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Securities Law—Partnerships—Adoption of an Expansive Test for Defining a Security. *Casali v. Schultz*, 292 Ark. 602, 732 S.W.2d 836 (1987).

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NOTES

SECURITIES LAW—PARTNERSHIPS—ADOPTION OF AN EXPANSIVE TEST FOR DEFINING A SECURITY. *Casali v. Schultz*, 292 Ark. 602, 732 S.W.2d 836 (1987).

Glenn R. Schultz, who possessed an extensive background in law and banking, approached J.A. McEntire, a banker, with a plan to purchase an investment banking firm. Eight doctors and an art dealer joined Schultz and McEntire in this endeavor and, with a total contribution of \$1,175,000.00,¹ the group formed KGS Partners. The investors, many of whom previously participated in limited partnerships where they lacked managerial control, agreed to form a general partnership so they could be involved in the management of the venture. All of the partners agreed to use the partnership assets to purchase the stock of Park, Ryan, Inc., a New York investment banking firm. A provision in the partnership agreement specified that three of the partners, Schultz, McEntire and a physician-investor, Kent Westbrook, would manage the partnership business.²

Park, Ryan, Inc. ultimately went into bankruptcy and the partners liquidated KGS Partners. Appellant Casali, a physician investor, filed suit for rescission, claiming that the sale of partnership units in KGS Partners constituted a sale of securities which, if not exempt from registration, should have been registered by the partners³ under the Arkansas Securities Act.⁴ The Pulaski County Circuit Court

1. A second solicitation raised an additional \$875,000.00. *Casali v. Schultz*, 292 Ark. 602, 603, 732 S.W.2d 836, 837 (1987).

2. The initial partnership interests were: Schultz, 12.8%; Westbrook, 8.5%; McEntire, 4.3%; other partners, 74.4%. *Id.* at 608, 732 S.W.2d at 839.

3. Of the three managing partners only two, Schultz and McEntire, were defendants in this action. Westbrook was not a party. *Id.* at 602, 732 S.W.2d at 836.

4. ARK. CODE ANN. § 23-42-501 (1987) provides, "It is unlawful for any person to offer or sell any security in this State unless: (1) It is registered under this chapter; or (2) The security or transaction is exempted under §§ 23-42-503 or 23-42-504." ARK. CODE ANN. § 23-42-106(a)(1) (1987) states that "[a]ny person who [fails to register or obtain an exemption] is liable to the person buying the security from him, who may sue either at law or in equity to recover the consideration paid for the security, together with interest at six percent (6%) per year from the date of payment, costs, and reasonable attorneys' fees, less the amount of any income received on the security, upon the tender of the security and any income received on it, or for damages if he no longer owns the security."

ruled that the transaction was not a sale of securities as a matter of law. The Arkansas Supreme Court reversed, holding that the arrangement constituted an "investment contract" subject to the provisions of the Arkansas Securities Act.⁵ *Casali v. Schultz*, 292 Ark. 602, 732 S.W.2d 836 (1987).

The problem raised in *Casali*, under what circumstances a partnership interest will be deemed a security, is one that has arisen under both state and federal securities laws.⁶ Both the Arkansas Securities Act⁷ and the federal securities statutes⁸ include within their definition of security the amorphous term "investment contract."⁹ The category of investment interests falling within the scope of "investment contract" is quite broad, including such diverse interests as certificates of deposit,¹⁰ pyramid sale arrangements,¹¹ muskrats,¹² gold bars,¹³ leases of pregnant cows,¹⁴ and whiskey warehouse receipts.¹⁵

The federal definition of "investment contract" was first articu-

5. 292 Ark. at 606, 732 S.W.2d at 838. Since the court rendered the *Casali* decision prior to recodification, the court cited to ARK. STAT. ANN. §§ 57-1235 to -1261 (1966).

