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Limited Liability Company Interests as Securities: Planning and Drafting Strategies Related to Securities Law Considerations

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LIMITED LIABILITY COMPANY INTERESTS AS SECURITIES: PLANNING AND DRAFTING STRATEGIES RELATED TO SECURITIES LAW CONSIDERATIONS

*Elaine A. Welle**

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I. INTRODUCTION

While some commentators have argued that an ownership interest in a limited liability company ("LLC") should not be treated as a security,¹ federal and state securities regulators have taken the position that certain LLC interests are securities. To date, the Securities and Exchange Commission has filed at least seven lawsuits against LLC promoters alleging violations of the federal securities laws in connection with the offer or

1. See, e.g., 1 LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES § 14.02, at 14-5 to 14-6 (1994) (proposing there should be at least a presumption against a security characterization for LLC interests or LLC interests might be characterized as non-securities because they are closely held); MARK A. SARGENT, LIMITED LIABILITY COMPANY HANDBOOK (1993-94), ch. 3 (concluding LLC interests are not securities in most instances); Carol R. Goforth, *Why Limited Liability Company Membership Interests Should Not be Treated as Securities and Possible Steps to Encourage this Result*, 45 HASTINGS L.J. 1223 (1994) (arguing LLC interests should not be treated as securities). *Contra* Marc I. Steinberg & Karen L. Conway, *The Limited Liability Company as a Security*, 19 PEPP. L. REV. 1105 (1992) (arguing LLC interests normally are securities); Elaine A. Welle, *Limited Liability Company Interests as Securities: An Analysis of Federal and State Actions Against Limited Liability Companies Under the Securities Laws*, 73 DENV. U. L. REV. (forthcoming January 1996) (concluding certain LLC interests may be securities).

sale of ownership interests in LLCs.² In addition, as many as thirty-five states have taken the position, either formally or informally, that LLC interests may be securities.³ Of those, at least sixteen states have taken action against entities offering LLC interests alleging violations of state securities laws.⁴

2. See *SEC v. Vision Communications, Inc.*, Litigation Release No. 14026, 56 SEC Docket 880, 1994 WL 96945 (SEC) (Mar. 24, 1994); *SEC v. Parkersburg Wireless Ltd. Liab. Co.*, Litigation Release No. 14085, 56 SEC Docket, 1994 WL 186833 (SEC) (May 16, 1994); *Commission Obtains TRO Against Knoxville, LLC*, SEC News Dig. 94-130-10, 1994 WL 328317 (SEC) (July 12, 1994); *SEC v. Future Vision Direct Marketing, Inc.*, Litigation Release No. 14384, 58 SEC Docket 1716, 1995 WL 25731 (SEC) (Jan. 18, 1995); *SEC v. American Interactive Group, LLC*, Litigation Release No. 14462, 59 SEC Docket 203, 1995 WL 229088 (SEC) (Apr. 10, 1995); *SEC v. United Communications, Ltd.*, Litigation Release No. 14477, 59 SEC Docket 424, 1995 WL 254714 (SEC) (Apr. 24, 1995); *SEC v. Irwin Harry Bloch*, Litigation Release No. 14511, 59 SEC Docket 931, 1995 WL 317420 (SEC) (May 25, 1995).

3. These states include Alaska, California, Colorado, Connecticut, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Michigan, Minnesota, Mississippi, Missouri, Montana, New Jersey, New Mexico, New York, North Carolina, North Dakota, Ohio, Oklahoma, Pennsylvania, South Carolina, South Dakota, Tennessee, Texas, Utah, Vermont, Virginia, Washington, Wisconsin, and Wyoming. See 1 Blue Sky L. Rep. (CCH) ¶ 6551. See also Limited liability company interpretative release, 1A Blue Sky L. Rep. (CCH) ¶ 14,562 (Conn. Aug. 24, 1994) [hereinafter Connecticut Release]; Statement of policy on classification of limited liability company interests as securities, 1A Blue Sky L. Rep. (CCH) ¶ 24,681 (Ind. Sept. 20, 1993) [hereinafter Indiana Policy Statement]; Interpretative Opinion, *Orchards Drug, L.C.*, 1991 WL 101804 (Kan. Sec. Com. May 1, 1991) [hereinafter Kansas Interpretative Opinion]; Exemption for professional limited liability companies, 2 Blue Sky L. Rep. (CCH) ¶ 32,630 (Mich. Mar. 24, 1994) [hereinafter Michigan Exemptive Order]; Rule .1510, Limited liability company membership interests as securities, 2A Blue Sky L. Rep. (CCH) ¶ 43,474 (N.C. Dec. 1, 1994) [hereinafter North Carolina Rule]; Exemption request - Offers of interests in limited liability company, 2 Blue Sky L. Rep. (CCH) ¶ 40,642 (N.J. Bureau of Sec., July 27, 1994) [hereinafter New Jersey Exemption Request]; Exemption request - Membership interests in a limited liability company, 2A Blue Sky L. Rep. (CCH) ¶ 46,664 (Okla. Aug. 28, 1992) [hereinafter Oklahoma Exemption Request]; Statement of Policy 95-2 - Limited liability company membership interest as securities, 2A Blue Sky L. Rep. (CCH) ¶ 51,580 (S.C. Sec. of State and Sec. Com. June, 1995) [hereinafter South Carolina Statement of Policy]; Limited liability company interests as securities, 2A Blue Sky L. Rep. (CCH) ¶ 54,521 (Tenn. Mar. 7, 1995) [hereinafter Tennessee Statement of Policy]; Draft Interpretative Opinion Memorandum, *Are Limited Liability Company Memberships Securities?* (Wyo. Sec. of State, July 16, 1993) (in-house opinion drafted by staff members of the Wyoming Securities Division that has not been released as a formal legal opinion of the Wyoming Attorney General's office) [hereinafter Wyoming Draft Opinion].

4. John R. Emshwiler, *New Kind of Company Attracts Many—Some Legal, Some Not*, WALL ST. J., Nov. 8, 1993, at B1. In November 1993, an article in the Wall Street Journal stated at least 16 states have filed legal actions against a variety of wireless cable and related communications technology firms on the grounds that they have violated securities laws by offering or selling LLC interests. In at least 12 states, state courts or state securities regulators have ordered LLC promoters to cease and desist from offering or selling LLC interests in violation of state securities laws, based on findings that there was sufficient evidence to conclude such LLC interests were securities. Orders have been issued under the securities laws of Colorado, Georgia, Illinois, Indiana, Kansas, Minnesota, Missouri, North Dakota, Pennsylvania, South Dakota, Washington and Wisconsin. Many are summary cease and desist orders. See *infra* notes 90-93 and accompanying text. Some of these orders are available on either Westlaw or Lexis. Unfortunately, many trial and administrative decisions are unreported. For example, California and New York courts, as well as federal courts, frequently do not publish their secu-

Whether an LLC interest is a security is of great practical importance to practitioners. If an LLC interest is a security, this triggers, among other things, possible securities registration requirements, broker-dealer registration requirements, securities fraud liability and in some cases substantial disclosure obligations.⁵ The Securities Exchange Commission ("SEC"), state securities commissioners and private parties may bring suit for securities law violations.⁶ Criminal liability may even be incurred under certain circumstances.⁷

Commentators, federal regulators and state regulators have advanced a number of different theories to bring LLC offerings within the ambit of the securities laws. Absent legislative action,⁸ however, it is unlikely courts will hold that all ownership interests in LLCs are securities.⁹ Nevertheless, it appears likely courts will hold that ownership interests in LLCs with certain characteristics are securities.¹⁰ Consequently, the way an LLC is structured may determine whether the interest is a security and whether federal or state securities laws apply.

This article begins by providing a brief overview of the various theories asserted by commentators, federal regulators and state regulators as grounds for claiming certain LLC interests are securities.¹¹ The article then identifies and discusses those characteristics that may increase the risk of a court deeming an LLC interest a security.¹² The article concludes by describing some practical steps a practitioner may take to reduce the risk of securities law violations in connection with an LLC offering.¹³

rities opinions. 12 JOSEPH C. LONG, *BLUE SKY LAW* at xi (1995). As a result, there may be numerous orders relating to alleged violations of state securities laws for the offer and sale of LLC interests that are not reported.

5. See 1 RIBSTEIN & KEATINGE, *supra* note 1, §§ 14.02 & 14.03, at 14-6 to 14-12 (describing federal and state requirements). See also 3 HAROLD S. BLOOMENTHAL, *SECURITIES AND FEDERAL CORPORATE LAW* §§ 1.02 & 1.03 (1994); 12 LONG, *supra* note 4, §§ 1.02 & 1.03.

6. See 3 BLOOMENTHAL, *supra* note 5, §§ 1.15 & 1.17; 12A LONG, *supra* note 4, § 7.01.

7. See 3 BLOOMENTHAL, *supra* note 5, § 1.15[1]; 12A LONG, *supra* note 4, § 8.01.

8. See *infra* note 15 and part II.E.

9. See *infra* part II. See also Welle, *supra* note 1, parts III.A, III.B, III.E; Report and Recommendation of the Referee, *Cleland v. Express Communications, Inc.*, No. 50-93-0075, at 40-41 (Ga. Mar. 23, 1994) [hereinafter *Georgia Express Action*].

10. See *infra* part III. See also Welle, *supra* note 1, parts III.A, III.B, III.E; *Georgia Express Action*, *supra* note 9, at 41-42.

11. See *infra* part II.

12. See *infra* part III.

13. See *infra* part IV.

II. BASES FOR SECURITIES LAW CLAIMS

The securities laws only apply if a transaction involves a security.¹⁴ Although a few states have amended their state law definition of a "security" to include specific references to interests in limited liability companies,¹⁵ the federal securities acts and most state securities laws do not expressly list limited liability company interests in the definition of a "security."¹⁶ Absent such a specific statutory reference, the SEC, state regulators and commentators have asserted that certain LLC interests are securities because they fall into general catch-all categories listed in the definition of a "security." For example, they argue that certain LLC interests are securities because (i) the interests consti-

14. 3 BLOOMENTHAL, *supra* note 5, §2.02.

15. The legislatures in Alaska, California, Indiana, New Mexico, Ohio, Pennsylvania, Vermont and Wisconsin amended the definition of a "security" in their state securities laws to expressly include certain LLC interests. ALASKA STAT. § 45.55.990(12) (1994); CAL. CORP. CODE § 25019 (West Supp. 1995); IND. CODE ANN. § 23-2-1-1(k) (Burns 1995); N.M. STAT. ANN. § 58-13B-2(V) (Michie Supp. 1994); OHIO REV. CODE ANN. § 1707.01(B) (Baldwin Supp. 1995); PA. STAT. ANN. tit. 70, § 1-102(t) (Supp. 1995); VT. STAT. ANN. tit. 9, § 4202a(14) (Supp. 1995); WIS. STAT. ANN. § 551.02(13)(c) (West Supp. 1994). For example, VT. STAT. ANN. tit. 9, § 4202a(14) (Supp. 1995) provides that the term "security" includes "any membership interest in a limited liability company."

16. For example, section 2(1) of the Securities Act of 1933 [hereinafter Securities Act], which is virtually identical to the definition in section 3(a)(10) of the Securities Exchange Act of 1934 [hereinafter Exchange Act] and the definitions in the Uniform Securities Act, provides:

The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

15 U.S.C. § 77b(1) (1988).

Section 3(a)(10) of the Exchange Act defines a security in substantially the same manner except (i) it does not contain a reference to "evidence of indebtedness," (ii) it excludes from the definition short-term "commercial paper," and (iii) it uses a slightly different approach to classify oil and gas interests. Securities Exchange Act of 1934 § 3(a)(10), 15 U.S.C. § 78c(a)(10) (1988).

The definition of "security" in the Uniform Securities Act is modeled after the definition in section 2(1) of the federal Securities Act. UNIF. SEC. ACT (1958), 7B U.L.A. 583 cmt. (1985). Thirty-five states have adopted securities acts based on the 1956 version of the Uniform Securities Act, which was amended in 1958. UNIF. SEC. ACT (1958), 7B U.L.A. 154 (Supp. 1995). Six states have adopted securities acts based on the 1985 revision of the Uniform Securities Act, which was amended in 1988. UNIF. SEC. ACT, 7B U.L.A. 87 (Supp. 1995). Therefore, forty-one jurisdictions have adopted acts modeled on the Uniform Securities Act. The term "security" is defined in section 401(1) of the 1956 Uniform Securities Act and in section 101(16) of the 1985 Uniform Securities Act. UNIF. SEC. ACT § 401(1) (1958), 7B U.L.A. 580-81 (1985); UNIF. SEC. ACT § 101(16) (1988), 7B U.L.A. 94 (Supp. 1995).

tute an investment contract,¹⁷ (ii) the interests meet the requirements of the risk capital test adopted by some states,¹⁸ (iii) the interests possess the characteristics of stock,¹⁹ (iv) the interests constitute interests commonly known as securities,²⁰ or (v) there are state statutory grounds for arguing LLC interests are securities.²¹ A brief description of each of these theories follows to provide background for the discussion of possible risks and preventative steps.

A. *Investment Contract*

The SEC²² and at least eighteen state securities commissions²³ have taken the position that certain LLC interests may be securities under the investment contract test set forth in *SEC v. W.J. Howey Co.*²⁴ and its progeny. The Securities Act of 1933, the Securities Exchange Act of 1934 and most state securities laws provide that an "investment contract" is a security.²⁵ In *Howey*, the United States Supreme Court set forth a four-prong test to determine whether an interest is an "investment contract."²⁶

17. See *infra* part II.A.

18. See *infra* part II.B.

19. See *infra* part II.C.

20. See *infra* part II.D.

21. See *infra* part II.E.

22. See, e.g., Plaintiff Securities and Exchange Commission's Memorandum of Points and Authorities in Support of Its Motion for Temporary Restraining Order, Preliminary Injunction and Other Relief at 9-13, *SEC v. Vision Communications, Inc.*, No. 94-0615 (CRR), 1994 WL 326868 (D.D.C. May 11, 1994) [hereinafter Plaintiff's Memorandum in Vision]; Plaintiff Securities and Exchange Commission's Memorandum of Points and Authorities in Support of Its Motion for Temporary Restraining Order, Preliminary Injunction and Other Relief at 11-16, *SEC v. Parkersburg Wireless Ltd. Liab. Co.*, Civ. Action No. 94-1079 (SSH) (D.D.C. filed May 16, 1994) [hereinafter Plaintiff's Memorandum in Parkersburg]; Memorandum of Points and Authorities in Support of Plaintiff Securities and Exchange Commission's *Ex Parte* Application for Temporary Restraining Order and Other Relief and Application for Preliminary Injunction and Other Relief at 10-19, *SEC v. Knoxville, LLC*, Civ. Action No. 941073B (RBB) (S.D. Cal. filed July 11, 1994) [hereinafter Plaintiff's Memorandum in Knoxville].

