Sherman v. Lloyd and Mutual Selection in California Limited Partnership Law

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Comments

SHERMAN v. LLOYD AND “MUTUAL SELECTION” IN CALIFORNIA LIMITED PARTNERSHIP LAW

When is a limited partnership’s existence in doubt? According to the California Court of Appeal in Sherman v. Lloyd, no limited partnership exists unless the limited partners have “mutually selected” each other for admission into the limited partnership. This Comment criticizes this recent twist in limited partnership doctrine, arguing from both a practical and an analytical standpoint that “mutual selection” has no place in California law.

INTRODUCTION

The limited partnership is a widely used and accepted form of business organization. From its statutory beginnings it has evolved into a tool by which large blocks of investors can take advantage of

2. The limited partnership was “not recognized at common law and is strictly a creature of statute.” Evans v. Galardi, 16 Cal. 3d 300, 305, 546 P.2d 313, 317, 128 Cal. Rptr. 25, 29 (1976). It has existed on the European continent since medieval times but was first established in the United States in New York in 1822. Hrusoff & Cazares, Formation of the Public Limited Partnership, 22 HASTINGS L.J. 87 n.1 (1970); see generally Ames v. Downing, 1 Bradf. 329-31 (N.Y. 1850) (explaining history of limited partnership from origins in statutes of Pisa and Florence in 1166 to the French Code, from which New York adopted the arrangement). Limited partnerships were recognized in California specifically when the state adopted the Uniform Partnership Act in 1929.
its particular tax benefits and favorable liability limitation. Limited partnerships are used in a plethora of settings. Real estate investment is a notable example. Other areas include oil and gas exploration, cattle and agricultural production and motion picture financing. Most recently, the research and development partnership has emerged as a valuable tool for financing entrepreneurial efforts in high technology industries.

Limited partnerships must be formed according to statutory guidelines. California law provides that if otherwise in compliance with the statutes, a limited partnership comes into existence when the certificate of limited partnership is filed with the Secretary of State's office. The statutes do not specify any duty or right of the limited partners to approve each others' admission into the partnership during its formation. Such a requirement would be inconsistent

3. Hrusoff & Cazares, supra note 2, at 96. Unlike corporations, limited partnerships are not taxpaying entities. The partnership itself is not subject to tax on its income. It is a "conduit" for tax purposes. Each partner's personal tax return must reflect his distributive share of any profits realized by the business. The corporate entity, on the other hand, is subject to income tax, and the shareholders also are subject to tax on income distributed to them by the corporation. C. Friedman, Choice of Business Entity 38 (1983).

Prior to the Tax Reform Act of 1986, partnership losses could be used to reduce each partner's personal taxable income according to each partner's share. At present, limited partnership losses generally may be used only to offset income from that activity or other "passive" activities (with exceptions pursuant to phase-in rules). The losses may not be deducted from other taxable income. I.R.C. § 469 (West Supp. 1987).

   (a) Except as provided in subdivision (d), a limited partner is not liable for any obligation of a limited partnership unless named as a general partner in the certificate or, in addition to the exercise of the rights and powers of a limited partner, the limited partner participates in the control of the business. If a limited partner participates in the control of the business without being named as a general partner, that partner is nevertheless not liable to persons who transact business with the limited partnership unless they do so with actual knowledge of that partner's participation in control and reasonably believing that partner to be a general partner.

   Cal. Corp. Code § 15501, superseded by the above section in 1984, but still applicable to partnerships entered into prior to July 1, 1984, stated it more succinctly: "The limited partners as such shall not bound by the obligations of the partnership." Cal. Corp. Code § 15501 (Deering 1979).


9. The written partnership agreement is the primary repository of the limited and general partners' rights and duties under California law. Unlike the 1984 California Revised Limited Partnership Act, the Uniform Limited Partnership Act does not require
with the reality of large public limited partnerships. Moreover, with regard to the admission of additional limited partners, the statute requires the consent of all existing limited partners only if the partnership agreement does not provide otherwise.

There seems to be no legal impediment to the formation of a limited partnership if the statutory requirements are met. The statutes do not mandate the partners’ mutual approval of admission into the partnership. Further, the California Corporations Code, in effect, states that a partnership agreement can provide for admission of additional partners without the limited partners’ consent. Compliance with the partnership agreement and statutes would appear to satisfy California law regarding formation and operation of limited partnerships without hindrance.

