San Diego Law Review

Volume 26 | Issue 3 Article 9

5-1-1989

Matek v. Murat: Back to Terms of Agreement

Jeffrey D. Winter

Matek v. Murat: Back to "Terms of Agreement"

I. Synopsis

Since the Supreme Court's decision in *Securities & Exchange Commission v . W.J. Howey Co.*,[1] the definition of "security" has undergone many changes. The elasticity of this definition includes within its scope investment contracts. By giving itself a broad definition to work with, the Court has, in effect, extended federal assistance to those investors that previously may not have qualified for federal remedies. Plaintiffs were understandably fond of this broad definition. At the very least, it afforded them a valuable bargaining tool. At best, it allowed the plaintiff to reap much larger awards. Predictably, in the cases following *Howey*, it became a plaintiff's job to convince the court that her particular contract satisfied the elements of an investment contract: an investment in a common enterprise in which the anticipated profits were to come solely from the efforts of others.[2]

Eventually, this definition was expanded, albeit in dicta, to include general partnership organizations. In *Williamson v. Tucker*,[3] the Fifth Circuit added a new test to determine whether an interest in a general partnership amounted to a security. The new test, consisting of three prongs, looked not only at the agreement between the parties, but also at the "economic realities" of their situation. In particular, the court focused on whether the investor was inexperienced and unknowledgeable, and if the investor was so otherwise dependent upon a unique capability of the managing partner that the investor could not meaningfully exercise the powers of partnership.[4]

Recent evidence indicates that the expansion in this area may have reached its limit. In 1988, the Ninth Circuit Court of Appeals, in *Matek v. Murat*,[5] ruled that the question whether an interest in a

1. 328 U.S. 293 (1946).
2. This is the test enunciated by the *Howey* court. *See infra* note 12 and accompanying text.
3. 645 F.2d 404 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981).
4. *Williamson*, 645 F.2d at 424.
5. 862 F.2d 720 (9th Cir. 1988).

general partnership amounts to a "security" should be determined only by the legal effect of the agreement between the parties.[6] This Note will analyze *Matek* in light of previous decisions from other circuits. This Note will then attempt to determine the impact of *Matek* on the field of securities regulation.

II. BACKGROUND

While both the Securities Act of 1933[7] and the Securities Exchange Act of 1934[8] define the term "security",[9] judicial construction is provided by the Supreme Court in *Securities & Exchange Commission v. W.J. Howey Co.*[10] In *Howey*, plaintiffs were investors in units of a citrus grove developed and sold by defendant. Under this investment scheme, a promoter owned half of the property and offered parcels of the remaining half to the public. Nearly eighty-five percent of the land was sold under a service contract in which a second promoter assumed possession of the grove and became responsible to the purchaser only for the net profits derived therefrom. The purchasers were not required, and in many cases were not able, to care for the citrus groves themselves.[11]

The Supreme Court considered the purchase contract and the service contract to be essentially one agreement, and held that, as a whole, it constituted an investment contract. The Court stated that "an investment contract for the 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 a promoter or a third party."[12]

Following *Howey*, the lower courts diligently applied their own versions of the test to find "securities" in investment schemes involving real estate,[13] limited partnerships,[14] and even beaver

---

6. *Id.*

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

8. Ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a - 78kk (1982)).

9. Section 2(1) of the Securities Act of 1933 states: "The term 'security' means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, . . .investment contract. . .or, in general, any interest or instrument commonly known as a 'security,' or any certificate of interest or participation in. . .any of the foregoing." Section 3(a)(10) of the Securities Exchange Act of 1934 uses almost identical language. The Supreme Court has determined that the two statutory definitions are "substantially the same." Tcherepnin v. Knight, 389 U.S. 332, 342 (1967).

10. 328 U.S. 293 (1946).

11. *Id.* at 295-96.

12. *Id.* at 298-99.

13. *See, e.g.*, Blackwell v. Bentsen, 203 F.2d 690 (5th Cir. 1953), *cert. dismissed*, 347 U.S. 925 (1954); Securities & Exch. Comm'n v. Orange Grove Tracts, 210 F. Supp. 81 (D.C. Mass. 1962).

