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I. THE FOURTH CIRCUIT'S NEW SECURITIES ANALYSIS MAY EXPAND SECURITIES LAWS COVERAGE TO GENERAL PARTNERSHIP INTERESTS

In *Bailey v. J.W.K. Properties, Inc.*[1] the Fourth Circuit Court of Appeals held that interests in a cattle breeding program were investment contracts and therefore subject to the federal securities laws. The court's holding is not surprising. The type of interests sold by the defendants would be investment contracts, and therefore securities, under the test of *SEC v. W.J. Howey Co.*[2] The court borrowed, however, analysis from case law formerly thought applicable only to general partnership interests and blurred the distinct way in which courts traditionally have treated these interests under the securities laws.

Plaintiff Bailey and four other investors purchased cattle embryos as part of defendant Albemarle Farms' (Albemarle) cattle breeding program. Because Albemarle designed the program to develop a superior breed of beef cattle, it priced the embryos above ordinary market value. The investors also entered into management contracts with Albemarle, which provided that Albemarle would select the cattle for breeding, care for the cattle, and direct the sale of the cattle. The investors retained the right to cancel the management contract and to direct the care of their cattle. This dispute arose when Albemarle canceled the breeding program.[3]

The investors' complaint alleged that Albemarle violated the disclosure requirements of the federal securities laws. Albemarle moved for summary judgment on the grounds that the interests purchased by the plaintiffs were not "securities" under the federal securities laws. The district court referred the matter to a magistrate to conduct discovery on that issue.[4] The magistrate found that the interests were not securities and recommended that the district court grant Albemarle's motion for summary judgment.[5] After considering the matter de novo, the district court adopted the magistrate's report in its entirety and

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1. 904 F.2d 918 (4th Cir. 1990) (per curiam).

2. 328 U.S. 293 (1946); *see* T. HAZEN, THE LAW OF SECURITIES REGULATION § 1.5 (2d ed. 1990).

3. *Bailey*, 904 F.2d at 919-20.

4. *Id.* at 920.

5. Bailey v. J.W.K. Properties, Inc., 703 F. Supp. 478, 495-96 (W.D. Va. 1989) (mem.), *rev'd per curiam*, 904 F.2d 918 (4th Cir. 1990).

granted Albemarle's summary judgment motion.[6] The investors appealed.

The Fourth Circuit examined the practical limitations on the investors' ability to take an active role in Albemarle's breeding program, including the need for coordination among the investors, and found that those limitations rendered the investors "practically dependent" on Albemarle's efforts.[7] The court rejected the district court's limited approach and considered the facts and circumstances of the breeding program, rather than focusing solely on the language of the contracts.[8] The district court relied substantially on *Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.*,[9] in which the Fourth Circuit held that general partnership interests are not securities. The Fourth Circuit noted that in *Rivanna Trawlers* it was "unnecessary to consider whether individual partners had the knowledge or ability necessary to exercise ultimate control" because of the extensive involvement of the partners as a group.[10] Because the *Bailey* investors could not have "meaningfully exercised" the rights granted to them in the management contract and because they lacked knowledge and experience with cattle breeding programs, the Fourth Circuit held that the interests purchased by the investors were investment contracts.[11]

The court's attempt to distinguish *Rivanna Trawlers* was unnecessary. Courts usually treat general partnership interests differently than investment contracts under the federal securities laws.[12] The test for determining whether an interest is an investment contract is the *Howey* test. Under *Howey* an investment contract is "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party."[13] As the district court recognized, the inter-

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6. *Id.* at 479, 481-82.

7. *Bailey*, 904 F.2d at 924-25.

8. *Id.* at 925.

9. 840 F.2d 236 (4th Cir. 1988).

10. *Bailey*, 904 F.2d at 923.