23. The state securities commissions include Colorado, Connecticut, Indiana, Louisiana, Maryland, Mississippi, Missouri, New York, North Dakota, Oklahoma, South Carolina, South Dakota, Tennessee, Texas, Utah, Virginia, Washington, and Wyoming. See 1 *Blue Sky L. Rep. (CCH)* ¶ 6551.

24. 328 U.S. 293, 298-99 (1946).

25. Securities Act of 1933 § 2(1), 15 U.S.C. § 77b(1) (1988); Securities Exchange Act of 1934 § 3(a)(10), 15 U.S.C. § 78c(a)(10) (1988); UNIF. SEC. ACT § 401(1) (1958), 7B U.L.A. 580-81 (1985) (adopted by 35 states); UNIF. SEC. ACT § 101(16) (1988), 7B U.L.A. 94 (Supp. 1995) (adopted by six states).

26. See *Howey*, 328 U.S. at 298-99. For an extensive discussion of the *Howey* investment contract test see 2 LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 920-86 (1989). On the state law definitions of investment contract see 12 LONG, *supra* note 4, § 2.04; John J. Michalik, Annotation, *What Constitutes an "Investment Contract" within the Meaning of State Blue Sky Laws*, 47 A.L.R. 3d 1375.

The Court stated "an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person [1] invests his money, [2] in a common enterprise and [3] is led to expect profits [4] solely from the efforts of a promoter or a third party" ²⁷

LLC interests typically meet the first three prongs of the *Howey* test. ²⁸ The purchase of LLC interests generally involves an investment of money ²⁹ in a common enterprise ³⁰ with the expectations of profits. ³¹ As a

27. *Howey*, 328 U.S. at 298-99. The definition of "security" in section 3(a)(10) of the Exchange Act is virtually identical to the definition in section 2(1) of the Securities Act. See *supra* note 16. The United States Supreme Court has stated that the definition of "security" will be treated as identical for purposes of both the Securities Act and the Exchange Act. *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 686 n.1 (1985). As a result, even though the *Howey* Court expressly addressed the definition of "investment contract" under the Securities Act, the same four-prong test is used to interpret "investment contract" in the Exchange Act and in many state securities laws. See 2 LOSS & SELIGMAN, *supra* note 26, at 921 (stating *Howey* has become the seminal opinion on the meaning of "investment contract" under both federal and state statutes). While state courts are not bound by federal law in interpreting their state's securities statutes, state courts generally consider federal authority highly persuasive. See, e.g., *Lowery v. Ford Hill Inv. Co.*, 556 P.2d 1201, 1204 (Colo. 1976); *State v. Gunnison*, 618 P.2d 604, 606-07 (Ariz. 1980).

28. MARK A. SARGENT, LIMITED LIABILITY COMPANY HANDBOOK (1994-95) § 4.02[1], at 4-10 [hereinafter SARGENT HANDBOOK]; 1 RIBSTEIN & KEATINGE, *supra* note 1, § 14.02, at 14-2.

29. Courts have broadly interpreted the investment of money requirement. It is clear the investor need not invest cash. All that is required is that the investor give up some tangible and definable consideration. Such consideration may be goods or services. In fact, probably anything constituting legal consideration under contract law will be sufficient to meet the investment of money requirement. See *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 560 n.12 (1979) (expressly rejecting the argument that an investment must take the form of cash and requiring only that the purchaser give up "some tangible and definable consideration"); see, e.g., *Sandusky Land, Ltd. v. Uniplan Groups, Inc.*, 400 F. Supp. 440, 444-45 (N.D. Ohio 1975) (services); *El Khadem v. Equity Sec. Corp.*, 494 F.2d 1224, 1228 (9th Cir.) (supplying collateral for a loan), *cert. denied*, 419 U.S. 900 (1974); *Hector v. Wiens*, 533 F.2d 429, 432 (9th Cir. 1976) (providing credit for a loan); *Harris v. Republic Airlines, Inc.*, Fed. Sec. L. Rep. (CCH) ¶ 93, 772 (D.D.C. May 19, 1988) (specific wage concessions); see also Carl W. Schneider, *The Elusive Definition of a "Security,"* in GLOBAL CAPITAL MARKETS AND THE DISTRIBUTION OF SECURITIES 105, 108-09 (Franklin E. Gill ed., 1991). For a discussion of the state law interpretations of the investment of money requirement see 12 LONG, *supra* note 4, § 2.04[2][a].

30. All courts generally agree the common enterprise requirement is met when there is a pooling of the interests of several investors who share an investment risk with each other. This type of pooling of investor interests is known as "horizontal commonality." Courts disagree on whether "vertical commonality" is sufficient to meet the common enterprise requirement. Vertical commonality requires only that one investor and one promoter be involved in some common enterprise. Some courts require a showing of horizontal commonality, and not vertical commonality alone, to satisfy the common enterprise requirement. 2 LOSS & SELIGMAN, *supra* note 26, at 927-35. The Third, Sixth and Seventh Circuits hold that a showing of horizontal commonality is required to meet the common enterprise test. See, e.g., *Salcer v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 682 F.2d 459, 460 (3d Cir. 1982); *Hart v. Pulte Homes of Mich. Corp.*, 735 F.2d 1001, 1004 (6th Cir. 1984); *Milnarik v. M-S Commodities, Inc.* 457 F.2d 274, 276-77 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972). The Fifth, Ninth and Eleventh Circuits have expressly rejected the view that horizontal commonality is required to meet the common enterprise test. These circuits have found vertical commonality sufficient. See, e.g., *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 478-79 (5th Cir. 1974); *SEC v. Glenn W. Turner Enters., Inc.*, 474 F.2d 476, 482 n.7 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973);

result, the critical issue in determining whether an LLC interest is a security is whether profits are expected solely from the efforts of others.³² In applying the *Howey* test, federal and state courts have rejected a literal interpretation of the word “solely.”³³ Most courts simply require proof that “the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.”³⁴ Consequently, many courts have found an investment constituted a security, even when the investor was required to participate to some extent, provided his efforts were not the undeniably significant ones.³⁵ So if profits are to come substantially from the efforts

Villeneuve v. Advanced Business Concepts Corp., 698 F.2d 1121, 1124 (11th Cir. 1983), *aff'd en banc*, 730 F.2d 1403 (11th Cir. 1984). Some state statutes expressly state that vertical commonality is sufficient to meet the common enterprise requirement. *See, e.g.*, COLO. REV. STAT. ANN. § 11-51-201(17) (West Supp. 1994) (“For purposes of this article, an ‘investment contract’ need not involve more than one investor nor be limited to those circumstances wherein there are multiple investors who are joint participants in the same enterprise.”). For a discussion of the state law interpretations of the common enterprise requirement see 12 LONG, *supra* note 4, § 2.04[2][b].

31. The United States Supreme Court noted that in referring to “profits” it has meant either capital appreciation from the development of the initial investment or a participation in earnings resulting from the use of investor funds. *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 852 (1975). The Court stressed that the critical inquiry is the motive of the purchaser. *Id.* at 852-53. If the investor is attracted by the prospects of a return on his investment, the expectation of profits element is met. *Id.* at 852. However, when a purchaser is motivated to use or consume the item purchased, the expectation of profits element is not met. *Id.* at 852-53 (holding that the sale of stock to tenants in a cooperative housing project was not a security because the tenants purchased the stock for personal consumption, to provide living quarters for personal use). *See generally*, 2 LOSS & SELIGMAN, *supra* note 26, at 936-41. For a discussion of the state law interpretations of the expectation of profits element see 12 LONG, *supra* note 4, § 2.04[2][c].

32. *See, e.g.*, Connecticut Release, *supra* note 3, at 10,554; Indiana Policy Statement, *supra* note 3; Kansas Interpretative Opinion, *supra* note 3, at *2; Oklahoma Exemption Request, *supra* note 3, at 41,655-56; Tennessee Statement of Policy, *supra* note 3, at 48,559-60; Wyoming Draft Opinion, *supra* note 3, at 1, 4. *See also* Welle, *supra* note 1, part III.A; SARGENT HANDBOOK, *supra* note 28, § 4.02[1], at 4-10; 1 RIBSTEIN & KEATINGE, *supra* note 1, § 14.02, at 14-2.

33. *See generally*, 2 LOSS & SELIGMAN, *supra* note 26, at 941-48. For a discussion of the state law interpretations of the solely from the efforts of others element see 12 LONG, *supra* note 4, § 2.04[2][d].

34. This more liberal and flexible test is set forth in *SEC v. Glenn W. Turner Enters., Inc.*, 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973). The more liberal interpretation of the term “solely” has been adopted by nine other circuits. *Baurer v. Planning Group, Inc.*, 669 F.2d 770, 779 (D.C. Cir. 1981); *SEC v. Aqua-Sonic Prods. Corp.*, 687 F.2d 577, 582 (2d Cir.), *cert. denied sub nom.*, *Hecht v. SEC*, 459 U.S. 1086 (1982); *Goodwin v. Elkins & Co.*, 730 F.2d 99, 103 (3rd Cir.), *cert. denied*, 469 U.S. 831 (1984); *Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.*, 840 F.2d 236, 240 n.4 (4th Cir. 1988); *Williamson v. Tucker*, 645 F.2d 404, 418 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981); *SEC v. Professional Assocs.*, 731 F.2d 349, 357 (6th Cir. 1984); *Kim v. Cochenour*, 687 F.2d 210, 213 n.7 (7th Cir. 1982); *Fargo Partners v. Dain Corp.*, 540 F.2d 912, 914-15 (8th Cir. 1976); *Aldrich v. McCulloch Properties, Inc.*, 627 F.2d 1036, 1040 n.3 (10th Cir. 1980).

35. *See, e.g.*, *SEC v. Glenn W. Turner Enters., Inc.*, 474 F.2d 476, 482 (9th Cir.) (the fact that investors were required to exert some efforts if a return was to be achieved would not preclude a finding of an investment contract), *cert. denied*, 414 U.S. 821 (1973); *SEC v. Koscot Interplanetary*,

of others, the LLC interest may be a security. On the other hand, if profits are to come from the joint efforts of the LLC members, the interest may not be a security.³⁶

B. Risk Capital Analysis

A 1993 survey of state securities regulators indicated that some state securities commissions have taken the position, either formally or informally, that certain LLC interests may be securities under a risk capital analysis.³⁷ Also, at least one state no-action letter³⁸ and three state administrative decisions³⁹ have cited the risk capital test as possible grounds for finding LLC interests are securities.⁴⁰

A number of states⁴¹ have adopted the risk capital test⁴² by case law,⁴³ statute,⁴⁴ or administrative ruling.⁴⁵ There are many variations of

Inc., 497 F.2d 473, 479, 485 (5th Cir. 1974) (promotional scheme held to be an investment contract when investor's sole contribution is nominal and ministerial).

36. Cf. 2 LOSS & SELIGMAN, *supra* note 26, at 961-63 (analogous discussion distinguishing partnership interests that are securities from those that are not).

37. Mark A. Sargent, *Will Limited Liability Companies Punch a Hole in the Blue Sky?*, 21 SEC. REG. L.J. 429, 431-34 (1994).

38. Exemption request — *Membership interests in a limited liability company*, 2A Blue Sky L. Rep. (CCH) ¶ 46,664 (Aug. 28, 1992) (citing Oklahoma's risk capital test, OKLA. STAT. ANN. tit. 71, § 2(s)(16) (current version at OKLA. STAT. ANN. tit. 71, § 2(u)(15) (West Supp. 1996)).

39. Georgia Express Action, *supra* note 9, at 44-61 (noting that, under Georgia law, the definition of a security includes both the *Howey* test and the "risk capital" test, but focusing primarily on the *Howey* test elements as applied in Georgia in finding that the LLC interests constituted securities); In re Express Communications, Inc., No. 9200106, 1993 WL 566300, at *11 (Ill. Sec. Dept.) (Dec. 13, 1993) [hereinafter Illinois Express Action] (noting Illinois Administrative Code Rule 130.201(d) provides a broad risk capital test, but analyzing the facts and holding the LLC interests were securities under the *Howey* test as applied in Illinois); In re Dallas MobileComm L.C., No. 94-03-0018, 1995 WL 431589, at *1 (Wash. Sec. Div.) (July 10, 1995) (stating the offer and/or sale of investments in the LLC constituted the offer and/or sale of "an investment contract and/or risk capital").

40. In the no-action letter and two of the administrative decisions, the authors applied the *Howey* test and its progeny to determine whether the LLC interests constituted securities. Since the administrative hearing officers found the LLC interests in question to be securities under the *Howey* test, there was no reason to apply the broader risk capital test. Nevertheless, by citing the risk capital test in each of these opinions, the authors are indicating the risk capital test as possible grounds for finding that an LLC interest is a security. See *supra* note 39.

41. States adopting the risk capital test in some form include Alaska, California, Georgia, Hawaii, Illinois, Michigan, North Dakota, Ohio, Oklahoma, Oregon, and Washington. See *infra* notes 43-45.

42. For a discussion of the various state law risk capital tests see 12 LONG, *supra* note 4, § 2.04[3].

43. See, e.g., Silver Hills Country Club v. Sobieski, 361 P.2d 906, 908-09 (Cal. 1961); State v. Hawaii Market Center, 485 P.2d 105, 109 (Haw. 1971); State ex rel. Healy v. Consumer Business System, Inc., 482 P.2d 549, 552-54 (Or. App. 1971); Jaciewicki v. Gordarl Assocs., Inc., 209 S.E.2d 693, 695-97 (Ga. App. 1974); State v. George, 362 N.E.2d 1223, 1226-29 (Ohio App. 1975).

44. See, e.g., ALASKA STAT. § 45.55.990(12) (1994); GA. CODE ANN. § 10-5-2(26) (1994); MICH. COMP. LAWS ANN. § 451.801(l) (Supp. 1995); N.D. CENT. CODE § 10-04-02(13) (Supp.

the risk capital test.⁴⁶ The most common statutory formulation defines a “security” as an “investment of money or money’s worth including goods furnished or services performed in the risk capital of the venture with the expectation of some benefit to the investor where the investor has no direct control over the investment or policy decisions of the venture.”⁴⁷ Investments in an LLC will typically meet the first three elements of a risk capital test.⁴⁸ An investment in an LLC normally involves contributing money, property or services to the venture. In most LLCs, the investment involves some risk of loss.⁴⁹ Also, an investor usually contributes to the LLC expecting some form of benefit in return. Like the *Howey* investment contract test, the key issue often will be whether the investor has control over the investment or policy decisions of the venture.⁵⁰

In essence, the risk capital tests are a refinement and an extension of the *Howey* investment contract test. Since the risk capital tests are expressly broader than the *Howey* investment contract test,⁵¹ the risk capital tests often lead courts to find a security where they would not under the *Howey* test.

