Hastings Law Journal

Volume 17 | Issue 4 Article 9

1-1966

# The Availability to the Syndicator of the Private Offering Exemption to the California Corporate Securities Law

Lindell L. Marsh

# THE AVAILABILITY TO THE SYNDICATOR OF THE PRIVATE OFFERING EXEMPTION TO THE CALIFORNIA CORPORATE SECURITIES LAW

In financing the development of a shopping center or the acquisition of a race horse,[1] the syndicator[2] is usually interested in a lithe entity,[3] quick in formation and relatively free of state regulation.[4] The limited partnership or joint adventure entity provides him just such agility, provided that he does not have to take the burdensome step of obtaining a permit to sell securities from the Commissioner of Corporations.[5]

The syndicator may free himself of this step if the offering can qualify under the private offering exemption to the Corporate Securities Law.[6] To qualify, it must be an offering of partnership or joint adventure interests, and it must not be offered to the public. In a milieu of project-oriented syndication where the syndicator is constantly bringing together new combinations of investors, these requirements are peculiarly elusive. This comment will discuss these requisites of the private offering exemption, and the availability of the exemption to the syndicator.

No adequate definition of the ambiguous phrase "not offered to the public" has been established by the California courts, nor is the business community sure of the meaning given it by the Commissioner of Corporations.[7] Therefore, in de-

[1] McDonald, *Syndication Is the New Big Game at the Racetrack*, Fortune, Jan. 1966, p. 159.

[2] A syndicator is the promoter of an association of individuals, formed for the purpose of conducting and carrying out some particular transaction, ordinarily of a financial character, in which the members are mutually interested. See generally Leighton & Kent, *What Is a Syndicate?*, in CALIFORNIA REAL ESTATE SYNDICATES AND INVESTMENT TRUSTS §§ 1.1-1.25 (1962). See also Swanson, Syndication as a Vehicle for Investment in Real Estate, April 19, 1961 (unpublished thesis on file in the Social Science Library, University of California, Berkeley).

[3] B. Smith, *Real Estate Syndication*, in REAL ESTATE INVESTMENT PROPERTY 103 (1964).

[4] A prominent attorney dealing in land development related several instances in which the delay resulting from having to obtain a permit resulted in the loss of the project. Interview With F M. Nicholas, Beverly Hills Attorney, in Beverly Hills, Aug. 1965. On the other hand, an Oakland firm dealing primarily in real property law related that it found the obtaining of a permit from the Commissioner of Corporations no hindrance, feeling that most resistance in applying for a permit comes from a preconceived distaste for state regulation. As a result the firm feels that the syndicator is far safer in subjecting himself to regulation than to try the various methods to avoid it. Interview With M. Starr, Oakland Attorney and Author, in Oakland, Feb. 18, 1966. It is the writer's opinion that the burden of state control is dependent on the individual state administrator and on familiarity with the Division of Corporations' procedure. Therefore, if one is dealing with a good state administrator, although he may encounter problems in ascertaining the requirements and procedures of the Commissioner, on his first application for a permit, subsequent applications should prove relatively quick and efficient.

[5] CAL. CORP. CODE §§ 25000-26104.

[6] CAL. CORP. CODE § 25100(m).

[7] Interview With H. Miller, Attorney and Author, in Oakland, Feb. 19, 1966. Interview With F M. Nicholas, Beverly Hills Attorney, in Beverly Hills, Aug. 1965.

veloping a definition our concern will be to observe the definition given to the same phrase as it is employed in the private offering exemption to the federal Securities Act of 1933,[8] then to consider the California court decisions, the practices of the Division of Corporations, and finally the *modus operandi* of attorneys engaged in syndication.

Before drawing any analogy to the federal act, we must consider two points of divergence between the California and federal acts: (1) while the federal act is designed to promote full disclosure of the material facts of the issue, the California act is designed to protect the investing public[9] "against the imposition of unsubstantial schemes and the securities based upon them"[10] by requiring the Commissioner in the first instance to determine "that the proposed plan of business of the applicant and the proposed issuance of securities are fair, just, and equitable, that the applicant intends to transact its business fairly and honestly, and that the securities that it proposes to issue and the method to be used by it in issuing or disposing of them are not such as, in his opinion, will work a fraud upon the purchaser thereof "[11] and (2) while the private offering exemption to the federal act concerns all types of securities,[12] the exemption to the California act concerns only partnership interests, joint adventure interests, and promissory notes.[13] The effect of these differences will be seen throughout the remainder of this note.

There have been four major considerations accepted under the federal act for determining whether an offer is private or public; (1) the number of offerees, (2) the character of the offerees, (3) the manner of offering, and (4) the number of units and their denomination.[14] Our concern will be with the first two factors. As to the latter two, it is sufficient to note that if the manner of offering includes the use of mass media advertising or an underwriter,[15] the offer will be considered public; and, while under the federal exemption the number of units and their denomination may be of importance, they are not important under the California exemption, which is limited to entities that do not normally issue share certificates in large quantities.