Unfortunately, one legal roadblock does seem to exist. The California Court of Appeal for the Second District decided *Sherman v. Lloyd* on May 28, 1986. *Sherman* revived a long-dormant doctrine, not followed since 1966, concerning the nature of limited partnerships. The doctrine essentially states that a limited partnership is not bona fide unless all limited partners mutually select each other as partners. *Sherman* appears to stand opposite both statutory law

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10. "California was slow to recognize public limited partnerships . . . For many years [the] Commissioner of Corporations actively discouraged the use of large limited partnerships, except for private offerings to sophisticated investors. With the promulgation of the regulations under the Corporate Securities Act of 1968, the policy was reversed, making possible the creation of publicly held limited partnerships." Hrusoff & Cazares, *supra* note 2, at 88. Large limited partnerships are commonplace today. R. Jennings & H. Marsh, *Securities Regulation* 253 (4th ed. 1977).

11. CAL. CORP. CODE § 15631(a)(1) (Deering Supp. 1987) states:

(a) After the filing of a certificate referred to in Section 15621, a person may become a limited partner:

(1) In the case of a person acquiring a limited partnership interest directly from the limited partnership, upon the compliance with the partnership agreement or, if the partnership agreement does not so provide, upon the written consent of all the partners.

12. CAL. CORP. CODE § 15631(a) (Deering Supp. 1987). Prior to July 1, 1984, admission of an additional limited partner was accomplished by simply amending the certificate of limited partnership. CAL. CORP. CODE §§ 15508, 15525, 15525.5 (Deering 1979).


15. *Sherman*, 181 Cal. App. 3d at 700, 226 Cal. Rptr. at 501. *Delectus personae*, or mutual selection of all partners, is a principle applicable to the formation of general partnerships under Corporations Code section 15018(g). That section states that "no per-
and current limited partnership practice.

Sherman's "mutual selection" doctrine poses a serious problem. Current practice and statutory law do not provide for mutual selection of limited partners. But, if Sherman is followed, the potential exists for finding that no true limited partnership existed where the statutory law indicates it did exist. Attorneys may have difficulty advising clients regarding the formation of limited partnerships. Further, although the mutual selection doctrine has been followed in but a single district in California, that district includes Los Angeles, the second most populous metropolitan area in the nation. Under Sherman, a true limited partnership in San Francisco may not be bona fide in Los Angeles.

This Comment addresses Sherman and its mutual selection doctrine and examines the doctrine's origin, theoretical basis and vitality. The Comment explores the legal and practical arguments against mutual selection. Finally, the Comment urges California courts to discard the mutual selection doctrine because of its lack of legal soundness and its potential harmful effects on limited partnership law and practice.

THE MUTUAL SELECTION DOCTRINE

Sherman v. Lloyd: Rivlin Resurrected

Sherman was a limited partner in ML-Airport Properties, Ltd. (ML). Sherman did not receive his guaranteed eight percent return son can become a member of a partnership without the consent of all the partners." CAL. CORP. CODE § 15018(g) (Deering 1979). See generally Comment, Are Limited Partnership Interests Securities? A Different Conclusion Under the California Limited Partnership Act, 18 PAC. L.J. 125, 147-49 (1986) (discussing delectus personae as it pertains to general partnerships). Neither California law, the Uniform Limited Partnership Act nor the Revised Limited Partnership Act incorporate a similar delectus personae provision as a requirement. Sherman adopts the concept of mutual selection as a prerequisite to limited partnership formation.


17. A hypothetical situation: The Acme Real Estate Investors Limited Partnership is comprised of 200 limited partners and four general partners. The limited partnership agreement provided for the general partners' determination of who would be admitted as limited partners, up to the subscription limit of 2000 shares or 200 investors. None of the limited partners has met any other limited partner nor has consented to the others' admission. Provided that all statutory requirements are met, such a limited partnership would be recognized as bona fide throughout California. But the mutual selection doctrine could enable, for instance, a disgruntled investor to seek rescission of the limited partnership agreement on the basis that no mutual selection took place. Conceivably, a court applying Sherman could reach that same result.
on his investment. Upon an attorney's advice that the partnerships' two-tier structure (discussed below) did not comply with California law, Sherman rescinded his agreement and sought restitution. After being denied restitution, Sherman sued the limited partnership, general partners and shareholders of the general partners.

