement" offerees, the section 4(2) exemption may be available.

Exemption under Rule 146, which requires absolute compliance with each of its terms, will not be available to joint venture partners. The rule requires filing Form 146 with the appropriate SEC regional office,[110] and failure to file destroys the availability of the exemption. Be-

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106. 15 U.S.C. § 77c(a)(11) (1976).

107. A discussion of the intricacies of the "intrastate exemption" is beyond the scope of this Article. Numerous commentators, however, have explored the problems in detail. *See* Carney, *Exemptions from Securities Registration for Small Issues: Shifting from Full Disclosure—Part II: The Intrastate Offering Exemption and Rule 147*, 11 LAND & WATER L. REV. 161 (1976); Cummings, *The Intrastate Exemption and the Shallow Harbor of Rule 147*, 69 NW. U.L. REV. 167 (1974); Gardiner, *Intrastate Offering Exemption: Rule 147—Progress or Stalemate?*, 35 OHIO ST. L.J. 340 (1974); Hicks, *Intrastate Offerings Under Rule 147*, 72 MICH. L. REV. 463 (1974).

108. 15 U.S.C. § 77d(2) (1976). "The provisions of section 77e of this title [registration provisions] shall not apply to . . . transactions by an issuer not involving any public offering." *Id.*

Secondary sources have extensively considered the problems of compliance with the private placement exemption at the federal level. *See* Ervin, *Private Placements and Limited Partnership Offerings: Changes in the Rules*, 11 CREIGHTON L. REV. 280 (1977); Green & Wittner, *Private Placements of Securities Under Rule 146*, 21 PRAC. LAW. 9 (1975); Kinderman, *The Private Offering Exemption: An Examination of its Availability Under and Outside Rule 146*, 30 BUS. LAW. 921 (1975); Schwartz, *Rule 146: The Private Offering Exemption—Historical Perspective and Analysis*, 35 OHIO ST. L.J. 738 (1974); Schwartz, *The Private Offering Exemption—Recent Developments*, 37 OHIO ST. L.J. 1 (1976); Scroghan, *supra* note 97; Wolfson, *Rule 146: Filing Requirements and Proposed Restrictions on Offeree Representatives*, 1 CORP. L. REV. 364 (1978).

109. 17 C.F.R. § 230.146 (1981).

110. 17 C.F.R. § 230.146(i) (1981).

cause the joint venture promoter and its counsel have concluded that the interest is not a security, consistency of interpretation requires them not to file Form 146. It is important to note, however, that failure to perfect a Rule 146 exemption is not fatal to a claim that the issuer has a valid exemption under section 4(2) because the rule is a "safe harbor" and is not the exclusive method of complying with section 4(2). Even in the absence of a Rule 146 exemption, the joint venture could still have a valid private placement exemption.

A joint venture promoter seeking to preserve a private placement exemption should obtain representations that the investor (1) can bear the economic risk of the investment; (2) is aware of the risks of real estate investment and its illiquid character; (3) is purchasing the interest for his own account and not with a view toward resale or redistribution; and (4) is aware that the interest cannot be assigned, transferred, or sold without an opinion of counsel that the transfer is lawful. The promoter should verify these representations with the investor and his advisors.

The presence of sophisticated investors with the capacity to fend for themselves is a predicate for both the private placement exemption and a finding under the second element of the *Williamson* test that a joint venture interest is not a security. Whether the promoter is seeking to preserve the private placement exemption or avoid a determination that the joint venture interest is a security, it is imperative that he offer the interests only to appropriate investors. If the investor is unsophisticated, his presence may render a private placement exemption unavailable. An unsophisticated investor may likewise be incapable of exercising managerial control and thereby cause his joint venture interest to be deemed a security. The outcome of involving inappropriate investors may be catastrophic, and, accordingly, the promoter should restrict all offers to investors who, either by themselves or in conjunction with their advisers, are sophisticated.