### *The Number of Offerees*

Writers have stressed that it is not the number of ultimate investors that is of concern, but rather the number of offerees.[16] For a number of years the Se-

[8] Securities Act of 1933 § 4(1), 48 Stat. 77 (1933), 15 U.S.C. § 77d(2) (1964).

[9] Leighton & Kent, *Federal and State Securities Regulations*, in CALIFORNIA REAL ESTATE SYNDICATES AND INVESTMENT TRUSTS 179 (1962).

[10] *In re* Leach, 215 Cal. 536, 543, 12 P.2d 3, 6 (1932), quoting Hall v. Geiger-Jones Co., 242 U.S. 539, 550 (1916).

[11] CAL. CORP. CODE § 25507.

[12] Securities Act of 1933 § 4(1), 48 Stat. 77 (1933), 15 U.S.C. 77d(2) (1964).

[13] CAL. CORP. CODE § 25100(*l*), (m).

[14] Campbell v. Degenther, 97 F Supp. 975, 977 (W.D. Pa. 1951). See generally SEC Securities Act of 1933 Release No. 285, Jan. 24, 1935.

[15] People v. Hoshor, 92 Cal. App. 2d 250, 206 P.2d 882 (1949); People v. Woodson, 78 Cal. App. 2d 132, 177 P.2d 586 (1947). *But see* Collier v. Mikel Drilling Company, 183 F Supp. 104 (D. Minn. 1958), where middleman received commission and yet offering was held to be private.

[16] 1 Loss, SECURITIES REGULATION 655-656 (1961). See generally Corporation Trust

curities Exchange Commission used the magic number of twenty-five offerees as the point where the offering normally turned public.[17] Then in 1953, the Supreme Court in *SEC v. Ralston Purina Co.*,[18] in holding that an offering to several hundred key employees was private, rejected any arbitrary standard based on the number of offerees, stating that the applicability of the exemption should turn on whether the particular class of persons affected need the protection of the act. Under this standard an offering could be public whether the offerees were "few or many." But the magic number was not cast aside completely. The court suggested that the Commissioner could still use twenty-five offerees as a "rule of thumb" to indicate when an investigation should be ordered.[19]

California has not judicially accepted any criterion based on a specific number of offerees. However, in *Cameron v. Long*[20] the court did consider offerings to forty-six and thirty-four persons as private. On the other hand, in *Mary Pickford Co. v. Bayly Bros., Inc.*,[21] which was decided under a now defunct California statute,[22] similar to the federal exemption, the court held that despite the small size of the group solicited, the offering was to the public. Then again in *People v. Whelpton*,[23] decided under the present California exemption, the court held that even though the group solicited was small, and was in fact made up of all stockholders of the offering corporation, the offering was to the public. However, these cases are of little help in providing a concrete standard. In *Whelpton* the court did not relate the number of actual offerees, and found that while the form of the interest was a promissory note, which is exempt from the act if not offered to the public, the substance of the interest was corporate stock which is not exempt even if offered privately. No matter how many offerees, the offering in that case could not have been exempt.[24] In *Pickford*, while the number of actual offerees was small, the court found that they were picked at random and therefore were just part of a general offering to the public.[25] Under California case law there is no indication as to the minimum number of offerees which will constitute the public.

Unlike the Securities Exchange Commission, the California Division of Cor-

---

Co. v. Logan, 52 F Supp. 999 (D. Del. 1943); SEC Securities Act of 1933 Release No. 4552, Nov. 6, 1962, p. 2.

[17] 1 Loss, Securities Regulation 662 (1961).

[18] 346 U.S. 119 (1953).

[19] *Id.* at 125; SEC Securities Act of 1933 Release No. 4552, Nov. 6, 1962. "On the pragmatic rather than the semantic level, therefore, the Supreme Court's opinion seems to have had little effect on the traditional position taken by the Commission except perhaps to strengthen it." 1 Loss, Securities Regulation 661 (1961).

[20] 184 Cal. App. 2d 292, 8 Cal. Rptr. 174 (1960).

[21] 12 Cal. 2d 501, 86 P.2d 102 (1939).

[22] Cal. Stat. 1917, ch. 532 § 2(b), at 674 as amended by Cal. Stat. 1925, ch. 447 § 2(7)d, at 962: "Any instrument offered for sale, or sold, or issued, to the public by any company, evidencing or representing any right to participate or share in the profits, earnings or income "

[23] 99 Cal. App. 2d 828, 222 P.2d 935 (1950).

[24] *Id.* at 831, 222 P.2d at 937.