Under California corporations law, because an interest in a limited partnership is a security, as discussed below, its sale must be qualified according to Corporations Code section 25110.18 ML's general partners had failed to qualify the limited partnership interests as securities.19 Instead, ML's general partners sought to apply California's safe harbor rule,20 exempting limited partnerships with ten or less investors from having to qualify their interests as securities. ML had more than ten investors. Consequently, ML's general partners created a second limited partnership, Stapleton, Ltd. (Stapleton). ML invested all of its funds in Stapleton. In fact, ML had been formed for the specific purpose of investing in Stapleton. Stapleton used the money to purchase a building in Denver. The arrangement reduced the number of partners in both ML and Stapleton to within the safe harbor rule's limits by splitting the investors between the two partnerships. Thus, the limited partnerships, each having ten or fewer investors, ostensibly would be exempt from qualification.21

In a summary judgment motion, however, the trial court granted Sherman restitution because, in essence, the two-partnership attempt to fall within the safe harbor rule was a sham. The defendants appealed. The appellate court held that no triable issue of fact existed as to whether the issuance of the limited partnership interests was exempt from qualification22 under Corporations Code section 25102(f),23 exempting bona fide limited partnership interests from

18. CAL. CORP. CODE § 25110 (Deering 1979). Failure to properly qualify a security not otherwise exempted under section 25102 is punishable by a fine of no more than $10,000 or one year imprisonment or both. If the violator proves he had no knowledge of the rule he may not be imprisoned. CAL. CORP. CODE § 25540 (Deering 1979). Sherman involved no question of criminal liability.
22. Id. at 700, 226 Cal. Rptr. at 499.
23. CAL. CORP. CODE § 25102(f) (Deering 1979) stated in pertinent part:

    The following transactions are exempted from the provisions of section 25110:

    (f) Any offer or sale, in a transaction not involving any public offering, of any bona fide general partnership, joint venture or limited partnership interest

This section was modified in 1981. See infra note 85.
qualification as securities. The court held that the partnership arrangement in the case was not a bona fide limited partnership. Thus the exemption was not applicable.\textsuperscript{24}

The court explicitly stated that the partnership was not bona fide because there was "no mutual selection of members in [the] partnership."\textsuperscript{25} In reaching its conclusion the court cited \textit{Rivlin v. Levine}\textsuperscript{26} for the proposition that a critical factor in determining whether a limited partnership is a true limited partnership\textsuperscript{27} is the element of mutual selection. \textit{Sherman} thus awakened a doctrine asleep since 1966 when the California Court of Appeal last applied the mutual selection criterion in \textit{Solomont v. Polk Development Company}.\textsuperscript{28}

\textit{Solomont} involved a limited partnership that suffered from a variety of statutory defects. Any of the defects alone would have supported the conclusion that no limited partnership existed.\textsuperscript{29} But the court found the mutual selection test determinative. It put its imprimatur on mutual selection by stating that the doctrine was "declarative of established partnership law" and requisite to the formation of a limited partnership.\textsuperscript{30}

\textit{Sherman}, like \textit{Solomont}, could have rested on grounds other than mutual selection. The foremost ground was the attempt to come under the ten-investor limitation of the safe harbor rule.\textsuperscript{31} The court stated that the two separate partnership offerings should be viewed as integrated into one offering.\textsuperscript{32} The number of investors would then exceed the rule's limit\textsuperscript{33} and constitute a public offering requiring qualification. However, the \textit{Sherman} court did not pursue the public offering argument. Instead, it used integration to buttress its conclusion regarding lack of mutual selection. It noted that Sherman had no relationship with the partners of Stapleton and mutual selection therefore was impossible.\textsuperscript{34}

\begin{footnotes}
\item[25] \textit{Id.} at 701, 226 Cal. Rptr. at 501.
\item[27] This Comment uses "bona fide limited partnership" and "true limited partnership" interchangeably. If one uses Black's definition, "bona fide limited partnership" means a true, genuine, actual, real limited partnership. \textit{BLACK'S LAW DICTIONARY} 223 (4th ed. 1951). Dahlquist, whose article may have begun the whole problem (see infra text beginning at note 38) used the terms "true" partnership and "bona fide" partnership interchangeably. Dahlquist, \textit{Regulation and Civil Liability Under the California Corporate Securities Act}, 33 \textit{CALIF. L. REV.} 343, 363 (1945). See also infra notes 91 and 97.
\item[29] \textit{Id.} at 494-95, 54 Cal. Rptr. at 26-27.
\item[30] \textit{Id.} at 497, 54 Cal. Rptr. at 28. \textit{But cf.} \textit{CAL. CORP. CODE} §§ 15621-15628; \textit{CAL. ADMIN. CODE} §§ 15501-02 (statutory criteria for limited partnership formation).
\item[31] \textit{CAL. ADMIN. CODE} tit. 10, R.260.102.2.
\item[33] \textit{CAL. ADMIN. CODE} tit. 10, R.260.102.2.
\item[34] The court stated: Given integration, our conclusion ML was not a bona fide partnership is even more apparent. Prior to executing the ML partnership agreement, Sherman
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To understand Sherman and its holding that a partnership in fact never existed because mutual selection did not exist, the doctrine's genesis must be examined. That genesis is in Rivlin and a forty-two year old law review article from which Rivlin erroneously originated its theory.