6. See *Rivanna Trawlers Unlimited v. Borchardt*, 1988 Fed. Sec. L. Rep. (CCH) ¶ 93,642 (4th Cir. 1988); *Goodwin v. Elkins & Co.*, 730 F.2d 99 (3d Cir.), cert. denied, 105 S. Ct. 118 (1984); *SEC v. Professional Assocs.*, 731 F.2d 349 (6th Cir. 1984); *Odom v. Slavik*, 703 F.2d 212 (6th Cir. 1983) (per curiam); *Williamson v. Tucker*, 645 F.2d 404 (5th Cir. 1981); *Goodman v. Epstein*, 582 F.2d 388 (7th Cir. 1978); *McGreghar Land Co. v. Meguiar*, 521 F.2d 822 (9th Cir. 1975); *Vincent v. Moench*, 473 F.2d 430 (10th Cir. 1973); *Sandusky Land, Ltd., v. Uniplan Groups, Inc.*, 400 F. Supp. 440 (N.D. Ohio 1975); *New York Stock Exchange, Inc. v. Sloan*, 394 F. Supp. 1303 (S.D.N.Y. 1975); *Casali v. Schultz*, 292 Ark. 602, 732 S.W.2d 836 (1987); *Fortier v. Ramsey*, 136 Ga. App. 203, 220 S.E.2d 753 (1975); *State v. Hawaii Market Center, Inc.*, 52 Haw. 642, 485 P.2d 105 (Hawaii 1971).

7. ARK. CODE ANN. §§ 23-42-106 to -508 (1987).

8. See 15 U.S.C. §§ 77a-77aa (1982) and 15 U.S.C. §§ 78a-78kk (1982).

9. ARK. CODE ANN. § 23-42-102(12) (1987) defines "security" as:

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*; variable annuity contract; voting-trust certificate; certificate of deposit for a security; certificate of interest or participation in an oil, gas, or mining title or lease or out of production under such title or lease; or, in general, any interest or instrument commonly known as a "security" or any certificate or interest or participation in, temporary or interim certificate for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing. (Emphasis added).

The federal securities statutes, which are similar to the Arkansas statutes, also include the term "investment contract." Cf. 15 U.S.C. § 77b(1) (1982) and 15 U.S.C. § 78c(a)(10) (1982).

10. *Swank Federal Credit Union v. C.H. Wagner and Co.*, 405 F. Supp. 385 (D. Mass. 1975).

11. *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473 (5th Cir. 1974).

12. *State v. Robbins*, 185 Minn. 202, 240 N.W. 456 (1932).

13. *SEC v. Brigadoon Scotch Distributors, Ltd.*, 388 F. Supp. 1288 (S.D.N.Y. 1975).

14. *Plunkett v. Francisco*, 430 F. Supp. 235 (N.D. Ga. 1977).

15. *Glen-Arden Commodities, Inc., v. Costantino*, 493 F.2d 1027 (2d Cir. 1974).

lated in *SEC v. W.J. Howey Co.*¹⁶ where the United States Supreme Court defined "investment contract" as "any 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 third party."¹⁷ A few courts applied the *Howey* "solely from the efforts of [others]" test literally, finding a modicum of participation by the investor sufficient to insulate the arrangement from the reach of securities laws.¹⁸ Such a mechanical approach to defining the term "investment contract" is subject to criticism.¹⁹

To avoid a literal application of the *Howey* test, some federal courts apply a liberal construction to the term "solely."²⁰ *SEC v. Glenn W. Turner Enterprises, Inc.*²¹ typifies this approach, where the court's inquiry was "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."²²

The "investment contract" analysis is frequently applied to partnership offerings to determine if a particular arrangement constitutes a transaction in securities. Limited partnership interests are almost always found to be "investment contracts" subject to securities laws²³ because limited partners by definition are passive investors who are

16. 328 U.S. 293 (1946).

17. *Id.* at 298 (emphasis added). The Court held that an offering of a contract for the purchase of individual rows of trees in an orange grove coupled with an arrangement for cultivating and marketing the product was an "investment contract." Most of the investors resided in other states, had no experience in horticulture, and were completely dependent on the skill and abilities of the sellers. See, e.g., Fitzgibbon, *What is a Security?—A Redefinition Based on Eligibility to Participate in the Financial Markets*, 64 MINN. L. REV. 893 (1980); Tew & Freedman, *In support of SEC v. W.J. Howey Co.: A Critical Analysis of the Parameters of the Economic Relationship Between Issuer of Securities and the Securities Purchaser*, 27 U. MIAMI L. REV. 407 (1973).