[25] "Persons to be solicited were selected at random, although a number of former purchasers of securities from each firm were invited to invest " 12 Cal. 2d at 514, 86 P.2d at 108.

porations has not established a specific number of offerees as a rule of thumb to determine when an investigation should be made.[26] Whether such a rule of thumb is used depends largely on the individual deputy commissioner concerned. In one instance a deputy suggested that he did use the twenty-five person rule of thumb,[27] and in another a deputy indicated that he would scrutinize an offering to any number.[28] However, number is an important factor and as the offerees grow more numerous the Commissioner will become more concerned, and at a point, perhaps 250-300 offerees, the offering will be considered public no matter what other factors are present that would indicate that it should be private.[29]

As to federal law, Professor Loss believes that it seems relatively safe to assume that an offering to not more than twenty-five persons will be considered exempt (at least as far as Commission intervention as distinct from civil liability is concerned) and that other factors become important only when it is desired to approach a greater number of offerees.[30] However, since the California exemption is limited to partnership and joint adventure interests, which are abhorred by the Commissioner due to a lack of investor control in the limited partnership,[31] and the unlimited liability in the general partnership and joint adventure, it is understandable that the commission may give the term a stricter interpretation. Therefore, no assumption can be made that twenty-five offerees is a safe number. While the syndicator may justly believe that his successful twenty or twenty-five partner syndicate will escape the eye of the Commissioner, if the project fails, the disheartened investor will be the first to bring the question of "public offering" to light and into the Commissioner's view. This is when the syndicate needs the protection of the exemption. In summary, it may be said that while the number of offerees is an important factor in determining whether the exemption is available, the syndicator must never rely on number alone to free himself from regulation.

The uncertainty of the term "public" has resulted in proposals that the term "public offering" be abandoned in favor of a more concrete standard.[32] For ex-

[26] Interview With Robert LaNoue, Assistant Commissioner of Corporations, in Sacramento, Nov. 1965.

[27] Telephone Interview With a Deputy Commissioner of Corporations, in Los Angeles, Aug. 1965.

[28] Interview With H. Mattes, Assistant Commissioner of Corporations, C. San Felipe, Deputy Commissioner of Corporations, and C. Howard, Supervising Deputy Commissioner of Corporations, in San Francisco, Feb. 24, 1966.

[29] Interview With Robert LaNoue, Assistant Commissioner of Corporations, in Sacramento, Nov. 1965; Interview With M. Starr, Attorney and Author, in Oakland, Feb. 18, 1966.

[30] 1 Loss, Securities Regulation 664 (1961).

[31] Interview With Robert LaNoue, Assistant Commissioner of Corporations, in Sacramento, Nov. 1965; Interview With H. Mattes, Assistant Commissioner of Corporations, C. San Felipe, Deputy Commissioner of Corporations, and C. Howard, Supervising Deputy Commissioner of Corporations in San Francisco, Feb. 24, 1966.

[32] Interview With F M. Nicholas, Attorney and Author, in Beverly Hills, Aug. 1965. "The exemption (to the Uniform Securities Act) nowhere uses the *undefined* criterion of a 'public offering' This is one recommendation on which the advice received was virtually unanimous because of the experience at the federal level." Draftsman's Commentary to the Uniform Securities Act § 402(B)(9) in Loss & Cowett, Blue Sky Law 372-73 (1958).

ample, the Uniform Securities Act provides that an offer to less than ten persons should be prima facie exempt.[33] Other states have set the limit of offerees at thirty, twenty-five, and ten.[34] However, California, in considering the adoption of the Uniform Act, proposed the retention of the present exemption, rather than the adoption of the ten person standard.[35]

Considering that most of the small private offering exemptions in other states and under the federal regulations are associated with a criterion ranging from ten to thirty, it would seem reasonable that the California courts will consider that an offer to between ten and twenty-five is prima facie private. Further, while the Division of Corporations has failed to commit itself to a numerical criterion, if a syndicator approached only fifteen to twenty-five specific offerees and of this number, ten to fifteen chose to associate in the entity, it would seem reasonable for the Division also to consider the offering prima facie private. While this is not the Division's present policy, it would be advantageous for it to implement, since it would give the syndicator a secure minimum standard without significantly endangering the public at large.

*Character of Offerees*

Three characteristics of the offeree which bear on the determination of whether an offer is private or public are: (1) the knowledge of the offeree; (2) the sophistication of the offeree; and (3) the relation of the offeree to the offeror and to the other offerees.

*The Offeree's Knowledge*

Under the federal act the knowledge aspect of the test for determining whether an offer is public was first espoused in *Ralston Purina*,[36] the Court stating that the class of persons who would not be considered "public" were those who did not need the protection of the act—those who, because of their position, had access to the same kind of information that the act would make available.

While there is no question that the paternalistic California act contemplates more in the way of investor protection than the full disclosure required by the federal act, this factor of knowledge either supplied directly to the investor or accessible to him is the keystone of protection. The knowledge the Division of Corporations requires is a knowledge of the character as well as the skill of the issuer, a knowledge of the risks and opportunities of the project, and a knowledge of the entity he is to join.[37]

Most syndicators as a matter of course develop a prospectus outlining the risks and opportunities of the project and the background of the syndicator.[38] How-

[33] *Id.* at 373.