Rivlin v. Levine

Rivlin involved "an action to recover amount paid for an interest . . . in a purported limited partnership." The "purported" limited partnership suffered from a variety of statutory defects, including failure to open a bank account, failure to do anything as a partnership, and failure to execute a limited partnership agreement.

Despite the numerous defects in the "purported" partnership, the Rivlin court chose to rest its conclusion on another basis. The court appropriated portions of an article by T.W. Dahlquist and formulated the mutual selection doctrine, against which the partnership arrangement was compared and found wanting. Rivlin quoted the following:

It is believed that one of the chief criteria for determining whether an interest in a partnership is a "security" under the Act is the element of selection of the partners. In all general partnerships, and also in bona fide limited partnerships, there is the right of delectus personarum, the right to determine membership. No partner is admitted without unanimous approval of every other partner. A true partnership is a relation of personal confidence and is a select closed group.

knew none of [Stapleton's] partners . . . except Lloyd and had no pre-existing relationship with the other partners. Only Lloyd was a partner in both partnerships. Moreover, it can be inferred that the limited partners in ML had no knowledge as to the limited partners in Stapleton.

Sherman, 181 Cal. App. 3d at 702, 226 Cal. Rptr. at 501 (emphasis in original).

35. See Dahlquist, supra note 27.
37. Id. at 15-19, 15 Cal. Rptr. at 589-91.
38. Dahlquist, supra note 27. Dahlquist was a well-respected California lawyer, considered an authority on the then-existing California corporate securities law. Letter from Richard W. Jennings to Homer Kripke (July 29, 1986) (discussing Rivlin) (on file with San Diego Law Review); see infra note 91.
39. Dahlquist's discussion focuses on whether a particular interest is a security or not. The idea is developed more fully infra at text accompanying notes 42-46.
40. Rivlin, 195 Cal. App. 2d at 23, 15 Cal. Rptr. at 592-93 (quoting Dahlquist, supra note 27, at 363); Sherman, 181 Cal. App. 3d at 700-701, 226 Cal. Rptr. at 500; see also Comment, supra note 1, at 643 n.142. The Dahlquist quote also stated that additional limited partners could be admitted but only by amending the certificate of limited partnership, signed and sworn to by all partners.

Hrusoff and Cazares noted that the requirement that all partners sign the amended certificate became an "impossible burden" with the advent of large limited partnerships. Hrusoff & Cazares, supra note 2, at 95. Dahlquist's statement may have been valid in
Rivlin interpreted Dahlquist to say that no true partnership, general or limited, was formed absent mutual selection. Whether Rivlin correctly interpreted Dahlquist's intent or whether Dahlquist's article actually supports Rivlin's theory is questionable.

Dahlquist's Article Examined

Dahlquist's article dealt primarily with regulation and civil liability under the California Corporate Securities Act. In the context of regulation, the article examined what constituted a security. Dahlquist pointed out that the then-current administrative interpretation considered general and limited partnership interests not to be securities. The Division of Corporations had steadfastly maintained its position that bona fide partnership interests were not securities. The article concluded that bona fide partnership and limited partnership interests were not securities.

In addition to administrative interpretation, Dahlquist rested his conclusion on the element of member selection. He cited no authority for the proposition. He remarked that "it is believed" that mutual selection is a chief criterion for determining whether a partnership interest is a security. The reasoning behind mutual selection as such a criterion is apparent.

Securities laws were promulgated primarily to protect investors from fraud. Indiscriminate public offerings of investment interests are the type of transactions condemned by the courts. As long as a partnership retains mutual selection and lack of free assignability, no need exists to protect the public from indiscriminate, random offerings. Therefore, since no need exists for securities regulation of limited partnership interests (as Dahlquist defines them), they should not be classified as securities.

Dahlquist thus differentiated between true partnership interests

1945 and perhaps in 1966, but in 1967 the statutes were amended to provide that if the partnership certificate permits and the partnership has 25 or more limited partners, only the selling limited partner, substituted limited partner and general partner need sign the amended certificate. 15631(a)(1) (Deering Supp. 1987).

43. Dahlquist, supra note 27, at 356.
44. Id. at 361.
45. Id.
46. Id. at 356.
47. Id. at 363.
49. Dahlquist, supra note 27, at 360; see People v. Simonsen, 64 Cal. App. 97, 220 P. 442 (1923).
and securities. *Rivlin* took Dahlquist to say that mutual selection was a prerequisite to the formation of a true partnership.\(^5\) Dahlquist said no more than an interest in a partnership in which mutual selection exists should not be classified as a security.\(^6\) He did not state that a bona fide limited partnership could not exist absent mutual selection. His discussion was based on the concept that limited partnership interests do not constitute securities interests, a concept that was under attack at the time he wrote\(^7\) and which now is considered obsolete.

