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Limited Liability Company Interests As Securities: An Analysis of Federal and State Actions Against Limited Liability Companies Under the Securities Laws

Elaine A. Welle

LIMITED LIABILITY COMPANY INTERESTS AS SECURITIES: AN ANALYSIS OF FEDERAL AND STATE ACTIONS AGAINST LIMITED LIABILITY COMPANIES UNDER THE SECURITIES LAWS

ELAINE A. WELLE*

* Assistant Professor of Law, University of Wyoming College of Law. Member, Colorado Bar; B.A., University of Colorado, 1977; M.B.A., University of Colorado, 1981; J.D., University of Arizona, 1986. The author thanks Professor Harvey Gelb and Professor J. Robert Brown, Jr. for their helpful comments, and Professor Mark Sargent for his assistance in locating certain state authorities. The author gratefully acknowledges the research assistance of Teresa K. Jensen and Susan E. Schell, law students at the University of Wyoming, and the editorial assistance of the *Denver University Law Review* Board of Editors. The author also wishes to thank Teresa Nelson whose unbelievable skill, efficiency, and accuracy, together with good humor, helped to produce this work. Funding for this research was provided by a University of Wyoming College of Law George Hopper Faculty Research Fund grant.

I. INTRODUCTION

A limited liability company ("LLC") is a business entity intended to offer its owners the limited liability protection of a traditional corporation and the tax advantages of a partnership.[1] Although the Wyoming legislature enacted

1. For a comprehensive analysis of limited liability companies, including tax and business aspects, see LARRY E. RIBSTEIN & ROBERT R. KEATINGE, 1 RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES (1994 & Cum. Supp. 1995); MARK A. SARGENT & WALTER D. SCHWIDETZKY, LIMITED LIABILITY COMPANY HANDBOOK (1994-95) [hereinafter SARGENT HANDBOOK]; Allan G. Donn, *Practical Guide to Limited Liability Companies, in* 1 STATE LIMITED LIABILITY COMPANY & PARTNERSHIP LAWS at PGLLC-1 (Michael A. Bamberger & Arthur J. Jacobson eds., 1995-1 Supp.); Wayne M. Gazur & Neil M. Goff, *Assessing the Limited Liability Company*, 41 CASE W. RES. L. REV. 387 (1991); Thomas E. Geu, *Understanding the Limited Liability Company: A Basic Comparative Primer (Part One)*, 37 S.D. L. REV. 44 (1992); Thomas E. Geu, *Understanding the Limited Liability Company: A Basic Comparative Primer (Part Two)*, 37 S.D. L. REV. 467 (1992) [hereinafter Geu, Part Two]; Robert R. Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW. 375 (1992). A bibliography of

the first limited liability company statute in 1977,[2] few states followed until the Internal Revenue Service ruled in 1988 that LLCs would be treated like partnerships for tax purposes.[3] Forty-seven states and the District of Columbia now allow for the formation of LLCs,[4] and thousands have been formed in the last few years.[5]

Treatises, articles, and commentaries written about LLCs have focused primarily on the organizational, tax, and formation aspects of the entity.[6]

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articles written about limited liability companies is set forth in Chapter 7 of the SARGENT HANDBOOK, *supra*.

2. Wyoming Limited Liability Company Act, ch. 158, 1977 Wyo. Sess. Laws 537 (codified as amended at Wyo. Stat. §§ 17-15-101 to -143 (1989 & Supp. 1994)).

3. Rev. Rul. 88-76, 1988-2 C.B. 360. Florida enacted LLC legislation in 1982, but few states followed Wyoming's and Florida's lead until Revenue Ruling 88-76 was announced. In 1990, Colorado and Kansas enacted LLC statutes and Indiana enacted a statute requiring foreign LLCs to register with the Indiana Secretary of State. In 1991, Nevada, Texas, Utah, and Virginia passed LLC legislation. By 1994, 43 states had enacted LLC statutes and six others were considering legislation. SARGENT HANDBOOK, *supra* note 1, § 1.02. For a discussion of the origins and pattern of LLC enactments, see SARGENT HANDBOOK, *supra* note 1, § 1.02; Keatinge et al., *supra* note 1, at 381-84.