11. *Id.*

12. *See* Bailey v. J.W.K. Properties, Inc., 703 F. Supp. 478, 494 n.13 (W.D. Va. 1989) (mem.), *rev'd per curiam*, 904 F.2d 918 (4th Cir. 1990); *see also Rivanna Trawlers*, 840 F.2d at 241 ("[O]nly under certain limited circumstances can an investor's general partnership interest be characterized as an investment contract."); T. HAZEN, *supra* note 2, § 1.5, at 38-40 (stating that if the partnership agreement gives the investor actual control, the transaction is not governed by securities laws; it is governed by the common law of fraud).

13. SEC v. W.J. Howey, Co., 328 U.S. 293, 298-99 (1946). The requirement that the investor expect profits "solely" from the efforts of others has been relaxed. *Bailey*, 904 F.2d at 920 n.3; *see also Bailey*, 703 F. Supp. at 479 n.1 ("[I]t is fair to gloss this requirement with the adverb 'largely.' ").

ests at issue in *Bailey* easily met the first two parts of the *Howey* test. The case turned on whether the facts supported a conclusion that the investors intended to profit largely from the efforts of others.[14] Courts have developed a control test to determine whether the investor retained the right to exercise sufficient control to significantly impact on profits or instead relied on the efforts of others.[15]

In applying the control test, the district court examined the *Rivanna Trawlers* court's formulation of the test. The court stated that the *Rivanna Trawlers* court's "explication of the third prong in *Howey* is . . . controlling," but then said that the court "is well aware of the structural differences between the commercial venture described [in *Rivanna Trawlers*] and the venture in the present matter."[16] The magistrate adopted the *Rivanna Trawlers* court's approach of limiting its examination to only the contractual language, but stated that the court "clearly approached the question of control from a far different perspective."[17] The magistrate further noted that "[i]nvestors in general partnerships historically have legal 'control over significant decisions of the enterprise.' "[18] The magistrate therefore suggested that courts should borrow from the general partnership analysis under *Rivanna Trawlers* to limit the control test to an objective inquiry. The district court adopted the magistrate's report in its entirety.[19]

Although a more limited approach to the inquiry may have appealed to the magistrate and the district court, such an approach would clearly undermine the purpose of the federal securities laws, which is to promote " 'full disclosure of information necessary to informed investment decisions.' "[20] The Fourth Circuit erred by not openly rejecting the district court's approach and by not reemphasizing the necessity of a broad inquiry into control under the third prong of *Howey*. Instead, the court attempted to distinguish *Rivanna Trawlers* without addressing the obvious differences between the investment contract offered by Albemarle and the general partnership interests purchased in *Rivanna Trawlers*. The court's analysis could lead to destruction of the distinction between the treatment of securities and general partnership interests under the federal securities laws.

The *Bailey* dictum could lead to the use of an individual analysis

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14. *Bailey*, 703 F. Supp. at 480.
15. *See id.* (citing *Rivanna Trawlers*, 840 F.2d at 240-41).
16. *Id.*
17. *Id.* at 494.
18. *Id.* at 494 n.13 (quoting *Rivanna Trawlers*, 840 F.2d at 240).
19. *Id.* at 482.
20. Bailey v. J.W.K. Properties, Inc., 904 F.2d 918, 921 (4th Cir. 1990) (quoting Matek v. Murat, 862 F.2d 720, 728 (9th Cir. 1988) (citing SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963))).

rather than a group analysis to determine whether the partners exercised sufficient control over the partnership such that their interests are deemed general partnership interests, which are beyond the scope of the federal securities laws. This shift in focus would unnecessarily broaden the scope of inquiry beyond that necessary to examine the economic realities of a transaction.[21] A post-transaction analysis of each individual investor may create a system under which an interest may be either a security or a general partnership interest, depending upon the characteristics of the *investor* rather than the characteristics of the transaction or the language of the agreement. The type of individual analysis suggested by the *Bailey* opinion is inappropriate for general partnership interests. Moreover, the *Rivanna Trawlers* court rejected such an approach.[22] An individual inquiry "would undercut the strong presumption that an interest in a *general* partnership is not a security."[23] The *Rivanna Trawlers* court found this potential result unacceptable and emphasized that "it is also important to bear in mind that Congress, in enacting the securities laws, did not intend to provide a federal remedy for all common law fraud."[24]