**Limited Partnership Interests as Securities**

California Corporations Code section 25019 enumerates what constitutes a "security" for securities law purposes.\(^8\) Limited partnership interests are not explicitly listed within that section.\(^9\) But cur-

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50. 195 Cal. App. 2d at 23, 15 Cal. Rptr. at 594.

Dahlquist dismissed Smith's contention on the grounds that it did "not purport to be an official ruling of the Division of Corporations" and that the cases Smith cited were distinguishable. Dahlquist, *supra* note 27, at 361. Dahlquist relied on tradition up to 1945 and failed to foresee the trend toward defining certain limited partnership interests as securities.

53. CAL. CORP. CODE § 25019 (Deering Supp. 1987) states, in pertinent part: "Security" means any note; stock; treasury stock; membership in an incorporated or unincorporated association; 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 or participation in an oil, gas or mining title or lease or in payments out of production under such a title or lease; put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof); or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency; any beneficial interest or other security issued in connection with a funded employees' pension, profit sharing, stock bonus, or similar benefit plan; or, in general, any interest or instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing. All of the foregoing are securities whether or not evidenced by written document.

54. The "investment contract" listed in Corporations Code section 25019 has been touted as a means by which limited partnership interests can be termed securities.
rent California case law holds that they may be considered securities.⁵⁶

In *People v. Graham*⁵⁶ the Fourth District Court of Appeal explained the tests to determine securities status of limited partnership interests and the circumstances under which such interests should be considered securities. The two approaches to determine the existence of a security interest are the *Howey* test,⁶⁷ and the “risk capital” test.⁶⁸

In *SEC v. Howey Company*, the United States Supreme Court held that an investment contract⁶⁹ meant 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 . . . .”⁷⁰ The elements for determining whether an interest is a security under *Howey* are: (a) a party invests money; (b)

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Comment, *supra* note 1, at 621. Because “investment contract” is so broad, one court has stated that simply analyzing whether the interest is a security without diving into the “investment contract” issue would be equally correct and less confusing. *People v. Graham*, 163 Cal. App. 3d 1159, 1165 n.4, 210 Cal. Rptr. 318, 322 (1985).

Like California law, the federal Securities Act and the Securities Exchange Act of 1934 do not include limited partnerships in their definitions of “security.” The “investment contract,” “certificate of interest or participation in any profit sharing agreement,” and “any instrument commonly known as a ‘security’” are concepts used to bring limited partnership interests under the federal securities law. T. *LYNN & H. GOLDBERG, REAL ESTATE LIMITED PARTNERSHIPS* 178 (2d ed. 1983). *See also* Real Estate Syndications, Securities Act Release No. 4,877, 32 Fed. Reg. 11,705 (Aug. 8, 1967) (interests in real estate limited partnerships in District of Columbia, Maryland and Virginia constitute investment contracts, hence securities).

⁵⁵. *See, e.g.* *Graham*, 163 Cal. App. 3d at 1165, 210 Cal. Rptr. at 322. One commentator simply states that limited partnership interests are securities by definition where “the investor does not have any right to control the operation of the business and cannot be given such right without destroying his status as a limited partner . . . .” H. *MARSH & R. VOLK, PRACTICE UNDER THE CALIFORNIA SECURITIES LAWS § 5.11(2) (1986). *See also* R. *JENNINGS & H. MARSH, supra* note 10, at 253; T. *LYNN & H. GOLDBERG, supra* note 54, at 179.

*Graham* is addressed in a recent discussion of the securities status of limited partnership interests. Comment, *supra* note 15, at 125. The Comment discusses in detail California Limited Partnership Act (RULPA). *Id.* at 126-27. It argues that limited partnership interests may not always be securities under California law because of the RULPA’s provision for enhanced limited partner “control” in various settings. *Id.* at 157-59. It concludes, however, that most limited partnership interests “should be treated as securities . . . .” That proposition does not contradict the position taken in the instant Comment. For all practical purposes, limited partnership interests will be treated as securities in California, even under the RULPA. *See, e.g.* notes 53-97 and accompanying text.

⁵⁶. 163 Cal. App. 3d 1159, 210 Cal. Rptr. 318.

⁵⁷. The test was defined in *SEC v. Howey Co.*, 328 U.S. 293 (1946).


⁵⁹. *See supra* note 54.