4. For the text of many state limited liability company statutes, see 2-4 RIBSTEIN & KEATINGE, *supra* note 1, app. D; 2-5 STATE LIMITED LIABILITY COMPANY & PARTNERSHIP LAWS (Michael A. Bamberger & Arthur J. Jacobson eds., 1994 & 1995-2 Supp.). For a survey of the existing statutes and pending legislation, see SARGENT HANDBOOK, *supra* note 1, ch. 5. As of this writing, 47 states and the District of Columbia have adopted limited liability company statutes and the remaining states (Hawaii, Massachusetts, and Vermont) are considering adoption. ALA. CODE §§ 10-12-1 to -61 (1994); ALASKA STAT. §§ 10.50.010-.995 (Supp. 1994); ARIZ. REV. STAT. ANN. §§ 29-601 to -857 (Supp. 1994); ARK. CODE ANN. §§ 4-32-101 to -1316 (Michie Supp. 1993); CAL. CORP. CODE §§ 17000-17705 (West 1995); COLO. REV. STAT. ANN. §§ 7-80-101 to -1101 (West Supp. 1994); CONN. GEN. STAT. ANN. §§ 34-100 to -242 (West Supp. 1995); DEL. CODE ANN. tit. 6, §§ 18-101 to -1107 (1993 & Supp. 1994); D.C. CODE ANN. §§ 29-1301 to -1375 (Supp. 1995); FLA. STAT. ANN. §§ 608.401-.514 (West 1993 & Supp. 1995); GA. CODE ANN. §§ 14-11-100 to -1109 (1994 & Supp. 1995); IDAHO CODE §§ 53-601 to -672 (1994 & Supp. 1995); ILL. ANN. STAT. ch. 805, para. 180/1-1 to /1-60 (Smith-Hurd Supp. 1995); IND. CODE ANN. §§ 23-18-1-1 to -19 (Burns 1995); IOWA CODE ANN. §§ 490A.100-.1601 (West Supp. 1995); KAN. STAT. ANN. §§ 17-7601 to -7652 (Supp. 1994); KY. REV. STAT. ANN. §§ 275.001-.455 (Michie/Bobbs-Merrill Supp. 1994); LA. REV. STAT. ANN. §§ 12:1301-:1369 (West 1994); ME. REV. STAT. ANN. tit. 31, §§ 601-762 (West Supp. 1994); MD. CODE ANN., CORPS. & ASS'NS §§ 4A-101 to -1103 (1993 & Supp. 1994); MICH. COMP. LAWS ANN. §§ 450.4101-.5200 (West Supp. 1995); MINN. STAT. ANN. §§ 322B.01-.960 (West 1995); MISS. CODE ANN. §§ 79-29-101 to -1204 (Supp. 1994); MO. ANN. STAT. §§ 347.010-.740 (Vernon Supp. 1995); MONT. CODE ANN. §§ 35-8-101 to -1307 (1993); NEB. REV. STAT. §§ 21-2601 to -2653 (Supp. 1994); NEV. REV. STAT. ANN. §§ 86.010-.571 (Michie 1994); N.H. REV. STAT. ANN. §§ 304-C:1 to :85 (1995); N.J. STAT. ANN. §§ 42:2B-1 to -70 (West Supp. 1995); N.M. STAT. ANN. §§ 53-19-1 to -74 (Michie 1993 & Supp. 1995); N.Y. LTD. LIAB. LAW §§ 101-1403 (McKinney Supp. 1995); N.C. GEN. STAT. §§ 57C-1-01 to -10-07 (1993 & Supp. 1994); N.D. CENT. CODE §§ 10-32-01 to -155 (1995); OHIO REV. CODE ANN. §§ 1705.01-.58 (Anderson Supp. 1994); OKLA. STAT. ANN. tit. 18, §§ 2000-2060 (West Supp. 1995); OR. REV. STAT. §§ 63.001-.990 (1995); 15 PA. CONS. STAT. ANN. §§ 8901-8998 (1995); R.I. GEN. LAWS §§ 7-16-1 to -75 (1992 & Supp. 1994); S.C. CODE ANN. §§ 33-43-101 to -1409 (Law. Co-op. Supp. 1994); S.D. CODIFIED LAWS ANN. §§ 47-34-1 to -59 (Supp. 1995); TENN. CODE ANN. §§ 48-201-101 to -248-606 (Supp. 1994); TEX. REV. CIV. STAT. ANN. art. 1528n (West Supp. 1995); UTAH CODE ANN. §§ 48-2b-101 to -158 (1994 & Supp. 1995); VA. CODE ANN. §§ 13.1-1000 to -1073 (Michie 1993 & Supp. 1995); WASH. REV. CODE §§ 25.15.005-.902 (West Supp. 1995); W. VA. CODE §§ 31-1A-1 to -69 (Supp. 1995); WIS. STAT. ANN. §§ 183.0102-.1305 (West 1994); WYO. STAT. §§ 17-15-101 to -144 (1989 & Supp. 1995).