B. *Disclosure*

If either the intrastate or private placement exemption is available the interest will be exempt from the federal registration provisions. Neither exemption, however, exempts the issuer from the disclosure requirements, including the antifraud provisions, that can be satisfied only by providing full disclosure. The promoter and his counsel should prepare and distribute to each offeree written information containing

all available information regarding the venture and the promoter. The investor should represent that he has received all the information regarding the joint venture, the promoter, and the venture's operations that he has requested. Verification of investor representations should be as comprehensive as if the offer were, in fact, an offering of securities. Prophylactic securities procedure and prudent business practice mandate that the promoter determine that his partners have the financial and educational sophistication required to participate meaningfully in management. The same logic compels providing investors with all material information.

If the joint venture promoter follows these procedures, he will prepare an effective substitute for a due diligence file. He will possess written evidence that he has investigated both the investment and the investors, just as he would for an acknowledged securities offering. The file should contain all correspondence with investors, including all written materials and projections furnished. Although the file will not contain a document directly corresponding to a prospectus, the aggregation of information may demonstrate that the investor received most, if not all, of the substantive information normally found in a prospectus. Depending upon the quality of the information provided, the promoter's due diligence file may permit him to demonstrate that he satisfied the disclosure requirements of the securities laws.

C. *State Exemptions from Registration*

Although some states have a registration exemption similar to the private placement exemption, the number of permitted offerees and the exact requirements for the exemption vary widely. Many states require a filing with the state securities division to secure the exemption either before or after the sale.[111] No state has a registration exemption patterned after the intrastate exemption. As a consequence, except in the relative handful of states that have a private placement exemption automatically available without filing, there is no exemption from state

111. *See, e.g.*, OHIO REV. CODE ANN. § 1707.03(Q) (Page Supp. 1980), which requires the filing of Form 3-Q with the Ohio Division of Securities within 60 days after the sale of a security sold in a private placement.

For a discussion of the blue sky statutory provisions corollary to the federal rules, see Note, *State Exemptions From Securities Regulation Coextensive with S.E.C. Rule 146*, 61 CORNELL L. REV. 157 (1975).

registration. If the joint venture interest is a security, its offer and sale will violate the state registration provisions.

D. *Federal Registration of Broker/Dealers*

In addition to registration and disclosure requirements, the securities laws require that the seller of a security either be registered as a broker/dealer pursuant to section 15[112] of the Securities Exchange Act or be exempt therefrom. There are two primary exemptions from the broker/dealer registration provisions: the intrastate exemption and the issuer exemption. There is not, however, a federal broker/dealer exemption parallel to the private placement registration exemption.

A broker/dealer exemption exists that parallels the "intrastate" registration exemption. The rule states:

> It shall be unlawful for any broker or dealer which is either a person other than a natural person or a natural person not associated with a broker or dealer which is a person other than a natural person (*other than such a broker or dealer whose business is exclusively intrastate and who does not make use of any facility of a national securities exchange*) . . . to induce or attempt to induce the purchase or sale of, any security . . . unless such broker or dealer is registered in accordance with subsection (b) of this section.[113]

If sale of the joint venture interest would qualify for the intrastate exemption from registration and all of the promoter's sales activities are restricted to residents of a single state, the exemption from broker/dealer registration may also exist.

The other broker/dealer exemption that may be available is the issuer exemption. The Securities Exchange Act defines a broker or dealer as an individual "engaged in the business" of effecting securities transactions. Individuals who effect only an isolated sale of a security are not engaged in the business of selling securities.[114] When an issuer of securities sells its own securities, using only its officers, partners, di-

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112. 15 U.S.C. § 78*o* (1976).

113. *Id.* § 78*o*(a)(1) (emphasis added).

114. Section 3(a)(4) of the Securities Exchange Act provides that the term "broker" means "any person engaged in the business of effecting transactions in securities *for the account of others*." 15 U.S.C. § 78c (1976) (emphasis added). Section 3(a)(5) of the Exchange Act provides that the term "dealer" means "any person engaged in the business of buying and selling securities *for his own account*, through a broker or otherwise, but does not include a bank, or any person insofar as he buys or sells securities for his own account, but not as part of a regular business." *Id.* (emphasis added).

rectors, and/or employees, as the case may be, registration may not be required, because it is only effecting transactions on its own account. The individual seller of the security may also be exempt from registration, because he likewise is not engaged in the business of selling securities. The sale of joint venture interests by its promoter, who is not engaged in the business of selling securities, may be exempt from the federal broker/dealer registration provisions.[115]