14. *See* Securities & Exch. Comm'n v. Murphy, 626 F.2d 633 (9th Cir. 1980) (because a limited partnership, by definition, is an investment in a common enterprise

breeding.[15] The courts seized upon the remedial nature of the federal securities legislation, determined to pursue a policy of broad protection for the public.[16] Such enthusiasm, however, has been less than uniform when the courts ruled on the issue of general partnership interests.

For example, to determine whether a security existed, courts from the Eighth and Tenth Circuits limited their examination primarily to the agreement between the parties. In *Fargo Partners v. Dain Corp.*[17] the Eighth Circuit held that if the investor retained managerial power by contract, there was no investment contract.[18] In *Fargo*, plaintiff entered into an agreement to purchase an apartment development with defendant serving as its broker. Plaintiff had signed a management agreement giving back to the defendant an exclusive right to manage the apartment project, reserving for itself only the right to cancel the agreement on thirty days notice. Plaintiff asserted that it was merely an investor supplying capital and was completely reliant upon the defendant for its managerial expertise.[19]

The Eighth Circuit affirmed the district court's ruling that the contract did not amount to an investment contract within the meaning of *Howey*. The court acknowledged that an investment contract may be found even in those situations in which the investor has some role to play,[20] but found that the plaintiff's role was a "significant one despite the management contract."[21] By reserving the right to cancel the management contract on thirty days notice, the court found that plaintiff had, in fact, retained ultimate control over the operation. In the court's view, the question was not whether plaintiff chose to exercise its power. Rather, the controlling question was

with the profits coming solely from the efforts of others, it is an investment contract); Goodman v. Epstein, 582 F.2d 388 (7th Cir. 1978) (a limited partnership interest, under state law, meets all the requirements of the *Howey* investment contract).

15. *See* Continental Mktg. Corp. v. Securities & Exch. Comm'n, 387 F.2d 466 (10th Cir. 1967), *cert. denied*, 391 U.S. 905 (1968) (defendant's brokerage of live beavers constituted a violation of the Securities Act of 1933 and the Securities Exchange Act of 1934). A similar scheme was unearthed in Smith v. Gross, 604 F.2d 639 (9th Cir. 1979), in which the defendant was found to have violated securities laws by selling earthworms as investments.

16. *See* Tcherepnin v. Knight, 389 U.S. 332, 336 (1967).

17. 540 F.2d 912 (8th Cir. 1976).

18. *Id.*

19. *Id.* at 913-14.

20. *Id.* at 914. Here, courts have held that the *Howey* requirement—that profits are to come solely from the efforts of others—is not to be strictly construed. *See* Miller v. Central Chinchilla Group, Inc., 494 F.2d 414, 416-17 (8th Cir. 1974).

21. *Fargo*, 540 F.2d at 915.

whether it *had* the power to exercise.[22] The court also noted that plaintiff was an experienced investor, having invested nearly three million dollars in this venture alone. In addition, the court found that plaintiff had failed to show that it was required to accept a "package deal" by which it surrendered management rights. In this regard, plaintiff had failed to show a substantial reliance on the efforts of a third party for a return on its investment.[23]

The same year, the Tenth Circuit decided *Ballard & Cordell Corp. v. Zoller & Danneberg Exploration, Ltd.*[24] In that case, Zoller & Danneberg, Inc. (ZDI), the defendant and counterclaimant, was engaged in oil and gas exploration. In 1970, ZDI acquired a twenty-five percent working interest in a well and participated in the drilling on a joint venture basis with plaintiff Ballard & Cordell (B&C). ZDI had entered into many similar operations in the past. Two years later, B&C made a public offering for the sale of its fifty percent interest in two producing wells. ZDI, which already owned twenty-five percent in one of the two wells, entered into negotiations with B&C for the purchase of its interest. Subsequently, however, ZDI withdrew its offer, claiming that B&C had failed to provide merchantable title. B&C sued for breach of contract. ZDI counterclaimed, alleging that B&C had violated the securities laws.[25]