[34] *Id.* at 369-70.

[35] A.B. No. 2531, proposed CAL. CORP. CODE § 25402(a) 14-15, in ASSEMBLY INTERIM COMMITTEE ON THE JUDICIARY, *The Uniform Securities Act*, ASSEMBLY INTERIM COMMITTEE REPORTS 70-71 (1959-60). But see A.B. No. 2531, proposed CAL. CORP. CODE §§ 25402(b)(9),(12), in ASSEMBLY INTERIM COMMITTEE ON THE JUDICIARY, *The Uniform Securities Act*, ASSEMBLY INTERIM COMMITTEE REPORTS 25; 30 (1959-60).

[36] SEC v. Ralston Purina Co., 346 U.S. 119, 124-25 (1953).

[37] Interview With Robert LaNoue, Assistant Commissioner of Corporations, in Sacramento, Nov. 1965.

[38] B. Smith, *Real Estate Syndication*, in REAL ESTATE INVESTMENT PROPERTY 103 (1964).

ever, while the protection to be afforded under the California act and especially under the federal act is adequate information, merely supplying the offeree with the same information that he would get if the act were complied with is not necessarily sufficient to exempt one from regulation. To hold that it is, argues the Securities Exchange Commission, would undermine effective regulation, since it would give each issuer the choice of registering or making its own voluntary disclosures without regard to the standards or sanctions of the federal act.[39] Under this view it would be best for the syndicator to deal with offerees who already were in a position of knowledge. This type of sophisticated offeree will be considered in the next section. Thus, while it is essential that the offeree is provided with the material facts of the offering in some manner, this alone may not be sufficient to gain the exemption.

*The Offeree's Sophistication*

Cases arising after *Ralston Purina* have emphasized the sophistication of the offerees in determining whether the particular class of persons affected needs the protection of the act. In *Repass v. Rees*,[40] the court found that the offerees involved were experienced businessmen and investors who did not need the protection of the act. *Woodward v. Wright*[41] put the criterion of whether the offerees could fend for themselves in terms of sophistication. However, Professor Loss argues that the Supreme Court's language in *Ralston Purina* does not support the view that the availability of the exemption depends on the sophistication of the offerees or buyers, rather than their possession of, or access to, information, regarding the issuer.[42] Professor Steffen argues further that not only do these cases go beyond the test of *Ralston Purina* but that the courts in general have gone beyond the intent of Congress when it first phrased the private offering exemption. He argues that "private" should not turn on the sophistication and knowledge of the offeree; rather, all offers should be registered except those to a few.[43]

Regardless of the opinions expressed by these writers, there is no doubt that the federal courts recognize the sophistication of the offeree as an important factor in considering whether the offer is public or private. The Securities Exchange Commission supports this view in generally not requiring registration of private placements to institutional investors.[44] With the purpose of the California act being not only full disclosure but also protection of the investor from an unfair offering, the California courts and the Commissioner have a stronger and more explicit statutory basis than have the federal courts in considering the sophistication of the offeree as a prime factor in determining whether the offering is private.

While the California courts as yet have not developed a sophisticated offeree criterion, the Commissioner has been very concerned with the sophistication of

[39] SEC Securities Act of 1933 Release No. 4552, Nov. 6, 1962.

[40] 174 F Supp. 898, 904 (D. Colo. 1959).

[41] 266 F.2d 108, 115 (10th Cir. 1959).

[42] 1 Loss, Securities Regulation 664 (1961).

[43] Steffen, *The Private Placement Exemption: What To Do about a Fortuitous Combination in Restraint of Trade*, 30 U. Chi. L. Rev. 211, 220-23 (1963).

[44] SEC Securities Act of 1933 Release No. 4552, Nov. 6, 1962; see Orrick, *Some Observations on the Administration of the Securities Laws*, 42 Minn. L. Rev. 25, 33 (1957).

the offerees.[45] In recognizing this concern one firm, in applying to the Commissioner for a permit to issue limited partnership interests as securities, developed a questionnaire stressing the education, employment, financial status, investments in real estate, and the relationship of the offeree to the other offerees and to the offeror.[46]

Unlike full disclosure, which is a nearly absolute requirement of a private offering, the requirement of sophistication is relative and must be weighed with factors of "relationship."

*Relation of the Offeree to the Offeror and to the Other Offerees*

There are two "relationships" that are factors in determining the availability of the private offering exemption: (1) the "close-knitness" of the original offeror-offeree group; and, (2) the legal relationship established by the joint adventure or partnership agreements between the offeror and offerees and among the various offerees.

