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Equine Syndications: A Legal Overview

An Analysis of the Possible Legal Ramifications and Problems of Syndication, Including Possible Securities' Problems

by

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NOTES

EQUINE SYNDICATIONS: A LEGAL OVERVIEW

An Analysis of the Possible Legal Ramifications and Problems of Syndication, Including Possible Securities' Problems

The syndication of animals exploded into celebrity with the now famous six-million-dollar agreement involving Triple Crown winner Secretariat. Nevertheless, syndication remains a relatively virgin legal field with most of the agreements now in effect dating from no earlier than the 1950's. An abundance of articles, ranging from those appearing in the most popular weeklies to the more sophisticated horse-oriented periodicals, have treated the subject of animal syndication, however, a dearth of information regarding the area exists in legal scholarship. As far as this writer can ascertain, no endeavor written from a legal viewpoint has ever entertained the subject with more than brief aside, and until this date, no case has ever centered wholly on the law of syndication.

Although this note is not intended to be exhaustive in its scope or treatment, its purpose is to attempt to provide to the attorney confronted with a syndicate problem general information, guidelines, and suggestions regarding the syndication of animals and to draw to his attention possible problem areas one might encounter when drafting a syndicate agreement or giving advice regarding syndication. Before looking at a few of the legal questions involved in syndication, however, a synopsis of the history, function, and advantages and disadvantages of syndication is appropriate.

I. Growth and Development of Horse Syndicates

A. *Background*

The precise date of the first horse syndication is lost in time and history; however, the impetus for modern syndication springs from the 1926 syndication of the thoroughbred Sir Galahad III.[1] Syndicate ownership of thoroughbreds at that time was far from commonplace, and the prices, by today's standards, were extremely modest. The

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[1] Rice, *Syndicate Wheeler-Dealers Revolve From Lexington,* The Lexington Leader, Aug. 21, 1964, at 11, col. 1 [hereinafter cited as Rice].

trend to big money investment reached full stride in 1955 when a syndicate purchased the great Nashua with a $1,250,000 sealed bid.[2] Today, animal syndications range financially from the ethereal heights of Secretariat to relatively modest investment opportunities.

Interest in the syndication of animals has experienced tremendous growth since the end of World War II. Prior to that time nearly all of the more famous thoroughbred stallions were privately owned, whereas since then a high proportion have been the property of syndicates.[3] A multiplicity of reasons are relevant to explain this phenomenon. Probably the greatest single impetus for syndicate ownership has been cost,[4] not only the spiraling costs of purchasing and maintaining the animal but also the cost of stud services. Inflationary trends which have affected other aspects of the world's economy have also affected the ownership of valuable racing and breeding animals. Closely related to the cost factor has been the concomitant increase in the risks the individual owner has had to bear. Syndicate ownership provides a means of lessening the devastating cost-risk ratio of private ownership. Horsemen are well aware of this aspect of syndication, as is noted by Morgan Stenley, an official of American Telephone and Telegraph Company and a syndicate participant:

> A fine stallion costs more than one man wants to risk, and the risk is very great . . . . So he takes in a number of shareholders to share the risk, and each one takes one or more shares.[5]

Beyond this, horsemen who are looking to the future know that the cost of breeding their animals to a famous stallion may be prohibitive or that the opportunity may be completely unavailable;[6] participation in a syndicate agreement may be the only means of providing an adequate solution to this problem as well.

Syndications also have become popular as a result of income considerations. As an investment, syndicate ownership offers a potential for income, though not without an equal amount of risk.

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[2] *Id.*

[3] Of the comparatively few privately owned major sires, Swaps, Bold Ruler, Native Dancer, Bull Lea, Citation and Tim Tam belong to the category. Of the syndicated stallions, Riva Ridge, Secretariat, Nashua, Carry Back, Bolero, Roman, Ambioris, and Nasrullah are representative. It has been estimated that 80% of this country's leading sires are syndicated. Nearly all major stallion importations from abroad are procured through syndicate purchases. These figures are based on 1959 statistics as quoted in Phelps, *Stallion Syndication: An Appraisal*, THE THOROUGHBRED RECORD, Sept. 5, 1959, at 11, Sept. 12, 1959, at 30 [hereinafter cited as Phelps].

[4] Phelps, Sept. 12, at 9.

[5] Tower, *The Hidden Gamble in Racing*, SPORTS ILLUSTRATED, Sept. 29, 1958, at 36 [hereinafter referred to as Tower].

[6] *Id.*

Finally, growing public interest in horse racing and other related sports has promoted interest in syndication. Accompanying the increasing public appeal have been concurrent increases in the numbers of tracks, the duration of the racing season, the amount of wagering, and the value of the purses.[7] Syndication has provided both a means for more people to participate in the horse business and means of obtaining more horses.

B. *Advantages of Syndication*

Syndicate ownership offers advantages to horsemen at various levels. To the owner, it is a mode of alleviating the sting of risk. Professor Humphries, in *Racing Law*, has surveyed the benefits of syndications to the owner:

> [S]yndication offers the stallion's owner a chance to sell shares in his horse while retaining either partial ownership, control or both. The great loss to be suffered through the death of a valuable animal can be spread among many, rather than borne by one.[8]

Equally, the shareholder enjoys certain benefits. To the shareholder who is a breeder, syndicate ownership provides a kind of triple reward. First, the breeder has the benefit of being able to make long range breeding plans; typically, as shall be developed, the syndicate agreement guarantees access to the syndicated horse for breeding purposes.[9] Moreover, if the shareholder-breeder should decide not to take advantage of this aspect, "he can sell or exchange his breeding season (a season is defined as the individual mating of a stallion to a broodmare) for a season to another stallion. Or instead he may sell his shares. . . ."[10] Third, syndication offers a practical means by which a shareholder can retain an interest in several stallions simultaneously.

II. SYNDICATION: CREATING A LEGAL ENTITY

A. *Formulation*

As a legalism, a syndicate is a loose term, awaiting the attorney's professional acumen to give it life, substance and meaning. "Syndicate," although widely used and referred to, does not apply to any particular legal or business form. On the contrary, any business association can appropriately be entitled a syndicate.[11] One writer

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[7] J. HUMPHRIES, RACING LAW 23 (1963) [hereinafter cited as HUMPHRIES].
[8] *Id.* at 23.
[9] Tower, *supra* note 5, at 38.
[10] *Id.*
[11] J. CRANE & A. BROMBERG, LAW OF PARTNERSHIP 138 (1968) [hereinafter cited as CRANE & BROMBERG].

has defined syndication as the "pooling of the resources of a group of individual investors to acquire and develop an asset."[12] Like most other business associations, the purpose of the syndicate is ultimately profit, either in the form of finances or in the form of guaranteed breeding rights. Depending on the subject matter of the agreement, the syndicate, as an entity, may consist of a handful of generally wealthy investors, well-known to one another and each personally participating in the operation of an enterprise, or it may be a widely held venture whose numerous participants are dependent upon the integrity, judgment and ability of the syndicate manager for their investment award. Syndicate ownership of horses is a hybrid of both these forms—usually consisting of 30-40 participants who may or may not know one another, while using a syndicate manager or a facsimile thereof to handle the enterprise.[13] The reasons for this particular developmental form in horse syndications are twofold: (1) as earlier indicated, the relatively small number of investors bears a close relation to the breeding abilities of the stallion; and (2) the management arrangement is dictated by the nature of the syndicate's property and the tradition of the thoroughbred industry.

Broadly speaking, horse syndications are of two types: the *closed syndicate,* in which all the seasons are reserved for syndicate shareholders or those to whom they have sold, traded, or otherwise released the season; and the *open syndicate,* in which there are some seasons open for sale to non-shareholders.[14] Sale of open seasons to nonshareholders is frequently left to the discretion and expert judgment of the syndicate manager. Occasionally, even in a closed syndicate, seasons may become available due to the death or illness of a shareholder's mare, the death of a shareholder, retirement from the syndicate by a member, or even a shareholder's decision not to breed during a particular season.

In creating a syndicate, three elements are essential to propel the enterprise from idea to reality. These are a good horse, a number of persons willing to invest money in it and accept the concomitant risks, and a promoter or syndicator who can quickly and efficiently bring these elements together.[15] Ordinarily, prior to the syndicate's formation, the promoter will have selected the horse that the venture will own; however, on occasion syndicates have been formed with the express purpose of increasing their purchase power at sales through

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[12] Berger, *Real Estate Syndication: Property, Promoters and the Need for Protection,* 69 YALE L.J. 725, 726-27 (1960) [hereinafter cited as Berger].

[13] Phelps, Sept. 5, at 11; Sept. 12, at 11.

[14] Phelps, Sept. 12, at 12.

[15] Tower, *supra* note 5, at 37.

the pooling of funds.[16] Remuneration for the promoter-syndicator's efforts may be in the form of a cash outlay, through shares and the rights attached thereto in the enterprise, or, if an attorney is acting as the promoter, through legal fees and a retainership for the duration of the enterprise.[17]

Syndication agreements can involve differing aspects of the horse's career. Typically the syndication occurs after the horse has shown some extraordinary promise; however, syndicate purchases of untried yearlings are not unknown.[18] Some syndications involve only the racing career of the horse with the shareholders or syndicate participating proportionately in the expense and winnings of the horse during its racing career; when the horse is retired from racing, the racing syndicate ends. Others (and the most frequent type), while created during the racing career of the horse, have syndicate ownership taking effect only when the horse is retired from racing in sound condition, and still others combine both racing and breeding aspects.[19] No legal bar exists to a syndication occurring at any point in the horse's career.

B. *Contractural Aspects*

Syndication agreements are essentially contractual in nature and are, therefore, governed by general contract principles. Consequently, the doctrine of freedom of contract is applicable, and the terms, duties, and conditions vary with the goals and purposes of the enterprise and the drafter's skills; however, certain characteristics appear in nearly all such agreements involving animals. For instance, if the syndicate is aimed primarily at the horse's breeding career, the number of shares sold is equivalent to "the maximum number of mares [normally 32] the stallion will presumably be able to service in a year."[20] Consequently, as previously noted, horsemen interested in obtaining the stallion's services are, therefore, attracted as potential investors since owning a share in the enterprise may be his only assurance of getting such service.

Frequently, the original owner of the horse will establish the syndication plan or, at a minimum, will be a controlling element in determining the terms of the contractual agreement and will retain one or more shares in the animal himself.[21] This owner-drawn form of syndication pact has certain distinct advantages for the owner-syn-

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[16] Phelps, Sept. 5, at 30.
[17] Berger, *supra* note 12, at 734-35.
[18] Phelps, Sept. 12, at 12.
[19] Rice, *supra* note 1.
[20] HUMPHRIES, *supra* note 7, at 23.
[21] *Id.*

dicator. For example, while selling shares permits the owner to spread the risk of loss and to minimize his expenses, it allows him to retain either partial ownership, control, or both, over the horse, thereby providing a means of retaining the pride of ownership which is so much a part of this unique industry. As a consequence of this recurrent owner-syndicator planning, it is not extraordinary for the syndication agreement, especially if the syndicate involves a horse still participating in racing, to contain a proviso vesting control over the management of the horse in the original owner as syndicate manager or in a committee or board on which the original owner is a member.[22] Often the selection of the syndicate manager has been predetermined as an included term of the contractual agreement; therefore, designation of a particular syndicate manager or appointment to the syndicate committee may be concluded before the share is even marketed. Regardless of the method of selection, the syndicate manager or committee is responsible for nearly every aspect of the horse's life as well as for handling the business aspects of the enterprise, such as providing accounting statements, setting extra-syndicate service fees, and generally guarding the welfare of the enterprise.[23] Additionally, the agreement permitting, the syndicate manager may be a significant party in arranging for resales of shares or sale of open seasons. Furthermore, this method provides an explanation of the phenomenon of a syndicated animal retaining the colors of the original owner and of its remaining in the possession of the original owner.

Virtually all syndication agreements, whether for racing or breeding, provide for a system by which all shareholders share in proportion to their interests the expenses and profits of the syndicate's business.[24] Commonly, assessments are made on a per share basis to provide for the animal's maintenance and expenses. Similarly syndicate income is ordinarily charged against the expenses of the enterprise, and any net profits are distributed on a per share basis. Where several open seasons are available, profits could be sizable. Likewise, where the private shareholder is able to market his unused seasons, returns could be quick and appreciable.