⁶⁰. *Howey*, 328 U.S. at 298-99; *see also* *Syde*, 37 Cal. 2d at 768, 235 P.2d at 603; *Graham*, 163 Cal. App. 3d at 1165, 2310 Cal. Rptr. at 322; 2 *BALLANTINE & STERLING, supra* note 9, at § 444.02 (examining California treatment of *Howey* test).
in a common enterprise; (c) expecting profit; (d) from others' efforts alone. The phrase "solely from the efforts [of others]" has led to criticism of the case for the language's ambiguity. Some courts have interpreted the words literally. They find that any participation whatsoever by an investor takes the interest out of the securities realm.

The Ninth Circuit Court of Appeals interpreted the Howey test more liberally in SEC v. Glenn W. Turner Enterprises. The court stated that the crucial efforts made by others are "those essential managerial efforts which affect the failure or success of the enterprise." Graham agreed with Glenn W. Turner that the "no control" element of Howey should be defined broadly.

Although the Graham court did not use the Howey test, other California courts have followed it. The Howey test applies to limited partnerships when limited partners invest money in the limited partnership, which satisfies the first two elements, investing money in a common enterprise. The third element, expectation of profit, generally is satisfiable, but it may pose a problem if the investment is for a tax shelter. The fourth element, no control on the investors' part, may prove difficult to fulfill in some cases if its strict definition is used, but usually it does not create difficulty because of the generally passive nature of limited partnership interests. Indeed, courts have held that limited partnerships can and do satisfy the Howey test. Graham applied the risk capital test instead of the Howey test.

61. Comment, supra note 1, at 622.
63. 474 F.2d 476 (9th Cir. 1973) (commonly cited as Glenn W. Turner).
64. Id. at 482.
67. The problem is addressed more thoroughly in Comment, supra note 1, at 629 n.56.
69. The Graham court stated that it would not decide whether the risk capital test was the exclusive California test or whether Howey and the risk capital test were alternatives. California explicitly adopted the Howey test in People v. Park, 87 Cal. App. 3d 550, 151 Cal. Rptr. 146 (1978) and also applied the risk capital test, for example, in Graham. It thus appears that the two tests are alternatives, although the Graham court inferred that the risk capital test may be predominant. Graham, 163 Cal. App. 3d at 1166-67, 210 Cal. Rptr. at 323.
The risk capital test’s key element is that third parties provide risk capital in a venture for profit. The investor need not expect any pecuniary profit, unlike under Howey’s profit expectation requirement. Risk of business capital is not the only element of the test, however. Graham effectively merged Howey with the risk capital approach by adding the element of lack of managerial control (the broad Glenn W. Turner definition) over the venture. Graham held that the limited partnership interest involved was a security because a third party investor risked capital in a common venture, and because a limited partnership — by definition — precludes investor participation in essential managerial efforts.

Graham is important in two respects. First, it stands for the proposition that a limited partnership interest can be, and generally is, a security. Its position is shared by cases, commentators and practitioners. It directly contradicts Dahlquist’s theory that limited partnership interests are not securities. Second, Graham indicates that active participation in a limited partnership, which Dahlquist asserts as a key ingredient in determining securities status, is precluded by definition.

Because limited partnership interests can be and often are securities, Dahlquist’s theory is essentially obsolete. Thus, Rivlin and Sherman based their discussion of mutual selection on an outdated conception of limited partnership law. Moreover, Rivlin and Sherman misinterpreted that obsolete theory to say something it did not say.

70. Graham, 163 Cal. App. 3d at 1167, 210 Cal. Rptr. at 324; Silver Hills Country Club, 55 Cal. 2d at 815, 13 Cal. Rptr. at 188.
71. Silver Hills Country Club, 55 Cal. 2d at 815, 13 Cal. Rptr. at 188.
72. Graham, 163 Cal. App. 3d at 1167, 210 Cal. Rptr. at 324.
73. Id. at 1168, 210 Cal. Rptr. at 324. The court found the passive investor requirement “implicit in the risk capital test . . .” Id. (citing SEC v. Koscot Int’l Inc., 497 F.2d 473 (5th Cir. 1974)).
74. Graham, 163 Cal. App. 3d at 1168-69, 210 Cal. Rptr. at 324-25. Under the pre-RULPA Corporations Code, a limited partner effectively became a general partner if he exercised managerial control beyond: (a) voting for election or removal of general partners; (b) terminating the partnership; (c) amending the partnership agreement; or (d) similar powers. CAL. CORP. CODE § 15507 (Deering 1979). See CAL. CORP. CODE § 15632(a) (Deering Supp. 1987); see also supra note 4.
76. People v. Feno, 154 Cal. App. 3d 719, 201 Cal. Rptr. 513 (1984); People v. Park, 87 Cal. App. 3d 550, 151 Cal. Rptr. 146 (1978); see also supra notes 66-68 and accompanying text.
77. I H. Marsh & R. Volk, supra note 55; R. Jennings & H. Marsh, supra note 10; Comment, supra note 1, at 628-30.
78. See, e.g., T. Lynn & H. Goldberg, supra note 54, at 178-79.
79. “Active participation” includes active selection of partners for admission into the partnership. See infra text accompanying note 93.
80. Dahlquist, supra note 27, at 362-63.
81. See supra text accompanying notes 50-52.