18. E.g., *Koscot Interplanetary, Inc. v. King*, 452 S.W.2d 531 (Tex. Civ. App. 1970); *Gallion v. Alabama Market Centers, Inc.*, 282 Ala. 679, 213 So. 2d 841 (1968); *Georgia Market Centers, Inc. v. Fortson*, 225 Ga. 854, 171 S.E.2d 620 (1969).

19. *SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476, 481 (9th Cir. 1973); *State v. Hawaii Market Center, Inc.*, 52 Haw. 642, 651-52, 485 P.2d 105, 111 (Hawaii 1971). See also Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135, 145-46 (1971).

20. See, e.g., *SEC v. Professional Assocs.*, 731 F.2d 349 (6th Cir. 1984); *Goodwin v. Elkins & Co.*, 730 F.2d 99 (3d Cir.), cert. denied, 105 S. Ct. 118 (1984); *SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476 (9th Cir. 1973).

21. 474 F.2d 476 (9th Cir. 1973).

22. *Id.* at 482.

23. E.g., *Mayer v. Oil Field Systems Corp.*, 721 F.2d 59 (2d Cir. 1983); *Goodman v. Epstein*, 582 F.2d 388 (7th Cir. 1978); *McGregor Land Co. v. Meguiar*, 521 F.2d 822 (9th Cir. 1975); *Bayoud v. Ballard*, 404 F. Supp. 417 (N.D. Tex. 1975); *Graham v. Kane*, 264 Ark. 949, 576 S.W.2d 711 (1979).

almost entirely dependent on the managerial efforts of the general partner.²⁴ However, courts prefer to look at substance rather than form; if the limited partner retains significant decisional powers, the arrangement may not be an "investment contract."²⁵

Unlike limited partnerships, general partnerships and joint ventures²⁶ may grant all partners equal rights in the management and control of the partnership business.²⁷ When general partners are active participants and are not dependent on others for managerial control, their relationship is the antithesis of an arrangement that denotes an "investment contract,"²⁸ because the partners do not rely "solely [on] the efforts of [others]."²⁹ However, when an inactive partner vests managerial control in others, his interest may be virtually indistinguishable from that of a limited partner. In that case, the interest of the general partner may constitute an "investment contract."³⁰

In *Williamson v. Tucker*³¹ the United States Court of Appeals for the Fifth Circuit identified three situations in which the interest in a general partnership may be classified as a security:

A general partnership or joint venture interest can be designated a security if the investor can establish . . . that (1) an agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership; or (2) the partner or venturer is so inexperi-

24. The Uniform Limited Partnership Act, codified in ARK. CODE ANN. §§ 4-44-101 to -131 (1987), and the Revised Uniform Limited Partnership Act, codified in ARK. CODE ANN. §§ 4-43-101 to -1109 (1987), restrict the managerial control of the limited partner. In general, the limited partner has no managerial authority, but can otherwise review the partnership records, demand an accounting and seek a dissolution and winding up of the arrangement by a court decree. ARK. CODE ANN. § 4-44-110 (1987). ARK. CODE ANN. § 4-44-107 (1987) states that "a limited partner shall not become liable as a general partner unless, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business."

25. *E.g.*, *Gordon v. Terry*, 684 F.2d 736 (11th Cir. 1982).

26. For most purposes, including this discussion, a general partnership and a joint venture are considered equivalent arrangements. A joint venture is usually undertaken to perform a particular project, while the partnership has broader purposes. *See generally*, Mechem, *The Law of Joint Adventures*, 15 MINN. L. REV. 644 (1931).

27. ARK. CODE ANN. § 4-42-201(1) (1987) provides: "A partnership is an association of two (2) or more persons to carry on as co-owners a business for profit."

28. Long, *Partnership, Limited Partnership, and Joint Venture Interests as Securities*, 37 MO. L. REV. 581, 612-15 (1972).