To prevent the overbreeding of a horse and a subsequent flood of the thoroughbred market or damage to the horse, a frequent stipulation in the agreement limits the number of mares to be covered annually. Some agreements state a maximum number of mares, conditions permitting, which the stallion will service, whereas other agreements grant

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[22] *Id.*
[23] Phelps, Sept. 12, at 11.
[24] HUMPHRIES, *supra* note 7, at 24.

authority to the syndicate manager, syndicate committee or some other appropriate party, such as a syndicate-committee-approved veterinarian, to determine the proper number.[25] While a shareholder, by virtue of his ownership, is given preferential access to the stallion, such access is not necessarily absolute. Frequently, approval by the syndicate manager or other party is a condition precedent to obtaining service whether the shareholder is attempting to bring his own mare or has sold his season's breeding right to a non-shareholder horseman.[26]

Finally, many syndication agreements provide for syndicate ownership to take effect only upon a specified event or upon certain conditions precedent, such as presentment of a sound and fertile horse. Until all conditions precedent are fulfilled, ownership, possession and control of the animal remain with the owner; the syndicate shareholders are merely contingent owners. If for any reason a condition precedent is not satisfied, the syndicate shareholder is released from his obligations and is refunded his cash outlay.[27] However, as shall be developed more fully, once syndicate ownership takes effect the investors bear all the risk of loss of invested capital.[28]

Since a syndicate is not per se a business association or form recognized by the law, any of a variety of entities with concomitant rights and obligations may designate itself a syndicate. Unlike corporation law, partnership law or limited partnership law, no distinct statutory body of "syndicate law" exists; therefore, the members of the syndicate by their association may be a limited partnership, a general partnership, a joint venture or even a corporation.[29] Contractual terms of the syndicate agreement and tax considerations generally dictate the operational form which the syndicate will assume.[30]

C. *Valuation and Sale*

One of the initial problems facing a party who is attempting to put together a syndication package is obtaining an accurate and fair valuation of the horse to be syndicated from which the price of shares can be determined. While professional horsemen sometimes allude to an "appraisal" value based upon the history, performance and antici-

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[25] *Id.*

[26] Interview with Arnold Kirkpatrick, President of THE THOROUGHBRED RECORD, in Lexington, Ky., Oct. 29, 1973 [hereinafter cited as Kirkpatrick Interview].

[27] *See generally* 3 A. CORBIN, CORBIN ON CONTRACTS §§ 627-28 (1951).

[28] Berger, *supra* note 12, at 729.

[29] Greenwood, *Syndication of Undeveloped Real Estate and Securities Law Implications*, 9 HOUS. L. REV. 53, 56-60 (1971).

[30] *See generally* Casey, *How to Determine Best Form For Real Estate Syndicate to Preserve Tax Advantages*, 7 J. TAX. 328-30 (1957); Rabinowitz, *Realty Syndication: An Income Tax Primer for Investor and Promoter*, 29 J. TAX. 92 (1968).

pated potential of the animal plus their own "horse sense", more often, especially in breeder syndications, a formula based on the estimated cost of stud fees is utilized. The formula works as follows: after estimating what the service fee per stand (a term of art designating the stud fee per broodmare serviced) will be, the syndicator multiplies this figure by three and assigns it as the price per share.[31] For example, if a stallion is estimated to be worth $50,000 for each mare it services (*i.e.* per stud fee), the cost of the syndicate share would be $150,000. This method is not as mystical as it appears at first glance. The figure three is chosen as the multiplier because it is felt this is the maximum risk period beyond which the prospective purchaser will not venture. After three breeding seasons, the equine's first foals are running, and at that point the shareholder is likely to realize the value of the stallion as a sire and the future of his investment. If the stallion's foals are winners, the syndicate shareholder probably has made a profitable investment. Conversely, if the stallion's foals are defective or are not good runners, the shareholder has probably lost all or a significant portion of his investment, except that portion he has been able to recapture through the sales of open or extra seasons. Unlike the corporate shareholder who can wait for an upturn in business after a losing period, the shareholder in a horse syndicate usually suffers irretrievable losses if the stallion's foals prove unsatisfactory.[32]

Once a value has been determined, sale of shares in an equine syndication varies with the terms of agreement. After the price is established by the syndicator-promoter, he then offers the shares, usually through individual contact, to parties whom he thinks might be interested in such an investment. Syndicate shares are not offered to the general public through the open market; nor, customarily, are they advertised.[33] Normally the sale of syndicate shares involves a kind of limited solicitation. Typically a prospective purchaser is given a specific time period in which to make his purchase; failure to exercise his purchase right frees the syndicator to make an additional offer elsewhere. Depending on the terms of the syndicate agreement, fractional parts of shares may be purchased;[34] however, full shares usually have the exclusive right to vote. When fractional interests are sold, the fractional shareholders must agree among themselves as to how the rights of share ownership are to be divided.

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31 Kirkpatrick Interview, *supra* note 26.

32 Robertson, *Put the Cards on the Table,* THE THOROUGHBRED RECORD, Nov. 28, 1970, at 1898 [hereinafter cited as Robertson].

33 Kirkpatrick Interview, *supra* note 26.

34 Phelps, Sept. 5, at 11.

III. SYNDICATES AS PARTNERSHIPS

Although many syndicate shareholders may consider themselves merely "members of a syndicate" and believe they are involved in no other legal relationship, the association, unless otherwise designated by the terms of the syndicate agreement (and registered accordingly if required by law), should be regarded as a general partnership for legal purposes and subject to the Uniform Partnership Act. Professor Humphries early noted that the question of legal identification of the syndicate relationship could be a source of problems. His concern ran to balancing the need for freedom in the syndicate manager's exercise of his expertise against the need to protect the shareholder's rights:

> If the stallion manager's decisions are scrutinized from the corporate law aspect, they may be unduly restricted. Yet if treated under partnership law the syndicate may be unable to sell, or forced into dissolution.[35]

The reasons why the syndicate relation should be treated as a general partnership in the eyes of the law, unless it designates itself otherwise, are multitudinous. One of the main reasons involves taxes. Most syndicate shareholders attempt to obtain the preferential taxation of a partnership on any profits earned by the syndicate, thereby avoiding the double taxation of a corporation.[36] That the syndicate shareholder sees himself as a partner for tax purposes supports the hypothesis that a syndicate is a form of partnership and should be governed by partnership law.

The provisions of the Uniform Partnership Act [hereinafter UPA] (which Kentucky adopted in 1954) also lend themselves to viewing the syndicate as a partnership relation. For instance, a partnership, defined in terms sufficiently broad to encompass syndicate ownership, is "an association of two (2) or more persons to carry on as co-owners of a business for profit."[37] Embodied in this statutory definition is a four-pronged test for determining whether or not an association is a general partnership: first, the association must have in excess of one

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[35] HUMPHRIES, *supra* note 7, at 24.

[36] B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 2.05 (3d ed. 1971). Note that

> [a] syndicate, pool, joint venture, or other incorporated group which carries on a business, financial operation, or venture is under Regs. § 301.7701-3(a), taxable as a partnership unless it constitutes a trust, estate, or association.

Id. at 2-12 (footnote omitted): *See* INT. REV. CODE OF 1954, § 761(a) for a statutory endorsement of this definition. For litigated cases regarding syndicates and other similar organizations, *see* Bloomfield Ranch v. Commissioner, 167 F.2d 586 (9th Cir. 1948); Junior Miss Co., 14 T.C. 1 (1950).

[37] KY. REV. STAT. § 362.175(1) (1971) [hereinafter cited as KRS]; UNIFORM PARTNERSHIP ACT § 6(1) [hereinarter cited as UPA].

member; second, and implied, the association must be voluntary; third, the association must have profit as its motivating force; and fourth, the members of the association must be co-owners. Each of these characteristics find easy applicability to the horse syndicate.

Horse syndicates, particularly breeding syndicates, ordinarily have in excess of thirty members; therefore, it easily exceeds the "two or more members" requirement. Moreover, although partnerships are usually not thought of as having thirty or more members outside of professional associations, the statute may clearly be construed to admit such a number without violence to the statutory language. Additionally, a few commentators have recently attempted to dispel the judicial and popular misconception that a general partnership as a business organization is not adaptable to financial ventures "by large groups of unrelated individuals seeking merely an investment opportunity."[38]

Another trait of partnerships which is equally characteristic of the horse syndicate is the voluntariness of the association. Like a partnership, a syndicate is the result of a voluntary act whereby the syndicate investors contractually agree to associate themselves for the purpose of carrying on a business. Since it is frequently stated that the partnership status depends upon whether the parties intend to form a partnership, it could be said, at least arguendo, that a syndicate is not a partnership because the contracting parties lack the requisite intent. This thesis, however, becomes enfeebled under the critical dissection of the objective rather than subjective standard which the courts and commentators have long urged and applied. It is the substance of the relationship—not its label—which is decisive:

> [T]he question is not what the parties have called their relation, but whether by their agreements and actions they show an intent to create the legal relationship which the law recognizes as constituting a partnership.[39]

Under this objective standard, whether the syndicate members subjectively intended to become partners is of little significance. If all of the legal ingredients for a partnership obtain in the business association, it will be deemed a general partnership for legal purposes.

The presence or absence of co-ownership is, perhaps, the most vital factor in determining whether a particular association is a partner-

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[38] Long, *Partnership, Limited Partnership, and Joint Venture Interests as Securities*, 37 Mo. L. Rev. 581, 587 (1972).

[39] Ham, *Kentucky Adopts the Uniform Partnership Act*, 43 Ky. L.J. 5, 9 (1955). The courts in Kentucky have long used an objective test for determining the presence of a partnership. *See* Crawford v. Wiedemann, 166 S.W. 595, 597 (Ky. 1914).

ship.[40] Co-ownership or joint ownership as it applies to determining partnership status turns on the power of ultimate control over the enterprise. While the ability to exercise the degree of control normally associated with co-ownership may be sharply curtailed under the contractual terms of the syndicate agreement (a practice provided for in the UPA[41] and a practice which could create problems regarding securities regulation), a sense of co-ownership is at the heart of the horse syndicate. Perhaps the best evidence of this is the scheme typically provided by the syndicate agreement whereby profits and losses are shared on a pro rata basis by the shareholders. Although the UPA emphasizes the concept of co-ownership and control, the presence of profit sharing provides a strong implication that the association is a partnership. Profit sharing as a characteristic of a partnership should not be underestimated because "[i]n the eyes of the law, profit sharing is undoubtedly the most important single factor indicating that the parties intend to carry on the business as partners."[42] The Kentucky Court of Appeals, while recognizing that the sharing of profits is not an exclusive test for a partnership, has stated that it is "an important consideration as an item of evidence tending to prove" the existence of such a relationship.[43] Furthermore, the UPA provides that the "receipt by a person of a share of the profits of a business is prima facie evidence that he is a partner."[44]

The control factor as related to the requisite co-ownership element must be placed in proper perspective in discussing horse syndications as partnerships. The amount of control exercisable by a shareholder in a horse syndication is dictated by the syndicate agreement. As shall be developed more fully, much of the shareholder's ultimate control over the project is relinquished through his acceptance of the terms of the syndicate agreement. While this lack of control may cause problems in other areas of the law, this should not prevent the syndicate from falling within the definition of a general partnership. On the contrary, such a pratice is clearly permitted by Section 362.235 of the Kentucky Revised Statutes which, echoing section 18 of the UPA, provides that "[t]he rights and duties of the partners in relation to the partnership shall be determined, subject to any agreement between them. . . ."[45]

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[40] CRANE & BROMBERG, *supra* note 14, § 14.
[41] *Id. See also* KRS § 362.235.
[42] Ham, *supra* note 39, at 10.
[43] Boreing v. Wilson, 108 S.W. 914, 922 (Ky. 1908). *See also* KRS § 362.180 (3)-(4).
[44] UPA § 7 (4). KRS § 362.180 (3)-(4).
[45] KRS § 362.235.

The final common characteristic of both the partnership and the syndicate is the profit *motive*. Profit, in the sense of monetary enrichment through financial return or through breeding rights, pervades the horse syndication and needs little discussion.

The horse syndication thus contains all of the requisite elements of a general partnership and should be treated as such for legal purposes. It is a hybrid form of partnership, put together by a tightly drawn agreement in which much of the traditional partnership control is forfeited. Nevertheless, the attorney, in advising his client about the extent of his liability through his membership in a syndicate, should be cognizant that, ultimately, partnership law will be applicable to this business association.

IV. DISADVANTAGES OF SYNDICATE OWNERSHIP

While the attractiveness and flexibility of the syndicate form of ownership has its stated advantages, the attorney should be aware, both as drafter and counselor, of the risks and disadvantages peculiar to such an association. Many knowledgeable horsemen feel syndication has been a major influence in causing the soaring costs in the horse industry.[46] Additionally, in the thoroughbred industry, if the horse is syndicated before retirement from racing, there is no assurance, absent a syndicate provision, that the horse is fertile. However, even if he is fertile when syndicated, fertility does not guarantee that his offspring will be of value as a racing animal. Moreover, for the shareholder who joins for breeding rights only, at least a twenty percent chance exists that he will have a barren mare each breeding season.[47] In addition, many horsemen feel syndication, with its contemporaneous effect on advertising and interest, may reduce the value and worth of a less renowed horse which might have good breeding potential.[48] Aside from these relatively unimportant risks from a legal standpoint, there are two major problem areas—liquidity and lack of investor control—with which the attorney must be familiar.