*The Close-Knit Group*

As discussed above, the Supreme Court espoused the criterion that the exemption is available where persons, because of their *position*, have access to the same kind of information that the act would make available.[47] Carlos Isreals suggests that *position* could be "any significant economic relationship to the issuer."[48] Orrick concurs with this view when he notes that the Securities Exchange Commissioner is concerned with the "relationship of the offerees to the issuer—such as close affiliation with directors and officers, existing financial interest in the issuer through securities ownership, and debtor-creditor, customer or attorney-client relationships."[49] The Division of Corporations suggests that a satisfactory "economic position" would be one where the offeree had sufficient knowledge of the issuer and the venture, such as the issuer's business management capacities, his reputation for honesty, the financing and structure of the venture, and the risks involved in it.[50]

There is no question that an offeree picked at random would not be considered as having a sufficiently unique economic position to bring him within the Supreme Court test.[51] On the other hand the courts and the Commissioner have allowed relatives and friends to come within the exemption, even though they are

---

[45] Interview With Robert LaNoue, in Sacramento, Nov. 1965; Interview With H. Mattes, Assistant Commissioner of Corporations, C. San Felipe, Deputy Commissioner of Corporations, and C. Howard, Supervising Deputy Commissioner, in San Francisco, Feb. 24, 1966.

[46] Interview With M. Starr, Oakland Attorney and Author, in Oakland, Feb. 18, 1966.

[47] SEC v. Ralston Purina Co., 346 U.S. 119, 124-25 (1953).

[48] Isreals, *Some Commercial Overtones of Private Placement*, 45 VA. L. REV. 851, 859 (1959).

[49] Orrick, *supra* note 44, at 33.

[50] Interview With Robert LaNoue, Assistant Commissioner of Corporations, in Sacramento, Nov. 1965.

[51] Mary Pickford Co. v. Bayly Bros., Inc., 12 Cal. 2d 501, 514, 86 P.2d 102, 108 (1939).

not necessarily in any economic position in relation to the offeror.[52] Here the offeree's personal knowledge of the offeror outweighs any lack of knowledge of the project, and perhaps any lack of sophistication. However, as the relative or friend becomes more distant the knowledge of the project and the sophistication of the offeree become increasingly more important.[53] The federal courts, when concluding that a private offering is present under these circumstances, usually state that the group was a "close-knit arrangement among friends and acquaintances on a purely personal basis without any systematic scheme or promotion "[54]

As the syndicator goes beyond his immediate circle of friends and acquaintances, the question of who constitutes a "close-knit" group becomes exceedingly more difficult to answer. The same is true where there are several offerors each making offers to his associates who are totally unrelated to the other offeror.

The federal courts have held that the group is close-knit: where the offeree was introduced to the offeror through a middleman, but had participated with him on a previous project;[55] where the offeree was known to one offeror-partner but not to the other;[56] and where the offeree was introduced to the offeror by another offeree.[57]

In one federal district court case,[58] the court concluded that an offering made through a broker to the broker's friends of "long standing" was private. These friends were previously unknown to the offeror, but the court found that the group was "close knit" even though one offeree had brought a friend into the project who was unknown to both the broker and the offeror, and furthermore, the broker was paid a commission. In coming to this unusual conclusion the court stressed three factors: that the number of offerees was in the vicinity of fourteen and was thus under the twenty-five person rule of thumb of the Commissioner; that the offerees were all sophisticated; and that they were given an adequate opportunity to inform themselves about the project and thus did not need the protection of the act.

While the California courts have not specifically discussed an offering to persons beyond the immediate circle of friends and acquaintances of the offeror, in *Cameron v. Long*,[59] which involved thirty-four and forty-six offerees, it is doubtful that all the offerees were known directly to the offeror. It would seem that the California courts should take the additional step and follow the federal lead and hold that a transaction such as that above is a private offering.

---

[52] Farnsworth v. Nevada-Cal Management, Ltd., 188 Cal. App. 2d 382, 10 Cal. Rptr. 531 (1961); Cameron v. Long, 184 Cal. App. 2d 292, 8 Cal. Rptr. 174 (1960); Interview With Robert LaNoue, Assistant Commissioner of Corporations, in Sacramento, Nov. 1965.

[53] Interview With H. Mattes, Assistant Commissioner of Corporations, C. San Felipe, Deputy Commissioner of Corporations, and C. Howard, Supervising Deputy Commissioner of Corporations, in San Francisco, Feb. 24, 1966.

[54] Collier v. Mikel Drilling Co., 183 F Supp. 104, 112 (D. Minn. 1958), quoting Campbell v. Degenther, 97 F Supp. 975, 977 (W.D. Pa. 1951).

[55] Campbell v. Degenther, *supra* note 54.

[56] Garfield v. Strain, 320 F.2d 116 (10th Cir. 1963).

[57] Woodward v. Wright, 266 F.2d 108 (10th Cir. 1959). Interview With Robert LaNoue, Assistant Commissioner of Corporations, in Sacramento, Nov. 1965.

[58] Collier v. Mikel Drilling Co., 183 F Supp. 104 (D. Minn. 1958).

[59] 184 Cal. App. 2d 292, 8 Cal. Rptr. 174 (1960).