E. *State Registration of Broker/Dealers*

The Uniform Securities Act contains a definitional exemption from registration as a broker/dealer that is similar to federal law.[116] The Act defines "broker-dealer" as "any person engaged in the business of effecting transactions in securities for the account of others or for his own account. 'Broker-dealer' does not include . . . an issuer . . . ."[117] Certain state statutes contain issuer exemptions that are comparable to the issuer exemption outlined in proposed SEC regulations.[118] For example, the Florida Securities Act provides that the term "broker" means "dealer"[119] and limits the meaning of the term "dealer."[120]

Certain states provide an alternative exemption from broker or dealer registration for persons selling securities in "private place-

115. The issuer exemption, however, may be unavailable to the frequent promoter of joint ventures if he were deemed a professional real estate syndicator whose regular business is to establish and sell joint venture interests.

In SEC Rel. No. 34-13195 (Jan. 21, 1977), 17 C.F.R. § 240.3(a)(4)(1) (1977), the Commission proposed the adoption of a new rule to the Exchange Act that "would provide a 'safe harbor' within which persons associated with an issuer would be deemed not to be brokers." Although the proposed rule has not been adopted, it may help determine whether selling activities constitute the actions of a "broker." The release stresses that the issuer exemption is not available to professional real estate syndicators, because they are engaged in the business of selling securities. The issuer exemption may be unavailable even for the first issue if the individuals effecting the distribution intend to engage in the business of selling securities. Since the promoter of multiple joint ventures may be engaged in the business of forming and selling such interests, he may derive little comfort from the existence of the issuer exemption.

116. For limitations of the definitional exemption, see note 115 *supra*.

117. UNIFORM SECURITIES ACT § 401(c).

118. *See* note 115 *supra*.

119. Florida Securities Act, FLA. STAT. ANN. § 517.021(4) (West Supp. 1981).

120. *Id.* § 517.021(6) defines "dealer" as

> any person associated with an issuer of securities if such person is a bona fide employee of the issuer who has not participated in the distribution or sale of any securities within the preceding 12 months and who primarily performs, or is intended to perform at the end of the distribution, substantial duties for, or on behalf of, the issuer other than in connection with transactions in securities.

ments." The Florida Securities Act provides that "the registration requirements of this section [registration of dealers, associated persons, and investments advisers] shall not apply in a transaction exempted by Section 517.061(1)-(16) [the private placement exemption]."[121]

In states such as Florida, a promoter who forms and sells joint venture interests in only a single private placement transaction each year may be exempt from state registration as a broker or dealer, even if the interests are securities under either an issuer or private placement exemptions. In other states with no private placement exemptions, the promoter of infrequent joint ventures may rely on the issuer exemptions. The frequent joint venture promoter, however, will have no exemption.

F. *Summary of State and Federal Securities Laws*

The foregoing review indicates that without concluding that the joint venture interest is a security, even the careful joint venture promoter cannot ensure compliance with all of the state or federal securities laws if the joint venture interest is in fact a security. Exemption from registration of the security and the broker/dealer is sometimes available at the federal and state level. Exemption from the disclosure requirements is never available. Although planning can increase the possibility that the promoter will comply with the securities laws even without conceding that the interest is a security, satisfaction of the full sweep of the disclosure and registration provisions is unlikely. As a consequence, every effort must be expended to structure the joint venture agreement to maximize the probability that an interest in the joint venture cannot constitute a security.

G. *Drafting a Joint Venture Agreement After* Williamson

No matter how the document is drafted, a typical joint venture agreement will normally satisfy the first three elements of the *Howey* test. The investor partners will make an investment in a common enterprise with the expectation of making profits. Effective planning and drafting, however, may eliminate an investor's potential claim that he anticipated making those profits based on the efforts of others. The failure to satisfy the fourth element of the *Howey* test will prevent a determination that the joint venture interest is a security.

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121. *Id.* § 517.12(3).

The salient theme of *Williamson* is that a joint venture interest is a security only when the investor is effectively precluded from exercising managerial control of the enterprise. To respond to this concern, the joint venture agreement should provide that all major joint venture decisions require approval of a majority in interest of the venturers. Decisions subject to venturer approval should include, at a minimum, whether to buy, sell, or refinance the venture's property or proceed with a development plan. The agreement should specify that regular, periodic meetings of all the venturers will be held to receive reports from the manager and to approve any management decisions implemented between meetings. Written notification stating when and where meetings will be held with an agenda should be sent to each investor. Accurate minutes of the meetings, reflecting discussions and votes on important issues, should be maintained.