5. John R. Emshwiller, *New Kind of Company Attracts Many—Some Legal, Some Not*, WALL ST. J., Nov. 8, 1993, at B1.

6. *See supra* note 1. For helpful background material refer to sources listed *supra* note 1,

Comparatively few authors, however, have addressed whether LLC interests should be considered securities. Those who have are divided on the issue of whether LLC interests should be treated as securities.[7]

While commentators continue to debate whether LLC interests should be treated as securities, the Securities and Exchange Commission ("SEC") and a number of state securities regulators have taken action. On March 24, 1994, the SEC filed a complaint in the United States District Court for the District of Columbia against Vision Communications, Inc. and several related parties.[8] The SEC alleged that the defendants violated the antifraud, securities registration, and broker-dealer registration provisions of the federal securities laws by selling membership units in a limited liability company.[9] By the summer of 1995, the SEC had filed complaints against defendants in at least six unrelated actions also alleging violations of the federal securities laws for selling interests in limited liability companies.[10] An attorney with the SEC Division of

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and see Limited Liability Company Bibliography in Chapter 7 of the SARGENT HANDBOOK, *supra* note 1, at 7-1 to 7-6.

7. Treatises, articles, and commentaries addressing whether LLC interests constitute securities include 1 RIBSTEIN & KEATINGE, *supra* note 1, § 14.02, at 14-5 (proposing that there should be at least a presumption against a "security" characterization for LLC interests or LLC interests might be characterized as nonsecurities because LLC interests are closely held); MARK A. SARGENT, LIMITED LIABILITY COMPANY HANDBOOK ch. 3 (1993-94) (concluding that LLC interests are not securities in most instances); Donn, *supra* note 1, § 3.4, at PGLLC-16 (noting that the determination depends on the circumstances of the particular case); S. Brian Farmer & Louis A. Mezzullo, *The Virginia Limited Liability Company Act*, 25 U. RICH. L. REV. 789, 828-30 (1991) (suggesting courts will find an LLC interest a security if it satisfies the definition of investment contract); Geu, Part Two, *supra* note 1, at 510-18, 520 (observing that there is no bright line test and suggesting a case-by-case analysis depending on the organization and operating agreement); 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 an LLC interest should not be treated as a security); Keatinge et al., *supra* note 1, at 403-04 (stating that the critical question is "whether profits are expected 'from the efforts of the promoter or a third party'"); Joseph C. Long, *Cellular Telephone and Wireless Cable Interests as Investment Contracts*, 1 Enforcement L. Rep. 86, 110-14 (1993) (stating that a unit in an LLC can be an investment contract and therefore a security); John A. Peralta, *Limited Liability Company Interests as Securities*, 1 Enforcement L. Rep. 29, 36 (1993) (LLC interests are usually securities); Larry E. Ribstein, *Form and Substance in the Definition of a "Security": The Case of Limited Liability Companies*, 51 WASH. & LEE L. REV. 807 (1994) (urging courts to hold that an interest in an LLC is presumptively not a security); Mark A. Sargent, *Will Limited Liability Companies Punch a Hole in the Blue Sky?*, 21 SEC. REG. L.J. 429, 439-40 (1994) (proposing that evaluation should be on a case-by-case basis, without a presumption that LLC interests are securities) [hereinafter Sargent Blue Sky]; Mark A. Sargent, *Are Limited Liability Company Interests Securities?*, 19 PEPP. L. REV. 1069 (1992) (arguing that LLC interests normally do not satisfy the definition of a security) [hereinafter Sargent Article]; Marc I. Steinberg & Karen L. Conway, *The Limited Liability Company as a Security*, 19 PEPP. L. REV. 1105 (1992) (arguing that LLC interests normally are securities) [hereinafter Steinberg Article].