1993); OKLA. STAT. ANN. tit. 71, § 2(u)(15) (West Supp. 1996); WASH. REV. CODE ANN. § 21.20.005(12) (West 1989).

45. See, e.g., ILL. ADMIN. CODE tit. 14, § 130.201(d) (Mar. 26, 1990), 1A Blue Sky L. Rep. (CCH) ¶ 22,614; Opinion of the Att’y Gen. of Cal. No. 66-284, [1961-1971 Transfer Binder] Blue Sky L. Rep. (CCH) ¶ 70,747 (June 2, 1967) (applying risk capital test to sale of a franchise); Opinion letter—Interpretation of franchise agreement as “security,” 2A Blue Sky L. Rep. (CCH) ¶ 46,641 (Okla. July 3, 1980) (applying risk capital test to a franchise agreement).

46. Compare the case law formulations cited *supra* note 43 with the statutory formulations cited *supra* note 44. See also 12 LONG, *supra* note 4, § 2.04[3] for a discussion of the various tests.

47. ALASKA STAT. § 45.55.990(12) (1994); N.D. CENT. CODE § 10-04-02(13) (Supp. 1993) (differs only in that it provides expectation “of profit or some other form of” benefit to the investor); OKLA. STAT. ANN. tit. 71, § 2(u)(15) (West Supp. 1996) (differs only in that it provides goods furnished “and/or” services performed); WASH. REV. CODE ANN. § 21.20.005(12) (West Supp. 1995) (differs in that it provides an investment of money or “other consideration,” the benefit must be a “valuable” benefit, and the investor “does not receive the right to exercise practical and actual control”).

48. See Welle, *supra* note 1, part III.B.

49. As one commentator noted, LLC investments do not generally provide fixed rates of return, any guarantees, or priority over creditors. See SARGENT HANDBOOK, *supra* note 28, § 4.02[2], at 4-14.

50. See SARGENT HANDBOOK, *supra* note 28, § 4.02[2], at 4-14; see also, Welle, *supra* note 1, part III.B.

51. The risk capital tests generally are considered more expansive than the *Howey* investment contract test because (i) nonmonetary investments are expressly recognized as sufficient to meet the investment requirement; (ii) the “common enterprise” requirement is eliminated; (iii) the expectation of “profits” is not required, only the expectation of a “benefit;” and (iv) the efforts of others standard is expressly relaxed. See Welle, *supra* note 1, part III.B; see also, MARC I. STEINBERG, UNDERSTANDING SECURITIES LAW, § 2.02[2][C], at 24 (1989); THOMAS L. HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 1.5, at 42 (2d ed. 1990).

C. Characteristics of Stock Test

Commentators⁵² and at least two state securities commissions⁵³ have asserted certain LLC interests may be securities under the characteristics of stock test⁵⁴ set forth in *Landreth Timber Co. v. Landreth*.⁵⁵ In *Landreth*, the United States Supreme Court held that if an instrument bears the label "stock" and possesses all the characteristics typically associated with stock, the securities laws apply.⁵⁶ The Court noted that the instrument's label is not determinative.⁵⁷ The key inquiry is whether the instrument bears the attributes usually associated with stock, meaning: (i) the right to receive dividends upon the apportionment of profits; (ii) negotiability; (iii) the ability to be pledged; (iv) voting rights in proportion to the number of shares owned; and (v) the capacity to appreciate in value.⁵⁸

The Tennessee Division of Securities has taken the position LLC interests may be securities under the characteristics of stock test set forth in *Landreth*. In a Statement of Policy, the Tennessee Division of Securities stated it believes LLC interests should be analyzed under *Landreth*.⁵⁹ The Division maintains that if an LLC interest possesses the five attributes usually associated with stock, the LLC interest "could be labeled as 'stock,'" which is a security under Tennessee law.⁶⁰

52. Steinberg & Conway, *supra* note 1, at 1116-19; John A. Peralta, *Limited Liability Company Interests as Securities*, 1993 Enforcement L. Rep. (NASAA) 29, 36-40.

53. See Tennessee Statement of Policy, *supra* note 3 (stating if an LLC interest possesses the characteristics of stock set forth in *Landreth*, it is the Tennessee Division of Securities' position the interest is a security); Georgia Express Action, *supra* note 9, at 46 (stating the Georgia Commissioner of Securities urged the referee to apply the test traditionally used to determine whether a particular investment constitutes stock to determine whether an LLC interest is a security). Also, in a request for an interpretative opinion from the Maryland Securities Division, an LLC issuer argued that the LLC interests at issue were not securities because, among other things, the interests bore no resemblance to stock as characterized by the *Tcherepnin*, *Landreth* and *Forman* Courts. The Maryland Securities Division stated it would take no action to require the registration of the LLC interests in question, but the Division did not state the grounds for its decision. Exemption request — Whether membership interests in a limited liability company are required to be registered, 2 Blue Sky L. Rep. (CCH) ¶ 30,579 (Md. Sec. Com. Apr. 25, 1994).

54. For a discussion of the characteristics of stock test and its possible applicability to LLCs see Steinberg & Conway, *supra* note 1, at 1116-19 (maintaining LLC interests ordinarily possess the five attributes usually associated with stock), and Larry E. Ribstein, *Form and Substance in the Definition of a "Security": The Case of Limited Liability Companies*, 51 WASH. & LEE L. REV. 807, 832-33 (1994) (maintaining, even if the test applied, LLC interests do not meet the characteristics of stock test).

55. 471 U.S. 681 (1985).

56. *Id.* at 686.

57. *Id.*

58. *Id.*

59. Tennessee Statement of Policy, *supra* note 3.

60. *Id.*

D. Commonly Known as a Security Test

The federal securities acts and most state securities acts define the term “security” to include any “instrument commonly known as a ‘security.’”⁶¹ At least one commentator has argued that an interest in an LLC constitutes an interest or instrument “commonly known as a ‘security.’”⁶² The phrase “commonly known as a ‘security’” has not generated much litigation.⁶³ Neither the United States Supreme Court nor other federal courts have provided much guidance on how to interpret the phrase.⁶⁴ But one commentator⁶⁵ suggests that to determine what interests or instruments are commonly known as securities, courts should (i) examine the expectations or perceptions of the investing public, or, alternatively, (ii) apply the family resemblance test set forth in *Reves v. Ernst & Young*.⁶⁶

While it does not appear that prosecutors are arguing LLC interests should be considered securities because they constitute interests or instruments “commonly known as a ‘security,’”⁶⁷ the United States Supreme Court has indicated repeatedly that the investing public’s expectations or perceptions are relevant to determining whether an instrument is a security.⁶⁸ As a result, a court may decide to consider the public’s expectations in determining whether an LLC interest is a security.

It also does not appear that prosecutors are citing the family resemblance test set forth in *Reves* to support their contention that certain LLC

61. Securities Act of 1933 § 2(1), 15 U.S.C. § 77b(1) (1988); Securities Exchange Act of 1934 § 3(a)(10), 15 U.S.C. § 78c(a)(10) (1988); UNIF. SEC. ACT § 401(1) (1958), 7B U.L.A. 580-81 (1985) (adopted by 35 states); UNIF. SEC. ACT § 101(16) (1988), 7B U.L.A. 94 (Supp. 1995) (adopted by six states). The Securities Act and Uniform Securities Acts list any interest or instrument commonly known as a security, while the Exchange Act lists only any instrument commonly known as a security. This distinction, however, appears to have little practical effect due to the expansiveness of other terms in the Exchange Act. 5B ARNOLD S. JACOBS, LITIGATION AND PRACTICE UNDER RULE 10b-5 § 38.03[a][i], at 2-155 to 2-156 (1994).

62. Steinberg & Conway, *supra* note 1, at 1119-22.

63. LOSS & SELIGMAN, *supra* note 26, at 209 (Supp. 1994) (supplementing page 875 n.18 in volume 2).

64. See *Tcherepnin v. Knight*, 389 U.S. 332, 343-44 (1967); 5B JACOBS, *supra* note 61, § 38.03[q].

65. See Steinberg & Conway, *supra* note 1, at 1119-22.

66. 494 U.S. 56 (1990).

67. For example, the SEC did not make the argument that LLC interests are interests or instruments “commonly known as a ‘security’” in its complaints or memorandums to the court in *Vision Communications, Parkersburg*, or *Knoxville*. See Plaintiff’s Memorandum in *Vision*, *supra* note 22; Plaintiff’s Memorandum in *Parkersburg*, *supra* note 22; Plaintiff’s Memorandum in *Knoxville*, *supra* note 22.

68. See *Reves*, 494 U.S. at 66; *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 850-51 (1975); *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 687, 693 (1985).

interests are interests “commonly known as a ‘security.’”⁶⁹ Nevertheless, since at least one commentator has suggested applying the *Reves* test to determine if LLC interests are securities,⁷⁰ it is probably only a matter of time before a prosecutor or plaintiff raises the theory in litigation. In *Reves*, the United States Supreme Court analyzed when a “note” is a security.⁷¹ The Court stated that in deciding whether a transaction involves a security, it examines four factors: (i) the motivations of the buyer and seller; (ii) the plan of distribution; (iii) the reasonable expectations of the investing public; and (iv) the presence of other risk-reducing factors.⁷² The Court uses these four factors to identify instruments that bear a strong “family resemblance” to items previously identified as securities.⁷³ If, based on these factors, an LLC interest bears a “strong family resemblance” to other items previously identified as securities, the interest may be deemed a security. Even though there are strong arguments that neither the public’s expectations nor the family resemblance test should determine whether an interest is an interest “commonly known as a ‘security,’”⁷⁴ it is worth noting that these are colorable arguments prosecutors and civil plaintiffs may raise to support their contention that certain LLC interests are securities.

E. State Statutory Grounds

Legislatures in eight states have amended their securities laws to expressly state that certain LLC interests are securities.⁷⁵ Six other states

69. For example, the SEC did not cite the *Reves* family resemblance test in its complaints or memorandums to the court in *Vision Communications*, *Parkersburg*, or *Knoxville*. See Plaintiff’s Memorandum in *Vision*, *supra* note 22; Plaintiff’s Memorandum in *Parkersburg*, *supra* note 22; Plaintiff’s Memorandum in *Knoxville*, *supra* note 22.

70. Steinberg & Conway, *supra* note 1, at 1119-22.

71. *Reves*, 494 U.S. at 60-73. For a discussion of the *Reves* family resemblance test see James D. Gordon III, *Interplanetary Intelligence About Promissory Notes as Securities*, 69 TEX. L. REV. 383 (1990); Janet Kerr & Karen M. Eisenhauer, *Reves Revisited*, 19 PEPP. L. REV. 1123 (1992); Marc I. Steinberg, *Notes as Securities: Reves and Its Implications*, 51 OHIO ST. L.J. 675 (1990).

72. *Reves*, 494 U.S. at 66-67.

73. *Id.* at 65-67.

74. See, e.g., Welle, *supra* note 1, part III.D; Goforth, *supra* note 1, at 1253-70.

75. These states include Alaska, California, Indiana, New Mexico, Ohio, Pennsylvania, Vermont, and Wisconsin. Some statutes specifically list LLC interests in the state securities act definition of a “security.” See, e.g., ALASKA STAT. § 45.55.990(12) (1994); N.M. STAT. ANN. § 58-13B-2(V) (Michie Supp. 1994); OHIO REV. CODE ANN. § 1707.01(B) (Baldwin Supp. 1995); VT. STAT. ANN. tit. 9 § 4202a(14) (Supp. 1995). For example, the Ohio statute provides “‘Security’ means any . . . membership interests in limited liability companies . . .” Other statutes also list LLC interests in the state securities act definition of a “security,” but in addition such statutes state that an LLC interest is not a security under certain specified circumstances. See, e.g., CAL. CORP. CODE § 25019 (West Supp. 1995); IND. CODE ANN. § 23-2-1-1(k) (Burns 1995); PA. STAT. ANN. tit. 70, § 1-102(t) (Supp. 1995). For example, some statutes state that an LLC interest is not a security when all the

have amended their securities laws to include references to LLCs.⁷⁶ Such references imply the offer and sale of LLC interests are subject to that state's securities laws. In addition, legislatures in four states have included provisions in their limited liability company acts that raise the securities law issue.⁷⁷ While such statutes are subject to judicial interpretation,⁷⁸ they provide prosecutors and civil plaintiffs with state law grounds for arguing certain LLC interests are securities.

F. *Assessment of Various Theories*

Commentators generally agree that certain LLC interests may be securities under the *Howey* investment contract test.⁷⁹ Whether a particular LLC interest is a security under the *Howey* test is a factual question based on a case-by-case analysis.⁸⁰ Such analysis will typically focus on the issue of whether profits are expected from the efforts of others.⁸¹ Since the risk capital tests are basically a refinement and an extension of the *Howey* test, it also seems clear that certain LLC interests may be securities under a risk capital analysis as well.⁸² Prosecutors and civil plaintiffs may also make colorable arguments that LLC interests are secu-

members of the LLC are actively engaged in the management of the LLC. *See, e.g.*, CAL. CORP. CODE § 25019 (West Supp. 1995); IND. CODE ANN. § 23-2-1-1(k) (Burns 1995). Another type of statute sets forth certain presumptions in its definition of a "security." For example, such statutes state that a "security" is presumed to include an LLC interest if the right to manage the LLC is vested in one or more managers or if the aggregate number of members exceeds a certain number. *See, e.g.*, WIS. STAT. § 551.02(13)(c) (West Supp. 1994).

76. *See, e.g.*, IOWA CODE ANN. § 502.207A(2)(a) (West Supp. 1995) (expedited registration); KAN. STAT. ANN. § 17-1262(l) (Supp. 1994) (exempt transactions); LA. REV. STAT. ANN. § 51:709(12) (West Supp. 1994) (exempt transactions); N.H. REV. STAT. ANN. § 421-B:17(k) (Supp. 1994) (registration exemption); N.D. CENT. CODE § 10-04-05 (1995) (exempt securities); VA. CODE ANN. § 13.1-514(B)(7) (Michie Supp. 1995) (exempt transactions).