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MUTUAL SELECTION IS INCONSISTENT WITH BONA FIDE LIMITED PARTNERSHIPS: People v. Feno

In People v. Feno, the Fourth District Court of Appeal persuasively reasoned that a bona fide limited partnership represented passive interests, and that mutual selection is inconsistent with passive interests. Feno was an appeal from a criminal conviction for offering securities in violation of Corporations Code section 25110.

Feno owned a used car business. He had (he thought) a bright idea. He solicited investors to enable him to buy used cars at auctions, recondition the cars, and sell them for a profit, which he would share with the investors. He advertised in the newspaper and drew several people into his scheme. The arrangement did not succeed and Feno managed to repay only one of the original investors. A jury convicted Feno of violating Corporations Code section 25110.

Feno tried to show that the interests were exempt from qualification as a private offering under Corporations Code section 25102(f). The court delved into an analysis of section 25102(f) which bears upon the issue of mutual selection.

The Feno court noted that section 25102(f) involves "non-public offerings of certain types of securities," including bona fide limited partnership interests. The court referred to the distinguishing characteristic of a security: "whether the interest represents a passive investment or an active participation in the venture on the part of the interest holder." Joint venture interests representing passive invest-
ments are securities and thus exempt if offered and sold privately under section 25102(f). Interests involving active participation are not securities\(^9\) (as \textit{Graham} states)\(^9\) and thus outside the scope of securities laws.

The \textit{Feno} court had to ascertain the meaning of "bona fide" in section 25102(f) before deciding whether the section applied to \textit{Feno}'s arrangement and exempted the venture from qualification. The court admittedly was puzzled by the use of "bona fide" in section 25102(f).\(^9\) The problem the court found was whether a "bona fide" interest, for example, a limited partnership interest, represented an active or a passive interest.\(^9\)

The question is central to the \textit{Rivlin} problem. \textit{Rivlin} found mutual selection a requirement for a bona fide limited partnership under section 25102(f)'s predecessor. \textit{Feno} noted that \textit{delectus personae}, mutual selection, is consistent with active participation in and control of the venture.\(^9\) Thus, in essence, \textit{Rivlin} found that a bona fide limited partnership was one in which the investors actively participated. As such, the limited partnership would fall under the statutory exemption.\(^9\)

However, \textit{Feno} pointed out that if an interest represents active participation, it is not even a security. It needs no exemption from securities laws. If a "bona fide" interest is an active interest, section 25102(f) is internally contradictory in that it provides an exemption from securities laws for an interest which is not a security.\(^9\) The entire section would be meaningless and superfluous. Yet the construction \textit{Rivlin} gives to "bona fide" produces such a result.

A more appropriate construction, one that gives meaning to section 25102(f), is that "bona fide" interests represent passive interests. As passive interests, limited partnership interests are securities\(^9\) and certain private offerings of those securities find exemption under 25102(f). Despite their passive nature, they are nonetheless "bona fide," true limited partnership interests. \textit{Feno} adopts this con-

\begin{itemize}
\item \textit{Feno}, 154 Cal. App. 3d at 726, 201 Cal. Rptr. at 516-17. Dahlquist probably used the words "bona fide limited partnership" in his article in contrast to "sham" partnerships. According to Richard W. Jennings, Coffroth Professor of Law, Emeritus at U.C. Berkeley and a member of the advisory committee for the 1968 Corporate Securities law, the draftsman of the 1968 law likely incorporated "bona fide" in section 25102(f) with Dahlquist's article in mind; i.e., "bona fide" meant the opposite of "sham." Letter from Richard W. Jennings to Homer Kripke, \textit{supra} note 38.
\item \textit{Id.}, 154 Cal. App. 3d at 726, 201 Cal. Rptr. at 516-17.
\item \textit{Id.} at 726 n.4, 201 Cal. Rptr. at 517 n.4.
\item \textit{Id.} at 726, 201 Cal. Rptr. at 517.
\item \textit{Id.}
\item \textit{See supra} text accompanying notes 53-81.
\end{itemize}
struction, noting that the idea that “bona fide” represents active interests simply “makes no sense.”

Thus, Rivlin’s and Sherman’s finding that bona fide limited partnerships require mutual selection renders an exemption for bona fide limited partnerships meaningless. Feno’s adoption of an opposite construction both avoids negating the meaning of 25102(f) and affirms that a true limited partnership interest is a passive interest, lacking mutual selection. Feno’s view is the most satisfactory. It illustrates the illogic of requiring mutual selection in formation of limited partnerships.