Counsel for real estate developers will readily recognize the difficulty of achieving compliance with the procedures outlined above. Including such provisions in the joint venture agreement, however, should evince the promoter's intention of establishing an enterprise to be managed by its partners. If the investor is unable, unwilling, or uninterested in attending meetings or receiving reports, his failure to do so represents a deliberate choice to decline managerial control. One inescapable conclusion from *Williamson* and the Eighth and Tenth Circuit cases upon which it relied is that an investor's decision to play a passive role when an active role is possible does not convert a nonsecurity interest into a security.[122] As the *Williamson* court stated, "[a]n investor who is offered an interest in a general partnership or joint venture should be on notice, therefore, that his ownership rights are significant, and that the federal securities acts will not protect him from a mere failure to exercise his rights."[123]

The second element of the *Williamson* test emphasizes that an investor who has the ability to exercise his managerial power does not purchase a security. The promoter's investigation of each investor should document the investor's capabilities on the basis of his educational and business background. The investor should represent that he is financially and/or educationally sophisticated and that it is his present intention to actively exercise his management powers.

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122. *See* note 86 *supra*.
123. 645 F.2d at 422.

If the promoter's investigation reveals that the potential investor is patently incapable of exercising such control, serious consideration should be given to excluding the investor as a joint venture partner. An alternative response to excluding an unsophisticated investor may be to permit the investor to designate a sophisticated agent. The agent could investigate the joint venture, vote on behalf of the investor, and attend joint venture meetings. The promoter may thus create a joint venture analog to the offeree representative concept of Rule 146.[124] The presence of an investment advisor may rehabilitate the investor as an appropriate partner by providing him with the financial sophistication and ability to exercise control otherwise lacking. Although this concept is not suggested in *Williamson*, it seems responsive to the court's principal concerns.

The third element of the *Williamson* test discusses the investor's dependence upon the promoter. In many respects, it is difficult to eliminate such dependence if in fact the promoter has unique talents. A real estate developer is generally able to form joint ventures, either with institutional or individual investors, precisely because his prior performance demonstrates exceptional talent. Although those talents may not be unique in the sense that they are not literally irreplaceable, they are talents not widely available or easily acquirable. There are fewer truly gifted real estate developers than there are investors with funds.

Because it may not be possible to respond to the "unique" aspects of managerial control, the joint venture agreement should squarely attempt to rebut the alternative formulation under the third element of the *Williamson* test, namely, that the manager is irreplaceable. The agreement should provide mechanics delineating when and how the promoter/manager may be replaced and the procedure for selecting a new manager. Removal may be permitted only if the manager fails to achieve certain development goals on time or specified levels of operating income. An alternative, based on the Eighth Circuit cases discussed in *Williamson*,[125] is to limit to a fixed time period the promoter/manager's right to manage. After the expiration of the period, the appointment of a manager would be periodically determined by all venture partners. By providing mechanics for removal in the first approach and a time limitation in the second, the promoter may refute an

124. 17 C.F.R. § 230.146(e)(1) (1981).
125. *See* note 86 *supra*.

argument that the investor is dependent upon an irreplaceable manager.

In practice, many joint venture promoters would not want to participate in a venture they no longer manage. The agreement should therefore permit the promoter to sell his interest to the venture and/or its partners at a price and terms based on a specific formula if he is replaced as manager. The obvious danger of this approach is the possibility that the buy-out provisions will be found to be so prohibitive that they cannot be exercised. Such a finding would leave the analysis where it began, that is, that the manager is irreplaceable.

V. Conclusion

Investment contract analysis is necessarily conducted on a transaction by transaction basis. Uncertain theory is applied to inherently unique facts. The *Williamson* test, although somewhat ambiguous and not above criticism, provides some basis for joint venture promoters and their counsel to design an interest that is not a security. By responding to the guidelines, restricting offers to sophisticated investors, and preserving meaningful management power for such investors, a joint venture promoter can successfully steer the real estate securities course between Scylla and Charybdis.