77. GA. CODE ANN. § 14-11-1107(n) (1994) provides "Nothing in this chapter shall be construed as establishing that a limited liability company interest is not a 'security'" MICH. COMP. LAWS ANN. § 450.5103 (West Supp. 1995) provides "An interest in a limited liability company to which this act applies is a security to the same extent as an interest in a corporation, partnership, or limited partnership is a security.;" MO. ANN. STAT. § 347.185 (Vernon Supp. 1994) states "It shall be rebuttably presumed that a member's interest in a limited liability company in which management is not vested in one or more managers is not a security for purposes of any and all laws of this state regulating the sale or exchange of securities." WIS. STAT. ANN. § 183.1303 (West Supp. 1994) provides "An interest in a limited liability company may be a security"

78. *See Welle, supra* note 1, part III.E; *see also* Louis R. Briska, *When does a member's interest in an LLC become a security?*, 67 WIS. LAW. 18, 20-21 (Sept. 1994); SARGENT HANDBOOK, *supra* note 28, § 4.03[1][a], at 4-15 to 4-18.

79. *See, e.g.*, Steinberg & Conway, *supra* note 1, at 1107; SARGENT HANDBOOK, *supra* note 28, § 4.02[1], at 4-10 to 4-13; 1 RIBSTEIN & KEATINGE, *supra* note 1, § 14.02, at 14-2 to 14-3; Welle, *supra* note 1, part III.A.

80. *See supra* notes 26-27 and accompanying text.

81. *See supra* notes 28-36 and accompanying text.

82. *See supra* note 51 and accompanying text.

rities under the characteristics of stock test and the commonly known as a security test. While it is unlikely the characteristics of stock test or the commonly known as a security test will be widely adopted to determine if LLC interests are securities,⁸³ courts are likely to consider the public's expectations or perceptions in determining whether an LLC interest is a security.⁸⁴ Finally, the recent passage of state statutes that define certain LLC interests as securities⁸⁵ provides prosecutors and plaintiffs with additional state law grounds for arguing LLC interests are securities.

G. Federal and State Decisions

At the time this article was written, no reported judicial opinions expressly discussed the rationale for finding an LLC interest to be a security.⁸⁶ Regardless, federal and state prosecutors have been extremely successful in obtaining injunctions and cease and desist orders against certain LLC promoters based on securities law violations. Several federal district courts have entered final judgments permanently enjoining certain LLC promoters from future violations of the federal securities laws.⁸⁷ These courts, however, made no findings of facts or conclusions of law.⁸⁸ The defendants agreed to the entry of permanent injunctions without admitting or denying the allegations. The defendants also waived the entry of findings of fact and conclusions of law.⁸⁹ Nevertheless, these injunc-

83. Both the Kansas Securities Commissioner and a trier of fact in an administrative hearing in Georgia considered, but ultimately rejected, the argument that LLC interests should be considered securities because they possess the characteristics of stock. Kansas Interpretive Opinion, *supra* note 3, at *3; Georgia Express Action, *supra* note 9, at 46. For commentary criticizing application of the characteristics of stock test to LLCs see SARGENT HANDBOOK, *supra* note 28, § 4.02[1], at 4-12 to 4-13; Ribstein, *supra* note 54, at 832-33; Goforth, *supra* note 1, at 1242-47; Welle, *supra* note 1, part III.C. For commentary criticizing application of the "commonly known as a security" test to LLCs using a public's expectations test or family resemblance test see Goforth, *supra* note 1, at 1253-70 (family resemblance test); Welle, *supra* note 1, part III.D (public's expectations test and family resemblance test).

84. See *supra* note 68 and accompanying text.

85. See *supra* part II.E.

86. SARGENT HANDBOOK, *supra* note 28, § 4.03[1][b], at 4-18; Georgia Express Action, *supra* note 9, at 40. However, hearing officers in Illinois and Georgia have issued administrative decisions. In both state enforcement proceedings, the hearing officers found the LLC interests constituted securities under state securities laws by applying the investment contract test. Georgia Express Action, *supra* note 9, at 61; Illinois Express Action, *supra* note 39, at *8.

87. See, e.g., SEC v. Vision Communications, Inc., No. 94-0615 (CRR), 1994 WL 326868, at *1-*2 (D.D.C. May 11, 1994) [hereinafter Vision Final Judgment]; SEC v. Parkersburg Wireless Ltd., No. 94-1079 (JHP), 1994 U.S. Dist. LEXIS 15006, at *1-*6 (D.D.C. Oct. 19, 1994) [hereinafter Parkersburg Final Judgment]; SEC v. Knoxville, LLC, Litigation Release No. 14538, 1995 SEC LEXIS 1594 (June 21, 1995) [hereinafter June 21, 1995 Litigation Release].

88. See, e.g., Vision Final Judgment, *supra* note 87, at *1; Parkersburg Final Judgment, *supra* note 87, at *1; June 21, 1995 Litigation Release, *supra* note 87.

89. See, e.g., Vision Final Judgment, *supra* note 87, at *1; Parkersburg Final Judgment, *supra* note 87, at *1; June 21, 1995 Litigation Release, *supra* note 87.

tions are significant because they imply that the LLC interests at issue were securities.

In addition, state courts and state securities regulators in at least twelve states have ordered certain LLC promoters to cease and desist from offering or selling LLC interests in violation of state securities laws, based on findings that there was sufficient evidence to conclude such LLC interests were securities.⁹⁰ The majority of these cases resulted in the issuance of summary cease and desist orders, where no opinion was issued, only a finding that there was sufficient evidence to conclude that a violation of the securities laws occurred.⁹¹ Often the trier of fact cited no legal theory⁹² or simply made a conclusory finding that the LLC interest constituted an investment contract.⁹³ Again, these decisions are significant because the sanctions indicate the state court or state administrative authority found the LLC interests to be securities. These federal and state enforcement actions are also significant because they indicate the type of LLC offerings prosecutors are targeting, the common characteristics the offerings allegedly share and the arguments prosecutors and private plaintiffs are likely to raise in litigation.

90. Actions have been taken against LLCs under state securities laws in Colorado, Georgia, Illinois, Indiana, Kansas, Minnesota, Missouri, North Dakota, Pennsylvania, South Dakota, Washington and Wisconsin. *See, e.g.*, *Feigin v. Infotech Group, Inc.*, No. 94 CV 1756, 1994 Colo. Sec. LEXIS 1 (Apr. 8, 1994); *Georgia Express Action*, *supra* note 9; *Illinois Express Action*, *supra* note 39; *In re Express Communications, Inc.*, No. 93-0027 CD, 1993 Ind. Sec. LEXIS 46 (Mar. 23, 1993); *In re Wireless Solutions, Inc.*, No. 95E011, 1994 WL 480778 (Kan. Sec. Com.) (Aug. 18, 1994); *In re Replen-K, Inc.*, Nos. SE 9209063, SE 9301897, SE 9304735, 1993 WL 451199 (Minn. Dept. Com.) (Oct. 7, 1993); *In re Wireless Cable Financial Consultants*, No. CD-94-08, 1994 Mo. Sec. LEXIS 31 (Mar. 3, 1994); *In re United Communications Ltd.* (N.D. Dec. 20, 1993) (the Consent Order for the North Dakota case *In re United Communications Ltd.* is attached as Exhibit 9 to an order issued by the Colorado District Court in *Feigin v. Infotech Group, Inc.*, No. 94CV1756, 1994 Colo. Sec. LEXIS 1 (Apr. 8, 1994)); *In re Parkersburg Wireless, LLC*, No. 9403-11, 1994 WL 125846 (Pa. Sec. Com.) (Apr. 6, 1994); *In re Parkersburg Wireless, LLC* (Mar. 28, 1994) (the Order to Cease and Desist for the South Dakota case *In re Parkersburg Wireless, LLC* is attached as Exhibit 10 to an order issued by the Colorado District Court in *Feigin v. Infotech Group, Inc.*, No. 94CV1756, 1994 Colo. Sec. LEXIS 1 (Apr. 8, 1994)); *In re Express Communications, Inc.*, No. 94-03-0018, 1995 WL 307000 (Wash. Sec. Div.) (May 2, 1995); *In re Knoxville Limited Liability Company*, No. X-94044(E), 1994 WL 424373 (Wis. Com. Sec.) (Aug. 4, 1994). For citations to additional cases see Welle, *supra* note 1, Table I.

91. *See, e.g.*, *Feigin v. Infotech Group, Inc.*, No. 94 CV 1756, 1994 Colo. Sec. LEXIS 1, *1-*6 (Apr. 8, 1994); *In re Express Communications, Inc.*, No. 93-0027 CD, 1993 Ind. Sec. LEXIS 46, *1-*12 (Mar. 23, 1993). For additional examples see Welle, *supra* note 1, Table I.

92. *See, e.g.*, *In re UEG, L.C.*, No. 93E068, 1993 WL 208898 (Kan. Sec. Com.) (May 12, 1993); *In re Replen-K, Inc.*, Nos. SE 9209063, SE 9301897, SE 9304735, 1993 WL 451199 (Minn. Dept. Com.) (Oct. 7, 1993). For additional examples see Welle, *supra* note 1, Table I.

93. *See, e.g.*, *Hancock Communications Riverside PCS*, No. 93E-058, 1993 WL 145928 (Kan. Sec. Com.) (Apr. 14, 1993); *In re Parkersburg Wireless, LLC*, No. 9403-11, 1994 WL 125846 (Pa. Sec. Com.) (Apr. 6, 1994). For additional examples see Welle, *supra* note 1, Table I.

III. CHARACTERISTICS THAT MAY INCREASE THE RISK OF AN LLC INTEREST BEING DEEMED A SECURITY

What does this mean for an attorney advising a client who plans to form an LLC or a client who intends to sell interests in an LLC? The federal and state enforcement actions⁹⁴ and various interpretative opinions issued by state securities regulators,⁹⁵ together with the precedent relied upon, make it clear that LLCs with certain characteristics are more likely to be the target of enforcement actions or civil litigation. Analysis of these enforcement actions, state interpretative opinions and prior precedent, when considered along with legal commentaries, recent administrative rules⁹⁶ and recent legislation,⁹⁷ indicate that LLC interests with specific characteristics run a greater risk of being deemed securities.

Following is a discussion of various characteristics that appear to increase the risk of an LLC interest being characterized as a security.⁹⁸ Such characteristics either appear to have affected a court's or an administrative agency's determination that the investment was a security or to have influenced prosecutors in their selection of cases for enforcement actions. While a number of recurring themes and factors emerge, one must remember that all such decisions are highly fact specific. In general, no one factor is determinative. Rather, such decisions often are influenced by the presence of a combination of factors. Nevertheless, it appears that attorneys can reduce the risk of an LLC interest being deemed a security by being aware of these factors and considering the impact of these factors when advising clients who intend to form an LLC. Practitioners should also consider these factors when advising clients with respect to the offer or sale of LLC interests and possible securities law compliance requirements.

A. *Lack of Management Control*

If an investment meets certain threshold requirements, whether the LLC interest is a security will turn on the issue of management control.

94. See *supra* notes 2 and 90.

95. See *supra* note 3.

96. See, e.g., North Carolina Rule, *supra* note 3.

97. See *supra* notes 75-77.

98. The organization of this analysis is based in large part on the framework Conrad E. J. Everhard used in his article *The Limited Partnership Interest: Is it a Security? Changing Times*, 17 DEL. J. CORP. LAW 441 (1992), dealing with when limited partnership interests could be deemed securities. See *id.* at 468-82.

As previously discussed, LLC interests typically meet the first three prongs of the *Howey* investment contract test.⁹⁹ The purchase of an LLC interest generally involves an investment of money in a common enterprise with the expectation of profits.¹⁰⁰ If those threshold requirements are met, the critical issue in determining whether the LLC interest is a security is whether the investor's profits are to be derived substantially from the efforts of others.¹⁰¹ Where profits are to come substantially from the efforts of others, the LLC interest may be a security. On the other hand, where profits are to come from the joint efforts of the LLC members and all LLC members are actively involved in the management of the venture, the interest may not be a security.¹⁰²

Similarly, LLC interests usually meet the first three requirements of the risk capital tests.¹⁰³ An investment in an LLC normally involves contributing money, property or services, some risk of loss and the investor generally expects some benefit in return.¹⁰⁴ The analysis therefore typically focuses on whether the investor has control over the investment or policy decisions of the venture.¹⁰⁵ Also, under several state statutes, an LLC interest will be treated as a security if all of the members are not actively engaged in the management of the LLC or if the right to manage the LLC is vested in one or more managers.¹⁰⁶

As a result, the nature and extent of an LLC member's right and ability to participate in the management and operation of the LLC venture affects whether the LLC interest is a security. If the investor lacks management control, it is likely the LLC interest will be deemed a security. At a minimum, to reduce the risk of an LLC interest being treated as a security, the LLC member must have the legal right to participate in the management of the entity.

1. Legal Right to Control

Whether an LLC member has the legal right to participate in the management of an LLC venture depends, among other things, on the legal rights conferred to LLC members under the applicable state limited

99. See *supra* notes 26-28 and accompanying text.

100. See *supra* notes 29-31.

101. See *supra* notes 32-35 and accompanying text.

102. See *supra* note 36.

103. See *supra* notes 47-48 and accompanying text.

104. See *supra* note 49 and accompanying text.

105. See *supra* note 50.

106. See, e.g., IND. CODE ANN. § 23-2-1-1(k) (Burns 1995); WIS. STAT. ANN. § 551.02(13)(c) (West Supp. 1994).

liability company statute, the management structure adopted by the LLC, and the way the LLC allocates management powers.

a. Statutory Rights

Since an LLC is a statutorily created business form, the scope of an LLC investor's legal powers depends on the powers granted to LLC members under the state statute where the LLC is organized. All LLCs are formed by filing an organizational document, called the articles of organization, with a designated state official.¹⁰⁷ LLC statutes also allow members to enter into agreements, usually referred to as operating agreements, to regulate the affairs of the LLC, the conduct of its business and the relationships among its members.¹⁰⁸ While there are some mandatory requirements for formation and certain statutory default provisions if the members fail to agree otherwise, LLC statutes generally permit LLC members to manage their business and allocate management power in any manner they choose.¹⁰⁹ As a result, an LLC member's legal right to manage the LLC usually depends on the provisions in the articles of organization, the operating agreement or other agreements among its members. The statutory provisions relating to a member's management authority typically govern only if the members fail to agree otherwise. This allows members to structure the LLC and allocate management power in such a way as to insure that all members have the legal right to participate in the management of the enterprise. If an LLC member lacks the legal right to participate in management decisions, it is likely the LLC interest will be deemed a security. To reduce the risk of an LLC interest being treated as a security, the articles of organization, the operating agreement and any other agreement among the members should grant the LLC members the legal power to control the LLC and should clearly provide that each member has the right to participate in management decisions of the LLC.

b. Management Structure

Most LLC statutes do not mandate any particular management structure. LLC statutes usually provide that an LLC will be managed by its members, if the members have not agreed otherwise.¹¹⁰ So LLC members

107. Goforth, *supra* note 1, at 1231 & n.30.

108. Allan G. Donn, *Practical Guide to Limited Liability Companies, in 8 STATE LIMITED PARTNERSHIP LAWS: LIMITED LIABILITY COMPANY STATUTES PGLLC-26* (Michael A. Bamberger & Arthur J. Jacobson eds., 1994 & 1994-3 Supp.) [hereinafter Donn].

