Tulsa Law Review

Volume 29
Issue 2 *Native American Symposia*

Winter 1993

The Oklahoma Limited Liability Company

Stacy Ward Wood

John Tristam Woodruff

COMMENTS

THE OKLAHOMA LIMITED LIABILITY COMPANY

I. INTRODUCTION

Recently, state legislatures across the nation have expressed great interest in Limited Liability Companies (LLCs).[1] The first LLC statute was enacted by Wyoming in 1984, but interest in the LLC has burgeoned since 1988, when the Internal Revenue Service indicated that LLCs would be treated as partnerships for tax purposes.[2] Oklahoma adopted its own LLC Act in May of 1992.[3]

Although this alternative business form's characteristics make it potentially attractive to many clients, much uncertainty continues to surround its use. The attractive characteristic of an LLC is that it allows partnership tax treatment and limited liability without the imposition of corporate formalities.[4] However, uncertainty still exists as to basic issues such as how informally LLC's may be structured and still retain partnership tax status, whether the entity will be subject to common law doctrines of piercing the corporate veil, whether LLC interests are securities under the state and federal securities acts, and numerous other concerns.[5]

This Comment's purpose is twofold. First, it seeks to educate the organizer as to the basic characteristics of an LLC and compare it to other similar business forms. Second, it seeks to address some of the most central questions that face an LLC organizer: (1) what must be

1. David Ransom, *Limited Liability Companies Are on the Rise*, TRIAL, May 1993, at 90-91.

2. *Id. See* discussion *infra* part III.A.

3. OKLA. STAT. ANN. tit. 18, §§ 2000-60 (West. Supp. 1994).

4. Rev. Rul. 88-76, 1988-2 C.B. 360.

5. Some of these concerns are whether the full faith and credit clause will force states to recognize the LLCs' limited liability, whether LLCs may be a bankruptcy debtor, whether LLCs hold property as a legal person or a juristic person, and whether the LLC may be used as an organizational vehicle for professions.

done to ensure partnership tax treatment; (2) how veil-piercing doctrines may be applied to LLCs, and (3) how the securities laws will be applied to LLC interests.

II. To LLC or Not to LLC, That Is the Question

A. The Characteristics of an LLC

An LLC is created when two or more persons, referred to as "members," file executed articles of organization with the Office of the Secretary of State.[6] The articles of organization must set forth the name of the LLC, the date on which it is to dissolve, its purposes, and other information.[7] Additionally, members may enter into an operating agreement that governs how the LLC will be managed.[8] The LLC Act, articles of organization, and the operating agreement work together to give LLCs the following general characteristics.

1. Limited Liability

Limited liability exists when owners are not personally liable for the business' debts. Instead, liability extends only to the owners' interests in the business. Section 2022 of the Oklahoma Limited Liability Act provides that a basic characteristic of an LLC is limited liability.[9] However, as with a corporation, owners could become personally liable if they personally guaranteed the business' debt or if veil piercing doctrines are applied.[10]

2. Continuity of Life

Continuity of life exists when, regardless of the status of a business' owners and managers, the organization survives.[11] The Oklahoma LLC resembles a corporation in that the LLC's default provision generally provides for continuity of life.[12] However, like a partnership, the LLC dissolves upon the happening of an event such

6. Okla. Stat. Ann. tit. 18, § 2004 (West Supp. 1994).

7. *Id.* §§ 2004-05. The articles should also include the address of the LLC's principal place of business in this state, the name and address of its resident agent in this state, and any other provisions which the members elect.

8. *Id.* § 2013.

9. *Id.* § 2022 ("A person who is a member or manager, or both, of a limited liability company is not liable for the obligations of a limited liability company solely by reason of being such member or manager or both.").

10. *See infra* Part III(B).

11. Revised Model Business Corp. Act § 3.02 (1984).

12. Okla. Stat. Ann. tit. 18, § 2037 (West Supp. 1994).

as death, bankruptcy, or withdrawal of one of its members, unless the articles of organization or operating agreement specify otherwise.[13]

3. Free Transferability of Interest

Free transferability of interest exists when the business' shares can be transferred by one owner without the other owners' consent.[14] The default provisions of the LLC Act place restrictions on the transferability of members' interests.[15] The statute provides that admittance of a new member is allowed only when authorized by the articles, operating agreement, or written consent of the members.[16]

4. Centralized Management

Centralization of management occurs when someone other than the business owners themselves manages the business.[17] The default provision of Section 2013 of the Oklahoma LLC Act provides that the LLC will be managed by or under the authority of one or more managers who may be, but need not be, members.[18] Thus, the LLC Act allows member management, but without the stringent formalities of a closely held corporation.

5. Pass-Through Tax Treatment

Pass-through tax treatment exists when the profits, gains, and losses of the business are directly included in the gross income of the partner or the member.[19] Corporations do not possess pass-through tax treatment, thereby exposing income to "double taxation" — once at the corporate level and once when profits are distributed to the shareholders.[20] Thus, pass-through tax treatment avoids double taxation, leading to direct tax savings. Additionally, if the business is incurring losses, pass-through tax treatment will allow the owners to offset their other personal income with the business' losses.[21] The Internal Revenue Service allows LLCs to benefit from pass-through tax

13. *Id.*
14. REVISED MODEL BUSINESS CORP. ACT § 6.27 (1993).
15. OKLA. STAT. ANN. tit. 18, §§ 2033, 2035. (West Supp. 1994).
16. *Id.*
17. REVISED MODEL BUSINESS CORP. ACT § 8.01 (1993).
18. OKLA. STAT. ANN. tit. 18, § 2013 (West Supp. 1994).
19. I.R.C. §§ 701-02 (West Supp. 1994).
20. *Id.* § 1 (imposing a tax on individuals); *id.* § 11 (imposing a separate tax on corporations). *See also id.* § 7701; *id.* § 61(a)(7).
21. I.R.C. §§ 701-02 (West Supp. 1994).

treatment, but only if the LLC possesses at least two non-corporate characteristics.[22]

B. *The LLC Compared to Other Business Forms*

On the surface an LLC closely resembles a Sub-Chapter S Corporation (S-Corp.) or a limited partnership, both of which provide for limited liability *and* pass-through tax treatment. However, a closer look reveals differences in matters such as filing requirements, organizational composition and structure, and member protection. These factors should be considered by the organizer when choosing a business form.

1. The LLC Versus the S-Corp.

Differences between an LLC and an S-Corp. begin with the requirements for partnership tax treatment. An LLC is afforded pass-through tax treatment if its organizer structures the LLC to avoid at least two corporate characteristics.[23] Once the LLC possesses this pass-through tax treatment, it continues to possess this characteristic without an independent filing requirement.[24] An S-Corporation, on the other hand is afforded partnership tax treatment only by filing an election statement and shareholder consent with the Internal Revenue Service.[25]

Differences also exist concerning member composition. An S-Corp. may have from one to thirty-five shareholders.[26] An LLC, on the other hand, must have at least two members, but there is no upper limit.[27] Additionally, an S-Corp.'s shareholders may only be natural persons, whereas LLC owners may be natural persons, partnerships, limited partnerships, other LLC's, trusts, estates, associations or corporations.[28]

There are also differences in member protection. If the directors in an S-Corp. retain dividends, choosing not to distribute them to the shareholders, the shareholders' hands are tied. The shareholders' options are limited because the shares are not publicly traded; therefore,

22. Treas. Reg. §§ 301.7701-2 to 4 (as amended in 1986); Rev. Rul. 88-76, 1988-2 C.B. 360. *See also infra* part III(A).
23. Rev. Rul. 88-76, 1988-2 C.B. 360.
24. OKLA. STAT. ANN. tit. 18, § 2004 (West Supp. 1994).
25. I.R.C. § 1362(a) (West Supp. 1994); I.R.C. § 1372 (West 1988).
26. *Id.* § 1361.
27. *Id.*
28. OKLA. STAT. ANN. tit. 18, § 2004 (West Supp. 1994).

there is no ready market to sell their shares. Conversely, if the members of an LLC are not satisfied with their distributions, they can resign their member status and the LLC must buy back their shares.[29]

Restrictions on the capitalization of the S-Corp. may also make the LLC form more acceptable to an investor. An S-Corp. may only have one class of stock, but no such limit is placed on LLC interests.[30] Thus, an LLC is provided more flexibility in arranging capitalization for the organization. For example, if a transaction is highly leveraged, debt can be reclassified as equity, creating an additional class of stock. If an S-Corp. tried to convert debt to equity, it would create an additional class of stock and thereby violate one of the requirements for S-Corp. status.[31]

2. The LLC Versus the Limited Partnership

The most obvious distinction between an LLC and a limited partnership is that in a limited partnership there must be a general partner who is subject to personal liability on behalf of the partnership.[32] Only the limited partners are shielded from liability as are the members of an LLC.[33] However, in order for the limited partners to maintain their limited liability, they must not participate in the management of the partnership.[34] Under Oklahoma's version of the Revised Uniform Limited Partnership Act (RULPA), limited partners may engage in management duties, but these duties are limited.[35] On the other hand, all LLC members are protected from personal liability even if they manage the business' affairs without restrictions.[36]

Finally, an LLC allocates its debt to all members and allows them to increase their basis, thereby providing the members with greater losses and deductions, and yet their limited liability shields the members from any personal risk for the debt.[37] However, distributing debt to a limited partner's basis could place him at risk for the debts. Debt

29. *Id.* § 2027.