29. *Odom v. Slavik*, 703 F.2d 212 (6th Cir. 1983); *Frazier v. Manson*, 484 F. Supp. 449 (N.D. Tex. 1980); *Hirsch v. duPont*, 396 F. Supp. 1214 (S.D.N.Y. 1975), *aff'd*, 553 F.2d 750 (2d Cir. 1977); *Romney v. Richard Prows, Inc.*, 289 F. Supp. 313 (D. Utah 1968).

30. *See generally*, Note, *General Partnership Interests as Securities under the Federal Securities Laws: Substance Over Form*, 54 FORDHAM L. REV. 303 (1985).

31. 645 F.2d 404 (5th Cir. 1981).

enced 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.³²

The court's articulation of the second and third situations where securities may be found is an expansion of the modified *Howey* test.³³ Recognizing that this is not an exclusive test, *Williamson* states that "[t]hese are the only factors relevant to the issue [in this case]. But this 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."³⁴ *Williamson* is cited with general approval by the jurisdictions that have considered it.³⁵

The Arkansas Supreme Court first considered the issue whether a general partnership or joint venture interest might be deemed a security in *Schultz v. Rector-Phillips-Morse, Inc.*,³⁶ in which it held that offerings in a joint venture constituted "investment contracts."³⁷ In *Rector-Phillips-Morse, Inc.* a real estate firm packaged a program constituting the financing, construction and operation of an apartment complex and marketed this program to passive investors³⁸ seeking a tax shelter.³⁹ The court applied a liberal reading of the definition of a security and stated "that it is better to determine in each instance from a review of all of the facts, whether an investment scheme or plan constitutes an investment contract . . ."⁴⁰ In so doing, the court did not adopt the *Howey* test,⁴¹ preferring instead the view adopted by Minnesota in *Minnesota v. Investors Security Corp.*⁴² Subsequent to

32. *Id.* at 424.

33. Levinson, *General Partnership Interests and the Securities Act of 1933: Recent Judicial Developments*, 10 OHIO N.U.L. REV. 463, 468 (1983).

34. 645 F.2d at 424 n.15.

35. *Rivanna Trawlers Unlimited v. Borchardt*, 1988 Fed. Sec. L. Rep. (CCH) ¶ 93,642 (4th Cir. 1988); *Deutsch Energy Co. v. Mazur*, 813 F.2d 1567 (9th Cir. 1987); *SEC v. Professional Assocs.*, 731 F.2d 349 (6th Cir. 1984); *McConnell v. Frank Howard Allen & Co.*, 574 F. Supp. 781 (N.D. Cal. 1983); *Pfohl v. Pelican Landing*, 567 F. Supp. 134 (N.D. Ill. 1983); *Morrison v. Pelican Land Dev.*, 1982 Fed. Sec. L. Rep. (CCH) ¶ 98,863 (N.D. Ill. 1982).

36. 261 Ark. 769, 552 S.W.2d 4 (1977).

37. *Id.*

38. Ironically, one of the plaintiff investors in this case was Glenn R. Schultz, the defendant in *Casali v. Schultz*.

39. 261 Ark. at 772-75, 552 S.W.2d at 6.

40. *Id.* at 781, 552 S.W.2d at 10.

41. See Note: *A Definition of "Investment Contracts" and Equitable Defenses to Suit for Recission for Nonregistration Under the Arkansas Securities Act*, 1 UALR L.J. 366, 375 (1978).