109. See Goforth, *supra* note 1, at 1232-33, 1237 & n.33; 1 RIBSTEIN & KEATINGE, *supra* note 1, § 8.02, at 8-2 to 8-3, 1S-38; SARGENT HANDBOOK, *supra* note 28, § 1.03, at 1-4.

110. Donn, *supra* note 108, at PGLLC-35; SARGENT HANDBOOK, *supra* note 28, at 1-13 n.38; 1 RIBSTEIN & KEATINGE, *supra* note 1, § 1.05, at 1-4. Minnesota, North Dakota, Oklahoma and Texas provide for management by separate managers, as in a corporation. Only Tennes-

may opt out of the member-managed form by agreeing to vest management in whole or in part in a manager or group of managers.¹¹¹ In other words, LLC members can choose to manage the LLC themselves or delegate full or partial responsibility for management to a manager or group of managers.¹¹²

In some states, the management structure adopted by the LLC may dictate whether the LLC is treated as a security. For example, some state statutes provide that if the right to manage the LLC is vested in one or more managers, the LLC interest is presumed to be a security.¹¹³ A number of state administrative regulations and interpretative opinions also provide that an interest in a manager-managed LLC will be presumed to be a security.¹¹⁴ While generally such presumptions are not conclusive, they shift the burden of proof to the offeror or seller.¹¹⁵ To rebut the presumption, the offeror or seller must present evidence that, despite the manager-managed form, the members retain the right to exercise actual or practical control over the entity.¹¹⁶

Obviously, the safest course is to adopt a member-managed organizational structure. Even in jurisdictions that appear to mandate a manager-managed form,¹¹⁷ the same result may be achieved by specifying in the operating agreement that all members automatically serve or must be selected to serve as managers.¹¹⁸ But as one commentator noted, the downside is that all members presumably would retain

see requires that LLCs have managers. 1 RIBSTEIN & KEATINGE, *supra* note 1, § 8.02, at 8-2, 1S-38.

111. Robert R. Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW 375, 390 (1992); 1 RIBSTEIN & KEATINGE, *supra* note 1, § 1.05, at 1-4.

112. SARGENT HANDBOOK, *supra* note 28, § 1.03, at 1-4; DONN, *supra* note 108, at PGLLC-35 to -36.

113. See, e.g., WIS. STAT. ANN. § 551.02(13)(c) (West, Supp. 1994).

114. See, e.g., Connecticut Release, *supra* note 3 (the Department will ordinarily presume interests in a "manager-member" form of LLC are securities); Kansas Interpretative Opinion, *supra* note 3, at *2 (Kansas Securities Commissioner concluded that "[i]f members elect managing members on an annual basis, who manage the business affairs on an ongoing basis in a manner similar to a corporate board, or otherwise delegate management authority to a select group, the interests would be securities"); North Carolina Rule, *supra* note 3 (membership interests shall be presumed to be securities where the articles of organization provide that all the members are not necessarily managers); South Carolina Statement of Policy, *supra* note 3 (the South Carolina Securities Commission will presume that membership interests in manager-managed LLCs with any members who are not equally participating managers are securities).

115. See, e.g., North Carolina Rule, *supra* note 3; South Carolina Statement of Policy, *supra* note 3.

116. See, e.g., North Carolina Rule, *supra* note 3.

117. For example, Tennessee requires LLCs to have managers, and therefore appears to mandate a manager-managed organizational structure. See TENN. CODE ANN. § 48-241-101 (1995).

118. Goforth, *supra* note 1, at 1301.

statutory management authority, which may include the authority to bind the LLC.¹¹⁹

c. Delegation of Management Powers

In many LLCs, the demands of the business or the desires of the members may dictate the need for a more centralized management structure. A pure member-managed form, where each member participates equally in management decision-making, may not be practical or advisable. The LLC statutes generally permit LLC members to delegate substantial authority to a member, group of members or a third-party manager.¹²⁰ For example, LLC members may wish to retain the right to approve extraordinary matters, such as the sale of assets, mergers, major acquisitions, refinancings, dissolution, approval, election or removal of members or managers, and the like. But they may wish to delegate the right to make day-to-day business decisions to a group of members or a manager.¹²¹

Some LLC promoters have crafted operating documents that grant legal control to the LLC members, but delegate certain decision-making authority to managers or third parties.¹²² LLC promoters and some commentators argue that the delegation of management power to others does not diminish the LLC members' management control.¹²³ They contend that since the LLC members retain legal control, the members are not dependent on the efforts of others and therefore the interest is not a security.¹²⁴ In support of their

119. Goforth, *supra* note 1, at 1302 & n.332.

120. SARGENT HANDBOOK, *supra* note 28, § 1.03, at 1-4; Donn, *supra* note 108, at PGLLC-35 to -36. The LLC statutes typically do not require managers to be members. Donn, *supra* note 108, at PGLLC-36 to -37; Keatinge et al., *supra* note 111, at 397.

121. Examples of such day-to-day decision making might include the right to approve expenditure of funds, borrowing funds, hiring of personnel and execution of contracts on behalf of the business. See Everhard, *supra* note 98, at 473-76 (discussing delegation of management authority in the context of limited partnerships).

122. See Defendants' Memorandum of Points and Authorities in Opposition to Plaintiff's Motion for Temporary Restraining Order at 17-19, SEC v. Vision Communications, No. 94-0615 (CRR), 1994 WL 326868 (D.D.C. May 11, 1994) [hereinafter Defendants' Memorandum in Vision]; Opposition to Plaintiff SEC's Application for Temporary Restraining Order and Other Relief and Memorandum of Points and Authorities at 15-18, SEC v. Parkersburg Wireless Ltd. Liab. Co., Civ. Action No. 94-1079 (SSH) (D.D.C. filed May 16, 1994) [hereinafter Defendants' Memorandum in Parkersburg].

123. See, e.g., Defendants' Memorandum in Vision, *supra* note 122, at 19; cf. Williamson v. Tucker, 645 F.2d 404, 423 (5th Cir.) (stating "[t]he delegation of rights and duties [by partners]—standing alone—does not give rise to the sort of dependence on others which underlies the third prong of the *Howey* test."), *cert. denied*, 454 U.S. 897 (1981). See also Goforth, *supra* note 1, at 1301-02 (arguing that in the general partnership context the delegation of authority does not result in general partnership interests being treated as securities); SARGENT HANDBOOK, *supra* note 28, at § 4.02[1], at 4-10 to 4-11 (drawing an analogy between LLC interests and general partnership interests).

124. See, e.g., Defendants' Memorandum in Vision, *supra* note 122, at 16-19, 24; see cf.

contention, they draw an analogy between LLC interests and general partnership interests,¹²⁵ which usually are not treated as securities.¹²⁶ They cite those cases where courts have held general partnership interests were not securities because the partners retained the ultimate power to control the business under the state partnership statute or the partnership agreement.¹²⁷ The essence of this argument is that the power to exercise management control is determinative, regardless of the control actually exercised. As long as the investor retains ultimate control, he has power over his investment and access to information about the venture, therefore, he is not dependent on the efforts of others.¹²⁸

The SEC and state securities regulators argue that the mere grant of management powers in the articles of organization or any other operating document should not shield the LLC from charges that its interests are securities.¹²⁹ They contend that if members delegate or abdicate their authority and simply become passive participants in the venture, the LLC interests should be treated as securities because profits are then expected from the efforts of others, not the efforts of the investor. In support of their position, prosecutors note that even general partnership interests may be securities if the agreement among the parties distributes power as in a limited partnership,¹³⁰ since limited partnership interests generally are considered securities.¹³¹

Banghart v. Hollywood Gen. Partnership, 902 F.2d 805, 808 (10th Cir. 1990).

125. See *supra* note 123.

126. See 1 RIBSTEIN & KEATINGE, *supra* note 1, § 14.02, at 14-3 to 14-4 (the general partnership form is close to a per se nonsecurity); SARGENT HANDBOOK, *supra* note 28, § 4.02[1], at 4-10 (general partnership interests are virtually presumed not to be securities).

127. Commentators and LLC promoters cite cases such as Goodwin v. Elkins & Co., 730 F.2d 99, 107 (3d Cir.) (must read the statute and the private agreement to determine legal powers vested), *cert. denied*, 469 U.S. 831 (1984); Banghart v. Hollywood Gen. Partnership, 902 F.2d 805, 808 (10th Cir. 1990) (whether the interest is a security turns on the partnership agreement); Odom v. Slavik, 703 F.2d 212, 216 (6th Cir. 1983) (indicating the issue is whether general partner had power under the partnership agreement and state partnership laws); Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc., 840 F.2d 236, 241-42 (4th Cir. 1988) (interest not a security because the partnership agreement conferred broad authority to manage and control the business); Reeves v. Teuscher, 881 F.2d 1495, 1500 (9th Cir. 1989) (the proper focus must be on the partnership agreement and not how the entity functioned).

128. Williamson v. Tucker, 645 F.2d 404, 424 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981).

129. See, e.g., Plaintiff's Memorandum in Vision, *supra* note 22, at 12-13; Plaintiff Securities and Exchange Commission's Reply Memorandum in Support of its Motion for Temporary Restraining Order at 5-6, SEC v. Vision Communications, Inc., No. 94-0615 (CRR), 1994 WL 326868 (D.D.C. May 11, 1994) [hereinafter Plaintiff's Reply Memorandum in Vision]; Plaintiff's Memorandum in Parkersburg, *supra* note 22, at 14-16. See also Welle, *supra* note 1, at parts III.A.1 and III.A.3.

130. See, e.g., Williamson v. Tucker, 645 F.2d 404, 423-24 (5th Cir.) (indicating that if an agreement allocates partnership power as in a limited partnership, such an arrangement may be held to be an investment contract), *cert. denied*, 454 U.S. 897 (1981).

131. See, e.g., 3 BLOOMENTHAL, *supra* note 5, § 2.05[2] (citing numerous authorities); L&B Hospital Ventures, Inc. v. Healthcare Int'l, Inc., 894 F.2d 150, 151 (5th Cir.), *cert. denied*, 498

Several LLCs, where promoters carefully crafted operating agreements in which the members retained legal control, but delegated certain management decision-making authority, have found themselves the subject of enforcement actions.¹³² While the courts have not resolved this issue, prosecutors have been successful in obtaining injunctions against promoters offering LLC interests where the members retained certain legal rights to control the entity, but delegated management decision-making authority to others.¹³³

In many circumstances, the delegation of some management authority to a member, a group of members or a manager may be necessary and will not affect the nature of the investment. But as members move away from equal participation in the decision-making process, the risk that the LLC interest will be deemed a security increases. The mere grant of legal control in the organizational documents will not immunize an LLC from charges that its interests are securities. If LLC members delegate substantial decision-making authority to others and abdicate their control of the venture to others, the likelihood that the LLC interest will be treated as a security increases.

2. Actual Ability to Exercise Management Control

Even if the members retain the legal right to control the LLC venture, their interests still may be deemed securities. A number of securities regulators have taken the position that management control depends not only on the legal control granted in the articles of organization or operating agreement, but also on the members' actual ability to exercise control in a meaningful way.¹³⁴ In support of their position, they cite general partnership cases, such as *Williamson v. Tucker*.¹³⁵ In *Williamson*, the Fifth Circuit noted that a general partnership interest may be a security (i) if the partner is so inexperienced and unknowledgeable in business affairs that he is incapable of exercising his partnership powers, or (ii) if the partner is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the promoter or manager or otherwise exercise meaningful

U.S. 815 (1990); *Goodman v. Epstein*, 582 F.2d 388, 406-08 (7th Cir. 1978), *cert. denied*, 440 U.S. 939 (1979).

132. See, e.g., Defendants' Memorandum in *Vision*, *supra* note 122, at 17-19; Defendants' Memorandum in *Parkersburg*, *supra* note 122, at 15-18.

133. See, e.g., *Vision* Final Judgment, *supra* note 87, at *1-*2; *Parkersburg* Final Judgment, *supra* note 87, at *1-*6.

134. See Connecticut Release, *supra* note 3, at 10,554; Indiana Policy Statement, *supra* note 3, at 19,571; Kansas Interpretative Opinion, *supra* note 3, at *2; Oklahoma Exemption Request, *supra* note 3, at 41,656; Tennessee Statement of Policy, *supra* note 3, at 48,560; Wyoming Draft Opinion, *supra* note 3, at 5.

135. 645 F.2d 404 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981).

partnership power.¹³⁶ Other courts, such as the Ninth Circuit, have also stated in the partnership context that courts must consider not only the partnership agreement, but also the practical possibility of the investors exercising the management or control powers they possess.¹³⁷

In the enforcement actions involving LLCs, the SEC and state prosecutors have focused, among other things, on (i) the lack of sophistication of certain LLC members, (ii) the special managerial or entrepreneurial skills supplied by promoters or third parties, and (iii) the lack of control that some members may have over their investment as a practical matter due to the number of members and the geographic distribution of members.¹³⁸ As previously noted, prosecutors have been successful in obtaining injunctions and cease and desist orders in such cases.¹³⁹ For example, in a Georgia enforcement action, the hearing officer found that although each member had the power to make managerial decisions for the LLC, the members could not effectively exercise management control because they lived in diverse geographic areas, and they lacked technical expertise and business experience.¹⁴⁰ The hearing officer noted that since the members were incapable of exercising the illusory powers granted to them, they were placed in a position of relying on the technical expertise and managerial ability of others.¹⁴¹ Similarly, in an Illinois enforcement action, the hearing officer found that even though the investor was offered the opportunity to become an officer of the LLC, he was unsophisticated and believed he was in the hands of an expert who would take care of matters for him.¹⁴² Consequently, he could effectively exercise his managerial rights only with the expert advice of others.¹⁴³ In each case, the hearing officer held that the LLC interests at issue were securities under state securities laws.¹⁴⁴

As a result, whether an LLC interest will be treated as a security may turn on whether the investor has the actual ability to exercise management control. This depends on a number of factors including, among other things, the knowledge, experience and sophistication of the investor, the investor's dependence on promoters, managers or third parties, and the number of members.

136. *Id.* at 424.

137. *Koch v. Hankins*, 928 F.2d 1471, 1478 (9th Cir. 1991).

138. *See, e.g.*, Plaintiff's Memorandum in *Vision*, *supra* note 22, at 12-13; Plaintiff's Memorandum in *Parkersburg*, *supra* note 22, at 14-15; *see also*, *Illinois Express Action*, *supra* note 39, at *4, *7-*8.

139. *See supra* part II.G.

140. *Georgia Express Action*, *supra* note 9, at 60.