30. The LLC Act does not place a restriction on the number of classes of stock. OKLA. STAT. ANN. tit. 18, §§ 2000-2060 (West Supp. 1993).

31. *See* Edward J. Roche, Jr. et al., *Limited Liability Companies Offer Pass-Through Benefits Without S Corp. Restrictions*, 74 TAX'N 248 (1991).

32. OKLA. STAT. ANN. tit. 54, § 142 (West 1991).

33. *Id.* § 320.

34. *Id.*

35. *Id.*

36. OKLA. STAT. ANN. tit. 18, § 2017 (West Supp. 1994).

37. Martha W. Jordan & Peter K. Kloepfer, *The Limited Liability Company: Beyond Classification*, 69 TAXES 203, 204 (1991).

distribution would cause the basis to be limited to the limited partner's contributed capital plus any net profits therefore the deductions and losses allowed by these limited partners would be less than with an LLC.[38]

III. Concerns and Uncertainties Regarding the LLC

Even if the LLC form fits a client's needs, an organizer must avoid pitfalls that could lead to a loss of benefits or to added liabilities. First, LLCs must lack certain corporate characteristics in order to receive the desired pass-through tax treatment. Second, actions should be taken to assure that doctrines similar to piercing the corporate veil will not be applied to the LLC, resulting in personal liability for its members. Finally, the organizer should determine whether federal and state securities laws apply to membership interests, thereby requiring compliance with applicable securities regulations.

A. *Taxation and the LLC*

1. The Benefits of LLC Tax Treatment

The LLC is a desired form of business largely because of the preferred tax treatment that it provides to its members. In short, the LLC provides the limited liability of a corporation or limited partnership and the tax treatment benefits of a general partnership.[39] The tax benefits of the LLC fall into two basic categories: (1) flow through tax treatment of gains and losses, and (2) preferable allocation of gains, losses, deductions and credits.

The most obvious tax benefit of the LLC is flow-through tax treatment. A corporation, although providing limited liability, does not protect its shareholders from double taxation.[40] When a corporation produces income, it is taxed at the corporate level due to its status as a separate legal entity. Additionally, when the profits of the corporation are distributed to a shareholder in the form of dividends, the individual shareholder's gross income increases, so the corporate owner is taxed again at the shareholder's individual tax rate. An LLC may allow its owners to escape double taxation by receiving partnership tax treatment—the income is included directly in the individual partner's income.

38. *Id.* at 206.
39. Rev. Rul. 88-76, 1988-2 C.B. 360.
40. *See supra* note 20 and accompanying text.

In addition to the benefits of pass-through tax treatment, LLC members can receive allocations of gains, losses, deductions and credits from the LLC.[41] The concept of allocation is the same as pass-through treatment of income. That is, since there is no corporate entity, the gains, losses, deductions and credits of the LLC filter directly to the members.[42] Allocation relates to the ability of an owner to reduce his *personal* income by subtracting losses or deductions incurred by the *business*.[43] The member's distributive share of income, gain, loss, deduction, or credit is determined by the terms of the operating agreement.[44] If the operating agreement does not provide in what percentage these items are allocated to the different members, then they are allocated in accordance with each member's ownership interest in the LLC.[45] However, if by the terms of the operating agreement an allocation of these items produces a *substantial economic effect* then the terms are disregarded and the items will be allocated by the member's ownership interest in the LLC.[46]

There are however limitations on the amount of LLC losses that a member can use to offset his other income.[47] Section 704(d) allows allocation of losses only up to the amount of the member's adjusted basis.[48] This adjusted basis is the amount of money and property initially contributed to the LLC by the member, as well as any additional contributions of money or property by the member, increased or decreased by the member's share of LLC income or loss plus his share of debt.[49]

2. Assuring Preferred Tax Treatment for the LLC

Although the preferred tax treatment given to LLCs may greatly benefit a client, it is not automatic. The Internal Revenue Service specifies that in order to qualify for partnership tax treatment there

41. I.R.C. § 702(a)(7) (West Supp. 1994).
42. *Id.*
43. *Id.* § 704.
44. *Id.* § 704(b)(2).
45. *Id.*
46. *Id.* § 704(b)(2). The Treasury Regulations have interpreted substantial economic effect in relation to partnerships. In regard to general partners, there is a substantial economic effect where upon liquidation of a partnership, the general partner would be liable for the deficit in his capital account. In regard to limited partners, if it appears that a limited partner's capital account balance will unexpectedly become negative as a result of an adjustment, allocation or distribution, such partner will be specially allocated sufficient partnership income and gain to prevent or eliminate the deficit quickly. Treas. Reg. § 1.704-1(b)(2)(ii)(a) (1983).
47. I.R.C. § 704(d) (West Supp. 1994).
48. *Id.* § 704.
49. *Id.* § 705.

must be *more noncorporate than corporate characteristics*.[50] Corporate characteristics include: (1) associates; (2) an objective to carry on business and divide the gains therefrom; (3) continuity of life, (4) centralization of management, (5) free transferability of interests, and (4) limited liability.[51] The Regulations state further that characteristics common to both a partnership and a corporation should not be considered in determining the organization's status. Since "associates" and "an objective to carry on a business and divide gains" are characteristics common to both types of entities, the Regulations conclude that an entity will be taxed as a corporation if the organization possesses at least three of the last four requirements.

As a result, for an LLC to qualify for partnership tax treatment the LLC must *lack at least two* of the last four characteristics.[52] The LLC statute mandates that the LLC owners are afforded limited liability.[53] This means that the trick for the LLC planner is to avoid two of the following three corporate characteristics: (1) continuity of life, (2) centralized management, and (3) free transferability of interest. The organizer is provided great flexibility to avoid the two corporate characteristics that are least suitable to the client's needs.

a. Avoiding Centralized Management

Centralized management is a corporate characteristic that exists when any person or group of persons (which does not include all the owners) has continuing exclusive authority to make management decisions which are necessary to conducting the business for which the organization was formed.[54] In the LLC context, appointing or hiring managers is insufficient to establish centralized management.[55] Instead, the company must be managed by persons who are not owners of the LLC.

---

50. Treas. Reg. § 301.7701-2(a)(1)(1983). *See also* BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 2.04, at 2-13 (5th abr. ed. 1987).

51. Treas. Reg. § 301.7701-2(a)(1)(1983).

52. *See, e.g.*, Rev. Rul. 88-76 (granting partnership tax treatment to a Wyoming LLC that lacked continuity of life and free transferability of interest).

53. OKLA. STAT. ANN. tit. 18, § 2022 (West Supp. 1994).

54. Treas. Reg. § 301.7701-2(c)(4) (as amended in 1983).

55. *See* Treas. Reg. § 301.7701—2(c)(4) (1983)(treating the general partner's managerial authority in a limited partnership as similar to the power of a board of directors of a corporation, even when the limited partners own substantially all of the interest); Zuckman v. United States, 524 F.2d 729, 738 (Ct. Cl. 1975); Fla. Ltr. Rul. 9010027 (finding no centralization of management where members reserved management powers in proportion to their interests in the LLC and each member could incur liabilities on behalf of the LLC); BITTKER, *supra* note 50, at ¶ 2.04.

It is likely that many organizers of Oklahoma LLCs will opt to allow its owners to manage the affairs of the business.[56] Owner management provides a close association with business affairs and decision-making. And in the context of an LLC the member will not face the possibility of personal liability as would exist in a partnership.[57]

b. Avoiding Continuity of Life

Continuity of life is present where the organization continues even when one or more of its owners dies, retires, resigns, or suffers insanity, bankruptcy, or expulsion.[58] Unlike Oklahoma corporations,[59] the default provision of the Oklahoma LLC avoids the characteristic of continuity of life by providing that LLCs dissolve when one of the following events of disassociation occurs:[60]

(1) a member withdraws by voluntary act;
(2) a member is removed in accordance with the operating agreement;
(3) a member assigns all interest in the LLC;
(4) there is majority vote to end the LLC;
(5) there is unanimous consent to end the LLC when the member makes an assignment for the benefit of creditors;
(6) there is a bankruptcy or reorganization; or
(7) a member dies or becomes incompetent.

The LLC can also be dissolved when the time specified in writing in the articles of organization or operating agreement expires, or when events specified in the articles of organization or operating agreement take place.[61] Finally, dissolution occurs when written consent is given by all members.[62]

It should be noted that after dissolution the LLC may actually continue, yet avoid continuity of life. One way that an LLC may go on is if the remaining members *unanimously* consent to continuing the

56. *See* Sylvester J. Orsi, Comment, *The Limited Liability Company: An Organizational Alternative for Small Business,* 70 NEB. L. REV. 150, 159-60 (1991).

57. OKLA. STAT. ANN. tit. 18, §§ 2016-17 (West Supp. 1994). However, a member or manager is not protected from liability for a breach of the duty of loyalty, where the act or omission is not in good faith, or where a transaction is for improper personal benefit.