However, the Division of Corporations seems to draw a more constricted circle about the offeror in considering the requisites for a close-knit group. The Division tends to require not only that an offeree introduced to the offeror through a middleman be knowledgeable and sophisticated, but that the middleman must be himself an offeree or offeror and very closely related to the new offeree; for example, as a spouse or very close friend. If the middleman is paid a commission for bringing in an offeree then the offer would be considered public.[60] While under the federal decisions it would seem that sophisticated real estate investors who are not known to each other directly but only indirectly by a web of connections could syndicate in small numbers of less than twenty-five, under the Division of Corporation's view so to do would amount to a public offering. Even considering the protection intended to be afforded by the California act as contrasted with the federal, if this type of offeree is in a position of knowledge there is no need to protect him by requiring a permit, provided that he is not part of an exceedingly large group of offerees, since he is usually more expert than the Commissioner in evaluating such an offer. Certainly when such a group numbers less than twenty-five it should be considered private by the Commissioner as well as the courts.

*The Legal Relationship Established by the Joint Adventure or Limited Partnership*

Two factors which qualify the availability of the private offering exemption flow from the peculiar limitation of the California exemption to the legal entities of partnerships and joint adventures. First, since the California exemption provides for only these certain entities, the association created must conform both in substance and in form—the entity must be bona fide. Second, since the purpose of the California act is to protect the public against the imposition of unsubstantial, unlawful and fraudulent stock and investment schemes and the securities based on them, the protection afforded the investor by the incidents of the entity agreement will be a factor in determining whether the offerees need the protection of the act.

The California courts have required that the partnership or joint adventure be bona fide.[61] Bona fide as the court has discussed it rests on the concept of *delectus personarum*—the right to determine membership. Thus the court has said that "as long as the requirement of unanimous agreement on the body of membership is preserved it would appear clear that the partnership is not an issuer of a 'security.' "[62] However, where the issuer went among his relatives, friends, and acquaintances, persons who would otherwise be considered a "close-knit" group, seeking those who would invest in his enterprise in return for a share of the contemplated profits, one by one designating those who would be allowed in the venture, and collecting the money from each as he was designated, with-

[60] Interview With H. Mattes, Assistant Commissioner of Corporations, C. San Felipe, Deputy Commissioner of Corporations, and C. Howard, Supervising Deputy Commissioner of Corporations, in San Francisco, Feb. 24, 1966.

[61] Rivlin v. Levine, 195 Cal. App. 2d 13, 15 Cal. Rptr. 587 (1961); Farnsworth v. Nevada-Cal Management, Ltd., 188 Cal. App. 2d 382, 10 Cal. Rptr. 531 (1961).

[62] Rivlin v. Levine, 195 Cal. App. 2d 13, 21, 15 Cal. Rptr. 587, 593 (1961), quoting Dahlquist, *Regulation and Civil Liability Under the California Corporate Securities Act*, 33 CALIF. L. REV. 343, 363 (1945).

out the group so much as ever coming together, the offering was considered the offering of a security and not within the private offering exemption.[63] In order to meet this requirement of *delectus personarum*, no partner may be admitted without the unanimous approval of the membership; however, in the case of a limited partnership the certificate of partnership may allow the addition or substitution of a new partner without the unanimous approval of the membership. In the latter case the certificate must expressly state the terms and conditions of the substitution or admission. In either such case the certificate must be amended and signed and sworn to by all partners, including any member to be substituted or added, and when a limited partner is to be substituted, also by the assigning limited partner.[64]

While the Division of Corporations has indicated that it is not overly concerned with the concept of *delectus personarum*, it is concerned with the relationship of the original partners (as discussed above) and that the interests in the entity are not freely transferable (to insure that an offering which is originally private remains private).[65] Therefore, in order to satisfy the Commissioner's concern with keeping the offering private, and the court's concern to retain unanimous approval of the membership, the transferability of the interests should be prohibited or severely restricted.

The language of the court in discussing the concept of the bona-fide partnership indicates that if this element is present then the partnership is not an issuer of a security.[66] This is not true. While the bona-fide entity is an essential requisite

---

[63] Rivlin v. Levine, *supra* note 62, at 23, 15 Cal. Rptr. at 594.

[64] *Id.* at 21, 15 Cal. Rptr. at 592, quoting Dahlquist, *supra* note 61.

[65] Interview With Robert LaNoue, Assistant Commissioner of Corporations, in Sacramento, Nov. 1965; Interview With H. Mattes, Assistant Commissioner of Corporations, C. San Felipe, Deputy Commissioner of Corporations, and C. Howard, Supervising Deputy Commissioner of Corporations, in San Francisco, Feb. 24, 1966. In one case where a syndicator using a joint venture entity did apply for a permit, the Commissioner required that all documents evidencing the securities contain in capital letters the following statement: "The sale of this security is authorized by permit of the Commissioner of Corporations which provides that the owner of this security shall not consummate a sale, transfer (whether or not for value), pledge or hypothecation of it, or any interest therein, or any portion thereof, or receive any consideration therefore, until the written consent or permit of the Commissioner shall first have been obtained so to do." Interview With M. Starr, Attorney and Author in Oakland, Feb. 18, 1966. This suggests the concern that the Commissioner has in seeing that an originally private offeree does not become a conduit resulting in sales to the public.