8. *See* SEC v. Vision Communications, Inc., Litigation Release No. 14026, 56 SEC Docket 880, 1994 WL 96945 (SEC) (Mar. 24, 1994); *Civil Action Against Vision Communications, Inc.*, SEC News Digest 94-56-4, 1994 WL 94496 (SEC) (Mar. 25, 1994); *SEC Enforcement: Alleged Boiler Room Sales of Interests in Cable Venture Subject to SEC Suit*, Sec. L. Daily (BNA) (Mar. 28, 1994); *Alleged Boiler Room Sales of Interests in Cable Venture Subject of SEC Suit*, Sec. Reg. & L. Rep. (BNA) No. 26, at 662 (May 6, 1994).

9. SEC v. Vision Communications, Inc., Litigation Release No. 14026, 56 SEC Docket 880, 1994 WL 96945 (SEC) (Mar. 24, 1994).

10. SEC v. Irwin Harry Bloch, Litigation Release No. 14511, 59 SEC Docket 931, 1995 WL 317420 (SEC) (May 25, 1995); SEC v. United Communications, Ltd., Litigation Release No. 14477, 59 SEC Docket 424, 1995 WL 254714 (SEC) (Apr. 24, 1995); SEC v. American Interac-

Enforcement stated that the SEC was evaluating a number of LLC operations to determine whether such organizations were violating federal securities laws.[11]

At least sixteen states have taken action under state securities laws against entities offering or selling LLC interests.[12] In at least twelve states, state courts or regulators have ordered LLC promoters to cease and desist from offering or selling LLC interests in violation of state securities laws, based on findings of sufficient evidence to conclude such LLC interests were securities.[13] In addition, a number of jurisdictions have adopted legislation that either expressly states or implies that LLC interests are securities. For example, the legislatures in eight states amended their securities laws to expressly state that certain LLC interests may be securities.[14] The legislatures in seven states have amended their securities law statutes to include references to LLCs.[15]

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tive Group, LLC, Litigation Release No. 14462, 59 SEC Docket 203, 1995 WL 229088 (SEC) (Apr. 10, 1995); SEC v. Future Vision Direct Mktg., Inc., Litigation Release No. 14384, 58 SEC Docket 1716, 1995 WL 25731 (SEC) (Jan. 18, 1995); SEC v. Parkersburg Wireless Ltd. Liab. Co., Litigation Release No. 14085, 56 SEC Docket 1974, 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). For a discussion of such actions see part II.A.

11. John R. Emshwiller, *SEC Sets Sights on Certain Limited Liability Companies*, WALL ST. J., Mar. 31, 1994, at B2.

12. Emshwiller, *supra* note 5. In November 1993, an article in the *Wall Street Journal* stated that at least 16 states had filed legal actions against a variety of wireless cable and related communications technology firms on the grounds that they had violated securities laws by offering or selling LLC interests. *Id.*

13. 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. 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 securities opinions. JOSEPH C. LONG, 12 BLUE SKY LAWS 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.

Table I of this article contains a summary of the various state actions either declaring that LLC interests are securities or indicating that LLC interests may be securities. Table I is organized by state and by case and provides the citation to each case. Table I sets forth the state action taken, the securities law violations raised, and the securities law theories discussed. Finally, Table I indicates whether the action was a summary order, or whether it resulted in written findings of fact, conclusions of law, or an opinion.

14. ALASKA STAT. § 45.55.990(12) (1994); CAL. CORP. CODE § 25019 (West Supp. 1995); IND. CODE ANN. § 23-2-1-1(k) (West 1995); N.M. STAT. ANN. § 58-13B-2(V) (Michie Supp. 1995); 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. 1995). Table II of this article contains a listing of the state statutes that expressly address whether LLC interests are securities under state law. Table II is organized alphabetically by state and provides the statutory citation, a short summary of the statutory provision, and the relevant statutory language.