141. *Id.*

142. *Illinois Express Action*, *supra* note 39, at *16.

143. *Id.*

144. *Georgia Express Action*, *supra* note 9, at 61; *Illinois Express Action*, *supra* note 39, at *8.

a. Knowledge, Experience and Sophistication of Investors

Even if LLC members have the legal right to exercise management control, their interests may be treated as securities if the members lack the knowledge, experience or sophistication to legitimately exercise such powers. For example, several state interpretative opinions indicate that LLC interests may be securities if the members are incapable of exercising their management powers due to limited knowledge or inexperience in business matters.¹⁴⁵ Lack of knowledge, experience or sophistication is a recurring theme in a number of LLC enforcement actions. In many of the enforcement actions brought against LLC communication ventures, prosecutors claimed the investors had little or no business experience.¹⁴⁶ Such investors included retirees, clerical workers and blue-collar workers unfamiliar with either business operations in general or communications technology in particular.¹⁴⁷ Prosecutors maintained that because the members were so inexperienced and unknowledgeable in business they were incapable of intelligently exercising management control.¹⁴⁸ Prosecutors claimed that as a result such members were dependent on the efforts of others, so the LLC interests were securities.¹⁴⁹

It is not clear whether the knowledge, experience and sophistication requirement can be satisfied by general business experience alone or whether an investor must have experience in the type of business the LLC conducts.¹⁵⁰ In the partnership context, some courts have suggested that knowledge and experience in business affairs generally is sufficient.¹⁵¹ Other courts, however, have indicated that some background in the business of the venture may be necessary.¹⁵² At least one state interpretative opinion states that if an LLC engages in a highly technical and specialized business in which the investor has no particular expertise, the LLC interest may be treated as a security.¹⁵³

145. See, e.g., Wyoming Draft Opinion, *supra* note 3, at 7; see also, Connecticut Release, *supra* note 3, at 10,554-55; Indiana Policy Statement, *supra* note 3, at 19,571; Tennessee Statement of Policy, *supra* note 3, at 48,560.

146. See, e.g., Plaintiff's Memorandum in Vision, *supra* note 22, at 2, 12; Plaintiff's Memorandum in Parkersburg, *supra* note 22, at 15-16; Georgia Express Action, *supra* note 9, at 60-61.

147. See, e.g., Plaintiff's Reply Memorandum in Vision, *supra* note 129, at 3-4.

148. See, e.g., Plaintiff's Memorandum in Vision, *supra* note 22, at 13.

149. Plaintiff's Memorandum in Vision, *supra* note 22, at 12.

150. For a discussion of this issue see Everhard, *supra* note 98, at 478-79.

151. *Williamson*, 645 F.2d at 424. See also, *Deutsch Energy Co. v. Mazur*, 813 F.2d 1567, 1570 (9th Cir. 1987).

152. *Long v. Schultz Cattle Co.*, 881 F.2d 129, 134 n.3 (5th Cir. 1989); *Bailey v. J.W.K. Properties, Inc.*, 904 F.2d 918, 924 (4th Cir. 1990); *Albanese v. Florida Nat'l Bank of Orlando*, 823 F.2d 408, 412 (11th Cir. 1987).

153. Indiana Policy Statement, *supra* note 3, at 19,571.

What this means is that the safest course is to involve only individuals or entities reasonably experienced and knowledgeable in business matters generally and in the business of the enterprise in particular. To determine if the investor is sufficiently knowledgeable, experienced and sophisticated, one must inquire into the investor's educational background, employment history, business experience, industry knowledge and investment history. If the investor will only contribute money to the venture and lacks the knowledge, experience and sophistication to legitimately exercise any management powers, the LLC runs the risk that its interests will be characterized as securities.

b. Dependence on Promoters, Managers or Other Third Parties

Dependence on a promoter, manager or third party typically arises in two types of situations: (i) where the investor lacks the business experience and technical expertise to intelligently exercise his management powers, and (ii) where the promoter, manager or third party has some special abilities, unusual experience or technical expertise that is necessary for the successful operation of the venture.¹⁵⁴ In each of these situations, the investor may find himself dependent on the efforts of others, and as a result, the LLC interest may be characterized as a security. For example, in *Vision Communications, Inc.*, the SEC alleged that the purpose of the LLC venture was to develop a wireless cable system.¹⁵⁵ The venture involved sophisticated technology and the venture operated in a highly regulated environment.¹⁵⁶ The SEC argued, among other things, that since the investors lacked both business experience in general and technical expertise in the communications industry in particular, the investors were forced to rely on the efforts of those with the technical expertise and business experience necessary for the successful operation of the venture.¹⁵⁷ The in-

154. *See id.* at 423.

155. Plaintiff's Memorandum in *Vision*, *supra* note 22, at 13.

156. *Id.*

157. *See id.* at 12-13. *See also* *Georgia Express Action*, *supra* note 9, at 55-56. This situation often arises in ventures of a highly technical nature. In *Cleland v. Express Communications, Inc.*, *supra* note 9, the LLC venture involved wireless telecommunications technology. The hearing officer noted:

Even a cursory review of the technical documents and informational literature presented to the investors in this case supports the conclusion that significantly complex and diverse technical expertise and knowledge is required if the investors are to successfully pursue an FCC license for a cellular unserved area. It is highly unlikely that even a sophisticated professional or business investor would have the degree of special expertise necessary to be able to maintain any "real" or significant control over the investment.

....

Although the LLC regulations provide that each member has the power to make managerial decisions for the LLCs, the Referee finds that the members under the facts of this case cannot in reality effectively exercise this control since they . . . lack the complex technical expertise and experience necessary to operate a business which files FCC appli-

vestors had no realistic alternative but to rely on the promoters or managers, who it appears they could not replace.

In *Williamson*, the Fifth Circuit noted that there must be more than mere reliance.¹⁵⁸ The investor must be so dependent on the promoter, manager or third party that he cannot replace the individual or he is unable to exercise meaningful management control.¹⁵⁹ As a result, the risk that an LLC interest will be deemed a security increases if (i) the promoter or manager alone possesses some unique skill or technical expertise that is necessary for the successful operation or management of the venture; (ii) the investor's lack of such technical skills or managerial expertise means he cannot exercise meaningful management control; or (iii) the investor's dependence on the promoter or manager is so great that such manager or promoter cannot be replaced.

c. *Number of Members*

The number of members may also determine whether interests in a particular LLC will be treated as securities.¹⁶⁰ In several states, presumptions with respect to whether an LLC interest is a security turn on the number of LLC members. For example, a securities law statute in Wisconsin provides that an LLC interest is presumed to be a security if the aggregate number of members exceeds thirty-five.¹⁶¹ An administrative rule promulgated by the North Carolina Securities Division states that LLC interests shall be presumed to be securities where all members are managers and the number of members is greater than fifteen.¹⁶² A South Carolina policy statement indicates that an LLC with more than twenty-five members will be treated as a security, unless facts and circumstances warrant a different result.¹⁶³

cations for cellular unserved areas and constructs and operates a highly technical cellular telephone system. The members are dependent upon the unique technical expertise and the entrepreneurial and managerial ability of Respondent ECI . . . to the extent that in reality Respondents cannot be replaced. Under the facts of this case, the member investors are incapable of exercising the illusory power granted under the LLC regulations. The investors are therefore placed in a position of dependency upon Respondents.

Id. at 56, 60-61. This case illustrates that even LLC ventures with sophisticated investors may be at risk of having their interests deemed securities if the venture involves business of a highly technical nature.

158. *Williamson*, 645 F.2d at 424.

159. *Id.*

160. Many state statutes require an LLC to have at least two members, although some states permit a single member LLC. Donn, *supra* note 108, § 4.3. There does not appear, however, to be any statutory limit on the number of members. As a result, some LLCs allegedly have hundreds, even thousands, of members. *See, e.g.*, Plaintiff's Memorandum in *Vision*, *supra* note 22, at 2 ("about 125 investors"); Plaintiff's Memorandum in *Knoxville*, *supra* note 22, at 17 (the SEC alleged the number of investors was "likely to be near 2,000").

161. WIS. STAT. ANN. § 551.02(13)(c) (West Supp. 1994).

162. North Carolina Rule, *supra* note 3.

163. South Carolina Statement of Policy, *supra* note 3, at 46,576.

The rationale for such presumptions is that at some point the LLC has so many members that a vote of the members is similar to a corporate shareholder vote, with each member's role diluted to the level of a single shareholder.¹⁶⁴ Once that point is reached, the number of members in itself serves to deprive each member of any meaningful role in the management of the LLC. If the members have no real ability to exercise management control, such LLC interests may constitute securities, regardless of any legal rights granted to the members. Consequently, the risk of an LLC interest being deemed a security increases as the number of members increases.

B. *Use of Certain Marketing Techniques*

The manner in which an offeror markets an investment appears to be another important factor in determining whether an interest is a security.¹⁶⁵ Even though the manner of offering is not an express element of the *Howey* investment contract test, the marketing techniques used may affect whether the interest is characterized as a security.¹⁶⁶ For example, courts often examine the marketing scheme, promotional literature or sales representations to determine whether the elements of the *Howey* investment contract test have been met.¹⁶⁷ Marketing techniques are also considered in determining whether an interest is a security under many of the risk capital tests. Several risk capital tests require a court to examine the offeror's promises or representations.¹⁶⁸

164. Cf. *Williamson*, 645 F.2d at 423 (discussing this issue in the context of partnership interests).

165. Lewis D. Lowenfels & Alan R. Bromberg, *What is a Security under the Federal Securities Laws?*, 56 ALB. L. REV. 473, 529 (1993).

166. Carl W. Schneider, *The Elusive Definition of a "Security": A 1990 Update*, in GLOBAL CAPITAL MARKETS AND THE DISTRIBUTION OF SECURITIES 119, 124 & n.27 (Franklin E. Gill ed., 1991).

167. See, e.g., *SEC v. Professional Assocs.*, 731 F.2d 349, 354 (6th Cir. 1984) (the Sixth Circuit held that the district court acted properly in considering the promotional brochure used by the defendants to determine whether the common enterprise element of the *Howey* investment contract test was met and whether the instrument was a security); *SEC v. International Loan Network, Inc.*, 968 F.2d 1304, 1307-08 & nn.9-10 (D.C. Cir. 1992) (the court examined the promoter's marketing scheme and promotional literature to determine whether the elements of the *Howey* test were met); *Wright v. Schock*, 571 F. Supp. 642, 648-54 (N.D. Cal. 1983), *aff'd*, 742 F.2d 541 (9th Cir. 1984) (the court examined the defendant's promotional literature, the content of seminar presentations and verbal representations to determine whether the common enterprise and profits anticipated through the efforts of others elements of the *Howey* test were met).

168. See, e.g., *State v. Hawaii Market Center, Inc.*, 485 P.2d 105, 109 (Haw. 1971) (the risk capital test adopted by the Hawaii Supreme Court requires that "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"); GA. CODE ANN. § 10-5-2(26) (1994) (one of the elements of the risk capital test in Georgia is that "[o]ne of the inducements to invest is the promise of promo-

In *Reves v. Ernst & Young*,¹⁶⁹ the United States Supreme Court noted that in deciding whether a transaction involves a security, the Court examines, among other things, the plan of distribution, the expectations of the investing public and the motivations of the buyer and seller to enter into the transaction.¹⁷⁰ In the majority of cases where the United States Supreme Court has held an investment to be a security, the investment involved a relatively high degree of risk and had been mass-marketed to numerous prospects, primarily as an investment for profit, in comparatively small units affordable by the average investor.¹⁷¹ Similarly, a number of the LLC offerings targeted by the government share these same characteristics. According to prosecutors, promoters in these cases mass-marketed LLC interests to the general public by offering investment units in amounts affordable by relatively small investors.¹⁷² Prosecutors alleged that the interests in these high risk ventures were touted as investments for profit and often sold based on claims of immediate and exorbitant returns.¹⁷³ The method in which an investment is marketed not only appears to affect courts in their determination of whether an investment is a security,¹⁷⁴ but also appears to influence prosecutors in their selection of cases for enforcement actions.

tional or sales efforts of the issuer or its affiliates on the investor's behalf"); MICH. COMP. LAWS ANN. § 451.801(l) (Supp. 1995) (the risk capital test in Michigan requires that "the furnishing of that capital is induced by the representations of an issuer, promoter, or their affiliates which give rise to a reasonable understanding that a valuable tangible benefit will accrue to the person furnishing the capital as a result of the operation of the enterprise").

169. 494 U.S. 56 (1990).

170. See *Reves*, 494 U.S. at 66 (discussed in the context of whether certain demand notes are securities within the meaning of the term "note" in section 3(a)(10) of the Securities Exchange Act of 1934).

171. Lowenfels & Bromberg, *supra* note 165, at 533, 558. In *Joiner, Howey, Variable Annuity, United Benefit, Tcherepnin* and *Reves*, the United States Supreme Court held that the investments in question were securities. Lowenfels and Bromberg observed that in all six cases there was a common element: "an instrument marketed primarily as an investment for profit to the public at large in comparatively small units for sums affordable by the average investor." *Id.* at 533. In contrast, in *Forman, Daniel*, and *Weaver*, the Court held that the investments at issue did not constitute securities and in each case the offeror employed markedly different sales and marketing techniques. *Id.*

172. See, e.g., Plaintiff's Memorandum in *Vision*, *supra* note 22, at 2, 4-6; Plaintiff's Reply Memorandum in *Vision*, *supra* note 129, at 3-4; Plaintiff's Memorandum in *Parkersburg*, *supra* note 22, at 2, 4-5, 7-8, 15; Plaintiff Securities and Exchange Commission's Supplement to Its Memorandum of Points and Authorities in Support of Its Motion for Preliminary Injunction and Other Relief at 6-8, 10-11, 17. SEC v. *Parkersburg Wireless Ltd. Liab. Co.*, Civ. Action No. 94-1079 (SSH) (D.D.C. filed June 9, 1994) [hereinafter Plaintiff's Supplemental Memorandum in *Parkersburg*].

173. See, e.g., Plaintiff's Memorandum in *Vision*, *supra* note 22, at 1, 14; Plaintiff's Reply Memorandum in *Vision*, *supra* note 129, at 2, 6-7; Plaintiff's Memorandum in *Parkersburg*, *supra* note 22, at 2, 6, 17; Plaintiff's Supplemental Memorandum in *Parkersburg*, *supra* note 172, at 23.

174. See *supra* notes 166 and 167.

While use of certain marketing techniques is not a prerequisite for finding that an offering involves a security, the promoter's marketing and sales techniques appear to be a factor that may tip the balance when courts and government prosecutors are considering whether an investment is a security. As a result, marketing and sales techniques, such as the manner of offering, the sales pitch, promotional materials, sales tactics and the nature of the investment opportunity, may affect whether prosecutors bring an enforcement action and the outcome of some cases.