A. *Liquidity*

Liquidity, a well-known problem in syndicate ownership,[49] surfaces when a syndicate shareholder wishes to sell his interest prematurely.

[46] Phelps, Sept. 12, at 9.
[47] Tower, *supra* note 5, at 38.
[48] Phelps, Sept. 12, at 9, 11.
[49] *See generally Problems in Selling Syndicate Shares,* THE BLOOD-HORSE WEEKLY, Nov. 21, 1970 at 4147-49 (Panel Discussion, Thoroughbred Club of America Meeting, Keeneland Race Course, Lexington, Ky., Nov. 12, 1970) [hereinafter cited as *Problems in Selling Stallion Shares*]. *See also* Robertson, *Put the Cards on the Table,* THE THOROUGHBRED RECORD, Nov. 28, 1970, at 1898.

The primary reason for the non-liquidity of syndicate shares is that there is no formal secondary market where the withdrawing member can sell; therefore, the syndicate investor who wants to dispose of his interest has to rely on his own resources to find an interested buyer. Occasionally, the syndicate manager or committee will assist in selling the share, a method preferred by many horsemen,[50] or the shareholder, unless prohibited by the syndication agreement, may put the share up at public auction.

A second factor affecting the liquidity of the syndicate share involves restrictions upon free alienability which may be imposed on the syndicate shareholder. Restraints on alienability are aimed at protecting the interests of the remaining shareholders, the personal relations of the syndicators and shareholders, and the pride of those shareholders who are still committed to the horse.[51] While the nature of the restraint varies with the specific terms of the syndicate agreement, the restrictive provisions often require that: (1) the transferee must be a member of a recognized or designated class; (2) the transferee must be approved by the syndicate manager, after notification is given of the intent to sell, the selling price, and the terms and conditions of the sale; or more frequently (3) the nonselling members reserve the right of first refusal.[52] Likewise, it is not uncommon for the agreement to prohibit the public auction of a share because of the unsatisfactory, unpredictable and often unrealistic bids that may result from the use of that sales method:

> Many of the bids offered at auction were so low as to be unrealistic, and some were downright insulting. While the syndicates could, and usually did, exercise their options of refusing such bids and retaining the shares, publication of the prices offered was an embarrassment to remaining syndicate members, to say nothing of the effect on outsiders who had bred to the stallion for a cash stud fee which often as not was higher than the auction "price" of a syndicate share.[53]

Similarly, some horsemen have even expressed dissatisfaction with sealed bid auctions.[54]

Problems in liquidity have a dual effect. Not only are they disconcerting to the seller, but also they may have an adverse effect upon the remaining syndicate members. Unless the syndicate decides to

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[50] Robertson, *supra* note 32, at 1898.
[51] *Problems in Selling Stallion Shares*, *supra* note 49.
[52] HUMPHRIES, *supra* note 7, at 24.
[53] Robertson, *supra* note 32, at 1898. *See generally Problems in Selling Stallion Syndicate Shares*, *supra* note 49.
[54] Kirkpatrick, *supra* note 26.

retain the share, a low selling price can adversely affect the value of all the shares. Concurrently, a low public sale price can raise the spectre of suspicion—with a resultant loss of business—in those who might have been considering a cash stud fee. Inevitably the dangers are accentuated in proportion to the number of shares offered for sale. Massive sales are indicative of massive problems. Methods of avoiding some of the problems related to public sales have been suggested, including the elimination of post auction options of first refusal and a clearing house for stallion shares;[55] however, little progress has been made to this date.

Liquidity involves considerations beyond the salability of the share. For credit purposes, the collateral value of an unincorporated syndicate share, the ordinary form of equine syndicates, is limited, with the loan to value ratio being disproportionately low.[56] While this should not usually be a factor with a person contemplating investment in an equine syndication, it makes the purchase of a syndicate share for a short term investment unwarranted.

B. *Lack of Control*

A second major drawback in the mechanics of syndicate operation concerns the lack of investor control. Repercussions from this characteristic of most equine syndications affect not only the unwary investor but also the attorney who might be involved in the actual syndication process. As shall be developed more fully, the lack of investor control is a prime consideration in the determination of whether the syndication of an animal involves a security and, therefore, requires the appropriate registration.

The degree of investor control, at least in part, derives from the legal form imposed upon or designated by the syndicate entity. For instance, assuming that a syndicate is treated as a general partnership,[57] the general partners, subject to the terms of the agreement, may examine the syndicate's books,[58] require full and true information on all matters affecting the syndicate,[59] obtain a full and formal account of syndicate affairs,[60] and share equally in the management and control of the enterprise.[61] Additionally, one partner (*i.e.* shareholder) may

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[55] *See generally* Berger, *supra* note 12.
[56] Robertson, *supra* note 32, at 1901.
[57] It is assumed the law applicable to partnerships would also apply to joint ventures. For the rights of limited partners, *see* KRS § 362.500.
[58] KRS § 362.240.
[59] KRS § 362.245.
[60] KRS § 362.255.
[61] KRS § 362.235(5).

hold all other partners accountable as fiduciaries.[62] Although all of these rights are statutorily granted, they are subject to the terms of the syndication agreement; therefore, many of them in reality may be illusory, having been forfeited by the investor as a condition precedent to his owning a syndicate share. Investor control, because of the nature of the enterprise, is usually severely limited, with the ultimate decision making or managerial functions regarding the horse being delegated to the syndicate manager or committee who act as agent for the investor. Typically, as Professor Berger has noted: "In this capacity [syndicate manager], the promoter needs consent only for stated major decisions."[63] In some instances, as will be seen, even major decisions may be within the scope of the decision-making power of the syndicate's management.

The range of decisions which the syndicate manager or committee may make regarding the syndicate's horse is virtually unfettered in many of the syndicate agreements. Many horsemen believe "the manager should be empowered to decide what's best for the horse, and thereby for the syndicate as a whole."[64] Some horsemen have even encouraged the adoption of a uniform syndicate agreement, provided one could be drawn which granted the manager the necessary free hand he requires in managing the affairs of the enterprise.[65] Decisions by the syndicate manager[66] or committee may extend from important areas requiring great expertise, such as the suitability of the horse for racing or breeding, the time to terminate the horse's racing career, and the establishment and collection of stud fees, to areas more mundane or business oriented, such as the selection of the colors the horse is to bear, the determination of a proper veterinarian to administer to the horse's medical needs, advertising regarding the horse, and even the location where the horse is to stand subsequent to his racing career.[67]

While the shareholders arguably retain the ultimate decision-making power through their voting rights on major decisions, many important decisions which are largely determinative of the success or failure of the enterprise are entrusted to the syndicate manager.

The unhappy investor may find that changes in the managerial

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[62] KRS § 362.250.

[63] Berger, *supra* note 12, at 744.

[64] Robertson, *supra* note 32, at 1901.

[65] *Id.*

[66] HUMPHRIES, *supra* note 6, at 23-24.

[67] If the syndicate manager is a syndicate member (as he often is) and the agreement vests in him virtually all control, he will probably be regarded as being in a fiduciary capacity to the other shareholders. *See* KRS § 362.250.

attitudes are difficult, if not virtually impossible, to effect. Not atypically, the position of syndicate manager (as well as membership on the syndicate committee) is for life. Changes may be brought about only by death or by a stipulated vote of the shareholders, such as a majority or two-thirds of the voting shares. Couple the duration of the appointments, the voting requirements and the lack of a market for a share, and it becomes apparent that the disenchanted investor, because of his lack of control, may be without a suitable remedy.

V. SYNDICATE SHARES: SECURITIES OR NOT?

Lurking beneath virtually every aspect of horse syndications thus far discussed in this note and closely related to some of the earmarks of such enterprises is the intricate and troublesome question of whether selling shares in a horse syndication involves the sale of a security under the Securities Act of 1933. Concurrently, the related question follows: if such a transaction does involve the sale of a security, must it be registered with the appropriate federal and/or state agencies? The significance of this inquiry is seen in the rather severe civil penalty for failure to register a security with the Securities and Exchange Commission. The statute provides that one who offers or sells a security in violation of the registration requirements is liable to the purchaser for either "the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if [the purchaser] no longer owns the security."[68]

The growing inclination of both the Securities and Exchange Commission and the nation's courts to expand the concept of a security, coupled with the tendency of the courts to provide buyers a wider choice of statutory remedies, has substantially magnified the impact of securities law on the business community.[69] While no horse syndication accomplished in Kentucky (or in other states as for as can be determined) has ever been registered as a security with either the appropriate state or federal agencies and while the question has not yet been raised in litigation, the knowledgeable attorney, as advisor or drafter of a syndication agreement, should be cognizant that this is potentially a highly flammable area and that, as noted previously, a

[68] 15 U.S.C. § 77*l*(1) (1970).

[69] Pasquesi, *The Expanding "Securities" Concept*, 49 ILL. B.J. 728 (1961) [hereinafter cited as Pasquesi]. *See also* Globus v. Law Research Service, Inc., 287 F. Supp. 188 (S.D.N.Y. 1968); Escott v. Barchris Construction Corp., 283 F. Supp. 643 (S.D.N.Y 1968)

failure to comply with registration requirements, should it be concluded that a security is involved, has rather severe results.[70]

Since state securities regulations vary greatly[71] and since the satisfaction of federal registration requirements can be coordinated to satisfy Kentucky's registration requirements,[72] the major focus of the possible security aspects of horse syndication will be in regard to the federal securities regulation. Federal regulation of newly issued securities received its major impetus from the enactment of the Securities Act of 1933[73] [hereinafter Act]. Centered around a philosophy of full disclosure,[74] the Act's main goal is to protect the public before invest-

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[70] On the federal level, violations of the Securities Act of 1933 expose the issuer to both civil and criminal sanctions:

Civil: The Securities Act of 1933 creates a cause of action in the security purchaser for recovery of the consideration paid less income, or for damages, against *any* person offering or selling securities in violation of 15 U.S.C. § 77e (1970), or by means of a misleading prospectus or oral communication if the mails or instruments of transportation or communication in interstate commerce are used. 15 U.S.C. § 77*l* (1970).

Criminal: The Act makes unlawful the use of "any means or instruments of transportation or communication in interstate commerce or of the mails" for the offering or sale of securities unless the registration statement, when required, is in effect for such security. 15 U.S.C. § 77e (1970). Moreover, the Act forbids *any* person from misrepresenting that an SEC registration is equivalent to SEC approval. 15 U.S.C. § 77w (1970). The maximum penalties for a criminal violation of the Act are $5,000 fine or 5 years imprisonment, or both. 15 U.S.C. § 77x (1970).

On the state level, Kentucky's Blue Sky Laws offer similar civil and criminal penalties.

Civil: KRS § 292.480 provides that any person who offers or sells or who "directly or indirectly controls or "materially aids" in the offer or sale of an unregistered, but not exempt, security or who sells a registered security by means of an untrue statement of a material fact or by omitting a material fact is

> liable to the person buying the security from him, who may sue either at law or in equity to recover the consideration paid for the security, together with interest at six percent (6%) per annum from the date of payment, costs, and reasonable attorney's fees, less the amount of any income received on the security, upon the tender of the security, or for damages if he no longer owns the security.

Criminal: KRS § 292.991 provides that any person who wilfully violates any provision of Chapter 292 (Securities), except KRS § 292.440 (regarding misleading statements), shall be fined not more than five thousand dollars ($5,000) or imprisoned not more than three (3) years, or both.

[71] Surprisingly, only Delaware, king of corporation legislation, has no securities act.

[72] KRS § 292.360.

[73] 15 U.S.C. § 77a-aa (1970).

[74] *See* the President's Message, March 29, 1933, contained in H.R. REP. No. 85, 73d Cong., 1st Sess. 1 (1933) wherein the President stated:

> . . . of course, the Federal Government cannot and should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that the value will be maintained or that properties which they represent will earn profit.
>
> There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.

ment funds are committed by providing registration machinery, which in turn furnishes a potential investor with the needed information to make a wise investment decision.[75] Similarly, by providing an investigatory service, the Act attempts to ferret out violators who fail to register, make untrue statements or deliberately omit material facts.