15. For example, the following state securities laws include references to LLCs: CONN. GEN. STAT. ANN. § 36b-1 (West Supp. 1995) (general statement); IOWA CODE ANN. § 502.207A(2)(a) (West Supp. 1995) (expedited registration by filing for small issuers); KAN. STAT. ANN. § 17-1262(l) (Supp. 1994) (exempt transactions); LA. REV. STAT. ANN. § 51:709(12) (West Supp. 1995) (exempt transactions); N.H. REV. STAT. ANN. § 421-B:11(II) (Supp. 1994) (registration requirement); N.H. REV. STAT. ANN. § 421-B:13(I) (Supp. 1994) (registration by coordination); N.H. REV. STAT. ANN. § 421-B:17(II)(k) (Supp. 1994) (registration exemption); N.D. CENT. CODE § 10-04-05(4), (10), (11), (13) (1995) (exempt securities); N.D. CENT. CODE § 10-04-06(4), (6), (10), (14) (1995) (exempt transactions); N.D. CENT. CODE § 10-04-07(2)(b)(3) (1995) (registration

These references imply that the offer and sale of LLC interests are subject to such securities laws.[16] The legislatures in four states included provisions in their limited liability company acts that raise the securities law issue.[17] Additionally, a 1993 survey of state securities regulators indicated that twenty-four states had taken the position, either formally or informally, that LLC interests may be securities under their state securities laws.[18] A more recent survey of state laws, regulations, and securities administrators indicates that now at least thirty-five states have taken that position, either formally or informally.[19]

The outcome of federal and state LLC securities litigation, together with the various legislative measures, is of great practical importance to practitioners. If an LLC interest is a security, it triggers, among other things, securities registration requirements, broker-dealer registration requirements, securities fraud liability, and in some cases disclosure obligations.[20] The SEC, state securities commissioners, and private parties[21] may bring suit for securities law violations. Criminal liability may even be imposed under certain circumstances.

Absent legislative action, many LLC ownership interests probably will not be deemed securities. It is highly unlikely that courts will hold ownership interests in all LLCs are per se securities. Nevertheless, based on the litigation to date, it appears highly likely courts will hold that ownership interests in LLCs with certain characteristics are securities.[22] As a result, the structure of an LLC may determine whether an ownership interest is a security.

Part II of this article provides an overview of the current federal and state LLC securities litigation. It describes the types of offerings targeted by the government and outlines the common characteristics these LLC entities allegedly share. Part III analyzes the various theories asserted by commentators, federal regulators, and state regulators to bring such LLC offerings within the

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by description); VA. CODE ANN. § 13.1-514(B)(7)(b) (Michie Supp. 1995) (exempt transactions).

16. *See supra* note 15.

17. GA. CODE ANN. § 14-11-1107(n) (1994) provides, "[n]othing 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, "[a]n 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. 1995) states, "[i]t 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. 1995) provides, "[a]n interest in a limited liability company may be a security . . . ."

18. *See* Sargent Blue Sky, *supra* note 7, at 430-35.

19. *See* 1 Blue Sky L. Rep. (CCH) ¶ 6551; *see also* Tables I, II, and III, *infra*, pp. 495-505.

20. *See* 1 RIBSTEIN & KEATINGE, *supra* note 1, §§ 14.02-14.03, at 14-6 to 14-12 (describing federal and state requirements).

21. The author found only one reported case in which private parties alleged violations of the securities laws in connection with the purchase or sale of an LLC interest. *See* Fransen v. Terps Ltd. Liab. Co., 153 F.R.D. 655 (D. Colo. 1994) (seeking damages for violation of federal and state securities laws in connection with the sale of membership interests in an LLC) (summary judgment granted for defendants on other grounds). Although there are few reported cases, from discussions with practitioners it appears that private parties are beginning to raise and litigate such securities law claims.

22. *See* discussion *infra* parts III.A, III.B, and III.E.

ambit of the securities laws. These theories include the investment contract theory, risk capital analysis, the characteristics of stock test, the commonly known as a security test, and state statutory grounds. Part III also presents possible defenses to each of these theories. The discussion of each theory concludes with the author's evaluation of the theory's applicability, and an assessment of the arguments asserted and the defenses presented. Part IV summarizes the analysis of these theories and discusses the author's conclusions.