42.. 297 Minn. 1, 209 N.W.2d 405 (1973). While Minnesota acknowledges that the *Howey*

Rector-Philips-Morse, Inc., in *Smith v. State*⁴³ the Arkansas Court of Appeals adopted a modified “risk capital”⁴⁴ test for identifying a “security” involving a joint venture in a mobile phone enterprise. The court listed the elements of this test:

- (1) the investment of money or money’s worth; (2) investment in a venture; (3) the expectation of some benefit to the investor as a result of the investment; (4) contribution towards the risk capital of the venture; and (5) the absence of direct control over the investment or policy decisions concerning the venture.⁴⁵

The court in *Smith* did not elaborate on its definition of a security, nor did it explain the relationship between its test and the approach of *Rector-Philips-Morse, Inc.*⁴⁶

*Casali v. Schultz*⁴⁷ presented the Arkansas Supreme Court with the opportunity to combine both the *Williamson*⁴⁸ test and the “risk capital”⁴⁹ test articulated in *Smith* in its holding that the offerings in KGS Partners constituted a security transaction. Articulating the *Williamson* test,⁵⁰ the court noted that the relationship between Casali and Schultz satisfied the first factor because the “arrangement in fact distributes power as would a limited partnership”⁵¹ In reaching this conclusion, the court probed the power granted to Casali and found that he possessed no managerial authority over the operation of Park, Ryan, Inc.⁵²

test is useful, it declines to adopt *Howey* as the exclusive test. Minnesota is a “merit state” for purposes of securities registration, the effect of which is that Minnesota courts adopt an “expansive view of [the] securities statutes.” *Id.* at 6, 209 N.W.2d at 409. Arkansas is also a “merit state” (ARK. CODE ANN. § 23-42-405 (1987)), but the *Rector-Philips-Morse, Inc.*, court did not explicitly recognize the Arkansas “merit” registration provision in its decision to apply the more expansive test. The *Rector-Philips-Morse, Inc.*, court looked to the economic reality of the transaction, stating that “by no means are all general partnerships or joint venture units securities within the meaning of the Arkansas Securities Act. It is not the label that determines whether these units are securities, but the economic substance of the financing of the venture.” 261 Ark. at 782, 552 S.W.2d at 11. The court found that the joint venture units were “securities,” but, invoking laches, declined to provide relief to the plaintiffs. *Id.* at 788, 552 S.W.2d at 14.

43. 266 Ark. 861, 587 S.W.2d 50 (Ark. App. 1979).

44. See, e.g., *Silver Hills Country Club v. Sobieski*, 55 Cal. 2d 811, 13 Cal. Rptr. 186, 361 P.2d 906 (1961). See generally, Coffey, *The Economic Realities of a “Security:” Is There a More Meaningful Formula?*, 18 W. RES. L. REV. 367 (1967).

45. 266 Ark. at 865, 587 S.W.2d at 52.

46. *Id.*

47. 292 Ark. 602, 732 S.W.2d 836 (1987).

48. See *supra* text accompanying notes 31-35.

49. See *supra* text accompanying notes 43-46.

50. 292 Ark. at 605, 732 S.W.2d at 837-38.

51. *Id.* (quoting *Williamson*, 645 F.2d at 424).

52. Casali could not: 1) hire employees of Park Ryan; 2) fire the employees of Park Ryan;

Although the court did not specifically address the second and third components of the *Williamson* test,⁵³ it implicitly applied these factors to its analysis of the partnership arrangement.⁵⁴ As to the second factor, the court noted the differences in business sophistication between Casali and Schultz by acknowledging the legal and business background of Schultz⁵⁵ and stating that Casali “did not have any training in business or management and had never traded in securities. His only other investment was in an 80 acre farm.”⁵⁶ Implicitly applying the third factor of the *Williamson* test,⁵⁷ the court stated that “Schultz alone among the investors had the knowledge, experience, and expertise necessary to operate an investment banking house.”⁵⁸

Applying the flexible definition given the term “security” in *Rector-Phillips-Morse, Inc.*,⁵⁹ the court added that the legislative intent of the broad definition accorded the term securities “was that, regardless of the label on a document, the underlying economic substance of a security is an arrangement where the investor is a mere passive contributor of risk capital to a venture in which he has no direct or managerial control.”⁶⁰

The dissent stated that the supreme court could reverse the trial court only if it found that the lower court “erred as a matter of law or its findings were clearly against the preponderance of the evidence.”⁶¹ While the dissent agreed with the majority that “an arrangement where the investor is a mere passive contributor of risk capital to a venture in which he has *no* direct or managerial control”⁶² is a security, it averred that the partners were active, not passive investors.⁶³ The dissent focused on the testimony of the parties, noting that one partner stated that the investors “did not want a limited partnership but instead *wanted a general partnership in which everyone had a par-*

3) trade securities for Park Ryan; 4) buy securities for Park Ryan; 5) sell securities for Park Ryan; 6) set salaries for Park Ryan; 7) mortgage property of Park Ryan; 8) open bank accounts; 9) sign checks; 10) incur any debts; 11) sell any assets; 12) determine how the stock of Park Ryan would be voted. *Id.* at 604, 732 S.W.2d at 837.