A. *Definitional Problems*

The availability to the syndicate investor of the Act's protection hinges preliminarily upon the definition of a security. If the participatory unit in a horse syndication (usually called a share) constitutes a security within the purview of the Act, the protection and appropriate remedies of the Act are available to the investor; however, if the unit does not constitute a security as defined by the Act, the protective devices, of course, do not apply. The Act defines a security as:

> . . . any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferrable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, 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 warranty or right to subscribe to or purchase, any of the foregoing.[76]

While there is some controversy regarding whether this definition, since it makes no direct reference to syndicates, will reach syndicate ownership, at least one writer believes that it will, especially in view of the recent expansions of the security concept. Professor Berger, in discussing security problems in his article on real estate syndicates, clearly indicates his belief that syndicate ownership could come within the purview of the Act's definition of a security:

> Because no explicit reference is made either to 'syndicate' or to the usual forms in which syndicate interests are marketed, some syndicate promoters have been willing to infer that they are beyond the pale of the act. It is doubtful, however, whether their inference will withstand the combined weight of legislative intent, judicial construction, and current SEC sentiment.[77]

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[75] A.C. Frost v. Coeur d'Alene Mines Corp., 312 U.S. 38, 40 (1941).

[76] 15 U.S.C. § 77b(1) (1970).

[77] Berger, *supra* note 12, at 761 (footnotes omitted). For discussions which indicate other unmentioned forms of financial arrangements which might also involve securities, *see* Long, *Partnership, Limited Partnership, and Joint Venture Interests as Securities,* 37 Mo. L. REV. 581, 587 (1972); Comment, *Franchise Sales: Are They Sales of Securities?*, 34 ALBANY L. REV. 383 (1970).

The mere fact that this broad definition makes no mention of syndicate participation nor takes into account the peculiar marketing technique of horse syndication should not lull one into the instinctive conclusion that a syndicate share is not a security.

Admittedly, equine and real estate syndications can be distinguished; however, when analyzed from a transactional viewpoint as a financial investment, the distinctions between the two falter. The salient consideration financially is that syndicate ownership, be it of real estate or horse flesh, involves the pooling of resources of a group of investors to acquire an agreed-upon asset. As a financial transaction involving a cash flow, to draw distinctions between real estate and equine investments is to distinguish without logical differences.

That ownership of syndicate shares in horses as well as other forms of property is a fairly modern and unique concept could explain why the Act makes no reference to syndicates; however, the modernness of the ownership form, like the absence of reference to it in the Act, provides no assurance that such an offering is not a security.[78] Congressional intent regarding what is a security abundantly indicates that the Act was intended to include not only the known forms of public security offerings but also any innovative and unknown forms:

> [T]he term security . . . [is defined] in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security.[79]

In keeping with this spirit, courts and the SEC as well, while unwilling to bring all transactions under the Act, have long indicated a willingness to read the definition flexibly enough to include many new forms of enterprise offerings.[80]

B. *Judicial Treatment*

1. *Sole Efforts Test*

The judiciary has often been in the vanguard in giving generous content to the definition of a security by the evaluation of novel investment devices. In *SEC v. C.M. Joiner Leasing Corp.*,[81] the Supreme

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[78] *See* Kroll, *The Why and How of Real Estate Syndications: Regulation Aspects*, 5 PRAC. LAW., 70 (Mar. 1959). For a discussion of theatrical producers choosing to register sales of limited partnership interests with the Securities and Exchange Commission rather than risk liability for securities violations, *see* Berger, *supra* note 12, 761 n.152.

[79] H.R. REP. No. 85, 73d Cong., 1st Sess. 11 (1933).

[80] *See, e.g.*, SEC v. Starmont, 31 F. Supp. 264, 267 (E.D. Wash. 1940), where the court stated that the Securities Act of 1933, a "remedial enactment," was "to be liberally construed so that its purpose may be realized."

[81] 830 U.S. 344 (1943).

Court opened the door to a liberal construction policy in defining "security":

> [T]he reach of the [Securities] Act does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices . . . are also reached if it be proved as a matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as "investment contracts," or "as any interest or instrument commonly known as a "security."[82]

With the vistas open in *Joiner*, the Court has retained a continual and vigilant policy of looking at substance rather than form,[83] a policy which leaves room within an expanding security concept for syndicate ownership. In *SEC v. W. J. Howey Co.*,[84] in emphasizing the economic realities rather than the form of transactions, the Court provided further impetus toward bringing most pure investment arrangements under the auspices of the Act. While not the penultimate of the Court's ambition to offer investors protection, it did present new guidelines for determining what kinds of investment transactions involved securities. Mr. Justice Murphy, speaking for the Court in *Howey*, gave substance to the theretofore nebulous term "investment contract" as a "security":

> [A]n investment contract for 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 the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise.[85]

Noting that the investors involved were predominantly professional and business men, as investors in horse syndications might be, the Court stressed that where investors depend primarily upon others for their profits they need the protection of the Act in spite of their knowledge, because they possess little actual control over or participation in the enterprise. Knowledge without control over the destiny of the investment enterprise renders the businessman powerless to protect his interest. Moreover, the Court took special pains to again

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[82] *Id.* at 351.

[83] *See* Tcherepnin v. Knight, 389 U.S. 332, 336 (1967), where the Court said that "form should be disregarded for substance and the emphasis should be on economic reality." This remedial approach has been consistently applied by the Supreme Court. *See also* SEC v. Capital Gains Research Bureau, 375 U.S. 180 (1963); SEC v. W. J. Howey Co., 328 U.S. 293 (1946).

[84] 328 U.S. 293 (1946).

[85] *Id.* at 298-99.

emphasize that the Act was remedial and easily adaptable to new investment schemes:

> It embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.[86]

The "investment contract" test has had far-reaching and definitive effects upon the determination of what transactions are to be construed as securities, as state and federal courts have consistently applied its rationale to transactions and writers have subjected its theory to academic analysis.[87] Whether or not a share in a horse syndicate is an investment contract and, consequently, a security, has never been litigated; nevertheless, it does not take a judicial opinion to point out that a share in a horse syndicate has many of the characteristics of such a transaction. Essentially, the Court in *Howey* enunciated a four-point test for determining the existence of an investment contract: first, the investors must provide money[88] and share the risk of loss; second, there must be an expectation of profits;[89] third, a common enterprise must be involved;[90] and finally, the profits must be expected to come solely from the efforts of others. Clearly, one who invests in a horse syndication provides capital and participates, in proportion to his interest, in the profits and losses of the enterprise. Similarly, while it can be argued that motives other than profit lead one to invest in a horse syndication, the profit motive, in the sense of breeding rights or monetary return, is at the heart of horse syndication. Expectation of profit solely from the efforts of others, therefore, is the key to whether such an enterprise is a security within the meaning of the Act.

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[86] *Id.* at 299.

[87] For a collection of "investment contract" decisions, *see* 1 L. Loss, SECURITIES REGULATIONS 488-89 (2d ed. 1961).

[88] Money here means value or money's worth. *See, e.g.*, Roe v. United States, 287 F.2d 435, 439 (5th Cir.), *cert. denied* 368 U.S. 824 (1961); Silver Hills Country Club v. Sobieski, 361 P.2d 906, 908-09, 13 Cal. Rptr. 186, 188-89 (1961); State v. Hawaii Mkt. Centers, Inc., 485 P.2d 105, 110 (Hawaii 1971).

[89] *See, e.g.*, Commonwealth *ex rel.* Pa. Sec. Comm'n, 199 A.2d 428 (Pa. 1964), wherein the court determined that the word "profit" should be taken literally. Therefore a contract providing for the payment of money regardless of the overall profitability of the enterprise could not be an investment contract. However, since the "profit" that the definition refers to is the investor's rather than that of the enterprise, the definition might more properly embrace the expectation of "benefit" rather than "profit." *See* Silver Hills Country Club v. Sobieski, 361 P.2d 906, 13 Cal. Rptr. 186 (1961). The Supreme Court has recognized that market price appreciation in value—not profits in the commercial sense—is sufficient to satisfy the profits test for an investment contract. *See* SEC v. United Benefit Ins. Co., 387 U.S. 202 (1967); SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65 (1959).

[90] *See* Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135, 162 (1971).

Hence, control and participation by the shareholder in the enterprise becomes crucial. In this regard it is important to keep in mind that one of the fundamental characteristics of horse syndicates is the lack of investor control and the accompanying domination of the enterprise by the syndicate manager.

Had the *Howey* definition as originally stated been left unaltered, one would be relatively comfortable in thinking that a share in a horse syndicate is not an investment contract, because such an investment did not rely *solely* on the efforts of others for its profits; however, such has not been the case. In *Howey,* the Court, while providing a definition for an investment contract, emphasized that the decision as to whether any transaction was a security ultimately depended on the "economic realities" of the transactions. Although still somewhat viable, the "sole efforts" requirement has gradually eroded under increasing attacks.[91] As early as 1958, the SEC implied that in spite of the Court's "sole efforts" language something less might suffice to bring an enterprise's offerings within the ambit of the Act:

> The wider the range of services offered and the more the investor must rely on the promoter or third party, the clearer it becomes that there is an investment contract.[92]

2. *Risk-Capital Test*

Simultaneous with the gradual demise of the sole efforts test has been the developing prominence of the *risk-capital* criterion for providing form to the heretofore amorphous "economic realities" language. Fundamentally, the risk-capital test involves discerning whether there is a "relationship between the success of the enterprise and the preservation or deterioration of the value which the buyer originally furnished."[93] If the fate of the purchaser's initial investment is inextricably tied to the success of the venture and if the investor is unfamiliar with and/or has little control over the enterprise, the investor's interest is a security.[94] Not stressed as much as the traditional

[91] Much of the erosion and dissatisfaction regarding the "sole efforts" requirement can be attributed to Coffey, *The Economic Realities of "Security"; Is There a More Meaningful Formula?* 18 WEST. RES. L. REV. 367 (1967) [hereinafter cited as Coffee].

See State v. Hawaii Mkt. Centers Inc., 485 P.2d 105 (Hawaii 1971). In that case, the Hawaii supreme court rejected the "sole efforts" test as being to mechanical and focused instead upon the economic realities of the situation. *See also* Silver Hills Country Club v. Sobieski, 361 P.2d 906, 13 Cal. Rptr. 186 (1961); State v. Silberberg, 139 N.E.2d 342, 344 (Ohio 1956). *See* Note, *Expanding the Definition of "Security": Silver Hills Country Club v. Sobieski,* 14 HAST. L.J. 181, 182 (1962).

[92] *See* SEC Securities Act Release No. 33-3892, 23 Fed. Reg. 840 (1958).

[93] Coffey, *supra* note 91, at 367.

[94] *Id.* at 396-97.

sole efforts test, the risk of loss notion is enjoying an increasing following both by the judiciary and the commentators.[95] As noted in *State ex rel. Commissioner v. Hawaii Market Center, Inc.*,[96] the risk-capital approach avoids the pitfalls of perfunctory application of the sole efforts test and is more in line with the Supreme Court's economic realities admonition:

> The primary weakness of the *Howey* formula is that it has led courts to analyse investment projects mechanically, based on a narrow concept of investor participation. . . . Thus courts become entrapped in polemics over the meaning of the word "solely" and fail to consider the more fundamental question whether the statutory policy of affording broad protection to investors should be applied even to those situations where an investor is not inactive, but participates to a limited degree in the operation of the business. . . . [W]e believe a sounder approach to securities regulation requires that courts focus their attention on the economic realities of securities transactions: that is, "[t]he placing of capital or laying out of money in a way intended to secure income or profits from its employment" in an enterprise.[97]

Therefore, under this approach it is the subjection of an investor's initial investment to the risks of an enterprise over which he exercises little or no managerial control which is the decisive factor.

C. *Investor Control*

Under the traditional sole efforts test and the risk-capital approach the common denominator is the amount of control or participation the investor enjoys in the enterprise. The key question thus becomes: Precisely what amount of participation removes one from the spectre of securities regulation? Any answer, of course, is largely speculative. In those courts applying only the sole efforts test, it was thought that participation even of a miniscule degree was enough;[98] however, such

[95] *See, e.g.*, Silver Hills Country Club v. Sobieski, 361 P.2d 906, 13 Cal. Rptr 186 (1961); State v. Hawaii Mkt. Centers, Inc., 485 P.2d 105 (Hawaii 1971); State v. Silberberg, 139 N.E.2d 342 (Ohio 1956). The SEC has announced its approval of such a view. *See* SEC Securities Act Release No. 33-5211, 36 Fed. Reg. 23289 (1971).

[96] 485 P.2d 105 (Hawaii 1971).

[97] *Id.* at 108-09, *citing* State v. Gopher Tire & Rubber Co., 177 N.W. 937, 938 (Minn. 1920) (footnotes omitted).