The Tenth Circuit agreed with the trial court's finding that no investment contract had been created. The court considered "several important factors, including the nature of the investor's financial and managerial participation in the enterprise; the state of the investor's knowledge, skill, and expertise concerning the enterprise; and whether the investor is providing 'risk capital' to finance a speculative venture."[26] It also agreed with the ruling by the trial court that the transaction was a transfer of a leasehold right, rather than a common venture, and that ZDI was both informed and skilled in the exploration of oil and gas.[27]

In 1981, the Fifth Circuit developed what was probably the most definitive test for determining whether a general partnership interest was a security. The Fifth Circuit articulated a three prong test in *Williamson v. Tucker*[28] that examined not only the four corners of the partnership agreement, but the facts underlying the transaction

22. *Id.*
23. *Id.*
24. 544 F.2d 1059 (10th Cir. 1976); *see also* Mr. Steak, Inc., v. River City Steak, Inc., 460 F.2d 666 (10th Cir. 1972) (restaurant franchise contract, in which the investor did not have the right to direct the daily operations of the restaurant, but retained the right to select the manager, did not constitute an investment contract).
25. *Ballard*, 544 F.2d at 1061-62.
26. *Id.* at 1065.
27. *Id.*
28. 645 F.2d 404 (5th Cir. 1981).

between the parties and the comparative sophistication of the plaintiff investor.[29]

In *Williamson*, plaintiffs were purchasers of joint venture interests that included parcels of undeveloped real estate. The property, located between Dallas and Fort Worth, was expected to appreciate due to the construction of the planned Dallas/Fort Worth Regional Airport. The property was marketed accordingly. Five years after entering the joint venture, plaintiffs defaulted on their payments. Plaintiffs then filed suit seeking rescission of the joint venture and recovery of amounts already paid. In their complaint, plaintiffs asserted claims based on violations of the Securities Act of 1933 and the Securities Exchange Act of 1934. The district court dismissed for want of federal subject matter jurisdiction.[30]

On appeal, the Fifth Circuit distinguished general partnerships from the oil, gas, and real estate interests considered by the Eighth and Tenth Circuits in *Fargo* and *Ballard*. General partnerships complicated matters because, although the partnership may have full ownership of the assets, "each individual partner has only his proportionate vote in the partnership."[31] The court expressed concern that an investment scheme hiding under the guise of a general partnership might take advantage of "inexperienced and unknowledgeable members of the general public."[32] To allay these fears, the court developed a test for an investor to show that an interest in a general partnership amounted to a security. The investor must show 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.[33]

Williamson was not important for its result,[34] but rather for the rea-

---

29. *Id.* at 424.
30. *Id.* at 408-09. The district court also held that the joint venture interest was not a security. *Id.* at 410.
31. *Id.* at 421. Still, the court recognized that even the individual partners "have the sort of influence which generally provides them with access to important information and protection against a dependence on others." *Id.* at 422.
32. *Id.* at 423.
33. *Id.* at 424.
34. The court did not, in fact, find that the plaintiffs' partnership interest amounted to a security, but only that their claim was not foreclosed as a matter of law.

soning used to arrive at its result. The Fifth Circuit concluded that plaintiffs had "an extremely difficult factual burden" to overcome if they sought to prove that joint venture interests were securities. Nevertheless, the court found that the district court had erred in dismissing the case for lack of subject matter jurisdiction.[35]

III. *MATEK V. MURAT*

A. Facts

In 1979, defendant Joseph Murat bought an old Navy vessel with the intent to convert it into a fish processing plant. Murat organized a general partnership for the purpose of financing the project and invited plaintiffs to invest in it. Twelve people each invested $100,000 in order to finance construction on the vessel and provide capital for the venture. The venture ultimately failed and creditors foreclosed on loans made to the partnership.

In seeking redress for their losses, plaintiffs alleged, among other things, violations of section 10(b) of the Securities Exchange Act of 1934. Murat responded by asking the court for a ruling that the plaintiffs' general partnership interests were not securities. The trial court found that the partnership agreement did not constitute an investment contract and accordingly granted summary judgment for defendant.[36]

B. Opinion

In affirming the lower court's grant of summary judgment, the Ninth Circuit noted that it had never before "directly faced" the issue of whether an interest in a general partnership was a security.[37] It also noted that all courts which had confronted this issue, with the exception of the Fifth Circuit, had uniformly held that general partnership interests were not securities, differing only as to the appropriate standard to examine such interests.[38]

The court began its analysis by rejecting the "bright-line" rule that the role of a general partner precludes, *as a matter of law*, a finding that the investment was a security.[39] The court stated that the test should be based upon the substance of the interest, rather

---

Id. at 425-26.