53. *See supra* text accompanying note 32.

54. As phrased, the factors are alternatives, and only one need be present to find a security under this test. 645 F.2d at 424.

55. 292 Ark. at 603, 732 S.W.2d at 836.

56. *Id.* at 604-05, 732 S.W.2d at 837.

57. *Id.* at 605, 732 S.W.2d at 838.

58. *Id.* at 604, 732 S.W.2d at 837.

59. *See supra* text accompanying notes 36-42.

60. 292 Ark. at 605, 732 S.W.2d at 837.

61. *Id.* at 606, 732 S.W.2d at 838.

62. *Id.* at 606-07, 732 S.W.2d at 838.

63. *Id.*

icipation in the management."⁶⁴ The dissent noted that one of the physicians acted as a managing partner and that all partners participated in the decision-making process at monthly business meetings.⁶⁵ Stating that the supreme court should not "weigh the evidence [or] observe and . . . determine the credibility of the witnesses," the dissent asserted that those functions were more properly within the scope of the trial court.⁶⁶

By adopting the *Williamson* test the Arkansas Supreme Court provides specific guidelines⁶⁷ for defining an "investment contract" under Arkansas law. However, by continuing to recognize the modified "risk capital" test, the court appears willing to inquire into the "economic reality" of the transaction, and not apply a specific formula.⁶⁸

The court's application of the *Williamson* analysis to the facts in this case is questionable. Under this test, the court's initial inquiry should focus on the extent of the powers of the complaining general partner.⁶⁹ Here, the court found that Casali possessed no managerial authority over the affairs of Park, Ryan, Inc. By listing the management functions of Park, Ryan, Inc. that were not under the direct control of the general partners, the court implied that shareholders (in this case KGS Partners) have significant management authority which in fact is usually relegated to the board of directors or corporate officers.⁷⁰

Under the second prong of the *Williamson* test, courts probe the business sophistication of the complaining general partner.⁷¹ But business sophistication is not a bright-line test.⁷² Other jurisdictions which make this inquiry reach disparate outcomes.⁷³ By not explic-

64. *Id.* at 607, 732 S.W.2d at 839.

65. *Id.*

66. *Id.* at 609, 732 S.W.2d at 840.

67. *See supra* text accompanying note 32.

68. By retaining the modified "risk capital" test, the court implicitly adopts the *Williamson* position that other factors might give rise to a security. 645 F.2d at 424 n.15.

69. *See supra* text accompanying note 32.

70. *See* 5 FLETCHER CYCLOPEDIA CORPORATIONS § 2097 (rev. perm. ed. 1987). In general, shareholders elect the board of directors which manage the corporation by appointing corporate officers. "Generally, the powers of management vesting in the stockholders as a body are very few." *Id.* at 501.

71. In *Williamson* the court found that the plaintiffs, who were business executives, possessed sufficient business sophistication even though their backgrounds did not include experience in real estate. 645 F.2d at 424.

72. *See* Soraghan, *Private Offerings: Determining "Access," "Investment Sophistication," and "Ability to Bear Economic Risk,"* 8 SEC. REG. L.J. 3, 23-24 (1980).

73. In *Morrison v. Pelican Land Development*, Fed. Sec. L. Rep. (CCH) ¶ 98,863 (N.D. Ill. 1982), the court found that investments in a condominium project by a policeman having a

itly applying the second factor to its analysis of the KGS Partners arrangement, the court failed to provide interpretive guidance as to the level of business sophistication required of a partner for a finding that the agreement does not constitute a security.