[98] *See* Gallion v. Alabama Mkt. Centers, Inc., 213 So. 2d 841 (Ala. 1968 Georgia Mkt. Centers, Inc. v. Fortson, 171 S.E.2d 620 (Ga. 1969); Emery v. So-Sort, Inc., 199 N.E.2d 120 (Ohio 1964); Bruner v. State, 463 S.W.2d 205 (Tex. Crim. App. 1970); Koscot Interplanetary, Inc. v. King, 452 S.W.2d 531 (Tex. Civ. App. 1970). These courts determined that investors participation in the enterprise in *any* manner was sufficient to remove the investor's interest from the purview of the *Howey* definition and, therefore, from the scope of a "security".

a view, in light of the purpose of the Act, seems in error[99] and has been short lived.[100] While the courts have not been altogether lucid in this area, it appears that functional control or participation, that is, having powers which actually effect the success or failure of the enterprise, as opposed to titular or illusory control of the enterprise, is now being required.[101]

Under a functional approach, if the investor is an active participant, having managerial responsibilities and sufficient control to affect the success of the enterprise, the arrangement probably will not be a security.[102] Conversely, if the investor is inactive, merely investing in an enterprise while leaving control and management to other investors or to a paid professional manager, his investment is a security and must be registered unless otherwise exempted.[103] Questions regarding what is and is not a security, however, cannot be adequately answered in a vacuum. Facts and circumstances are determinative; therefore, a look at the developing case law is necessary in attempting to discern the dividing line between the active and the inactive investor.

It is clear that where one is participating in an enterprise from the onset, providing developmental ideas and initial services which make the enterprise possible, the arrangement is not a security. In *Romney*

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[99] *See* Comment, *Securities—Founder Purchase Contracts—"Contract" Defined*, 21 MERCER L. REV. 715 (1970), for a discussion of Georgia Mkt. Centers, Inc. v. Fortson, 171 S.E.2d 620 (Ga. 1969).

[100] No cases have been found which have followed the literal application of the "sole efforts" test which allows *any* efforts, regardless of how miniscule, to suffice and take the arrangement from under the definition of a "security" since 1970. The SEC has also denounced the view that minimal participation will take a transaction outside the scope of a security. *See* SEC Securities Act Release No. 33-5211, 36 Fed. Reg. 23289-90 (1971), in which the SEC explained:

> [T]he assignment of nominal or limited responsibilities to the participant does not negate the existence of an investment contract; where the duties assigned are so narrowly circumscribed as to involve little real choice of action or where the duties assigned would in any event have little direct effect upon receipt by the participant of the benefits promised by the promoters, a security may be found to exist.

[101] The difficulties which a "controlling efforts" test has experienced in supplanting the "sole efforts" test are due in part to judicial reluctance to apply it to franchise situations. *See* Chapman v. Rudd Paint & Varnish Co., 409 F.2d 635 (9th Cir. 1969); Mr. Steak, Inc. v. River City Steak, Inc., 324 F. Supp. 640 (D. Colo. 1970), *aff'd*, 460 F.2d 666 (10th Cir. 1972).

[102] *See, e.g.*, Continental Marketing Corp. v. SEC, 387 F.2d 466 (10th Cir. 1967); Romney v. Richard Prows, Inc., 289 F. Supp. 313 (D. Utah 1968); People v. Syde, 235 P.2d 601 (Cal. 1951); Polikoff v. Levy, 204 N.E.2d 807 (Ill. 1965); Sire Plan Portfolios v. Carpentier, 132 N.E.2d 78 (Ill. 1956).

[103] *See, e.g.*, United States v. Herr, 338 F.2d 607 (7th Cir. 1964); SEC v. Orange Grove Tracts, 210 F. Supp. 81 (D. Mass. 1962); Curtis v. Johnson, 234 N.E.2d 566 (Ill. Ct. App. 1968); Conroy v. Schultz, 194 A.2d 20 (N.J. Super. Ct. 1963).

v. Richard Prows, Inc.,[104] an attorney who had performed professional services in the acquisition and zoning of certain land and had acted as a professional consultant in the planning stages of the resulting housing enterprise, claimed that it involved the sale of an unregistered security. The court quickly found that it was without jurisdiction to hear the case, because the project involved a joint venture and not a security because the profits were "substantially dependant upon the efforts of the investors."[105] Notably here the investor was a sophisticated person who was a participant in the development of the project from the onset; his own ideas and efforts were part of the project. However, in the syndication agreement, the developmental aspect of the project is completed prior to the syndicate share being marketed. Typically, in a syndicate arrangement the promoter (who may be the original owner, the syndicate manager, or both) and the drafter of the syndicate agreement offer a pre-developed plan in which the investor purchases shares on a take it or leave it basis.[106] At the onset, the syndicate investor provides no service or participation beyond the investment of his money.[107] All arrangements for the purchase, care and control of the investment property are prearranged by the syndicate promoter; therefore, the initial participation in an investment enterprise which provides some investor control is absent in the syndicate arrangement.

Requiring the investor to provide continuing services in the enterprise also comprises a sufficient degree of participation and control to remove the scheme from the shadow of the Act. For instance, in *Lino v. City Investing Co.*,[108] plaintiff had purchased a license which granted him the right to operate a franchise sales center. The court, while acknowledging that it required more than minor or ministerial efforts by the investor to prevent the enterprise from involving a security, found that the plaintiff had to make significant efforts toward the success of the enterprise:

> He has to open a sales center, staff it, and devote full time and best efforts to his business. He must recruit area distributors. . . . The agreements demonstrate that his efforts are not nominal or insignificant.[109]

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[104] 289 F. Supp. 313 (D. Utah 1968).

[105] *Id.* at 314.

[106] Kirkpatrick Interview, *supra* note 26.

[107] *Id.*

[108] Nos. 72-1672/72-1673 (3d Cir., Aug. 20, 1973), reported in [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,124. *See also* Schuler, Jr. v. Better Equip. Launder Center, Inc., Civ. Act. 72-3823-F (D. Mass., July 16, 1973), reported in [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,074; Polikoff v. Levy, 204 N.E.2d 807 (Ill. Ct. App. 1965).

[109] Nos. 72-1672/72-1673 (3d Cir., Aug. 20, 1973), reported in [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,124.

Similarly, in *Schuler v. Better Equipment Launder Center, Inc.*,[110] a cleaning franchise was deemed not a security because the investor/franchisee "was to exercise a great deal of control over the day to day operations of the cleaning establishment."[111] While a horse syndication is clearly distinguishable from either of these arrangements, the conspicuous element the court points to as removing the transaction from the circumscription of a security is the continual investor participation in the management of and the exertion of control over the actual investment property. As Professor Coffey has noted, where the buyer is familiar with the enterprise and "actively participates in its affairs," the transaction should be excluded from the security category.[112]

Control over the investment property in a racing syndicate is wholly vested in the syndicate manager. As earlier noted, he makes virtually all decisions regarding the animal and the enterprise, from training techniques to the races to be entered. Therefore, exertion of control over the investment property in a racing syndicate by the investor is glaringly absent. While not so prominent or complete as the power vested in the manager of a racing syndicate, control over the investment property of a breeding syndicate, especially if the syndicate manager retains the power to veto the broodmare selected for breeding by the syndicate shareholder (or the party to whom he has sold an available season), rests almost solely in the syndicate manager. The investor, except during the short breeding seasons, may have little or no actual contact with the enterprise; the fate of the enterprise property rests completely with the syndicate manager. Even during the breeding season the syndicate shareholder may rely to a large extent upon the expert knowledge of a syndicate manager to determine whether to exercise his breeding rights or to sell them.[113] Consequently, where the syndicate manager retains the extensive authority to determine the suitability of a horse for breeding, to reject mares he deems unfit, and to establish and collect stud fees from seasons sold or saleable, it is at least questionable whether the periodic sending of mares for service by the shareholder will satisfy the degree or quality of control and participation which the courts now demand.

Some clarification of how much control can be vested in a manager charged with the maintenance and breeding of animals may be found in *Continental Marketing Corp. v. SEC*,[114] a case in which promoters

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[110] Civ. Act. 72-3823-F (D. Mass., July 16, 1973), reported in [1973 Transfer Binder] CCH FED. L. REP. ¶ 94,074.

[111] *Id.* at 94,324.

[112] Coffey, *supra* note 91, at 396.

[113] Kirkpatrick Interview, *supra* note 26.

[114] 387 F.2d 466 (10th Cir. 1967)

sold live breeding beavers to the public while simultaneously encouraging the purchasers to leave the animals at ranches where the beavers were already located and could be cared for by expert managers. Investors needed only to purchase the animals, pay the maintenance fees and reap the profits from the breeding of the beavers which was to be controlled by the managers, functions not unlike those provided by the syndicate manager. In finding "the nature of the investor's participation in the enterprise" to be critical, the court, applying a risk-capital test, concluded that the success of the enterprise was "inescapably tied to the efforts" of the expert managers, not the investors. Moreover, the court held that where the investor's role was primarily "one of providing capital with the hopes of a favorable return then it begins to take on the appearance of an investment contract" and requires registration.[115] It is conceded that selection of a broodmare by an investor goes beyond the participation of the investors in *Continental Marketing;* however, this is tenuous ground on which to base sufficient investor participation to withdraw the arrangement from the realm of securities regulation. Furthermore, this basis becomes even more insubstantial where the syndicate manager retains the power of rejection, for this renders the power of selection potentially nugatory or illusory.

Though most of the highly publicized horse syndications have been breeding syndicates, ostensibly involving persons whose primary purpose in purchasing shares has been to obtain breeding rights for their own animals, it is quite possible that an investor could purchase a syndicate share not to use the breeding rights for his own stock but to sell the breeding rights to interested purchasers each season. In such a situation the investor does not maintain even the thread of control associated with the selection process. Moreover the absence of control in this situation becomes even more vivid if, as is often present in the syndicate agreement, the syndicate manager is charged with aiding the investor in locating a buyer for his open season, establishing the stud fee, and collecting it.[116] In such a situation the investor maintains little more control than an investor in a racing syndicate, where every aspect of the investment property is controlled by the syndicate manager, and even if doubt persists as to whether other syndicates involve securities, wisdom dictates registration of this type of syndicate as a security offering.

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[115] *Id.* at 470.

[116] Phelps, Sept. 12, at 11. As noted previously, these are often duties which the syndicate manager assumes.

Neither mere retention of voting rights nor the reservation of an actual ownership interest in the investment enterprise is sufficient control or participation to ensure that the syndicate arrangement is out of the pale of securities regulations. In *Sire Plan Portfolios, Inc. v. Carpentier*,[117] the court found a real estate management arrangement in which the purchasers retained ownership rights and voting rights sufficient to term the management scheme a security. The corporation was to manage the property, pay the expenses and distribute the profits. Although cognizant that the investors' rights were sufficient to terminate the management contract, the court found the investors' control "illusory" and "not real" because the success of the enterprise depended on the professional management and because the investors were "without real control of the enterprise."[118] Similarly, in *1050 Tenants Corp. v. Jakobson*,[119] a real estate venture in which share ownership entitled one to proprietary leases subject to a management contract contrived by the sponsor, the court found the enterprise to be a security. Notably, the court emphasized the sponsors' pre-sale control of the destiny of the enterprise, a characteristic not uncommon in an equine syndicate agreement. In finding the investment arrangement to be a security, the court stressed that where a sponsor has control over the initial financial arrangements, establishes guidelines which control the destiny of the enterprise, is a part of the management plan, and makes several unalterable decisions for the enterprise preliminary to the selling of shares, the enterprise constitutes a security and must be registered.

Likewise, the fact that the syndicate is essentially a hybrid partnership form will not prevent the arrangement from being a security. Although equal control or right to control is characteristic of the partnership-type of association, partnership laws have made this right subject to the terms of the partnership agreement; therefore, as noted earlier, it can clearly be reduced by contract to a severely limited power.[120] Professor Long has argued wisely that where, as a condition precedent to one's entry into the partnership, the terms of the contract render the investor's control illusory, the transaction should be within the purview of the Act.[121] This restrictive agreement makes the partner more like a passive investor than an active investor:

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[117] 132 N.E.2d 78 (Ill. Ct. App. 1956).
[118] *Id.* at 80-81.
[119] 365 F. Supp. 1171 (S.D.N.Y. 1973).
[120] *See* KRS § 362.235.
[121] Long, *Partnership, Limited Partnership and Joint Venture Interests as Securities*, 37 MO. L. REV. 581 (1972).

> Where the limited partners have contracted away their voice in the selection and admission of other limited partners, it is irrelevant whether the limited partners know the identity of those to be admitted. In this regard, the limited partnership is like a corporation. In neither case does the investor have any control over the acceptance of the other individuals into the organization. . . . Actually, [the investor] is no longer a partner with the resultant common law partnership duties [and rights]; rather, he is a passive investor seeking a return on his capital through the operation of the enterprise by others.[122]

As mentioned previously, the syndicate investor typically agrees to the control of the investment property being vested in the syndicate manager as a condition precedent to his being able to purchase the syndicate share. Whether this reduces the syndicate shareholder's voice in the control of the enterprise disproportionately to his investment is clearly a close question of which all parties in the syndicate should be aware.