35. *Id.* at 425.

36. *Matek*, 862 F.2d at 723.

37. *Id.* at 725.

38. *Id.* at 726.

39. *See* Goodwin v. Elkins & Co., 730 F.2d 99 (3d Cir.), *cert. denied*, 469 U.S. 831 (1984) (a general partner's interest, by operation of state law, cannot amount to an investment security).

than its form.[40] To do otherwise would be to ignore the "economic reality" test required by the Supreme Court.[41] The "economic realities" were that: "[a] nominal general partnership created pursuant to state law may in reality operate more like a limited partnership, the functional equivalent of a public offering of preferred stock."[42] Moreover, the court disagreed with the inherent assumption of the "bright-line" rule that participation in management guaranteed access to information concerning the investment.[43] As between managerial control and access to information, the latter was considered by the court to be more important.[44]

Although the Ninth Circuit in *Matek* did not accept the "bright-line" test, it was also unwilling to fully adopt the three prong test set forth by the *Williamson* court. The court found that *Williamson* went "too far."[45] The court adopted the first part[46] of the *Williamson* test, but rejected the other two parts because they created uncertainty in the investment field: "An interest marketed as a general partnership might be transformed into a security simply because its holder is not diligent or knowledgeable in exercising his rights under the agreement."[47] The court noted that this could result in the anomaly of courts finding "an investment a security in relation to some investors and a partnership in relation to others."[48] Instead, the court decided to follow the Eighth and Tenth Circuits, and held that the true test of the interest was to be determined from the expectations of the parties and the terms in the contract.[49]

Applying this test to the facts, the *Matek* court found that the partnership contract had allocated both managerial control and access to information to the general partners. By the terms of the agreement, no partner could withdraw capital without the consent of all partners, nor could any partner lend partnership money without

40. *Matek*, 862 F.2d at 727.
41. The Supreme Court held that: "In considering these [investment] claims we again must examine the substance—the economic realities of the transaction—rather than the names that may have been employed by the parties." United Hous. Found., Inc. v. Forman, 421 U.S. 837, 851-52 (1974).
42. *Matek*, 862 F.2d at 727 (referring to Securities & Exch. Comm'n v. Murphy, 626 F.2d 633, 640-41 (9th Cir. 1980)).
43. *Id.* at 728.
44. *Id.*
45. *Id.*
46. This is the prong that examined how the agreement between the parties distributed the powers of partnership.
47. *Matek*, 862 F.2d at 729.
48. *Id.*
49. *Id.* at 729-30.

the consent of the majority. Although the agreement made defendants the managing partners, it also specified that defendants were to consult "as far as practicable" with the nonmanaging partners.[50] These powers, which are more than those normally associated with passive investors, led the court to conclude that the agreement was one which provided the plaintiffs with "sufficient power to protect their investments."[51]

IV. Discussion

The *Matek* court's alignment with the Eighth and Tenth Circuits signals a clear break from the expansive rationale in *Williamson.* However, the alignment was not complete. Unlike the other two circuits, the Ninth Circuit shifted the inquiry away from a plaintiff's legal management powers to focus on whether a plaintiff has sufficient access to information to protect his or her investment. Although managerial control was still an important factor, the crucial question was now whether there was adequate access to information.[52]

Under this analysis, an interest in a general partnership does not become a security by virtue of the ignorance or helplessness of the investor. Rather, the interest must be judged on its own merits. If it *is* a security, it is so because the agreement severely restricts the investor's power and access to information. Without this, the agreement fails the test and would not, therefore, be subject to federal securities regulation. This forces the court to consider only the legal rights of the parties, and deems irrelevant any investigation into whether the parties actually exercised those rights.