58. Treas. Reg. § 301.7701-2(b)(1)(1983). *See also id.* § 301.7701-2(b)(3) (providing that continuity of life will be present when no member has the power to dissolve the organization in contravention of the agreement).

59. *See* OKLA. STAT. ANN. tit. 18, § 1096 (West Supp. 1994).

60. *Id.* § 2037.

61. *Id.*

62. *Id.*

business.[63] The second option is to merge the LLC with another ongoing entity, such as a partnership or shell LLC.[64] A merger might be preferred because it only requires the consent of a *majority* of the members.[65]

c. *Avoiding Free Transferability of Interest*

Free transferability of interest exists if all members, or those members owning substantially all of the interests in the organization, can transfer their interests without the other owners' consent.[66] A transfer of "interest" confers actual membership upon the transferee, including voting and management rights, not merely an interest in profits.[67] Obtaining these rights without restrictions, such as consent to transfer to a third party, constitutes free transferability of interest.[68] Free transferability of interest may be a desirable characteristic since it provides greater marketability for shares.

The Oklahoma LLC statute provides for restriction of transferability of interests by allowing an assignee of a membership interest to become a member only if the articles of organization or operating agreement provide or if the members consent in writing.[69] If the LLC organizer provides for completely free transferability of interest in the articles of organization or operating agreement, then this corporate characteristic is not avoided.[70]

However, an LLC organizer may attempt to provide *some* marketability in order to restrict transferability as little as possible and yet avoid the "free transferability" characteristic. It is clear that the drafters of the Oklahoma LLC statute had this notion in mind because, unlike Wyoming's statute, the Oklahoma LLC statute allows the organizer to restrict transfers by unanimous consent (like Wyoming) or by mere *majority* consent.[71] Requiring unanimous consent is the safest way to avoid free transferability of interest.[72] For example, in

63. *Id.;* Rev. Rul. 88-76, 1988-2 C.B. 360 (holding that continuation after unanimous consent does not create continuity of life).
64. *See* OKLA. STAT. ANN. tit. 18, § 2054 (West Supp. 1994). *See also* Treas. Reg. § 1.708-1(b)(2)(i) (1956) (allowing a business with partnership tax treatment — including LLCs — to merge without losing preferred tax treatment).
65. OKLA. STAT. ANN. tit. 18, § 2054 (West Supp. 1994).
66. Treas. Reg. § 301.7701-2(e)(1) (1983).
67. OKLA. STAT. ANN. tit. 18, § 2035 (West Supp. 1994).
68. *Id.*
69. *Id.*
70. Treas. Reg. § 301.7701(2)(c)(e) (1983).
71. OKLA. STAT. ANN. tit. 18, § 2035 (West Supp. 1994).
72. Rev. Rul. 88-76, 1988-2 C.B. 360.

Revenue Ruling 88-76, the IRS held that there is no free transferability of interests where a transferee's ability to acquire all attributes of membership is contingent upon the approval of all remaining members.[73] Requiring only majority consent for transfer of shares could be a more desirable restraint, but it is not clear how the IRS will treat majority consent in the context of the free transferability of interest characteristic.[74]

B. *Assuring Limited Liability for the LLC*

One of the primary objectives of LLC legislation is to provide entrepreneurs with an alternative business organization that supplies limited liability.[75] Accordingly, the LLC supplies limited liability[76] while freeing its members from observing many corporate formalities[77] and allowing them to participate in management without losing limited liability. These benefits, however, may be limited if concepts similar to piercing the corporate veil are applied to the LLC. Thus, this section of the Comment raises two important issues: (1) will concepts similar to corporate veil piercing be applied to LLC's, and (2) if so, how?

1. Will Veil Piercing Concepts Be Applied to LLC's?

The Oklahoma LLC Act provides no language indicating an intent that veil piercing concepts apply.[78] On the other hand, the absence of such a provision may not indicate legislative intent since the

73. Wayne M. Gazur and Neil M. Goff, *Assessing the Limited Liability Company,* 41 CASE W. RES. L. REV. 386, 446 (1991); Robert R. Keatinge, et al., *The Limited Liability Company: A Study of the Emerging Entity,* 47 BUS. LAW. 375, 427 (1992).

74. *See* Treas. Reg. § 301.7701-2(e)(1) (1983); Texas Private Letter Ruling 92-10019 (stating that Texas' LLCs lack free transferability of interest if transfers are conditioned on the consent of managers or on the majority of members).

75. Gazur, *supra* note 73, at 389; Keatinge, *supra* note 73, at 385.

76. OKLA. STAT. ANN., tit. 18, § 2022 (West Supp. 1994) provides a broad-based liability exemption for managers and members of an LLC stating, "A person who is a member or manager, or both, of a limited liability company is not liable for the obligations of a limited liability company solely by reason of being such member or manager or both."

77. Under the Oklahoma Limited Liability Company Act, OKLA. STAT. ANN. tit. 18, §§ 2000-26 (West Supp. 1994), business formalities that must be observed appear to be limited to the following: filing of executed and conforming articles of organization with the Secretary of the State and payment of a filing fee, §§ 2004-2007; maintenance of a registered office and agent for service of process, § 2010; and maintenance of certain records, § 2021. Other formalities such as the organization of management, §§ 2013-2015, the allocation of member voting rights, §§ 2014 and 2018, and the allocation of distributions, §§ 2025 and 2026, may be varied by the terms of the operating agreement or the articles of organization.

78. Unlike Colorado, which statutorily applied the corporate veil doctrine to its LLCs. COLO. REV. STAT. § 7-80-107 (Supp. 1990).

veil piercing doctrine is a common law theory.[79] Indeed, the Oklahoma General Corporations Act[80] makes no mention of piercing the corporate veil although the theory has been judicially adopted.[81]

A clue as to the applicability of veil piercing doctrines to LLCs may be gleaned by comparing the application of that doctrine to other business forms. The veil piercing doctrine is applied to Oklahoma corporations but not to limited partnerships. Rather, a limited partner's liability shield depends upon whether he acted like a general partner or participated in the control of the business.[82]

The difference between these approaches likely results from an important structural distinction between the two business forms: all corporate shareholders are afforded limited liability, but a limited partnership must have at least one general partner with unlimited liability.[83] Thus, a limited partnership creditor can seek remedy through the general partner.[84] LLCs more closely resemble corporations in this regard, however, since they bestow limited liability upon all members.[85] Thus, creditors of the company, whether in contract or tort, may look only to the assets of the LLC when seeking judicial remedy. Allowing control to be a basis for imposing personal liability would conflict with express provisions of the Oklahoma LLC Act. If members elect to manage, the Oklahoma LLC Act clearly provides them limited liability.[86]

2. Oklahoma Veil Piercing Concepts in the LLC Context

This section will attempt to predict how corporate veil piercing concepts will be adapted to Oklahoma LLCs.[87] This approach examines the policies that prompt Oklahoma Courts to pierce the corporate veil, the evidence that invokes these concerns, and the translation of these concerns to the LLC context.

79. Keatinge, *supra* note 73, at 445.
80. OKLA. STAT. ANN. tit. 18, §§ 1001-1143 (West 1986 & Supp. 1994).
81. *See, e.g.*, Mid-Continent Life Ins. Co. v. Goforth, 143 P.2d 154 (Okla. 1943).
82. *See* Keatinge, *supra* note 73, at 444.
83. Gazur & Goff, *supra* note 75, at 403.
84. *Id.*
85. *See id.*; *see also* Keatinge et al., *supra* note 73, at 445. Thus, like a corporation, the LLC appears to be an entity distinct from the individuals composing it.
86. *Compare* the unconditional grant of limited liability in OKLA. STAT. ANN. tit. 18, § 2022 (West Supp. 1994) *with* the optional provision of management by membership in OKLA. STAT. ANN. tit. 18, §§ 2013, 2015 (West Supp. 1994).
87. Since Oklahoma adopted the Delaware Corporation Statutes, it is unclear whether Delaware precedent was likewise adopted. This paper makes no attempt to resolve that issue or to apply Delaware precedent.

A corporation is generally considered an entity distinct from its stockholders.[88] However, when necessary to prevent fraud, to protect the rights of third persons, or to accomplish justice, both law and equity will disregard the corporation as an entity distinct from the persons comprising it.[89] Similarly, in *Buckner v. Dillard*,[90] the Court stated that where a corporation's legal entity is used to defeat public convenience, justify wrong, protect fraud, or defend crime, the law will disregard the corporation as an association of persons.[91] Thus, a corporation is presumed to be a legal entity distinct from the individuals composing it unless the legal fiction is used to achieve an improper purpose.[92]

Veil piercing considerations thus may be grouped into three broad categories: (1) alter ego concerns;[93] (2) undercapitalization concerns; and (3) fraud, illegality or wrongful conduct concerns.[94] Each of these categories reflects a view that certain activities should not be legitimized under the guise of the corporate fiction.[95] For the following reasons, these concerns are largely mirrored in the LLC context.