[66] "As long as the requirement of unanimous agreement (*delectus personarum*) is preserved it would appear clear that the partnership is not an issuer of a security." Rivlin v. Levine, 195 Cal. App. 2d 13, 21, 15 Cal. Rptr. 587, 592 (1961). The court's misleading statement is a quote from an article by Dahlquist, *supra* note 62, at 363-64, which was a reply to an article by H. Smith, *Limited Partnership Interests as Securities Under the Corporate Securities Act*, 19 Los Angeles B.A. Bull. 257 (1944), Smith argued that under the old California Corporate Securities Law a partnership interest was a security. After the act was amended to provide the present exemption for partnership and joint adventure interests which are not offered to the public, Cal. Stat. 1945, ch. 399, § 2(b)12, at 856, Dahlquist argued that Smith was wrong and that so long as the entity was a partnership in both form and substance—a bona-fide partnership—the interests offered would not be subject to regulation. He further argued that the amend-

if a syndicator is to have available the private offering exemption, it is not the only consideration. For example, if a syndicator were to make a public offering in a newspaper to investors in general, there would be an immediate violation of the act notwithstanding that the group later came together and mutually selected each other. If the project went sour in spite of the fact that there was mutual selection of members, the court would say that this was a security originally offered to the public. The syndicator would then be subject to civil and criminal liability.

The factor that provides the attorney with the most versatility is the relationship between the offeror and offerees, and among the several offerees, as created in the entity agreement. In the same way that the Supreme Court has construed the federal exemption in light of the protection that the investor was to be afforded by the act—full disclosure—it would seem that if the California investor were to have the same protection that the California act would provide, the offering would be more likely considered private. However, as Professor Loss warned concerning the federal act, just as one cannot expect to escape federal regulation by merely offering ample information, one should not expect to escape the California act by merely providing the investor with protection. However, if one does provide such protection, he should expect the Commissioner and the court to be far more liberal in interpreting the exemption. To this end the syndicator should take into account three points: (1) the fairness of the return on the investment; (2) the exposure of the investor to loss; and (3) the control of the syndicate.

The project should be sound, offering the investor a fair return. The syndicator may build in any return for himself, but as it becomes larger, he should consider ways to assure the investor his profit.[67]

The protection of the investor, aside from assuring him a fair return, should limit his exposure to loss in two ways. First, the investor should be allowed to recover his capital outlay before any distribution to the syndicator; or if the investors are less sophisticated, more numerous, or have less contacts with the offeror, the investor should perhaps be allowed to take a percentage of his profits before the syndicator takes his, thus ensuring that the interests will not be watered from the beginning.[68] Second, the investor should be allowed to withdraw from

---

ment to the act was a change in form only and not in substance. However, as evidenced by the example in the text, there was a change in substance. Partnership and joint adventure interests were specifically made subject to the act, except in one instance—where the interests are not offered to the public. Therefore, even if the element of *delectus personarum* exists, if there is a public offering, the exemption will not be available and the interests will be subject to regulation.

[67] Interview With M. Starr, Attorney and Author, in Oakland, Feb. 18, 1966.

[68] *Ibid.* For example: "Any gain realized by the partnership from the sale of any of its assets shall be distributed as follows: A. All or so much of any such gain as shall be necessary for the purpose of repaying the total capital contribution of each of said Limited Partners. B. Upon repayment of the capital contribution, an amount equal to six percent shall be distributed to the Limited Partners C. The remaining portion shall be distributed to the partners " Or, if the syndicator is just an agent rather than a partner: "provided, however, that if the joint venturers do not realize at least three hundred (300) percent gross return on their capital contribution then no additional fee shall be payable to (the agent) at the time of

the partnership at any time under reasonable conditions. Not only does this limit the investor's exposure, it benefits the syndicate since the unhappy limited partner is usually more burden than benefit.[69]

The lack of investor control has caused the Division of Corporations, especially in the past, to be hesitant in granting permits to offer interests in limited partnerships to the public.[70] This policy becomes stricter when the offering of the limited partnership interest is argued to be a private offering and thereby not subject to the Division's regulation. Since 1963, when the Corporations Code was amended to allow the limited partners a certain amount of control over entity management,[71] the Division's policy has become somewhat more liberal.[72] Therefore, in order to allay this concern, the syndicator should provide for a significant amount of control to be vested in the limited partners, while being careful not to make them general partners.[73]

---

sale of the said real property." Provisions from agreements drawn by the firm of Miller, Starr and Regalia, obtained during an Interview With M. Starr, Attorney and Author, Feb. 18, 1966.