At least in theory, the *Matek* test is a compromise between the decisions of the Eighth and Tenth Circuits and the Fifth Circuit. While the Eighth and Tenth Circuits restricted the inquiry to whether the plaintiff held managerial control, the *Matek* test allows the plaintiff greater leeway. That is, if an investor can establish that the agreement deprived him of access to investment information, the agreement will be treated as a security interest notwithstanding the fact it may have included certain managerial powers within its provisions. The underlying rationale of this approach is that an uninformed investor will not be able to make any meaningful use of whatever managerial powers he or she may possess. However, pragmatically, it is difficult to see much difference between the decisions.

One questions whether a person who has access to information but

50. *Id.* at 731.
51. *Id.*
52. *Id.* at 728.

relatively limited managerial power is in a better position than one who has managerial power but no access to information. In the former scenario, the person has access to information but is powerless to exploit it. Thus, the information has minimal value. There is little this person can do to cut losses except withdraw from the partnership. While withdrawal may provide an adequate remedy in some cases, it provides no opportunity for active participation by the investor.

On the other hand, it might be argued that in the latter scenario, the person who enjoys certain managerial powers, but has no access to investment information, is in a better position than the person in the former scenario. The latter investor might opt to withhold funds or veto a resolution if he or she feels left out of the decisionmaking process. In effect, the second investor's power, if sufficient, may *provide* access to information. However, this result assumes an investor with some degree of sophistication. Moreover, the securities laws are meant to protect unwary investors by providing access to investment information.[53] In this respect, the *Matek* decision requiring adequate access to information appears well grounded.

Matek's effect will be to limit claims of securities violations to those instances in which a plaintiff can show that the terms of a partnership agreement were so restrictive as to deprive the plaintiff of investment information or powers of partnership. There will be no federal remedy in those cases where a plaintiff is afforded partnership powers and access to information, but refuses or fails to take advantage of these rights. The courts will examine the facts on a case-by-case basis, but only to the extent allowed by the terms of each agreement. The Ninth Circuit will not examine whether the plaintiff was particularly experienced in that area of investments or whether the plaintiff in fact exercised those powers provided by the agreement.

---

53. The need for full disclosure was an integral part of the 1933 Securities Act: "Alluring promises of easy wealth were freely made with little or no attempt to bring to the investor's attention those facts essential to estimating the worth of any security." H.R. REP. NO. 85, 73d Cong., 1st Sess., pt. 1, at 2 (1933) (describing the conditions leading to the Great Depression and the reasons for enacting the Act); *see also* Securities & Exch. Comm'n v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963) (a "fundamental purpose" of the regulations was to promote "full disclosure" to protect the buyer); Securities & Exch. Comm'n v. Ralston Purina Co., 346 U.S. 119, 126-27 (1953) (focusing on the knowledge of the offerees and the "protections afforded by registration").

V. Conclusion

Because of the broad remedial purpose underlying federal securities regulations, it is foreseeable that, as the regulations are expanded by case law, there will be instances in which the law will reach too far. The law may then encompass cases which it was not intended to remedy. A natural response to this overextension is to halt, or at least slow, the expansion. Not every investment is made under duress, nor should the Securities and Exchange Commission be brought in to play every time someone loses money.[54] This is especially true where people agree to form a partnership for the purpose of making a profit.

The *Matek* decision served to consolidate, rather than expand, the scope of securities regulation. It did so in two ways. First, the *Matek* court followed the Eighth and Tenth Circuits by looking to the terms of agreement between the parties to determine if the general partnership interest amounted to a security. Second, it shifted the focus of its examination from managerial control to access to information. This combination should effectively reduce unwarranted claims, and yet remain faithful to the purpose behind securities regulations.

The *Matek* test will carefully avoid those situations where the same instrument may be a security for one person, but merely an interest in partnership for another. It returns the definition of security to a somewhat more palpable state: a security is identifiable by the characteristics of the instrument itself, rather than by the characteristics of the purchaser.

Jeffrey D. Winter

54. "[T]he anti-fraud provisions [of the securities regulations] were not intended to remedy every instance of common law fraud. Nor are they to remedy every wrong that occurs in a partnership scheme." Odom v. Slavik, 703 F.2d 212, 215 (6th Cir. 1983) (citations omitted).