88. *See, e.g.*, State *ex rel.* Okla. Employment Sec. Comm'n v. Tulsa Flower Exch., 135 P.2d 46, 48 (Okla. 1943); Buckner v. Dillard, 89 P.2d 326, 329 (Okla. 1939); Chestnut Sec. Co. v. Okla. Tax Comm'n, 48 P.2d 817, 819 (Okla. 1935).

89. Mid-Continent Life Ins. Co. v. Goforth, 143 P.2d 154, 157 (Okla. 1943). The corporate fiction may be cast aside not only for the purpose of imputing liability to the shareholder(s) but also for gaining jurisdiction over a shareholder. An example of the latter situation is where a plaintiff seeks to have the corporate veil pierced in order to gain personal jurisdiction over a shareholder using state long arm statutes. *See, e.g.*, Home-Stake Prod. Co. v. Talon Petroleum, 907 F.2d 1012 (10th Cir. 1990). However, the test relating to the amenability of service of process and forum does not require as stringent a showing as that required to impute legal liability. *See* Rea v. An-Son Corp., 79 F.R.D. 25, 31 (W.D. Okla. 1978); *Home-Stake*, 907 F.2d at 1017-18.

90. 89 P.2d 326 (Okla. 1939).

91. *Id.* at 329.

92. The *Mid-Continent* court summarized this view:

> The doctrine that a corporation is a legal entity, separate and apart from the persons composing it, is a legal theory introduced for purposes of convenience and to subserve the ends of justice, but the concept will not be extended to a point beyond its reason and policy, and when invoked in support of an end subversive of said policy will be disregarded by the courts.

Mid-Continent, 143 P.2d at 157.

93. *See* Warner Bros. Theaters v. Cooper Found., 189 F.2d 825, 830 (10th Cir. 1951).

94. *Compare* HARRY G. HENN, HANDBOOK OF THE LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES § 146, at 253 (2d. ed. 1970).

95. For a more complete analysis of Oklahoma's treatment of the doctrine of piercing the corporate veil, see Kenneth B. Watt, Comment, *Piercing the Corporate Veil: A Need for Clarification of Oklahoma's Approach*, 28 TULSA L. J. 869 (1993).

a. LLC Veil Piercing Based Upon Alter Ego Concerns

One circumstance in which courts pierce the corporate veil is where the corporation is the alter ego of or a mere instrumentality of the shareholders.[96] This concern addresses the possibility that creditors will rely on a false belief that they are dealing with either an individual shareholder or parent corporation (as opposed to the actual corporation with whom they are dealing).[97] Further, if corporate records are not properly maintained, creditors may be hindered in their search for assets, and the improper distribution of assets may be concealed.[98]

A number of factors influence a court's decision on whether the corporation is merely an alter ego or a mere instrumentality. Where the veil is pierced to the detriment of an *individual shareholder*, courts look to whether the corporation is without separate books, does not have its finances kept separate from the individual's finances, pays the individual's obligations or vice versa, is not following corporate formalities, or is merely a sham.[99]

Alternatively, where a plaintiff seeks to pierce the corporate veil to the detriment of a *corporate* shareholder, the question hinges primarily on control.[100] To determine if one corporation is merely an instrumentality of another, courts may consider whether: 1) the parent corporation owns all or most of the subsidiary's stock; 2) the corporations have common directors or officers; 3) the parent provides financing to its subsidiary; 4) the dominant corporation subscribes to all the other's stock; 5) the subordinate corporation is grossly undercapitalized; 6) the parent pays the salaries, expenses, or losses of the subsidiary; 7) almost all of the subsidiary's business is with the parent or the assets of the former were conveyed from the latter; 8) the parent refers to its subsidiary as a division or a department; 9) the subsidiary's officers or directors follow directions from the parent corporation; or 10) legal formalities for keeping the entities separate and independent are observed.[101]

96. *See, e.g.*, Key v. Liquid Energy Corp., 906 F.2d 500, 503-04 (10th Cir. 1990) (not reaching the question whether under Oklahoma law proof that a subsidiary corporation is a mere instrumentality or alter ego of its parent corporation is enough to pierce the corporate veil absent a showing of fraud, illegality, of inequity).

97. *C.f.* HARVEY GELB, PERSONAL CORPORATE LIABILITY: A GUIDE FOR PLANNERS, LITIGATORS, AND CREDITORS' COUNSEL § 1.8 (1991).

98. *Id.*

99. Home-Stake Prod. Co. v. Talon Petroleum, 907 F.2d 1012, 1018 (10th Cir. 1990).

100. Frazier v. Bryan Memorial Hosp. Auth., 775 P.2d 281 (Okla. 1989).

101. *Id.* at 288.

While the exact evidentiary burden concerning these factors is unclear, courts applying Oklahoma law have developed some guidelines. All of the factors need not be shown to convince a court that one corporation is merely the instrumentality of another corporation.[102] Apparently, not all the factors indicative of individual liability need be shown either.[103] Further, fraud is not a necessary element to veil piercing.[104] On the other hand, an entity will not be disregarded merely because all or a majority of its stock is owned by a single individual[105] or by a single corporation.[106] Beyond these guidelines, the trier of fact is apparently free to weigh the factors on an *ad hoc* basis.

The rationale underlying alter ego concerns seems equally applicable in the LLC context. An LLC, whether owned individually or by a legal person, may be operated as the mere instrumentality of its owner(s).[107] A creditor may then be confused about whom he is dealing with and enter into a transaction with the LLC basing his expectation of payment upon the member's financial stability. In this situation there seems no reason to treat the LLC debtor differently than the corporate debtor. Thus, where the LLC commingles company and individual funds, improperly converts company revenues to individual use, causes subsidiaries to turn over all revenue to the parent leaving them essentially judgment proof, or in numerous other scenarios does not respect the separate identities of the entity and the equity holder(s), the LLC should receive no more favorable treatment in the courts than would a corporate debtor.

On the other hand, an LLC member should not experience the difficulty corporate shareholders do in observing formalities. The LLC statute provides for little in the way of actual formalities, merely

102. *Id.*

103. *Home-Stake*, 907 F.2d at 1018-19.

104. *In re* Moran Pipe & Supply Co., Inc., 130 B.R. 588, 591 (Bankr. E.D. Okla. 1991). *But see Home-Stake*, 907 F.2d at 1017. The veil piercing test requires "a showing not only that the corporation is a shell, but that it was used to commit a fraud." *Id.*

105. *See, e.g.*, Robertson v. Roy L. Morgan, Prod. Co., 411 F.2d 1041 (10th Cir. 1969); Sautbine v. Keller, 423 P.2d 447 (Okla. 1966); Garrett v. Downing, 90 P.2d 636 (Okla. 1939).

106. *See* Key v. Liquid Energy Corp., 906 F.2d 500 (10th Cir. 1990); Rea v. An-Son Corp., 79 F.R.D. 25 (W.D. Okla. 1978); Frazier v. Bryan Memorial Hosp. Auth., 775 P.2d 281, 288 n.35 (Okla. 1989) ("Something more than a community of interest in pursuit of a common end must be shown before a court of equity will, for the purposes of a given case, strip two corporations of their distinct personalities and practically blend them into one.").

107. *See, e.g., In re* Tureaud, 45 B.R. 658 (Bankr. N.D. Okla. 1985) (disregarding separate existence of non-debtor corporations where debtor organized and controlled entities as a front to raise money for himself and to hinder creditors).

requiring the filing of executed and conforming articles of organization with the secretary of state and the payment of a filing fee, maintenance of a registered office and agent for service of process, and maintenance of certain records.[108] Thus, it should be difficult for a plaintiff to assert a veil piercing theory predicated only upon a failure to follow LLC formalities.[109]

b. *LLC Veil Piercing Based on Undercapitalization Concerns*

Inadequate capitalization may be an important factor in a court's decision to pierce the corporate veil where the corporation was not organized with adequate capital for its foreseeable business needs.[110] This concern is especially weighty where the claimant is an involuntary creditor such as a tort victim who did not choose to deal with the corporation and thus had no opportunity to ascertain its financial stability before dealing with it. A voluntary creditor, on the other hand, ostensibly has the ability to review the finances of the corporation.[111] However, under a given set of facts, this supposition may not be realistic.[112] For example, a trade creditor in a competitive field may have little practical ability to ascertain whether the corporation is adequately capitalized.[113] This difficulty may arise because the corporation may not want its finances subject to review either because of the additional cost and trouble[114] or for other reasons. In a competitive market the corporation may substitute goods or services from other creditors that do not demand such assurances. Thus, an individual creditor in a weak bargaining position may not be able to demand such assurances and remain in business.

These concerns seem equally applicable to LLC creditors, whether in contract or in tort. A creditor who has no reasonable ability to review the financial stability of the LLC before interacting with it should have the same recourse as it would against a corporate

108. OKLA. STAT. ANN. tit. 18, §§ 2004-05 (West. Supp. 1994).

109. *Cf.* Keatinge, *supra* note 73, at 446.

110. *See In re* Moran Pipe & Supply Co., 130 B.R. 588 (Bankr. E.D. Okla. 1991); *see also* Home-Stake Prod. Co. v. Talon Petroleum, 907 F.2d 1012 (10th Cir. 1990); Frazier v. Bryan Memorial Hosp. Auth., 775 P.2d 281 (Okla. 1989); GELB, *supra* note 97, § 1.6[1].