[69] Interview With M. Starr, Attorney and Author, in Oakland, Feb. 18, 1966. For example: "Any joint venturer may voluntarily retire from the joint venture at any time, by giving (30) days written notice. Said notice shall include an offer to sell at a price equivalent to the purchase price. [T]he joint venture shall have the exclusive right to accept the offer provided however, that if the joint venture shall determine not to purchase the remaining venturers shall have the exclusive right to purchase. Any interest not purchased may be offered to other interested parties." Provisions from agreements drawn by the firm of Miller, Starr and Regalia, obtained during an Interview With M. Starr, Attorney and Author, Feb. 18, 1966.

[70] Interview With Robert LaNoue, Assistant Commissioner of Corporations, in Sacramento, Nov. 1965.

[71] CAL. CORP. CODE §§ 15502(1)a, 15507(b).

[72] Interview With Robert LaNoue, Assistant Commissioner of Corporations, in Sacramento, Nov. 1965; Interview With H. Mattes, Assistant Commissioner of Corporations, C. San Felipe, Deputy Commissioner of Corporations, and C. Howard, Supervising Deputy Commissioner of Corporations, in San Francisco, Feb. 24, 1966.

[73] For example, in a joint adventure agreement: "Except as specifically provided for herein, all decisions with respect to the conduct of the joint venture business and the sale of its assets including the terms and conditions of the sale of the joint venture's real property, shall be made by joint venturers owning 51% or more of the interest in the joint venture." Provision from an agreement drawn by the firm of Miller, Starr and Regalia, obtained during an Interview With M. Starr, Attorney and Author, in Oakland, Feb. 18, 1966. Or, for example, in a limited partnership agreement: "the Limited Partners shall, pursuant to the terms and provisions of section 15502 of the California Corporation Code, have the right to vote for the election of or removal of a General Partner and to cause other action to be effected as such right is set forth in and governed by section 15502(1)(a)XV of said California Corporation Code and shall include termination of the partnership, any amendment of the partnership agreement, and the sale of all or substantially all of the assets of the partnership. All sales of the real estate shall be made upon the recommendation of the General Partners and the confirmation of at least 51% of the total limited partnership interest." Provisions from an agreement drawn by the firm of Miller, Starr and Regalia, obtained during an Interview With M. Starr, Attorney and Author, in Oakland, Feb. 18, 1966.

Provision should be made for adequate regular reports to the members. Voting rights should be given the limited partners which will allow them to voice their concern on major acquisitions, sales, and liquidations, and on the removal of a general partner from a management position.[74] As to the removal of a general partner, the Division of Corporations has argued that while this is legally possible, usually the limited partners do not have the skill to manage the entity, or the desire to incur the liability of a general partner; therefore as a practical matter, they will never exercise this power.[75] Therefore, in a questionable case, the syndicator may go so far as to design the syndicate so that he is only the agent of the syndicate, subject to dismissal at any time, with his compensation coming in the form of a fixed fee or a percentage of the profits.[76]

The use of the foregoing provisions should vary, depending on how obviously private the offering is. At most their use will encourage the Commissioner or the court to find that the offering was not made to the widows, children, and incompetents that the act was designed to protect. And if the syndicator is looking at the long run, he will find that the Commissioner's concerns are not necessarily antithetical to his own.

*Conclusion*

In order for the syndicator using a limited partnership or joint adventure entity to come within the private offering exemption to the California Securities Law he should:

(1) Offer the interest to less than twenty-five persons who generally meet the other requirements below, so that the group will come within the standard generally adopted around the country for a small or private offering.

(2) Offer the interest only to investors sophisticated in the particular field, who have been given or have access to all the material facts concerning the syndicator and the project, or to very close relatives or friends who have, in lieu of a sophisticated knowledge of the project, a thorough personal knowledge of the issuer.

(3) Offer the interest only to persons who have been associated with the syndicator in the past, preferably in business, or who have been associated with other offerees or offerors who have been associated with the syndicator in the past.

(4) Offer such interest on the condition that the offeree will be allowed to purchase such interest only if his membership in the partnership or joint adventure is unanimously approved by all other members of the syndicate.

(5) Provide in the entity agreement: that the assignability of the interests is severely limited; that the investor have sufficient priority over the syndicator in withdrawing funds from the project to cover his original investment and perhaps a percentage of his profits; that the investor should be able to withdraw from the syndicate at will subject only to reasonable conditions; and that control over

---

[74] *Ibid.*

[75] Interview With H. Mattes, Assistant Commissioner of Corporations, C. San Felipe, Deputy Commissioner of Corporations, and C. Howard, Supervising Deputy Commissioner of Corporations in San Francisco, Feb. 24, 1966.

[76] Interview With M. Starr, Attorney and Author, in Oakland, Feb. 18, 1966; see 68 *supra.*