CONCLUSION

The weight of evidence opposes mutual selection as a requirement for a limited partnership’s bona fide existence. The Corporations Code recognizes that a limited partnership is formed upon compliance with statutory requirements which do not include mutual selection, contrary to Rivlin’s doctrine. It recognizes the partnership’s right to add limited partners without the other limited partners’ consent, if the partnership agreement so provides. And,

97. Feno, 154 Cal. App. 3d at 726, 201 Cal. Rptr. at 516-17.

Solomont quoted a commentator’s statement that mutual selection is necessary at formation of the limited partnership. Solomont took that statement quite out of context. The statement was made in the course of a discussion of general partnerships alone. See 1 S. Rowley, PARTNERSHIP 499-500 (2d ed. 1960). Rowley’s statement is valid with respect to general partnerships. The discussion of limited partnerships in the accompanying volume makes no mention of delectus personae as a requirement for the formation of limited partnerships. 2 S. Rowley, PARTNERSHIP 549-601 (2d ed. 1960). See also supra note 15.

100. CAL. CORP. CODE § 15631(a)(1) (set out supra note 11). See also supra note 8. The partnership agreement can provide for admission of additional limited partners without the other limited partners’ consent. Two simple provisions from real estate limited partnership agreements illustrate this. First, the American Property Investors VII Limited Partnership Agreement, art. XVI, § A, an offering of 60,000 limited partnership units dated May 16, 1977, provides: “The Certificate of Limited Partnership of the Partnership shall be amended without additional consent of Limited Partners when: . . . 3. An additional Limited Partner is admitted.” D. Augustine & P. Fass, REAL ESTATE SECURITIES: PUBLIC AND PRIVATE 9, 124 (1978)).

The second example, the University Real Estate Investors Amended Limited Partnership Agreement, § 6.4, an offering of 15,000 limited partnership units dated July 23, 1979, provides under the subheading: “Consents of Limited Partners:” “By executing or adopting this Partnership agreement, each Limited Partner hereby consents to the admission of additional or substituted Limited Partners by the General Partners and to any Assignee of his Partnership Units becoming a substituted Limited Partner.” D. Augustine-
as one observer of the situation has noted, no doubt the Commission of Corporations would not have permitted the "vast number of sales" of public limited partnership interests in California if such partnerships had no true existence.\footnote{101}

The analysis that limited partnership interests are securities destroys the mutual selection doctrine's theoretical basis. Dahlquist's obsolete view of the essence of a true limited partnership fails to accord with contemporary law and practice.\footnote{102} And Feno's analysis of section 25102(f), placing mutual selection into the active participation category, illustrates the illogic of mutual selection as a requirement for limited partnership.\footnote{103}

The mutual selection doctrine advanced by \textit{Sherman, Solomont,} and \textit{Rivlin} in California's second appellate district reflects an unrealistic view of limited partnership law. If the doctrine is followed, the potential exists for finding no limited partnership ever existed where all the parties believed, and the law indicated, it did exist. Disgruntled investors might use the doctrine as a ploy to recoup lost investments. The rights of parties could be drastically confused. Attorneys would be hard-pressed to reconcile the doctrine with the realities of large limited partnerships.

But \textit{Sherman} and its doctrine need not, indeed should not, be followed. The doctrine is not now, nor ever was, accepted law in California.\footnote{104} Better means of determining the existence of a partnership are available. For example, failure to comply with statutory formation requirements, fraud, or failure to qualify the interests as securities should be used where appropriate.

Where the statutory requirements have been met, California courts should affirm the bona fide existence of limited partnerships, despite the members' lack of unanimous consent to each other's admission into the partnership. \textit{Sherman v. Lloyd, Solomont v. Polk Development Company} and \textit{Rivlin v. Levine} should be overruled.

\textit{George M. Means

\footnotesize

\texttt{TINE \& P. FASS, PUBLIC REAL ESTATE LIMITED PARTNERSHIPS 1980, at 110 (1980).}

\footnotemark[101] Homer Kripke, Distinguished Professor of Law, University of San Diego; Professor of Law Emeritus, New York University. Letter from Homer Kripke to Marshall Rich (July 24, 1986) (discussing Sherman v. Lloyd) (on file with \textit{San Diego Law Review}).

\footnotemark[102] See supra notes 74-81 and accompanying text.

\footnotemark[103] See supra notes 82-95 and accompanying text.

\footnotemark[104] With the exception of the Second District in \textit{Solomont} and \textit{Sherman}, no court has followed \textit{Rivlin}'s mutual selection doctrine.