111. GELB, *supra* note 97, § 1.6[2].

112. *Id.*

113. *Cf.* ROBERT CHARLES CLARK, CORPORATE LAW 76 (1986).

114. Ascertaining the wealth of the corporation or other investors could entail significant information costs. *Cf.* GELB, *supra* note 97, at 68.

debtor. There seems no reason to treat the LLC differently with respect to inadequate capitalization claims than the corporate debtor would be treated.

c. *LLC Veil Piercing Based Upon Fraud Concerns*

Finally, a finding that a corporation operates to commit fraud, illegality, or wrong upon the public may compel a court to pierce the corporate veil.[115] This situation often arises where the corporation was initially adequately capitalized but the directors or officers siphon off the assets through salaries, dividends, or loans, leaving to little to satisfy creditors. For example, in *Stoltz, Wagner & Brown v. Cimmaron Exploration Co.*[116] the defendant, who was the sole officer, director, shareholder, and employee of the corporation, was found to be both the alter ego of the corporation and to have wrongfully diverted incoming monies, intended to be forwarded to the plaintiffs, to his personal use.[117]

This category is ill-defined in Oklahoma but appears to require less than a showing of actual fraud.[118] Thus, courts are free to give the word fraudulent a generous reading[119] and do not restrict its application to transfers that are deceptive. Rather, courts also include transfers that are unfair to creditors.[120] There is no "great reason to distinguish between a management's taking value away from shareholders by lying to them and their taking value away from shareholders by means of an unfair self-dealing transaction that is fully disclosed."[121]

These concerns should apply equally in the LLC context. An undercapitalized LLC should not be allowed to commit fraud upon its creditors by sheltering profits through member distributions and then circumventing individual liability by hiding behind the business' identity. A court would probably not hesitate to look behind the legal fiction merely because the business is an LLC. Thus, there seems to be no reason to treat the LLC as a favored child when it uses its legal fiction for an improper purpose.

115. Buckner v. Dillard, 89 P.2d 326 (Okla. 1939).
116. 564 F.Supp. 840 (W.D. Okla. 1981).
117. *Id.* at 853-54; *see also* Selected Inv. Corp. v. Duncan, 260 F.2d 918, 920-21 (10th Cir. 1958).
118. *Selected Inv.*, 260 F.2d at 920.
119. CLARK, *supra* note 113, at 456.
120. *Id.*
121. *Id.* at 457.

Given the structural similarity between the two business entities, corporate veil piercing policies generally apply to LLCs. Differences in the organization of LLCs and corporations may make a difference in the weighing of veil piercing factors; however, the underlying policy considerations should remain the same. Thus, courts should look to corporate veil piercing precedents and adopt a similar rationale for the LLC.

3. A Final Caveat

Although the preceding discussion has attempted to explicate the policies and factors that underlie the veil piercing doctrine and its potential application to the Oklahoma LLC, the test in reality is far from cut and dried. Determining whether certain factors support a veil piercing theory is a question of fact[122] and requires consideration of the totality of the evidence.[123] No hard and fast rules or definitive legal standards apply.[124] Moreover, courts are reluctant to pierce the corporate veil and will do so only in extraordinary circumstances.[125] Thus, each case should be evaluated in accordance with its individual facts.

C. *Securities Regulations and LLC Interests*

Courts have not yet addressed whether the securities laws apply to LLC interests.[126] However, if LLC interests come within the purview of the Securities Act of 1933[127] or the Oklahoma Securities Act,[128] their offer or sale must be accompanied by registration with the Securities Exchange Commission[129] and/or the Oklahoma Securities Commission,[130] unless an exemption from registration applies.[131] Further, securities status may create substantial disclosure obligations and subject the issuer to the anti-fraud provisions of the securities

122. *Id.*; *see also* Moran Pipe & Supply Co., 130 B.R. 588, 592 (Bankr. E.D. Okla. 1991).
123. *Moran*, 130 B.R. at 593.
124. Keatinge, *supra* note 73, at 444.
125. *Id.*; *see also* Selected Inv. Corp. v. Duncan, 260 F.2d 918 (10th Cir. 1959).
126. Marc I. Steinberg & Karen L. Conway, *The Limited Liability Company as a Security*, 19 PEPP. L. REV. 1105, 1106 (1992).
127. 15 U.S.C. § 77a (1988 & Supp IV 1992).
128. OKLA. STAT. ANN. tit. 71 §§ 1-501 (West 1987 & Supp. 1994). Currently, at least 16 states have filed legal actions against LLC's seeking to enjoin the sale of interests on the grounds that they are unregistered securities. *See* John R. Emshwiller, *New Kind of Company Attracts Many - Some Legal, Some Not*, WALL ST. J., Nov. 8, 1993, at B1.
129. 15 U.S.C. § 77f(a) (1988).
130. OKLA. STAT. ANN. tit. 71, §§ 3, 201, 202, 301 (West 1987 & Supp. 1993).
131. For typical exemptions, see 15 U.S.C. §§ 77c-77d (Supp. 1992); OKLA. STAT. ANN. tit. 71, §§ 2, 401 (West Supp. 1993).

laws.[132] The following analysis addresses the applicability of federal and Oklahoma securities laws to Oklahoma LLC interests.

1. Federal Securities Law and the Oklahoma LLC

The Securities Act of 1933 does not provide a substantive definition of the term security.[133] Rather, it provides a laundry list of specific interests that are considered securities.[134] From among these enumerated interests, "stock" and "investment contract" are the categories that could cover LLC interests.

At least one commentator, Marc I. Steinberg, has posited that interests in a LLC may be classified as securities under the *Landreth Timber Company v. Landreth*[135] analysis of stock as a security.[136] Steinberg states that "because LLC interests are issued by an entity called a 'Company' and the typical issuance of an equity interest by a commercial enterprise calling itself a company or corporation is stock, substance should prevail over form, thereby mandating that LLC interests be analyzed pursuant to the ordinary attributes of stock standard."[137] Steinberg recognizes that, unlike LLC interests, the interests in *Landreth* were actually denoted as "stock," but he nevertheless believes that the "same or similar characteristics" test may be used to analyze LLC interests.[138]

This conclusion seems doubtful. The *Landreth* Court noted that the plain language of the securities act states that "stock" is to be considered a security within the meaning of those acts. The court went on to note that the fact that an instrument bears the label "stock" is not of itself sufficient to invoke the coverage of the acts. Significantly, however, the court stated that when an instrument is *both called stock and bears stock's usual characteristics*, a purchaser may justifiably assume the federal securities laws apply. The reasons for this conclusion were specifically outlined:

132. *See* Mark A. Sargent, *Are Limited Liability Company Interests Securities?*, 19 PEPP. L. REV. 1069, 1071 (1992).

133. *Id.* at 1081.

134. 15 U.S.C. § 77(b)(1) (Supp. 1993). The Securities Exchange Act of 1934 also contains a list of definitions of the term "security" in § 3(a)(10). The Supreme Court has stated that the two definitions are virtually identical and should be treated as such. Landreth Timber Company v. Landreth, 471 U.S. 681, 686 n.1 (1985).

135. 471 U.S. 681 (1985).

136. Steinberg, *supra* note 126, at 1116.

137. *Id.*

138. *Id.*

> [S]tock may be distinguishable from most if not all of the other categories listed in the Acts' definition.
> * * *
> First, traditional stock "represents to many people, both trained and untrained in business matters, the paradigm of a security." . . . Thus, persons trading in traditional stock have a high expectation that their activities are governed by the Acts. Second, as we made clear in *Forman*, "stock" is relatively easy to identify because it lends itself to consistent definition. Unlike some instruments, therefore, traditional stock is more susceptible of a plain meaning approach.
> * * *
> We hold . . . that "stock" may be viewed as being in a category by itself for purposes of interpreting the scope of the Acts' definition of "security."[139]

Thus, the Court placed great weight on the reasoning that an instrument labeled as stock causes an expectation in the minds of investors that the investment will be governed by the securities acts. LLC interests are not denoted "stock." It is also unlikely that LLC interests have gained enough public recognition as an investment tool to foster a public expectation that the interests are governed by the securities acts. Therefore, they are not likely to be viewed as "stock" under federal securities acts.[140]

Instead, "investment contract" is probably the enumerated category most likely to cover LLC interests.[141] Although this term is rather vague, the Supreme Court defined it in *SEC v. Howey Co.*,[142] stating that:

> an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the

139. Landreth Timber Co. v. Landreth, 471 U.S. 681, 693-94 (1985). *See also* Reves v. Ernst and Young, 494 U.S. 56 (1990); Gould v. Ruefenacht, 471 U.S. 701 (1985).