II. BACKGROUND ON FEDERAL AND STATE ACTIONS

Federal and state actions against LLC offerings have focused primarily on entities selling interests in so-called "wireless cable"[23] and related communications technology.[24] Although such actions have been directed at wireless communications companies, these cases indicate: (1) the type of LLC offering the government is targeting; (2) the common characteristics these offerings allegedly share; and (3) the types of claims raised by the government. But even more importantly, these cases dispel certain myths and misconceptions about LLCs.

For example, commentators have argued that LLC interests should not be treated as securities because LLCs generally are closely held and member-managed.[25] They maintain that since most LLC members are actively engaged in the management of the LLC, such investors are not dependent on the efforts of others and therefore are not in need of the protection provided by the securities laws.[26] They contend that LLC interests should not be treated as securities because LLCs resemble general partnerships.[27] General partnership interests are presumed not to be securities because each partner retains control over the management of the partnership.[28]

The federal and state actions against LLCs illustrate that not all LLCs are closely held or member-managed. In fact, some LLCs have hundreds of members.[29] These cases demonstrate that many LLC promoters have mass-market-

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23. Wireless cable, also known as Super High Frequency Television ("SHFTV"), refers to a method of transmitting video entertainment programming through the use of microwave radio technology. SHFTV is a new broadcast system that uses microwave technology to transmit up to 32 video channels from a transmitter antenna to small rooftop antennas where signals are received and sent to television sets for viewing. SHFTV technology allows wireless networks to broadcast television programming similar to that offered by cable television companies. *See* 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 3 n.2, SEC v. Vision Communications, Inc., No. 94-0615 (CRR), 1994 WL 326868 (D.D.C. May 11, 1994) [hereinafter Plaintiff's Memorandum in Vision].

24. *See, e.g., infra* Table I pp. 495-98 (19 of the 23 state actions cited involve companies in the telecommunications business).

25. *See, e.g.*, 1 RIBSTEIN & KEATINGE, *supra* note 1, § 14.02, at 14-5; SARGENT HANDBOOK, *supra* note 1, § 4.02[1], at 4-10 to 4-13.

26. *See, e.g.*, 1 RIBSTEIN & KEATINGE, *supra* note 1, § 14.02, at 14-5 to 14-6.

27. *See, e.g.*, 1 *id.* at 14-4; SARGENT HANDBOOK, *supra* note 1, § 4.02[1], at 4-10 to 4-11.

28. *See, e.g.*, Youmans v. Simon, 791 F.2d 341, 346 (5th Cir. 1986); Williamson v. Tucker, 645 F.2d 404, 424 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981).

29. *See, e.g.*, Plaintiff's Memorandum in Vision at 2, 7, 1994 WL 326868 (No. 94-0615); Plaintiff Securities and Exchange Commission's Memorandum of Points and Authorities in Sup-

ed LLC offerings indiscriminately to the general public, using telemarketing techniques, promotional mailings, and even television infomercials to induce financially unsophisticated individuals to invest their retirement funds in LLC ventures.[30] The SEC and state regulators allege that such LLC investors often have no practical control over their investment due to the number of investors, the relatively small size of each investment, the geographic dispersion of the investors, and the lack of sophistication of the typical investor.[31] Such investors appear to be precisely the type of investors the securities laws were designed to protect.

Prosecutors have targeted primarily LLC investment opportunities which allegedly involved a relatively high degree of risk and were mass-marketed to unsophisticated investors using high pressure sales techniques and claims of immediate and exorbitant returns.[32] Admittedly, these egregious cases are not representative of all LLCs, but they clearly demonstrate the inaccuracy of common assumptions and generalizations that all LLCs are closely held and member-managed. The following is an overview of several selected cases that briefly describes the characteristics of these offerings, the claims raised by the government, the defenses presented by promoters, and the status of the litigation to date.

A. *Federal Cases*

1. *Vision Communications*

On March 24, 1994, the SEC filed suit against Vision Communications, Inc., Wilkes-Barre-Scranton L.C., and two individual defendants.[33] *SEC v. Vision Communications, Inc.*[34] was the first case in which the SEC sought a judgment under the federal securities laws in connection with the offer and sale of LLC interests.[35] The case raised an issue of first impression[36] in the federal courts: whether an LLC interest was a security and therefore subject to federal securities laws.