While there is no litmus test for resolving the control question, some additional guidance in this area appeared recently in the language of the court in *SEC v. Glenn W. Turner Enterprises, Inc.*,[123] a case involving a pyramiding scheme in which the buyer of a motivation course "earned" his profit from the enterprise by recruiting other purchasers. There the court warned:

> The most essential consistency in the cases which have considered the meaning of 'investment contract' is the emphasis on whether or not the investor has substantial power to affect the success of the enterprise. When his success requires professional or managerial skill on his part, and he has authority corresponding with his responsibility, his investment is not a security within the meaning of the securities acts. When he is relatively uninformed and unskilled and then turns over his money to others, essentially depending upon their representations and their honesty and skill in managing it, the transaction is an investment contract.[124]

Paramount in this view is not the position the investor holds in the enterprise, but rather the functional control the investor exerts in the enterprise. No longer is the court willing to accept a mere modicum of participation by the investor. In an opinion affirming the district court in *SEC v. Glenn W. Turner Enterprises, Inc.*,[125] the Court of Appeals for the Ninth Circuit acknowledged that the investors, a group with mixed sophistication, had to exert some effort in the enterprise; however, the

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[122] *Id.* at 591 (footnote omitted).
[123] 348 F. Supp. 766 (D. Ore. 1972), *aff'd*, 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).
[124] 348 F. Supp. at 775.
[125] 474 F.2d 476 (9th Cir. 1973).

court found their activities to be functionally deficient because they were not "the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."[126] Perhaps warning those involved in financial arrangements in which less than a share of the functional control of an enterprise is held by an investor, the court went on to note that:

> It would be easy to evade [the sole efforts test] by adding a requirement that the buyer contribute a modicum of effort. Thus the fact that the investors here were required to exert some efforts if a return were to be achieved should not automatically preclude a finding that the Plan or Adventure is an investment contract. To do so would not serve the purpose of the legislation [Securities Act of 1933].[127]

Similarly, in *State v. Hawaii Market Center, Inc.*,[128] a case involving the inflated purchase of a sewing machine or a cookware set as part of a founder-member contract with a right thereafter to earn income on later sales by the enterprise made possible by the revenue raised on the initial inflated sales, the court found the enterprise to be in violation of the state's security regulations, stating that "[i]n order to negate the finding of a security the offeree should have practical and actual control over the managerial decisions of the enterprise."[129]

Little doubt exists that the initial requirements for a security (an investment of money in a common enterprise with an expectation of profit) inheres in the horse syndicate arrangement. Whether, in light of the judicial scrutiny being applied to the "economic realities" of investment schemes, there is sufficient control and participation by the syndicate shareholder to "affect the success or failure of the enterprise" is a more opaque question. Arguably, there is more than a

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[126] *Id.* at 482.

[127] *Id.*

[128] 485 P.2d 105 (Hawaii 1971).

[129] *Id.* at 111. It should be noted that the definition of an investment contract offered in this case has been recognized by the SEC as "equally applicable under the federal securities law" and consistent with the remedial views of the Act as applied by the Supreme Court. *See* Securities Act Release No. 33-5211, 36 Fed. Reg. 23289 (1971). The definition is clearly in line with the risk-capital approach. An investment contract exists when:

> (1) An offeree furnishes initial value to an offeror, and
> (2) a portion of this initial value is subjected to the risks of the enterprise, and
> (3) the furnishing of the initial value is induced by the offeror's promises or representations which give rise to a reasonable understanding that a valuable benefit of some kind, over and above the initial value, will accrue to the offeree as a result of the operation of the enterprise, and
> (4) the offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise.

36 Fed. Reg. at 23291, *citing* State v. Hawaii Mkt. Center, Inc., 485 P.2d 105, 109 (Hawaii 1971).

modicum of participation by a syndicate shareholder because of his retained breeding and voting rights. Equally, it might be ventured that where *all* of the syndicate investors or offerees are sophisticated and knowledgeable about the investment property, there should be an inverse correlation to the amount of participation required to exclude the transaction from the security classification. Thus, if all the offerees and purchasers are sophisticated (though it is probably a shortsighted view of the potential and possibly the realities of horse syndications to presume that only wealthy, sophisticated investors are involved), perhaps a lesser degree of control should exclude the syndicate from coverage under the Act due to the abilities of the investors to protect themselves. Counterbalanced against these arguments remains the great authority normally vested in the syndicate manager by the terms of the syndicate agreement and the exigencies of syndicate ownership which have shareholders residing in different states and countries and rarely, if ever, contacting the other syndicate members regarding the destiny of the enterprise. Where so much is at stake, the risks so great and the balance so precarious, it would behoove one to look carefully at the terms of the syndicate agreement before sloughing off all thought of possible securities problems.

VI. EXEMPTION POSSIBILITIES

Not every transaction involving the sale of a security falls within the purview of the Act. Assuming that the sale of a horse syndicate share under conditions in which the purchaser forfeits his control or is severely restricted constitutes an investment contract and, therefore, a "security", it is not automatically necessary that it comply with the compulsory regulation requirements. In an effort to reduce the workload of the SEC, Congress specifically exempted from registration certain securities which involved minimal risks to the prospective investor or which could be adequately policed on the state or local level.[130] Some types of securities are specifically exempted from the broad provisions of the Act (except for the provisions relating to fraud), whereas in other situations it is the transaction and not the security itself which is exempt from registration. For instance, small offerings are exempt.[131]

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[130] Jacobson, *Exemptions in Securities Act Registration*, 33 FLA. B.J. 69 (1959) [hereinafter cited as Jacobson].

[131] 15 U.S.C. § 77c(b) (1970) provides:

> The Commission may from time to time by its rules and regulations . . . add any class of securities to the securities exempted as provided by this section, if . . . enforcement . . . is not necessary in the public interest and for the protection of investors . . . ; but no issue of securities shall

(Continued on next page)

Two frequently utilized exemptions which make registration in any form unnecessary and which seem potentially more acclimated to horse syndications than any other exemptions are the intrastate exemption[132] and the private offering exemption.[133] While these exemptions are clearly statutorily provided, before one relies too heavily upon them he should be aware that their usefulness is restricted to narrow factual circumstances and that reliance upon such an exemption requires care and foresight in planning. Moreover, the availability of these exemptions is so curtailed that they may be of no, or extremely limited, use in the horse syndication situation. Additionally, one who relies upon a statutory exemption should be aware that the burden of proof in such a matter is upon the party claiming the exemption and that the exemption is strictly construed against the claiming party.[134]

A. *Intrastate Exemption*

The intrastate exemption has been described as "a narrow exemption channel."[135] Its purpose is to exempt the local financing of local industries.[136] While the thoroughbred industry is normally associated

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(Footnote continued from preceding page)

> be exempted . . . where the aggregate amount at which such issue is offered to the public exceeds $500,000.

The utility of this provision is limited in that only $500,000 can be raised over a two-year period.

[132] 15 U.S.C. § 77c(a)(11) (1970). This provision exempts:

> Any security which is part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such State or Territory.

[133] 15 U.S.C. § 77d(2) (1970) states that the registration requirements of the Act are inapplicable to "transactions by an issuer not involving any public offering." *See generally* Israels, *Some Commercial Overtones of Private Placement*, 45 VA. L. REV. 851 (1959); Note, 86 HARV. L. REV. 403 (1972); Note, 24 U. FLA. L. REV. 458 (1972).

[134] SEC v. Culpepper, 270 F.2d 241 (2d Cir. 1959); SEC v. Sunbeam Gold Mines Co., 95 F.2d 699, 701 (9th Cir. 1938).

[135] McCauley, *Intrastate Securities Transactions Under the Federal Securities Act*, 107 U. PA. L. REV. 937, 938 (1959) [hereinafter cited as McCauley]. It may be more narrow than previously anticipated. The SEC has recently promulgated Rule 147, which will remove many existing uncertainties and also eliminate possible flexibilities which now exist. SEC Rule No. 147, 39 Fed. Reg. 2353 (1974), requires that the transaction meet four conditions for the rule to be available: (1) the issuer must be residing and doing business within the state or territory where all offers and sales are made; (2) the offerees and purchasers must be residents within such state or territory; (3) reoffers and resale must be limited to residents of such state or territory for a period of nine months from the date of the last sale of any part of the issue; (4) precautions, including legends on securities, must be taken against interstate distribution. Rule 147 is not the exclusive method by which persons may claim this exemption. Compliance may also be satisfied by judicial and administrative interpretations effective on the date of the issuance. 39 Fed. Reg. at 2356.

[136] Delaney, *Exemptions Under the Securities Act of 1933*, 19 BROOK. L. REV. 40, 50-51 (1953) [hereinafter cited as Delaney].

with Kentucky, it would be exceedingly difficult to claim, with any credibility, that the horse industry is limited to citizens of Kentucky or that financial interests in it are a state-oriented phenomenon.

When contemplating use of the intrastate exemption, it must be noted that there may not be a parallel state exemption;[137] therefore, while federal registration may not be required, it is possible that compliance with state regulations still may be mandatory. Moreover, even though an offering qualifies for the intrastate exemption, the issuer and others, under certain circumstances, may still remain subject to the Act's civil liability or anti-fraud provisions.[138]

To qualify for the intrastate exemption the entire issue must be offered and sold only to residents of the same state or territory in which the issuer is a resident and doing business.[139] If any term or condition for the exemption is violated, the exempt status is lost for the entire issue;[140] therefore, the *mere offer* to sell to a nonresident is sufficient to extinguish the benefit of the exemption and to make one liable for selling unregistered securities in violation of the Act.[141] This liability, of course, runs to the entire issue of the nonexempt securities.[142] Thus, the Kentucky thoroughbred syndicator who relies upon the intrastate exemption is restricted to offering and selling shares only to fellow Kentuckians.

Much of the vagueness and uncertainty surrounding reliance on the intrastate exemption has been clarified by the SEC's adoption of Rule 147, which became effective March 1, 1974.[143] Rule 147 is intended to provide more objective standards upon which responsible local businessmen intending to raise capital from local sources may rely in claiming the intrastate exemption. However, all offers and sales which are part of the same issue must comply with all of the conditions of Rule 147 for the exemption to be available. Noncom-

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[137] Kentucky has a limited intrastate exemption. *See* KRS § 292.410(9).

[138] *See* 15 U.S.C. § 77q (1970) which states a broad prohibition against the use of the mails or interstate commerce for the fradulent offering or sale of *any* security and 15 U.S.C. § 77l (2) (1970), which provides a civil cause of action to the purchaser of an exempt security if the security is touched by fraud.

[139] 15 U.S.C. § 77c(a)(1) (1970). For a history of this requirement *see* H.R. REP. No. 85, 73d Cong., 1st Sess. 6 (1933) and SEC Securities Act Release No. 33-1459, 11 Fed. Reg. 10958 (1937).

[140] *See* Hillsborough Investment Corp. v. SEC, 276 F.2d 665 (1st Cir. 1960); SEC v. Truckee Showboat, Inc., 157 F. Supp. 824 (S.D. Cal. 1957).

[141] *See* SEC Securities Act Release No. 33-4434, 26 Fed. Reg. 11896 (1961).

[142] *See* SEC Securities Act Release No. 35-5450, 39 Fed. Reg. 2353 (1974). *See also* SEC Securities Act Release No. 33-4877, 32 Fed. Reg. 11705 (1967). For a discussion of possible civil and criminal liabilities, *see* McCauley, *supra* note 135, at 959. *See also* Lively v. Hirschfeld, 440 F.2d 631 (10th Cir. 1971) and Studia Oil & Uranium Co. v. Wheelis, 251 F.2d 269 (10th Cir. 1957).

[143] SEC Securities Act Release No. 33-5450, 39 Fed. Reg. 2353 (1974).

pliance results in liability under Sections 12 and 15 of the Act.[144]

The two essential prerequisites of Rule 147 are that "the issuer be a resident of and doing business within the state or territory in which all offers and sales are made"[145] and that "no part of the issue be offered or sold to nonresidents within the period of time specified in the rule."[146] With some limited allowances for persons controlling the issuer, the rule provides "exemption for offers and sales by the issuer only."[147] As shall be discussed, this stipulation can cause serious problems if resale of the shares occur.