An individual analysis is also inappropriate because of the dramatic differences in the structure, individual control, and individual liability between general partnerships and limited partnerships.[25] General partners are jointly and severally liable for wrongful acts of any of the partners and jointly liable for all debts and obligations of the partnership.[26] However, limited partners are not personally liable for the obligations of the partnership.[27] To prevent general partners from escaping individual liability by merely calling their interests limited partnership interests, the Revised Uniform Limited Partnership Act (RULPA) provides a standard for determining whether the partners exercise sufficient control to qualify as general partners.[28] The RULPA clearly establishes the relationship between control and liability among general partners and limited partners. Because general partners have personal liability for the obligations of the partnership, they are naturally inclined to exercise their statutory and contractual powers of con-

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21. *Rivanna Trawlers*, 840 F.2d at 241 n.7.

22. *Id.*

23. *Id.*

24. *Id.* at 241 (citing Marine Bank v. Weaver, 455 U.S. 551 (1982)); *see also id.* at 242 ("[T]he securities laws were not intended to be a substitute for state fraud actions.").

25. Investment programs and limited partnership interests traditionally have been treated similarly under the securities laws. T. HAZEN, *supra* note 2, § 1.5, at 38-40.

26. UNIF. PARTNERSHIP ACT §§ 13-15, 6 U.L.A. 163-74 (1914).

27. REVISED UNIF. LTD. PARTNERSHIP ACT § 303, 6 U.L.A. 307-09 (1976).

28. *Id.*

trol and supervision. If a partner chooses to remain passive, this choice alone cannot convert a general partnership interest into a security.[29] Therefore, the protection of the federal securities laws is not normally necessary or appropriate for a general partner.

The Fourth Circuit also looked to partnership rights under Virginia law for additional evidence of access to information.[30] Because access to information is guaranteed by the law, a partner could easily obtain sufficient knowledge to exercise control. Thus, the knowledge requirement appears to be satisfied. The court does not, however, suggest a method by which a court can examine the required ability of each investor to exercise control, except perhaps by the use of empirical evidence. Additionally, the court's reliance on Virginia partnership law is a bit meaningless. Virginia has adopted the Uniform Partnership Act.[31] Virtually all American jurisdictions have some version of the Uniform Partnership Act.[32] Therefore, investors in Virginia partnerships are not accorded any special rights.

If the Fourth Circuit intended to adopt a broader scope of inquiry into general partnership transactions, the standard by which the courts would judge the facts of each case is unclear. The court stated that courts must determine whether each individual investor possesses knowledge and ability to exercise control, but excused the *Rivanna Trawlers* court's failure to investigate because of the "structure and protection" of the partnership agreement.[33] Issuers of general partnership interests cannot be sure whether they must meet an individual or group standard or how to comply with the standard. The court should articulate meaningful guidelines before it expects compliance.

In *Bailey* the court reached the right result for the wrong reason. The result is correct because the interests in the cattle breeding program constituted securities under the traditional *Howey* test. However, courts should not read *Bailey* for the proposition that general partnership agreements should be subjectively examined beyond the scope of the contractual language or that an individual control analysis should be applied to general partners.

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29. Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc., 840 F.2d 236, 240-41 (4th Cir. 1988).

30. Bailey v. J.W.K. Properties, Inc., 904 F.2d 918, 923 n.7 (4th Cir. 1990) (per curiam).

31. VA. CODE ANN. §§ 50-1 to -43 (1989).

32. *See* UNIF. PARTNERSHIP ACT Table of Jurisdictions, 6 U.L.A. 1 (Supp. 1990).

33. *Bailey*, 904 F.2d at 923.