140. If LLC interests are not considered stock under the Securities Acts, the "sale of business doctrine" could result in a denial of security status for a sale of a controlling share of an LLC. Under this doctrine, a majority of lower courts once held that the sale of all the stock in a corporation did not constitute the sale of a security since the purchaser would not derive his profits from the efforts of others. In *Landreth*, the Supreme Court rejected the applicability of the sale of business doctrine to stock because "stock" is an enumerated class of security. *Landreth*, 471 U.S. at 685-87. Unlike stock, LLC interests do not fall under an enumerated security category. This means that the investment contract test will likely apply, under which security status is only conferred if profits are derived solely from the efforts of others. A sale of a controlling interest in an LLC gives the investor latent control over the management of the enterprise such that profits are not derived "solely from the efforts of others." The Oklahoma LLC Act requires at least two members to form an LLC. OKLA. STAT. ANN. tit. 18, § 2004 (West Supp. 1994). However, an investor could still purchase a share significant enough that profits would not be derived solely from the efforts of others.

141. *See* Sargent, *supra* note 132, at 1096; Keatinge, *supra* note 73, at 403.

142. *Howey*, 328 U.S. at 293.

> efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise.[143]

Thus, an investment contract possesses four characteristics: (1) the investment of money, (2) in a common enterprise, (3) with the expectation of a profit, and (4) with that profit to be realized through the efforts of someone other than the investor.[144]

a. Investment of Money

The "investment of money" element of *Howey* requires that the purchaser contribute some tangible and definite consideration[145] for his right to take part in the venture.[146] Oklahoma LLC interests should fall within the scope of this language since the LLC is capitalized through member contributions of value, including cash, property, services rendered, notes and other binding obligations.[147] While the Oklahoma Act does not specifically address the admission of additional members, presumably leaving the issue to the operating agreement,[148] it is probable that the agreement will provide for the contribution of cash, goods, or services for an interest in the company. Thus, the acquisition of an interest in an Oklahoma LLC should involve an investment of some tangible and definite consideration within the meaning of the *Howey* test.

b. Common Enterprise

The "common enterprise" element of the *Howey* test requires the promoter or some third party take positive action to bring about the promised investor profit.[149] There is, however, disagreement among the federal courts as to whether the proper test requires horizontal commonality or merely vertical commonality.[150] Horizontal commonality, a pooling of the interests of investors,[151] requires a common goal between investors.[152] Hence, there must be at least two investors to

143. *Id.* at 298-99.
144. JOSEPH C. LONG, 1984 BLUE SKY LAW HANDBOOK § 2.03[2], at 2-15 (1984).
145. International Bhd. of Teamsters v. Daniel, 439 U.S. 551, 559 (1979).
146. This consideration usually takes the form of cash, but goods and services may also be sufficient. *See* Steinberg, *supra* note 126, at 1107.
147. OKLA. STAT. ANN. tit. 18, §§ 2001(4), 2023 (West Supp. 1993).
148. *See supra* text accompanying note 7.
149. LONG, *supra* note 144, § 2.03[2][b] at 2-20.
150. Steinberg, *supra* note 126, at 1108.
151. MARC I. STEINBERG, UNDERSTANDING SECURITIES LAW 250 (1989).
152. Steinberg, *supra* note 126, at 1108.

satisfy the horizontal common enterprise element.[153] Horizontal commonality is sufficient for a finding of common enterprise in all judicial circuits.[154] Alternatively, several circuits, including the Tenth,[155] merely require vertical commonality. Vertical commonality, which is the intermingling of promotor and investor interests, requires only one investor and one promoter advancing a common goal.[156]

Oklahoma LLCs should typically meet either of these tests. The Oklahoma act requires at least two members to form an LLC,[157] so the vertical commonality requirement in the Tenth Circuit[158] should be satisfied upon organization. Additionally, only in rare instances would the members of an LLC lack a common business purpose sufficient to meet a horizontal commonality test.[159] Therefore, an Oklahoma LLC should generally be considered a common enterprise within the meaning of the *Howey* test.

c. *Expectation of Profit*

In *United Housing Fund v. Forman*[160] the Supreme Court held that the expectation of profits may take two forms: (1) capital appreciation resulting from development of the initial investment; or (2) participation in earnings resulting from the use of the investor's funds.[161] Thus, profit is a tangible economic benefit derived from the increased value of the item invested[162] or the payment of money for the use of the investors capital.[163] The court reasoned that in these cases the investor is attracted solely by the prospect of a return on the investment.[164]

The typical LLC investor will contribute capital to the enterprise with the expectation of receiving profit in one of these forms at some

153. *See* LONG, *supra* note 144, § 2.03[2][b] at 2-22.
154. *Id.*
155. McGill v. American Land and Exploration Co., 776 F2d 923, 925-26 (10th Cir. 1985).
156. LONG, *supra* note 144, § 2.03[2][b] at 2-21.
157. OKLA. STAT. ANN. tit. 18, § 2004 (West Supp. 1993).
158. *McGill*, 776 F.2d at 926.
159. Steinberg, *supra* note 126, at 1108-09; *cf.* LONG, *supra* note 144, § 2.02[2][b], at 2-22 (discussing the limited circumstances in which the horizontal commonality requirement acts as a constraint to a finding of the investment contract element).
160. 321 U.S. 837, 852 (1975).
161. *Id.* at 854-55.
162. The item invested apparently may take the form of property as well as cash as long as the investor expected the contribution to appreciate. *See* LONG, *supra* note 144, § 2.03[2][b], at 2-23; *see also* OKLA. STAT. ANN. tit. 18, § 2023 (West Supp. 1994) (listing items an LLC member may contribute in return for an interest, including property).
163. For example, interest or dividend payments. *See* LONG, *supra* note 144, § 2.03[2][b], at 2-23.
164. *Forman*, 321 U.S. at 854-55.

point in the future. In fact, the Oklahoma Act contemplates the distribution of profits to members on a *pro rata* basis.[165] Further, some courts have held that an expectation of tax benefits derived from initial losses is a sufficient expectation of profits.[166] Hence, most LLC investors will contribute capital with an expectation of tangible economic benefit as required by *Forman*.

d. Through the Efforts of Others

The final and most problematic element of the *Howey* test requires that profits be derived soley from the efforts of others.[167] The Ninth Circuit, in *SEC v. Glenn W. Turner Enterprises, Inc.*,[168] adopted a liberal interpretation of the efforts of others test.[169] The court held that the word "soley" should not be strictly construed. Instead, the test is whether 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.[170] Thus, the "solely" requirement was re-interpreted to mean "substantially."[171] This interpretation, while not explicitly adopted by the Supreme Court,[172] has been accepted by eight circuits,[173] including the Tenth.[174] Thus, to avoid security classification in the Tenth Circuit, an investor must contribute managerial efforts to the enterprise rather than a mere showing of physical effort.[175]

---

165. OKLA. STAT. ANN. tit. 18, § 2025 (West Supp. 1994).

166. MARK A. SARGENT, LIMITED LIABILITY COMPANY HANDBOOK 3-17 (1993).

167. Most commentators, in analyzing the LLC interest as a security, have presumed the foregoing elements would be satisfied and concentrated instead on the final element of the *Howey* test. *See* Sargent, *supra* note 132, at 1082 (noting that the efforts of others criterion has been the key question in determining whether interests in general partnerships and limited partnerships should be considered securities).

168. 474 F.2d 476, 482 (9th Cir. 1973) *cert. denied*, 414 U.S. 821 (1973).

169. The "solely" requirement, if literally applied, would exempt many would be securities from the Securities Acts, allowing promoters to security status by having investors contribute very modest efforts to the enterprise. *See* LONG, *supra* note 144, § 2.03[2][d], at 2-28 to 2-29.

170. *Id.*

171. *See* LONG, *supra* note 149, § 2.03[2][d], at 2-29 to 2-30, 2-32.

172. United Hous. Fund v. Forman, 321 U.S. 837, 852 n.16 (1975) (declining to specify whether it was adopting the *Glen W. Turner* approach).

173. Sargent, *supra* note 132, at 1083.

174. *See* Aldrich v. McCulloch Properties, Inc., 627 F.2d 1036, 1040 n.3 (10th Cir. 1980); Crowley v. Montgomery Ward & Co., 570 F.2d 875, 877 (10th Cir. 1975).

175. *See Crowley*, 570 F.2d at 877 ("A mechanical application of 'solely' . . . runs contrary to the broad remedial purposes of the Acts and rejects consideration of 'economic reality.' We agree with [*Glenn W. Turner*] that the test is 'whether 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.'").