1. Manner of Offering (Public versus Private Offering)

The coverage of the securities laws is not limited to instruments traded on securities exchanges and the over-the-counter market.¹⁷⁵ Nevertheless, an interest marketed to the general public appears to run a greater risk of being deemed a security than an interest offered to a carefully selected few.¹⁷⁶ In *Marine Bank v. Weaver*, the United States Supreme Court noted that instruments found to be securities in its prior cases generally involved offers to a number of potential investors, rather than directly-negotiated offers.¹⁷⁷ The Court then went on to hold that the unique agreement in question, which was negotiated directly between the parties, was not a security.¹⁷⁸ The *Marine Bank* case, together with prior precedent, appears to indicate that an interest offered to the public at large is more likely to be characterized as a security than an interest offered to only a few selected investors in directly-negotiated, private transactions. This observation appears to hold true with respect to LLC offerings as well. For example, in the LLC offerings targeted to date by the SEC and in many of the LLC offerings targeted by state securities regulators, promoters allegedly marketed the interests to the general public.¹⁷⁹ While mass-marketing or sales to the general public are not prerequisites for finding a security, it appears that the risk of an enforcement action and the risk of a

175. *Marine Bank v. Weaver*, 455 U.S. 551, 556 (1982).

176. Schneider, *supra* note 166, at 124; *see also*, Lowenfels & Bromberg, *supra* note 165, at 529-34.

177. *Marine Bank*, 455 U.S. at 559-60; *see, e.g.*, SEC v. W.J. Howey Co., 328 U.S. 293, 295 (1946) (42 purchasers); SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 346 (1943) (offers to sell oil leases were sent to over 1,000 prospects); Tcherepnin v. Knight, 389 U.S. 332, 333 n.2 (1967) (more than 5,000 purchasers solicited through mailings); Reves v. Ernst & Young, 494 U.S. 56, 58-59 (1990) (advertised in newsletter that went to approximately 23,000 members).

178. *Marine Bank*, 455 U.S. at 560.

179. *See, e.g.*, Plaintiff's Memorandum in Vision, *supra* note 22, at 4-5, 7 (prosecutors alleged nationwide effort to sell LLC interests resulted in sales to 125 investors); Plaintiff's Supplemental Memorandum in Parkersburg, *supra* note 172, at 17 (prosecutors alleged LLC interests were sold to over 700 investors nationwide).

court deeming an LLC interest a security increases as the number of offerees increases.¹⁸⁰

2. Sales Methods

The sales method used to offer and sell an investment opportunity is another factor that appears to influence the selection of cases for enforcement actions and the outcome of certain cases. As previously noted, an interest mass-marketed to the general public appears to run a greater risk of being deemed a security than an interest offered to a carefully selected few.¹⁸¹ As a result, the use of mass-marketing sales methods, such as bulk mailings, telephone solicitations and television advertising, is likely to increase the risk of an LLC interest being characterized as a security. For example, in several cases where the United States Supreme Court found that the investment in question constituted a security, the Court noted and described the mass-marketing sales methods employed by the promoters.¹⁸² Similarly, prosecutors in a number of cases involving LLC offerings have emphasized the sales methods used by promoters. In several of the LLC offerings targeted, prosecutors alleged promoters utilized televised infomercial broadcasts, toll free telephone numbers, mailings or cold call telephone solicitations to offer and sell LLC interests.¹⁸³ While the sales method used is not necessarily determinative,¹⁸⁴ use of mass-marketing sales methods provides evidence that the interests were offered to the general public and therefore increases the risk that the LLC interest will be treated as a security.

180. 5B JACOBS, *supra* note 61, § 38.03[a][ii], at 2-202.

181. *See supra* notes 176-180 and accompanying text.

182. *See, e.g.*, SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 346 (1943) ("sales campaign was by mail addressed to upwards of 1,000 prospects"); Tcherepnin v. Knight, 389 U.S. 332, 333 (1967) ("petitioners had purchased such securities in reliance upon printed solicitations received from City Savings through the mails"); *Reves v. Ernst & Young*, 494 U.S. 56, 58-59 (1990) (the notes at issue were advertised in a newsletter distributed to approximately 23,000 members); SEC v. W.J. Howey Co., 328 U.S. 293, 296-97 (1946) (hotel advertising used to attract potential investors).

183. *See, e.g.*, Plaintiff's Memorandum in *Vision*, *supra* note 22, at 4-5 (prosecutors alleged the use of televised infomercial broadcasts with 800 telephone numbers and cold call telephone solicitation techniques); Plaintiff's Memorandum in *Parkersburg*, *supra* note 22, at 10-11 (prosecutors alleged the use of televised infomercials with toll free telephone numbers and telephone solicitations); Plaintiff's Memorandum in *Knoxville*, *supra* note 22, at 5 (prosecutors alleged the use of televised infomercials, promotional brochures, information packages, videotapes and telephone calls to solicit potential investors).

184. *See* 2 LOSS & SELIGMAN, *supra* note 26, at 960-61 n.206, for a discussion of the use of advertising and the difference between a bona fide search for an active partner and a public offering of a security.

3. Sales Representations and Targeted Investors

The sales pitch of the promoter and the type of investor targeted also appear to affect whether an investment will be designated a security.¹⁸⁵ Courts routinely examine promotional materials and verbal representations to determine whether an interest is a security.¹⁸⁶ As the United States Supreme Court noted in *SEC v. C.M. Joiner Leasing Corp.*,¹⁸⁷ “it is not inappropriate that promoters’ offerings be judged as being what they were represented to be.”¹⁸⁸

In several of the LLC enforcement actions to date, prosecutors have focused on the sales representations allegedly made by promoters to prove that the LLC interests at issue were securities. Prosecutors have quoted promotional brochures, telephone solicitation scripts and other sales representations as evidence that profits were expected from the efforts of others. For example, in *Vision Communications*, to prove that profits in fact were expected from the efforts of others, prosecutors pointed to promotional materials that described the investor’s role in the LLC as similar to a shareholder’s and touted the technical expertise of the management team.¹⁸⁹ Some state securities regulators have indicated that they would find certain representations relevant to their determination of whether an LLC interest is a security, such as representations that the promoter or some third party possesses special expertise that is necessary to the success of the venture.¹⁹⁰

Similarly, the targeted investor may also be a significant factor.¹⁹¹ If sales efforts are directed to investors who are likely to be passive and lack the ability to become actively involved in the management of the venture, this factor militates toward finding a security.¹⁹² Prosecutors in some of the LLC enforcement actions to date have alleged that LLC promoters in those cases primarily solicited investors with little or no business experience knowing full well that such investors were not able to become actively involved in the management of the LLC.¹⁹³ Representations encouraging passive investment, claims of some unique expertise and sales

185. Schneider, *supra* note 29, at 108; Schneider, *supra* note 166, at 124.

186. See *supra* notes 167-168.

187. 320 U.S. 344 (1943).

188. *Id.* at 353.

189. Plaintiff’s Memorandum in *Vision*, *supra* note 22, at 4, 12; see also Plaintiff’s Memorandum in *Parkersburg*, *supra* note 22, at 14-15.

190. See, e.g., Indiana Policy Statement, *supra* note 3.

191. Schneider, *supra* note 166, at 124.

192. *Id.*

193. See, e.g., Plaintiff’s Reply Memorandum in *Vision*, *supra* note 129, at 3-4.

efforts primarily targeted at passive investors each increase the risk that an LLC interest will be deemed a security.

4. Nature of Investment Risk and Sales Tactics

As one commentator noted, courts often are very result oriented.¹⁹⁴ The *Howey* investment contract test,¹⁹⁵ the risk capital tests,¹⁹⁶ and many of the statutory provisions¹⁹⁷ are broadly drawn and therefore provide courts and regulatory authorities great latitude when determining whether an investment is a security.¹⁹⁸ More than one commentator has observed that the greater the investment risk and the more questionable the sales effort, the more likely the investment will be deemed a security.¹⁹⁹ Such courts apparently are seeking to protect investors from inadequate disclosure or even fraud. Consequently, in the LLC offerings targeted to date, some prosecutors have focused on the risks associated with the investments and the sales tactics used by promoters. For example, in *Vision Communications*, prosecutors characterized the investment as risky and alleged investors were misled about the degree of risk.²⁰⁰ Prosecutors also claimed promoters used high pressure sales techniques to induce financially unsophisticated investors to invest their retirement funds with promises of immediate and exorbitant returns.²⁰¹ While risky investments and questionable sales tactics are not prerequisites to finding a security, it appears that the more risky an investment and the more questionable the sales tactics, the more likely it is that the LLC interest will be treated as a security.

C. Possessing the Characteristics of Stock

Some commentators and at least two state securities commissions have asserted that certain LLC interests may be securities if the interests

194. Schneider, *supra* note 166, at 125.

195. See *supra* part II.A.

196. See *supra* part II.B.

197. See *supra* part II.E.

198. See Schneider, *supra* note 166, at 125.

199. See *id.*; Lowenfels & Bromberg, *supra* note 165, at 529-39; see also 5B JACOBS, *supra* note 61, § 38.03[a][ii], at 2-202 to 2-204. For example, Lowenfels and Bromberg observed that in *Joiner*, *Howey*, *Variable Annuity*, *United Benefit*, *Tcherepnin*, *Landreth* and *Reves*, seven cases where the United States Supreme Court addressed whether certain investments were securities, "a meaningful degree of investment risk rested with the purchasers of the instruments." Lowenfels & Bromberg, *supra* note 165, at 537.

200. Plaintiff's Reply Memorandum in *Vision*, *supra* note 129, at 6-7.

201. Plaintiff's Memorandum in *Vision*, *supra* note 22, at 1-2, 4-5.

possess the same attributes or characteristics as stock.²⁰² In *Landreth Timber Co. v. Landreth*,²⁰³ the United States Supreme Court set forth what it viewed as the five attributes or characteristics usually associated with stock.²⁰⁴ These attributes include: (i) the right to receive dividends upon the apportionment of profits; (ii) negotiability; (iii) the ability to be pledged; (iv) voting rights in proportion to the number of shares owned; and (v) the capacity to appreciate in value.²⁰⁵ While it is unlikely such a theory will be widely adopted to determine if LLC interests are securities,²⁰⁶ at least one state securities commission has issued a statement of policy taking the position that if an LLC interest possesses the five attributes usually associated with stock, the LLC interest could be treated as a security.²⁰⁷

If the characteristics of stock test is applied to LLC interests, many LLC interests may possess the attributes usually associated with stock. Nevertheless, with the client's consent and careful drafting, practitioners can easily eliminate one or more of these characteristics.²⁰⁸ For example,²⁰⁹ the operating agreement may restrict a member's ability to pledge his or her interests. The operating agreement may allocate voting rights on a per capita rather than a pro rata basis. The operating agreement may allocate distributions on a basis other than the member's contribution. By considering these factors and eliminating at least one of the five characteristics with appropriate provisions in the operating agreement, the drafter can reduce the risk of an LLC interest being deemed a security under the characteristics of stock test.

D. *The Public's Expectations*

Even though it does not appear that the SEC or state securities regulators are arguing LLC interests should be considered securities because they constitute interests or instruments "commonly known as a 'security,'"²¹⁰ the United States Supreme Court has stated in a number of cases that the investing public's expectations and perceptions are relevant in

202. See *supra* notes 52-53.

203. 471 U.S. 681 (1985).

204. *Id.* at 686.

205. *Id.*

206. See *supra* note 83.

207. Tennessee Statement of Policy, *supra* note 3, at 48,560.

208. See Alex J. DeYonker, *Are Michigan Limited Liability Company Interests Securities?*, 16 MICH. BUS. L.J. 19, 22-23 (1994); Ribstein, *supra* note 54, at 833; Goforth, *supra* note 1, at 1242-48.

209. The applicable state LLC statute must be consulted prior to making any of these suggested changes to determine if such provisions are statutorily permitted.

210. See *supra* note 67.

determining whether an instrument is a security.²¹¹ A court, therefore, may decide to consider the public's expectations in determining whether an LLC interest is a security. While there are a number of compelling arguments that the public's expectations alone should not be determinative,²¹² it is possible that a court will consider the public's expectations along with other factors. If a court finds that, among other things, an investor purchasing an LLC interest reasonably expected the transaction to be governed by the securities laws, the court may find that the LLC interest is a security.

There is little that one can do to affect the expectations or perceptions of the general public. It is possible, however, to affect the expectations or perceptions of an individual investor. With this concern in mind, some practitioners have begun to expressly disclose in their LLC offering documents that the LLC interests being offered are not expected to be securities, are not registered under any securities laws and may not be subject to the protection of the securities laws.²¹³ While offerings where LLC promoters made similar disclosures have been the subject of enforcement actions, in those cases the SEC did not argue that the investors expected the interests to be securities or expected the protection of the securities laws.

Even though such a disclosure may reduce the risk of an LLC interest being characterized as a security on the grounds of an investor's expectations, such a disclosure also presents certain risks. If a court finds that the LLC interest in question was clearly a security under the laws of the relevant jurisdiction, the court may view the disclosure as misleading, or worse, fraudulent. If the court views the disclosure as misleading, such a disclosure could influence the court's decision and may even result in liability. It is also worth noting and explaining to clients that a disclaimer does not provide the offeror or seller with any protection from securities law coverage in general. If the investment is a security under state or federal securities laws, the securities laws apply regardless of any disclosures. A seller may not effect a waiver of the securities laws by simply stating the securities laws do not apply.²¹⁴

211. See *supra* note 68.

212. See *supra* note 83.

213. See, e.g., Defendants' Memorandum in Parkersburg, *supra* note 122, at 9-11.

214. See, e.g., Securities Act of 1933 § 14, 15 U.S.C. § 77n (1988) ("Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the Commission shall be void."). A similar provision prevents waiver of the Exchange Act. See Securities Exchange Act of 1934 § 29(a), 15 U.S.C. § 78cc(a) (1988).

Of course, a practitioner should only make such a disclosure after carefully reviewing all the facts relating to the transaction and the current statutory, case and regulatory authority in each jurisdiction where the LLC interest will be offered or sold. Furthermore, a practitioner should not make any such disclosure unless in the attorney's considered professional opinion it does not appear a court, administrative body, or regulatory authority in the relevant jurisdictions will deem the LLC interest in question a security. Generally, the attorney should qualify any such disclosure in terms of "the membership interest is not expected to be treated as a security," rather than "the membership interest is not a security."²¹⁵ Any such disclosure should be clearly and prominently displayed. If the disclosure is simply included along with other boilerplate language and buried in the fine print, the effect of the disclosure may be diminished. Some practitioners appear to be making these disclosures about securities law issues in the body of the offering document, in the risk factor section of the offering document, on the signature page and even in investor qualification questionnaires.²¹⁶ While such a disclosure brings with it inherent risks, if the disclosure is well-founded, qualified and carefully crafted, it may reduce the risk of the LLC interest being characterized as a security on the grounds that the investor expected the protection of the securities laws. After receiving such a warning, an investor would have difficulty arguing that he expected the LLC interests to be securities or that he expected the protection of the securities laws.