Judicial inquiry into the third factor of the *Williamson* test focuses on promoter or managerial dependence.⁷⁴ Even though the partnership agreement may grant the partners the right to fire the manager, that grant is merely illusory if, by exercising that right, the partners forfeit the skill and ability of the manager upon whose shoulder is borne the success of the enterprise.⁷⁵ The *Casali* court should have inquired whether the talents and abilities of Schultz were unique. Under the usual methods of corporate organization, shareholders select the board of directors who in turn hire the corporate officers.⁷⁶ Nothing in the record suggests that a majority of the partners could not cause KGS Partners, as the sole shareholder controlling Park, Ryan's board, to find and hire another individual to manage the daily operations of Park, Ryan, Inc. According to *Williamson*, "a partnership can be an investment contract only when the partners are so dependent on a particular manager that they cannot replace him"⁷⁷

The *Casali* decision evinces a willingness on the part of the court to closely scrutinize partnership arrangements to accommodate its expansive reading of "investment contract." Features of an agreement which fall within this expansive reading run the risk of subjecting the agreement to the aegis of securities laws. "To find a 'security' is to subject a transaction to regulation governing: (1) the process of the security's creation and distribution; (2) the process of trading in the security; and (3) matters associated with holding the security."⁷⁸ Individuals who participate in partnerships, or draft partnership agreements, will undoubtedly want to exercise immense care to avoid the

high school education presented a triable question of fact as to the issue of a security. In *Rivanna Trawlers Unlimited v. Borchardt*, 1988 Fed. Sec. L. Rep. (CCH) ¶ 93,642 n.7 (4th Cir. 1988), the court, per Powell, J., stated that inquiry into the business expertise of each partner "would undercut the strong presumption that an interest in a *general* partnership is not a security." However, in *Youmans v. Simon*, 791 F.2d 341 (5th Cir. 1986), the court found that a physician investor in a real estate venture had sufficient business sophistication. Unlike *Casali*, *Youmans* engaged in other business transactions unconnected with the operators in the disputed venture.

74. See *supra* text accompanying note 32.

75. See Morgenstern, *Real Estate Joint Venture Interests as Securities: The Implications of Williamson v. Tucker*, 59 WASH. U.L.Q. 1231, 1256 (1982).

76. See FLETCHER, *supra* note 70.

77. 645 F.2d at 424.

78. 11 SOWARDS, BUSINESS ORGANIZATIONS—SECURITIES REGULATIONS, § 2.01 n.5 (1987).

"investment contract trap." Failure to obtain an exemption or to register the security may subject the promoter or manager to both civil⁷⁹ and criminal⁸⁰ actions.

To avoid this "trap," the careful drafter of a partnership agreement might include provisions for the following: 1) the approval of all major decisions by a majority vote, with regular meetings held to keep the partners apprised of the partnership business;⁸¹ 2) the exclusion of an investor who lacks business sophistication or, in the alternative, appointment of a sophisticated agent to act in his behalf; 3) the establishment of a fixed time period for the manager's right to manage, with choice of a replacement manager left to the investors; and 4) allowing the investors to remove the manager and appoint a replacement.⁸² Since the *Casali* court was concerned about the lack of investor power in the daily management of the corporation (Park, Ryan, Inc.),⁸³ participants in agreements involving control of corporations should insure that all partners have a voice in the operations of the corporation. Granting officer or director positions to the general partners may assist in this goal. Alternatively, general partnerships might be advised to avoid investing in corporations.

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79. See ARK. CODE ANN. §§ 23-42-106 to -508 (1987).

80. ARK. CODE ANN. § 23-42-104(b) (1987) makes a "knowing" violation a Class D felony. ARK. CODE ANN. § 23-42-104(c) (1987) makes a "negligent" violation a Class A misdemeanor.

81. This provision alone might not be sufficient since in the *Casali* arrangement meetings were held on a monthly basis and decisions were voted on by the partners. See *supra* text accompanying note 65.

82. See generally, Morgenstern, *supra* note 75, at 1265.

83. See *supra* note 52.