The actual operation of the efforts of others test is best illustrated by its application to general and limited partnership interests. A general partnership interest is virtually a per se non-security[176] because investors typically exercise significant managerial control.[177] Further, it does not matter whether an investor actually exercises this control or delegates it to others.[178] The possession of latent control of the organization is a sufficient showing that the investors are not dependent upon the efforts of others to realize profit.[179]

Williamson v. Tucker,[180] however, stands as an important qualification to this line of reasoning. The *Williamson* court, applying an economic reality test, held that a general partnership is not dispositively insulated from securities treatment.[181] Rather, the fact that a partner possesses power may be overcome by a showing of such dependence upon a promoter or third party that the partner could not exercise meaningful partnership powers. The court provided three non-exclusive examples of such a situation: (1) an agreement between the parties leaves so little power in the hands of a partner that the entity resembles a limited partnership; (2) a partner is so inexperienced in business affairs that he cannot intelligently exercise his partnership powers; and (3) a partner is so dependent upon the unique entrepreneurial or managerial ability of the promoter or manager that he cannot either replace the manager or otherwise exercise his partnership powers.[182] The Tenth Circuit adopted a more restrictive approach in *Banghart v. Hollywood General Partnership*, stating that the primary inquiry is not on actual control and participation but on the powers possessed by the partners *through the operation of the partnership agreement.* Presumably then, in the Tenth Circuit, a general partner would have to contractually relinquish all latent control over the management of the partnership in order to be a protected investor under the Securities Acts.[183]

Limited partnership interests, on the other hand, are generally considered investment contracts.[184] They are so considered because a

176. Keatinge, *supra* note 73, at 404.
177. *See* Steinberg, *supra* note 126, at 1111.
178. *See* Sargent, *supra* note 132, at 1084.
179. *Id.*
180. 645 F.2d 404 (5th Cir. 1981) *cert. denied*, 454 U.S. 897 (1981).
181. *Id.* at 422.
182. *Id.* at 424.
183. Banghart v. Hollywood General Partnership, 902 F.2d 805, 808 (10th Cir. 1990) (analogizing to Maritan v. Birmingham Properties, 875 F.2d 1451 (10th Cir. 1989)).
184. *See* Steinberg, *supra* note 126, at 1110.

limited partner who exercises too much control loses limited liability status.[185] Further, courts have continued to treat most limited partnership interests as securities even though the Revised Uniform Limited Partnership Act[186] provides the limited partner with fairly extensive participation rights.[187]

Several cases, however, suggest a qualification to this line of reasoning,[188] indicating that a limited partnership interest may escape classification as an investment contract if: (1) the limited partners in fact exercise substantial control over the limited partnership; and (2) the number of limited partners is small.[189] The Tenth Circuit, in *Maritan v. Birmingham Properties*,[190] adopted a similar approach, stating that the economic realities of the transaction determine whether the investors are in need of the protection of the Securities Act.[191] The court opined that the proper focus of the examination is the contract, and the retention of real power in the investors is sufficient to show that the interest is not a security.[192] The court went on to find that the limited partnership interest did not constitute a security because, whether or not exercised, the investor's access to critical information, his power under the agreement, and his demonstrated active involvement gave him sufficient control over the ultimate expectation of profits. As a result, the "efforts of others" prong of the *Howey* test was not satisfied and the interest was therefore not a security.[193] The number of limited partners, however, was not discussed in the opinion. Hence, the number of investors in the scheme may not be an important factor in the 10th Circuit.[194] Rather, it appears that securities status may be avoided by a showing of substantial control

185. *See* Sargent, *supra* note 132, at 1088 (citing the Uniform Limited Partnership Act § 7).

186. REVISED UNIF. LIMITED PARTNERSHIP ACT §§ 301-64, 6 U.L.A. Supp. 298 (Supp. 1993). Oklahoma adopted the Revised Uniform Limited Partnership Act at OKLA. STAT. ANN. tit. 54, §§ 301-365 (West 1991).

187. OKLA. STAT. ANN. tit. 54, § 320 (West 1991) provides that limited partners may engage in several important activities without being deemed to exercise control of the partnership. These activities include: (1) being an officer, director, or shareholder of a general partner that is a corporation; (2) bringing a derivative action on behalf of the limited partnership; and (3) voting on various matters including dissolution, sales of all or substantially all of the assets of the limited partnership, the admission of partners, and, significantly, "matters related to the business . . . not otherwise enumerated." *Id.*

188. *See* Sargent, *supra* note 132, at 1089.

189. *Id.*

190. 875 F.2d 1451 (10th Cir. 1989).

191. *Id.* at 1457.

192. *Id.* at 1458.

193. *Id.* at 1459.

194. The number of investors is apparently an important factor in some courts' analyses of securities status. *See* Sargent, *supra* note 132, at 1090.

irrespective of the number of investors. Thus, limited partnership interests essentially carry a rebuttable presumption of security status.

The precedents developed in partnership and limited partnership cases provide a guide as to how courts will apply the *Howey* test to Oklahoma LLC interests. The Oklahoma Limited Liability Company Act provides for centralized management of the company by managers who may or may not be members.[195] Such managers have the authority to bind the LLC as its agent.[196] Thus, an LLC that has not altered the default provisions of the Oklahoma Act appears to have a power structure similar to that of a limited partnership. The manager(s) has the sole binding authority to manage the company[197] and to enter into transactions on behalf of the company.[198]

Like limited partners, members may also retain certain rights concerning the management of the business. These rights include the power to elect managers, to terminate managers without cause,[199] and to approve or disapprove of the dissolution and winding up of the company, the disposition of all or substantially all of the assets of the company, a merger of the company, and amendments to the articles of organization or the operating agreement.[200] Thus, the company is managed by managers and the members are vested with limited approval rights. While these rights are arguably participatory, they are no greater in breadth than those allowed by the Oklahoma Revised Uniform Limited Partnership Act (ORULPA).[201] In fact, the Oklahoma LLC Act appears to draw heavily from ORULPA. Hence, interests in a LLC governed by the default provisions of the Oklahoma Act resemble those in a limited partnership and should generally be treated equally.[202] Absent a showing of actual managerial power, these interests should be investment contracts.

195. OKLA. STAT. ANN. tit. 18, § 2013 (West Supp. 1994).
196. *Id.* § 2019.
197. *Id.* § 2013.
198. *See id.* § 2019.
199. *Id.* § 2014.
200. *Id.* § 2020.
201. OKLA. STAT. ANN. tit. 54, §§ 301-65 (1991). The ORULPA provides a list of activities that a limited partner may engage in without participating in the control of the business. *Id.* at § 320 (B). This enumeration appears to encompass all of the powers granted to a default member in an Oklahoma LLC and is probably much broader. This assertion is especially compelling given the broad scope of § 320(B)(6)(j) which enables a limited partner to propose, approve, or disapprove of any matter related to the business not otherwise enumerated which the partnership agreement states may be subject to such approval or disapproval. *Id.*
202. *Cf. id.* at 34 (asserting that LLC's are functionally equivalent to limited partnerships); *compare* Steinberg, *supra* note 126, at 1113 (discussing the Texas LLC Statute, which also provides for managers to operate the company).

However, members might take an active role in managing the business. The articles of organization or operating agreement may provide for direct member governance,[203] and the Oklahoma Act specifically provides that the members may elect to manage the company without managers.[204] In such cases, the members are deemed to be the managers and are subject to all managerial duties and liabilities.[205] Also, given the broad ability of LLC organizers to alter the default provisions of the Act,[206] the members could presumably create for themselves a supervisory role vested with more responsibility than that of a default member but with less than that of a default manager. Thus, the members might resemble a board of directors with the managers assuming officer-like roles.[207]

If the articles of organization or the operating agreement grant the members this type of actual or latent managerial power, or a member has demonstrated active involvement in the management of the enterprise, the economic realities of the enterprise may dictate that the member is not deriving his profits substantially from the efforts of others.[208] An LLC with direct member management clearly resembles a general partnership. The members are bound to manage the company with the care an ordinary and prudent person in like circumstances would exercise[209] and, thus, have at least latent managerial power in the enterprise. An interest in an LLC of this character should generally be considered a non-security under federal law.

Finally, there is the possibility of securities status if an investor has no actual ability to exercise managerial power because the agreement so provides or the member is actually not competent to exercise that power.[210] Again, the focus is on economic reality, and actual ability to control the enterprise appears to be the touchstone.[211]

203. OKLA. STAT. ANN. tit. 18, § 2013 (West Supp. 1993). *See also id.* § 2015.

204. *Id.* § 2015.

205. *Id.*

206. For instance, the articles of organization or the operating agreement may state that the LLC is to be managed by members rather than managers. *Id.* §§ 2013, 2015. *See also id.* § 2014 (providing that the operating agreement or the articles of organization may vary the provisions for election and removal of managers).

207. Of course the resemblance is exaggerated since the hypothetical board is composed of the members rather than being representative of them, but the point is that the members could presumably adopt a role intermediate to those contemplated by the statute.

208. Maritan v. Birmingham Properties, 875 F.2d 1451, 1452-53 (10th Cir. 1989).

209. OKLA. STAT. ANN., tit. 18, § 2016 (West Supp. 1994).

210. Williamson v. Tucker, 645 F.2d 404 (5th Cir. 1981). "[T]he mere fact that an investment takes the form of a general partnership or joint venture does not inevitably insulate it from the reach of the federal securities laws." *Id.* at 422. *See also* Steinberg, *supra* note 126, at 1112.

211. *Cf.* Steinberg, *supra* note 126, at 1112.

Although an interest in a member-managed LLC should enjoy a non-security presumption, the courts exalt substance over form[212] and may find that a particular interest is a security if the agreement does not provide the member with any managerial power or the member is prevented from exercising that power.

In summary, the application of federal securities laws to an interest in an Oklahoma LLC appears to be an *ad hoc* analysis.[213] The nature of the LLC Act, which gives the members wide latitude to vary LLC the characteristics, and the vague definition of investment contract in the Securities Act force the LLC organizer to speculate concerning whether a particular LLC interest will be deemed a security. What comfort there is in precedent is best derived from the treatment of partnership and limited partnership interests. Thus, the LLC organizer can obtain the greatest predictability by tailoring the articles of organization and the operating agreement to resemble one of the two partnership forms.