The "resident" requirement, for purposes of the intrastate exemption, has been problematical; however, many of the problems which plague a less specialized type of offering would probably not inhere in the rather unique horse syndication situation as it presently exists due to the usually limited clientele and frequent business or social relationship among them. Nevertheless, Rule 147 requires that "the issuer of the securities [in horse syndicates, most often the issuer will be the syndicator, the syndicate manager, or the previous owner] shall at the time of any offers and the sale be a person resident and doing business within the state or territory in which all of the offers, offers to sell, offers for sale and sales are made."[148] Generally the issuer is deemed a resident of the state or territory: (1) where "it is incorporated or organized" if organized under the laws of a state; (2) where "its principal office is located" if not organized under state law; or (3) where "his principal residence is located, if an individual."[149]

Not only must the issuer reside within the state, he must also conduct business there. One without the other is insufficient. Prior to the adoption of Rule 147, however, the doing business requirement was muddled, with explanations of the requirement ranging from 100% to bare minimum contacts within his state of residence.[150] The SEC has attempted to remedy this situation by providing some definitive standards for the requirement in the new rule. Essentially, it requires one of the following: (1) that the principal office of the issuer be located in the state or territory where the security is offered; (2) that the issuer derive 80% of its gross revenues from the state wherein

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[144] *Id.*
[145] *Id.*
[146] *Id.*
[147] *Id.*
[148] *Id.*
[149] *Id.*
[150] For a few of the conflicting views on the "doing business" requirement, *see, e.g.*, McCauley, *supra* note 135, at 950; 1 L. Loss, SECURITIES REGULATION 252 (2d ed. 1961); Berger, *supra* note 16, at 769.

the security is offered; (3) that at least 80% of issuer's assets be located in the state wherein the security is offered; or (4) that the issuer intends to use and does use 80% of the net proceeds of sales of syndicate shares in connection with the operation of a business or of real property located in the state wherein the security is offered.[151] Although far from being lucid, this rule clarifies much of the confusion regarding the "doing business" requirement and clearly rules out anything less than substantial contacts.

Once assured that the issuer fulfills the "resident" and "doing business" conditions, one relying upon the intrastate exemption must next look to the resident requirements of offerees and purchasers. Rule 147 demands that:

> [o]ffers, offers to sell, offers for sale and sales of securities that are part of an issue shall be made only to persons resident within the state or territory of which the issuer is resident.[152]

Corporations and partnerships not specifically formed to purchase the security and other forms of business organizations are deemed a resident of the state in which they have their principal office.[153] Individuals are considered residents of the state in which they maintain their principal residence.[154] Since a general partner retains his personal identity to a degree and has property rights with respect to the partnership property, a partnership formed solely for the purpose of acquiring an issue or part of an issue is not a resident of a particular state unless all of the beneficial owners are residents of such state.[155] A syndicate, therefore, if a general partnership, would not qualify for the intrastate exemption unless all syndicate members were residents of the issuer's state.

Where the issuer is uncertain of the state of residence of a prospective offeree or purchaser, an investigation should be made before making the sale or offer. Rule 147 recommends the use of affidavits to provide evidence on the part of the issuer to meet the requirements of the intrastate exemption, but relying on affidavits or letters of investment intent clearly does not ensure the application of the exemption.[156] Additionally, the resident requirement cannot be sidestepped by selling or offering an issue to a resident agent of a non-

[151] SEC Securities Act Release No. 33-5450, 39 Fed. Reg. 2353 (1974).
[152] *Id.*
[153] *Id.*
[154] *Id.*
[155] McCauley, *supra* note 135, at 948.
[156] SEC Securities Act Release No. 33-5450, 39 Fed. Reg. 2353 (1974).

resident buyer or to a buyer who is only a temporary resident.[157] Such devices, while technically in compliance with the rule, are clearly in violation of the intent of Rule 147 and would destroy the exempt status of an offering.[158]

Another severe limitation which would make reliance on the intrastate exemption hazardous should the horse syndicate arrangement be declared a security manifests itself in the restriction on resales. Before the adoption of Rule 147 by the SEC, if during the course of distribution of the securities being sold in reliance on the intrastate exemption, a person, who qualified as a resident, purchased the security for resale and sold his security to a nonresident, the exemption would be defeated.[159] Moreover, since the exemption was valid only if the entire issue was distributed under the specified conditions, the resale to the nonresident contaminated the entire distribution of the issue, and the issuer was, therefore, subject to sanctions for the entire issue.[160]

Rule 147 has not radically altered the resale restriction; if anything it makes the requirement even *more* rigid with the addition of a holding period. Rule 147 dictates that:

> during the period in which securities that are part of an issue are being offered and sold and for a period of nine months from the date of the last sale by the issuer of any part of the issue, resales of any part of the issue by any person shall be made only to persons resident within the same state or territory.[161]

For the exemption to be available, the syndicate shares, if securities, must be placed only in the hands of investors residing within the state at the time of completion of the ultimate distribution. Additionally, the shares cannot be sold to a nonresident for nine months from the date the last share is sold by the issuer. The issuer, should a shareholder sell the share to a nonresident before the holding period has expired, is susceptible to liability for the entire issue because the exemption has been destroyed and the entire transaction contaminated. Merely offering to sell in a resale situation does not destroy the intrastate exemption. Although the resale rule is harsh, it is considered with the above-noted policy of the SEC to strictly construe the terms of an exemption against the one seeking to rely on it.[162]

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[157] SEC v. Hillsborough Investment Corp., 173 F. Supp. 86 (D.N.H. 1958); *see also* THOMAS, SECURITIES ACT HANDBOOK 28 (1959).

[158] SEC Securities Act Release No. 33-5450, 39 Fed. Reg. 2353 (1974).

[159] *Id.*

[160] *See* note 72 *supra*.

[161] SEC Securities Release Act No. 33-5450, 39 Fed. Reg. 2353, 2357.

[162] *Id.*

Analysis of the restrictions on the intrastate exemption indicates that promoter reliance upon it in the horse syndicate situation may be misplaced. With the stringent residency requirements and the even more rigid resale limitations, the intrastate exemption is, at best, of dubious value to an enterprise such as a horse syndication, even one consisting of few shareholders. If the issuer expects to rely on the intrastate exemption, both he and his attorney must be aware of several factors: (1) that registration under the state law may still be mandatory; (2) that in every state, given proper conditions, the anti-fraud and civil liabilities provisions of the federal law may still be applicable; (3) that violations may subject one to both state and federal criminal or civil sanctions; and (4) that a resale to a nonresident within nine months of final distribution can destroy the intrastate exemption, contaminate the entire transaction, and make one liable for the selling price of each issue sold.

B. *The Private Offering Exemption*

A second possible, and perhaps more accommodating, exemption under which a share in a horse syndication might escape registration is the private offering exemption.[163] The factor which makes this exemption of dubious value, however, is that the exact dimensions of a "public offering" are unclear.[164] One author has ventured that "where an entire issue is offered and sold only to a few large investors who purchase for investment and not with a view to distribution, there are no registration requirements."[165] Under such an interpretation, a horse syndication could arguably be exempted.[166] Many state laws, including those of Kentucky, provide quantitative tests in terms of the numbers of offerees which differentiate between private and public offerings.[167] Amid speculation and hypothesis, the issuer, relying on the exemption, should realize that the federal statute does not define "public offering" nor does it provide a quantitative test; therefore, the facts and circumstances of each situation are determinative.[168]

For many years it was assumed that offerings to twenty-five or

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[163] 15 U.S.C. § 77d(2) (1970).

[164] Comment, *Securities Regulations—Private Offering Exemption: SEC Proposed Rule 146*, 48 WASH. L. REV. 922, 934-40 (1973).

[165] Delaney, *supra* note 136, at 55.

[166] It should be noted, however, that the Delaney explanation is dated and that the current trend is moving away from such a broad view. Also, Delaney contemplated "large investors" as institutional investers—not private individuals.

[167] *See* KRS § 292.410(9) which exempts an offer to ten persons or fewer.

[168] Jacobson, *supra* note 130, at 69-70. *See also* SEC Securities Act Release No. 33-285, 11 Fed. Reg. 10952 (1935).

fewer persons would constitute a private offering;[169] however, the Supreme Court in *SEC v. Ralston Purina Co.*[170] made it clear that a quantitative test was more of a convenience than an entirely dependable rule of thumb. The crucial factor obtains in "the need of the offerees (whether few or many) for the protection afforded by registration."[171] Although quantitative factors are relevant, the private offering exemption does not depend on numbers, but rather hinges on the nature of the offering and the personal characteristics of the offerees. As the Court in *Ralston Purina* stated: "[a]n offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering.'"[172] Requiring that the judiciary scrutinize whether the offerees are "able to fend for themselves," the Court, by implication, acknowledged that under proper conditions even a miniscule number of offerees would need the protection afforded by federal registration. The SEC has indicated that numbers alone is no protection to the party claiming the private offering exemption. Rather it has announced as its policy that:

> the number of persons to whom the offering is extended is relevant only to the question whether their association with and knowledge of the issues is such that they do not need the protection of the Act.[173]

Lower federal courts, in deciding whether the offerees *need* protection have emphasized the previous business relationship between the parties and the "sophisticated discernment" with which the parties entered into the transaction.[174] Recurrent factors which have been cited as vital in construing the public-private dichotomy have included: the number of offerees and their relationship to each other and to the issuer,[175] the size of the offering and the manner of the offering,[176] and

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[169] *See* Victor & Bedrick, *Private Offering: Hazards for the Unwary*, 45 VA. L. REV. 869, 872 (1959) [hereinafter cited as Victor & Bedrick].

[170] 346 U.S. 119 (1953).

[171] *Id.* at 125.

[172] *Id.*

[173] SEC Securities Release No. 33-4552, 27 Fed. Reg. 11316 (1962).

[174] *See, e.g.*, Gilligan, Will & Co. v. SEC, 267 F.2d 461 (2d Cir. 1959); Hirtenstein v. Tenney, 252 F. Supp. 827 (S.D.N.Y. 1966); Campbell v. Degenther, 97 F. Supp. 975 (W.D. Pa. 1951).

[175] 4 L. LOSS, SECURITIES REGULATION 2644 (Supp. 1969); Fooshee & McCabe, *Private Placements—Resale of Securities: The Crowell-Collier Case*, 15 BUS. LAW. 72 (1959). For cases discussing this factor, *see, e.g.*, Katz v. Amos Treat & Co., 411 F.2d 1046 (2d Cir. 1969); Strahan v. Pedroni, 387 F.2d 720 (5th Cir. 1967); Woodward v. Wright, 266 F.2d 108 (10th Cir. 1959); Hirtenstein v. Tenney, 252 F. Supp. 827 (S.D.N.Y. 1966); Shimer v. Webster, 225 A.2d 880 (D.C. Ct. App. 1967).

[176] The size of the offering is probably the least important consideration today. *See* 2 S. GOLDBERG, PRIVATE PLACEMENTS AND RESTRICTED SECURITIES § 2.2 (1972).

the expertise of the offerees and their alternative means of success in obtaining the information which registration would disclose.[177] Some recent cases have shown a tendency among the courts to read the "need" requirement strictly. In *Lively v. Hirschfeld*,[178] in requiring that the evidence offered by the issuer be explicit and exact and not built upon mere conclusory statements, the court stated that in order to qualify as a private offering two factors must be shown: first, the group must "include only persons of exceptional business experience," and second, they must be in a "position where they have regular access to all the information and records which would show the potential for the corporation."[179] A factor which should be considered by the courts in determining whether an investor is "able to fend" for himself is derived from the risk-capital approach to determining whether an investment scheme is a security. If an investor, sophisticated and having access to information, is unable to protect the destiny of his investment due to lack of control, he should be considered unable "to fend for himself." The sophisticated and informed investor who lacks control in the enterprise is reduced to sterility regarding his investment. The control necessary to retain the private offering exemption should be the same as that in defining a transaction as a security.

Quite clearly, the horse syndicator should not rely upon his relatively small number of offerees to bring him within the scope of the private offering exemption. There simply is "no magic number" which guarantees exemption.[180] Nevertheless, a comparison of the characteristics of horse syndications with the determinative factors regarding a private offering lends some support to the view that even if an investment in such an enterprise is a security, it is exempt from federal registration. For instance, the methods of solicitation thus far used in horse syndications have manifested many traits common to private offerings. These include the extensive use of person-to-person solicitation, the absence of an underwriting agreement and a disdain for the use of mass media advertising. In horse syndications, very often the promoter conducts no formal solicitation; mere rumors that the syndicate is being organized may result in its oversubscription. Similarly, shares in horse syndications are usually sold directly rather

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[177] Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680 (5th Cir. 1971); Lively v. Hirschfeld, 440 F.2d 631, 633 (10th Cir. 1971); United States v. Custer Channel Wing Corp., 376 F.2d 675 (4th Cir. 1967).

[178] 440 F.2d 631 (10th Cir. 1971).

[179] *Id.* at 633.