IV. PLANNING AND DRAFTING STRATEGIES TO REDUCE THE RISK OF AN LLC INTEREST BEING DEEMED A SECURITY

What steps may a practitioner take to reduce the risk of securities law violations in connection with the offer or sale of an LLC interest? Given that specific characteristics appear to increase the risk of a court deeming an LLC interest a security, the way the LLC is structured, the characteristics of the LLC and the method of marketing may determine whether the LLC interest is characterized as a security.²¹⁷ Consequently, it appears that an attorney may employ certain drafting and planning strategies to reduce the risk of an LLC interest being characterized as a security.

215. In addition, it may also be advisable to warn investors of the risks if the interests are subsequently construed to be securities, including the fact that the LLC may be subject to certain penalties related to the sale of unregistered securities and resulting restrictions on the offer and sale of such securities.

216. See, e.g., Defendants' Memorandum in Parkersburg, *supra* note 122, at 9-11.

217. See *supra* part III.

While a number of factors may affect whether an interest is deemed a security, obviously not all of these factors must be present for a court to find that the LLC interest is a security.²¹⁸ Nevertheless, the presence of a factor makes it more likely the interest will be deemed a security. Conversely, the presence of even a number of these factors does not dictate the LLC interest will be deemed a security.

As previously noted, whether an LLC interest constitutes a security is a developing and evolving area of the law. The positions taken by courts and regulators to date may not be consistent with the positions taken by courts and regulators in the future. As a result, practitioners must carefully review the facts of each transaction in light of current federal and state case law, statutes, regulations and regulatory authority. For example, some state statutes expressly provide that certain LLC interests are securities.²¹⁹ Similarly, many state securities regulators have set forth guidelines specifying under what circumstances they will consider certain LLC interests to be securities.²²⁰ An attorney therefore must review the securities laws and relevant authorities in every jurisdiction where the LLC interest will be offered or sold, in addition to applicable federal authority, to determine if the interest is a security.

Nevertheless, based on the authority at the time this article was written, it appears an attorney may reduce the risk of an LLC interest being deemed a security in certain jurisdictions by taking some of the steps described below. Of course, the client must be consulted to determine if such measures are acceptable or practical in light of the needs of the business or the desires of the members. In addition, the attorney must review all applicable state statutes, case law and regulatory authority to determine if such measures are statutorily permitted. With these caveats in mind, the following suggestions may reduce the risk that certain LLC interests will be designated securities:

VEST LEGAL RIGHT TO CONTROL THE LLC IN ITS MEMBERS.

The organizational documents of the LLC should clearly state that management and legal control of the LLC is vested in the members of the LLC.²²¹ The documents should also provide that each member is granted all legal rights and powers to manage and control the LLC, to the full extent permitted under the law of the jurisdiction where the LLC is organized. It should be clear from a review of the articles of

218. See generally Lowenfels & Bromberg, *supra* note 165, at 557-60; Schneider, *supra* note 166, at 123-27; 5B JACOBS, *supra* note 61, § 38.03[a][ii], at 2-201 to 2-204.

219. See *supra* note 75.

220. See, e.g., *supra* note 3.

221. See *supra* part III.A.1.a.

organization, the operating agreement and any other agreements among the members that each member has the legal power to control the LLC, including unfettered access to information and the right to participate in all management decisions.

ADOPT A MEMBER-MANAGED ORGANIZATIONAL STRUCTURE. The organizational documents should provide that the LLC shall be managed and controlled by its members and shall not have any “managers” as that term is defined in the LLC statutes in the jurisdiction where the LLC is organized.²²² It should be clear from a review of the articles of organization, the operating agreement and other agreements among the members that the LLC has adopted a member-managed form of organization. In jurisdictions that appear to mandate a manager-managed form, the same result may be achieved by specifying in the operating agreement that all members automatically serve or must be selected to serve as managers.²²³

LIMIT THE AMOUNT OF MANAGEMENT AUTHORITY EACH MEMBER DELEGATES TO OTHERS. The grant of legal control to members in the organizational documents may not immunize the LLC from charges that its interests are securities.²²⁴ Some courts and regulators have indicated that they will look beyond the documents to determine how the entity is actually managed. If members delegate substantial decision-making authority to others or abdicate their control to others, so that the LLC becomes the functional equivalent of a limited partnership, the likelihood that the LLC interests will be deemed securities increases.²²⁵ Consequently, members should avoid broad delegation of authority to other members, managers or third parties.²²⁶ If the demands of the business or the desires of the members dictate the need to delegate some authority to others, the delegation of such powers should be narrowly drawn and, to the extent possible, limited to ministerial or de minimis matters. In particular, members should avoid delegating authority with respect to material management decisions and approval of extraordinary matters.

REQUIRE MEMBERS TO ACTIVELY PARTICIPATE IN THE MANAGEMENT OF THE LLC.²²⁷ This may be accomplished, in part, by informing all members at the outset that they will be required to actively participate in the management of the venture. For example, request each member to

222. *See supra* part III.A.1.b.

223. *See supra* notes 117-119. Of course, this assumes the applicable laws of the jurisdiction where the LLC is organized permit such a provision.

224. *See supra* notes 129-133 and accompanying text.

225. *Cf. supra* note 130.

226. *See supra* part III.A.1.c.

227. *See supra* part III.A.2.

sign an acknowledgment form that describes the investor's management and control rights and states that the investor understands such rights and agrees to actively participate in the management of the LLC. Also establish procedures to encourage members to be actively involved in the management of the LLC on an on-going basis. For instance, delineate the types of information that the LLC will distribute to all members, such as quarterly financial statements, audited year-end reports or other periodic business reports, so that members receive sufficient information about the business to make informed management decisions. In addition, establish requirements, with respect to voting rights, notice, meetings, attendance at meetings, proxies and other items, designed to promote member participation in the management decision-making process.

INVOLVE ONLY KNOWLEDGEABLE, EXPERIENCED AND SOPHISTICATED INVESTORS. Screen all potential investors to insure that they are sufficiently knowledgeable, experienced and sophisticated, in business matters generally and in the business of the LLC in particular, to participate in the management of the LLC.²²⁸ This may be accomplished by promoters or members requesting information about the potential investor's educational background, employment history, business experience, industry knowledge and investment history. For example, a simple questionnaire may be designed to screen potential investors and determine if the potential investor possesses the actual ability to reasonably exercise management powers. A questionnaire similar to the type used to comply with the Regulation D exemption²²⁹ would probably be sufficient to accomplish this purpose, with some modifications and additions.²³⁰ In addi-

228. See *supra* part III.A.2.a.

229. Regulation D sets forth rules promulgated by the SEC governing limited offers and sales of securities without registration under the Securities Act of 1933. 17 C.F.R. §§ 230.501 to 230.508 (1995). The rules exempt from the federal securities law registration requirements specific offers and sales of securities to "accredited investors" and certain other investors who are not "accredited investors." 17 C.F.R. § 230.506 (1995). The rules define an "accredited investor" to include specific entities and individuals meeting designated net worth and income requirements. 17 C.F.R. § 230.501(a) (1995). To qualify for the exemption, a non-accredited investor must have "such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment." 17 C.F.R. § 230.506(b)(2)(ii) (1995). Many practicing attorneys have designed questionnaires to determine if potential investors meet the "accredited investor" or non-accredited investor requirements, by asking standard questions about net worth, annual income, household income, investment experience and other pertinent information.

230. George G. Yearsich et al., *Partnerships and Limited Liability Companies (LLCs): Uniform Acts, Taxation, Drafting, Securities, and Bankruptcy*, ALI-ABA Resource Materials, WL R176 ALI-ABA 1155, *1200 (June 2, 1994) (suggesting, with respect to partnership interests, that counsel may use a "Regulation D approach" to qualify potential investors, including employing certain Regulation D net worth and income tests, requiring a disclosure letter, requiring questionnaires, requiring "purchaser representatives" for non-accredited investors, and trying to make investors active on an on-going basis).

tion, if any dispute arises as to whether the LLC interests are securities, the screening questionnaires would provide evidence that all investors were qualified to take part in the management of the LLC.

AVOID DEPENDENCE ON PROMOTERS, MANAGERS OR OTHER THIRD PARTIES. Each member should individually possess the technical knowledge and managerial ability to exercise meaningful management control.²³¹ Attempt to minimize dependence on promoters, members or third parties with unique technical expertise or special managerial abilities. While this may be difficult from a practical standpoint, dependence may be minimized by either hiring a consultant with similar skills to independently advise the investors on matters requiring technical expertise²³² or by involving a number of unrelated individuals with similar skills as investors. The goal is to insure that the LLC members are not so dependent on a promoter, manager or third party that (i) the members cannot exercise meaningful management control, or (ii) such promoter, manager or third party cannot be replaced.

RESTRICT THE NUMBER OF MEMBERS. The risk of an LLC interest being deemed a security increases as the number of members increases.²³³ In several states, presumptions regarding whether an LLC interest is a security turn on the number of LLC members.²³⁴ In some states, the presumption is triggered if the number of members exceeds thirty-five.²³⁵ In other states, the presumption is triggered if the number of members is greater than fifteen.²³⁶ While there is no magic number, if the number of members grows so large that each individual member has no real ability to exercise management control, then the LLC interests are likely to be deemed securities. As a result, the operating documents should limit the number of members so that each member will be able to exercise meaningful management control.

TARGET THE OFFERING TO A SELECT FEW. An interest marketed to the general public appears to run a greater risk of being deemed a security than an interest offered to a carefully selected few.²³⁷ As a result, the promoter or member should not widely market the offering to the public at large. Instead, the offering should be targeted to a few selected and qualified investors in directly-negotiated, private transactions.

231. See *supra* part III.A.2.b.

232. See Yearsich, *supra* note 230, at *1201 (suggests hiring a “purchaser representative”-type advisor”).

233. See *supra* part III.A.2.c.

234. See, e.g., *supra* notes 161-163.

235. See *supra* note 161.

236. See *supra* note 162.

237. See *supra* part III.B.1.

REVIEW AND MONITOR SALES METHODS AND REPRESENTATIONS. Promoters or members should refrain from using mass-marketing sales methods, such as television advertising, bulk mailings or cold-call telephone solicitations, to market the LLC interests.²³⁸ The use of such marketing methods provides evidence that the promoters or members offered the interests to the general public and therefore increases the risk that the LLC interests will be deemed securities. Counsel should also review promotional materials and sales representations. Prosecutors and plaintiffs often point to promotional brochures, telephone solicitation scripts and other sales representations as evidence that profits were expected from the efforts of others and therefore the interests are securities.²³⁹ Representations promising passive investment, claims that an individual or the management team has some unique expertise and sales efforts targeted at financially unsophisticated investors increase the risk that the interests will be characterized as securities.

CONSIDER THE NATURE OF THE INVESTMENT RISK. Commentators have observed that many courts are result oriented.²⁴⁰ Therefore, the greater the investment risk and the more questionable the sales tactics, the more likely the investment will be treated as a security. Consequently, counsel should consider the nature of the investment risk and the type of sales tactics to be used when determining whether to comply with applicable securities laws. Use of high pressure sales techniques, solicitation programs aimed at financially unsophisticated individuals and offerings of interests in high risk ventures appear to increase the likelihood that an LLC interest will be characterized as a security.

ELIMINATE AT LEAST ONE OF THE FIVE CHARACTERISTICS USUALLY ASSOCIATED WITH STOCK. Structure the transaction so as to eliminate one or more of the five characteristics usually associated with stock.²⁴¹ These characteristics include: (i) the right to receive dividends upon the apportionment of profits; (ii) negotiability; (iii) the ability to be pledged; (iv) voting rights in proportion to the number of shares owned; and (v) the capacity to appreciate in value.²⁴² Counsel may eliminate one or more of these characteristics by including appropriate provisions in the LLC operating agreement. For example, the operating agreement could include provisions (i) that restrict a member's ability to pledge his or her interests; (ii) that allocate voting rights on a per capita rather than a pro rata basis; or (iii) that allocate distributions on a basis other than the member's contribution.

238. See *supra* part III.B.2.

239. See *supra* part III.B.3

240. See *supra* part III.B.4.

241. See *supra* part III.C.

242. Landreth Timber Co. v. Landreth, 471 U.S. 681, 686 (1985).

INCLUDE APPROPRIATE SECURITIES LAW DISCLOSURES IN THE OFFERING DOCUMENTS. Some practitioners expressly disclose in their offering documents that the LLC interests being offered are not expected to be securities, are not registered under any securities laws and may not be subject to the protection of the securities laws.²⁴³ While such a disclosure brings with it inherent risks, if the disclosure is well-founded, appropriately qualified and carefully crafted, it may reduce the risk of an LLC interest being characterized as a security on the grounds that the investor expected the protection of the securities laws. If such a disclosure is made, counsel should also consider warning investors of the risks if the interests are subsequently determined to be securities. These risks include the fact that the LLC may be subject to certain penalties in connection with the offer or sale of unregistered securities and resulting restrictions on the offer and sale of the LLC interests.

In closing, while the steps outlined above may reduce the risk of certain LLC interests being deemed securities, it is not always possible for counsel to structure the transaction in a way that the securities laws will not apply. The needs of the business or the desires of the members may require the LLC to have certain characteristics that increase the likelihood that the LLC interests will be deemed securities. Under such circumstances, counsel should proceed as if a security is in fact involved and advise the client accordingly. For instance, counsel should consider possible exemptions from registration, disclosures requirements, broker-dealer registration requirements and other securities law compliance issues.²⁴⁴ As some commentators have noted, if a securities lawsuit is brought, counsel may wish that he or she had treated the interests as if they were securities and planned accordingly.²⁴⁵ Nevertheless, by employing certain planning and drafting strategies, counsel may significantly reduce the risk that certain LLC interests will be treated as securities.

243. See *supra* part III.D.

244. A discussion of securities law exemptions and securities law compliance requirements is beyond the scope of this article. For a discussion of the various securities law requirements see 1 RIBSTEIN & KEATINGE, *supra* note 1, §§ 14.02 & 14.03, at 14-6 to 14-12 (describing federal and state requirements). See also 3 BLOOMENTHAL, *supra* note 5, §§ 1.02 & 1.03 (1994); 12 LONG, *supra* note 4, §§ 1.02 & 1.03.

245. See Yearsich, *supra* note 230, at *1201.