2. The Oklahoma Securities Act and Oklahoma LLCs

The Oklahoma Securities Act[214] essentially tracks the definition of a security found in the Securities Act of 1933 with several changes.[215] There are two definitions of security in the Oklahoma Securities Act that are of chief importance in determining whether an interest in an LLC will be treated as a security.[216] These two alternatives[217] are the investment contract and risk capital tests.[218]

Investment contract analysis under the Oklahoma Securities Act should be identical to the analysis of an investment contract under the Securities Act of 1933 discussed above. The Oklahoma Securities Act provides that it should be construed to coordinate its interpretation and administration with related federal regulations.[219] Further, case law in the state has recognized the *Howey* test[220] as the definition of an investment contract for the purposes of the Oklahoma Securities

212. Maritan v. Birmingham Properties, 875 F.2d 1451, 1456 (10th Cir. 1989).
213. *See* Steinberg, *supra* note 126, at 1114-15.
214. OKLA. STAT. ANN. tit. 71, §§ 1-501 (West 1987 & Supp. 1994).
215. *Compare* OKLA. STAT. ANN. tit. 71, § 2(s) (West Supp. 1994) *with* 15 U.S.C. § 77(b)(1) (1988).
216. *See* Sargent, *supra* note 132, at 1069. *But see* Steinberg, *supra* note 126, at 1105.
217. Sargent, *supra* note 132 at 1093.
218. OKLA. STAT. ANN. tit. 71, §§ 2(s)(11), (16) (West 1987 & Supp. 1993).
219. *Id.* § 501.
220. SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

Act.[221] Thus, any LLC interest that is an investment contract under federal law is an investment contract under the Oklahoma Securities Act.[222] Alternatively, the risk capital test is different than the definition of an investment contract. Oklahoma's risk capital test[223] states that a security includes "investment of money or money's worth including goods furnished and/or services performed in the risk capital of a venture with the expectation of some benefit to the investor where the investor has no direct control over the investment or policy decision of the venture."[224] However, in *State v. Petco Oil and Gas* the Oklahoma Supreme Court stated that the risk capital test is, "with some modifications, a codification of the definition of an investment contract used . . . in *SEC v. Howey Co.*. . . ."[225] Courts seem to use the risk capital test somewhat interchangeably with the *Howey* test.[226]

Some elements of the tests are very similar. First, the investment of money element is very similar to the *Howey* investment concept.[227] Second, the element of lack of direct control over the investment and policy decisions of the venture is similar to the liberalized *Glenn W. Turner*[228] version of the *Howey* efforts of others element. This view is especially compelling in Oklahoma since the Oklahoma Court of Criminal Appeals recently stated that the proper test of *Howey* is "substantially" through the efforts of others rather than "solely."[229]

On the other hand, the tests differ in that the risk capital test speaks in terms of the expectation of a benefit rather than profit.[230]

221. *See* Probst v. State, 807 P.2d 279, 284 (Okla. Crim. App. 1991); Howell v. Ballard, 801 P.2d 127, 128 (Okla. Ct. App. 1990).

222. Further, an investment contract that would be exempted from the application of federal securities law by operation of the exemption for securities sold only to persons resident in a single state will still be subject to the blue sky laws of the State of Oklahoma. *See* 15 U.S.C. § 77c(a)(11) (1988).

223. Several states have risk capital tests that differ from Oklahoma's. Further, some states have adopted the risk capital test as an alternative means of defining an investment contract while Oklahoma has adopted the test as an independent means of defining a security. *See* Sargent, *supra* note 132, at 1092-93.

224. OKLA. STAT. ANN. tit. 71, § (2)(s)(16) (Supp. 1994).

225. State v. Petco Oil & Gas, Inc., 558 P.2d 1163, 1166 (Okla. 1977).

226. *See, e.g.*, Probst v. State, 807 P.2d 279 (Okla. Crim. App. 1991); Armstrong v. State, 811 P.2d 593 (Okla. Crim. App. 1991); Howell v. Ballard, 801 P.2d 127 (Okla. App. 1990). However, commentators have compared the two tests in more detail. *See, e.g.*, Sargent, *supra* note 132, at 1094; LONG, *supra* note 144, § 2.03[3], at 2-40 to 2-41.

227. "The concept of investment in this regard is identical to the concept of investment developed previously under the *Howey* test." LONG, *supra* note 144, § 2.03[3] at 2-40.

228. SEC v. Glenn W. Turner Enter., Inc., 474 F.2d 476, 482 (9th Cir. 1973) *cert. denied*, 414 U.S. 821 (1973).

229. Probst v. State, 807 P.2d 279, 285 (Okla. Crim. App. 1991). The *Turner* view has likewise been adopted by the Tenth Circuit in Crowley v. Montgomery Ward and Co., Inc., 570 F.2d 875, 877 (10th Cir. 1975).

230. OKLA. STAT. ANN. tit. 71, § (2)(s)(16) (West Supp. 1994).

The benefit can be non-monetary and tangible or intangible as long as it is the motivation for the investment.[231] While this is a departure from *Howey*, the expanded concept of benefit should not be a change of great magnitude since only rarely will an investor expect a return that will not fit within the definition of profits.[232]

The requirement of an investment in the risk capital of the venture also differs from the *Howey* test and is much vaguer than the other elements. The Oklahoma Supreme Court stated that the subjection of an investor's money to the risks of a venture constitutes risk capital,[233] but whether the investors must have only residual rights to the invested capital is unclear. At least one commentator believes that the definition should include debt and equity financing as well as membership payments and some franchise fees.[234] Realistically, however, a membership interest in an LLC should usually be an equity investment that is not collateralized and hence subject to the risks of the enterprise.[235]

Another difference is that the risk capital test does not include a commonality requirement. Since the Oklahoma investment contract test only requires vertical commonality, however, this change is unlikely to have any effect on LLC's. As a practical matter, an LLC investor should generally share a common business purpose with the promoter such that an interest would be covered by the vertical commonality requirement.

Finally, a potential difference between these tests is indicated by the Tenth Circuit's consideration of the risk capital test in *Meyer v. Dans un Jardin, S.A.*[236] There, the court stated that under the risk capital test a security is present whenever the investor's funds provide the initial or venture capital needed to develop a new enterprise.[237] Under this view, the membership interest might not be considered risk capital if the interest is not obtained through initial capitalization.[238]

231. LONG, *supra* note 144, § 2.03[3] at 2-40 (providing examples of such schemes including advance hotel reservations, vacation licenses, and condominium time sharing agreements).

232. *See* Sargent, *supra* note 132, at 1094.

233. State *ex rel.* Day v. Petco Oil and Gas, Inc., 558 P.2d 1163, 1167 (Okla. 1977).

234. *See* LONG, *supra* note 144, § 2.03[3] at 2-40.

235. *Cf.* SARGENT, *supra* note 135, at 3-14.

236. 816 F.2d 533 (10th Cir. 1987).

237. *Id.* at 536 (rejecting the application of the risk capital test to a federal securities claim to the extent the tests differed).

238. *Id.* at 536; *compare* SARGENT *supra* note 135, at 3-14.

Some other jurisdictions have taken this limited view of the risk capital definition as well.[239] Once again, the question is probably academic when applied to Oklahoma LLCs since an interest that does not stem from initial capitalization is still subject to investment contract analysis. Practically, the LLC member who contributes capital after the initiation of the venture will have his investment considered under the investment contract definition.[240] Therefore, in most cases, the risk capital test should be interchangeable with the investment contract test. Only in rare cases will the risk capital test reach LLC interests that the investment contract test will not.

In summary, investors should find the *Howey* precedents to be their best guide in determining the applicability of state and federal securities laws. The LLC member in Oklahoma should be able to predict the application of securities laws by tailoring the structure of the enterprise to one of the two partnership forms discussed.

IV. CONCLUSION

LLCs are becoming extremely popular because they bestow pass through tax treatment while providing limited liability to all members and relieving the burden of many corporate formalities. In the initial analysis this interest is tax driven, but the LLC organizer must be careful to structure and manage his business so that liability is not incurred under the securities laws or the doctrine of veil piercing. Weighing these concerns and plotting a safe course may seem difficult given the current paucity of precedent. The careful LLC organizer, however, should be able to reap the rewards of this versatile business structure without subjecting the business or its members to liability.

Stacy Ward Wood
John Tristam Woodruff

239. *See, e.g.*, State *ex rel.* Healy v. Consumer Business Sys., Inc., 482 P.2d 549, 555 (Or. Ct. App. 1971); *In re* Jet Set Travel Club, [1971-1978 Transfer Binder] Blue Sky L. Rep. (CCH) ¶ 71,175 (Or. Corp. Comm'n Oct. 28, 1974), *rev'd on other grounds*, 535 P.2d 109 (Or. Ct. App. 1975).

240. Some support for this assertion is found by the author's inability to find any Oklahoma case other than State *ex rel.* Day v. Petco Oil & Gas, 558 P.2d 1163 (Okla. 1977) which applies the risk capital definition.