[180] Jacobson, *supra* note 130, at 71. *See also* Sargent, *Private Offering Exemption: Current Problems in Securities Regulations*, 21 BUS. LAW. 117-29 (1965).

than through any established securities distribution channels.[181] This direct sale technique is commonly thought of as indigenous to private offerings:

> transactions accomplished through direct negotiation between issuer and offeree rather than through established methods of securities distribution, tend to be non-public in their nature.[182]

The requirement that the investors have access to pertinent records which would aid them in making an informal investment[183] is partially, if not fully, satisfied in that the blood lines and other records regarding equines are available to the public. While this information does not apprise the investor of the mechanics of the syndicate, it does provide him with sufficient material by which to determine if he desires to make an investment and should satisfy the "access to information" requirement. Notably, however, courts have been inconsistent in this area with the result that what will satisfy this requirement is unclear.[184]

The comparison becomes more strained, however, when one looks beyond the foregoing characteristics. For example, although many investors in horse syndicates are sophisticated purchasers, the type of transaction certainly lends itself to being offered to less sophisticated investors who need the protection and information registration would afford. Additionally, it should be noted that a mere offer to one unsophisticated investor terminates the availability of the exemption for the entire issue.[185] Similarly, the private offering exemption has generally been associated with large, institutional investors rather than private individuals;[186] therefore, it is conceivable that the private offering exemption is unavailable to the horse syndicate from the onset. In any event it seems certain that if diverse or less sophisticated offerees are involved or if the investors are deemed to be unable to fend for themselves because of lack of control over their initial invest-

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[181] Kirkpatrick Interview, *supra* note 26.

[182] Jacobson, *supra* note 130, at 71.

[183] SEC Rule 146, 39 Fed. Reg. 15263 (1974).

[184] In Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680 (5th Cir. 1971), the court indicated that even though only executive officers with thorough knowledge and high sophistication were involved, the exemption might not be available. In Gilligan, Will & Co. v. SEC, 267 F.2d 461 (2d Cir. 1959), the court urged that only where the investors were shown to have available the same information that registration affords would reliance on the exemption be warranted. For the most restrictive view yet, *see* SEC v. Continental Tobacco Co., 463 F.2d 137 (5th Cir. 1972), in which the court stated that the burden of proving the availability of the information is placed upon the party seeking the benefit of the exemption; if the burden is not carried as to all offerees, the exemption will be lost.

[185] SEC Rule 146, 39 Fed. Reg. 15263 (1974).

[186] Victor & Bedrick, *supra* note 169, at 870.

ment, the arrangement probably would not qualify for the exemption.

Proposals for clarifying the "forty years of confusion"[187] regarding the private offering exemption must also be taken into account when considering reliance upon it. These proposals, while not yet law, provide definite indications as to the future of the private offering exemption and the restrictions which will be placed upon it.[188] The American Law Institute Federal Securities Code[189] would limit the private offering to "one in which . . . (A) the initial buyers are institutional investors and not more than thirty-five other persons. . . ."[190] The requirement of the involvement of institutional investors would all but eliminate the feasibility of the exemption for horse syndications.

A possible solution to the existing confusion about the private offering exemption is the SEC's recently adopted Rule 146.[191] Under this rule, the issuer is required generally to meet five conditions[192] before reliance upon the Rule is justified: (1) the issuer must not utilize any form of general advertising or solicitation in making the offer available to prospective purchasers; (2) prior to making any offer or sale, the issuer has an explicit duty to make a reasonable inquiry as to the offeree's knowledge and experience in financial affairs; (3) the offeree or his representative must be in a position to obtain the same kind of information that registration would provide or they must be furnished with that information;[193] (4) there must be no more than 35 persons who purchase securities in any offering; and (5) the issuer must take precautionary measures to prevent the transfer

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[187] Remarks of former Chairman William J. Casey of the Securities and Exchange Commission [1972-73 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,108, at 82,396. For a sampling of the confusion surrounding the private offering exemption, *see e.g.*, Harrison, *Thirty-Eight Years Without Definition—The Private Offering Exemption*, 24 ARK. L. REV. 417 (1971); Israels, *Some Commercial Overtones of Private Placement*, 45 VA. L. REV. 851 (1959); Sargent, *Private Offering Exemption*, 21 BUS. LAW. 118 (1965); and Note, *Reforming the Initial Sale Requirements of the Private Placement Exemption*, 86 HARV. L. REV. 408 (1972).

[188] For an excellent discussion of both the ALI proposed securities approach and the SEC Proposed Rule 146 approach to the private offering exemption, *see* Recent Developments, 48 WASH. L. REV. 922 (1973).

[189] ALI FEDERAL SECURITIES CODE (Tent. Draft No. 1, 1972).

[190] *Id.*

[191] For the full text of Rule 146, *see* 39 Fed. Reg. 15266-68 (1974).

[192] The conditions set forth represent general requirements for compliance with Rule 146. The full text of the Rule should be consulted for the requirements under any particular set of facts. Moreover, the SEC made clear that compliance with Rule 146 was not the exclusive means by which one can obtain a private offering exemption.

[193] The issuer is also required to disclose any "material relationship" between an offeree representative and himself at the time of the transaction, or to be contemplated, or which existed during two years preceding the present transaction. For a definition of "material," the SEC looked to Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128 (1972). 39 Fed. Reg. 15263 (1974).

of the securities by the purchaser unless the purchaser first complies with the Act's registration requirements. The Rule is not without its potential for confusion; however, it is abundantly clear that its aim is to restrict rather than to broaden the availability of the exemption and to clarify it for easier use by those who fulfill its conditions.

Another risk inherent in relying on the private offering exemption is the troublesome access-to-information requirement. Whether the type of information which is accessible to the thoroughbred investor will satisfy the information requirement is unclear. Additionally, there is the danger that the courts may look to see if the investor has sufficient control over the enterprise to make his access to information useful in the sense of protection for his investment. If he lacks that control, reliance on the private offering exemption may be unjustified.

Finally, perhaps the most dangerous aspect of reliance on the private offering exemption is the effect of resales on the exempt status. Securities sold under the private offering exemption are considered restricted securities, and the resale of such securities is governed by the operation of Rule 144.[194] To ensure that the private offering exemption is available, the issuer must be sure that he is not selling his shares to an underwriter, because the effect of such a sale is to make the exemption unavailable. An underwriter is broadly defined in Section 2(11) of the Act to include

> any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking. . . .[195]

The traditional emphasis in this definition has focused on "with a view to . . . distribution." Clearly, an individual investor such as a syndicate shareholder may come within the scope of this definition, which is not limited to persons who act as professionals.[196]

The issuer must therefore take extreme precautionary measures to assure that a public offering does not result through resales of securities purchased in transactions otherwise qualifying for the private offering exemption, for if, in fact, the purchasers do acquire the securities with a view to distribution, the seller assumes the risk of possible violation of the registration requirements of the Act and consequent civil and

[194] For the full text of Rule 144, *see* 17 C.F.R. § 230.144 (1973). *See also* SEC Securities Act Release No. 33-5452, 39 Fed. Reg. 6069 (1974), for amendments to Rule 144.

[195] 15 U.S.C. § 77b(11) (1970).

[196] *See* SEC Securities Act Release No. 33-5307 [1972-73 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,001; SEC Securities Act Release No. 33-5452, 39 Fed. Reg. 6069 (1974). *See also* SEC v. National Bankers Life Ins. Co., 334 F. Supp. 444 (N.D. Tex. 1971), aff'd, 477 F.2d 920 (5th Cir. 1973).

criminal liabilities. The sale of one share in a horse syndicate, should it be deemed a security, to a purchaser who "has a view to distribution" (although this is not the only criterion) is enough to contaminate the entire transaction, force the loss of the exemption, and place the issuer in jeopardy of selling an unregistered, unexempt security in violation of the Act.[197]

The key to retaining the exemption for the issuer, then lies in selling to a person who will not be deemed to be engaged in a distribution; in other words, to a person who is not an underwriter. To provide the issuer with some additional guidance in this regard Rule 144 sets out five essential conditions which, if met, should remove the possibility of a sale to an underwriter.[198] Essentially they are: (1) there must be available adequate public information with respect to the issuer of the securities (adequacy here is extremely limited and probably not the type of information the typical issuer of horse syndicate shares could satisfy, as it applies, in general, only to certain registration and filing requirements under Section 12 of the Securities Exchange Act of 1934 or available public information that would satisfy the Act if he were required to do such filing); (2) the person for whose account the securities are sold shall have been the beneficial owner of the securities for a period of at least two years prior to the sale; (3) if the sale is by an affiliate (roughly a person who, directly or indirectly, is controlled by or in control of the issuer) or non-affiliate, the sale is limited to one percent of the shares outstanding; (4) the manner of sale is limited to broker transactions; and (5) the shareholder must file a Form 144 with the SEC if the sale price exceeds $10,000.[199]

Unless these criteria are satisfied, resale of the share by a shareholder could result in loss of the exemption.[200] While at one time it was thought that affidavits of intent, the legending of the shares or the issuance of stop-transfer orders would ensure retention of the exemption for the issue, the SEC has made it clear that these precautions do not provide a "basis for the exemption" but merely provide a means of preventing illegal distributions.[201] The presence of

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[197] SEC Securities Act Release No. 33-5452, 39 Fed. Reg. 6069 (1974). *See also* United States v. Abrams, 357 F.2d 539 (2d Cir.), *cert. denied*, 386 U.S. 1001 (1966).

[198] SEC Securities Act Release No. 33-5452, 39 Fed. Reg. 6069 (1974).

[199] This filing requirement may cause the private offering exemption to lose some of its appeal for the horse syndicate arrangement.

[200] SEC Securities Act Release No. 33-5452, 39 Fed. Reg. 6069 (1974).

[201] SEC Securities Act Release No. 33-5121, 36 Fed. Reg. 1525 (1971).

the precautions, however, does seem to be a factor necessary for the initial offering to qualify for the exemption.[202]

In light of the confusion and limitations regarding the private offering exemption, reliance upon this exemption by the issuer of horse syndicate shares is at best hazardous. While many of the characteristics of the private offering inhere in the syndicate arrangement, sufficient pitfalls and questions remain to make overzealous reliance on the exemption both unwise and unwarranted. There are simply too many indications that the exemption, if available at all, would be available only on the most restricted and careful basis. Moreover, even if the issuer overcame the initial hurdle of being exempt from the *federal* registration requirements, *state* requirements may negate the exemption completely or differ substantially from the federal prerequisites of the private offering exemption.[203]

III. CONCLUSION

Syndicate ownership of animals is not shrouded in legal mystery; however, the law applicable to such an arrangement is yet in its evolutionary stage. Although many of the uncertainties are entwined in the uniqueness of the type of ownership and the flexibility of the syndicate agreement, the syndicate entity, unless otherwise expressly designated, should be treated in legal analysis as a partnership (or joint venture) and the syndicate agreement regarded essentially as a type of partnership agreement controlled by contract principles.

Even though there is no mystery surrounding syndicate ownership, such an arrangement should not be approached lightly by the attorney who advises either the syndicators or a prospective investor. Advantages and disadvantages inhere in syndicate ownership of which both the syndicator or the potential investor should be made aware.

Not the least of the problems clouding syndications as they now exist, especially those in which the syndicate agreements shackle any real investment control or render the control illusory as a condition precedent to the purchase of syndicate shares, is the possibility that violations of security regulations pervade the scheme, carrying potential penalties perhaps not anticipated by either the attorney, the investor, or the syndicator. Clearly most, if not all, units presently being sold in

[202] *Id.*

[203] KRS § 292.410(9) may provide a sizable state level obstacle for the horse syndicator, should his arrangement be deemed a security, seeking to claim the private offering exemption. This provision limits private offering to ten persons unless part of the investors are institutional investors.

horse syndications are being done so without any attempt by the offeror to comply with either state or federal securities regulations. Whether this is caused by the uncertainty as to whether such a transaction is a "security" within the meaning of the Act, the availability, real or illusory, of statutory exemptions, the aversion by most non-security attorneys to become involved with securities law, or the SEC's failure to police syndicate ownership is unknown.[204] What is known and should be recognized, however, is that the judiciary and the SEC's growing propensity to expand the concept of a security[205] brings the syndicate share, especially if it contains debilitating control restrictions, into the gray area of uncertainty regarding the reach of the broadening securities laws. The troublesome and narrow questions the attorney proffering counsel regarding syndicates faces, therefore, is whether or not to register the offering as a security and whether, if he is dealing with a security, it qualifies for one of the narrow registration exemptions. When weighing the risks involved in nonregistration and the chances of fitting the enterprise into the shrinking exemptions, caution, at a minimum, is advised.

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[204] Reluctance to register securities involving real estate syndicate shares is discussed in Berger, *supra* note 12, at 760.

[205] Pasquesi, *supra* note 69, at 728. For an enlightened discussion of the practical problems involving an estate with a thoroughbred as an asset, *see* Henderson, *The Thoroughbred Racehorse as an Estate Asset,* 113 TRUST & ESTATE 380 (1974).