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port of Its Motion for Temporary Restraining Order, Preliminary Injunction and Other Relief at 2, SEC v. Parkersburg Wireless Ltd. Liab. Co., (No. 94-1079) (SSH) (D.D.C. May 16, 1994) [hereinafter Plaintiff's Memorandum in Parkersburg].

30. *See, e.g.*, Plaintiff's Memorandum in Vision at 2, 4-6, 1994 WL 326868 (No. 94-0615); Plaintiff Securities and Exchange Commission's Reply Memorandum in Support of its Motion for Temporary Restraining Order at 3-4, 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 at 2, 5, 7-8, 15, (No. 94-1079).

31. *See, e.g.*, Plaintiff's Memorandum in Vision at 13, 1994 WL 326868 (No. 94-0615); Plaintiff's Memorandum in Parkersburg at 15-16, (No. 94-1079).

32. *See supra* note 30.

33. SEC v. Vision Communications, Inc., Litigation Release No. 14026, 56 SEC Docket 880, 1994 WL 96945 (SEC) (Mar. 24, 1994).

34. SEC v. Vision Communications, Inc., No. 94-0615 (CRR), 1994 WL 326868 (D.D.C. May 11, 1994).

35. Emshwiller, *supra* note 11.

36. *See* Defendants' Memorandum of Points and Authorities in Opposition to Plaintiff's Motion for Temporary Restraining Order at 12-14, SEC v. Vision Communications, No. 94-0615 (CRR), 1994 WL 326868 (D.D.C. May 11, 1994) [hereinafter Defendants' Memorandum in Vision].

The defendants in *Vision Communications* purportedly were developing a wireless cable television system.[37] They claimed to be selling interests in an LLC to raise capital to obtain a license to install, operate, and market a super-high-frequency-television system, or to purchase an interest in such a system in the Wilkes-Barre-Scranton, Pennsylvania area.[38]

The SEC alleged several violations of the federal securities laws. First, the SEC maintained that membership units in the LLC constituted investment contracts and as such were securities under the Securities Act of 1933[39] ("Securities Act") and the Securities Exchange Act of 1934[40] ("Exchange Act").[41] Second, the SEC charged that the defendants offered and sold these unregistered securities in violation of sections 5(a) and 5(c) of the Securities Act.[42] Third, the SEC asserted that the defendants engaged in the business of selling the securities without registration as broker-dealers in violation of section 15(a) of the Exchange Act.[43] Finally, the SEC alleged that the defendants made false and misleading statements about the LLC and its business prospects in violation of section 17(a) of the Securities Act,[44] section 10(b) of

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37. Plaintiff's Memorandum in Vision at 3, 1994 WL 326868 (No. 94-0615).
38. *Id.* at 3, 5.
39. 15 U.S.C. § 77a-77aa (1994).
40. 15 U.S.C. § 78a-78*ll* (1994).
41. *See* Plaintiff's Memorandum in Vision at 9-16, 1994 WL 326868 (No. 94-0615).
42. *Id.* at 1. Section 5(a) of the Securities Act provides:

> Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly
>
> (1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or
>
> (2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

15 U.S.C. § 77e(a).

Section 5(c) of the Securities Act provides, in pertinent part:

> It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security . . . .

15 U.S.C. § 77e(c).

43. Plaintiff's Memorandum in Vision at 1, 1994 WL 326868 (No. 94-0615). Section 15(a) of the Exchange Act provides, in pertinent part:

> It shall be unlawful for any broker or dealer . . . to make use of the mails or any means or instrumentality of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security . . . unless such broker or dealer is registered in accordance with [the Exchange Act].

15 U.S.C. § 78o(a)(1).

44. Plaintiff's Memorandum in Vision at 1-2, 1994 WL 326868 (No. 94-0615). Section 17(a) of the Securities Act provides:

> It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

the Exchange Act,[45] and Rule 10b-5 promulgated under the Exchange Act.[46] The SEC sought emergency relief, including a freeze on the defendants' assets, a temporary restraining order, an order for a preliminary injunction, an order for a permanent injunction, and civil penalties.[47]

The SEC described the defendants' sales activities as a "boiler room operation"[48] where sales people made cold calls and used high pressure sales techniques[49] to solicit scores of financially unsophisticated, geographically dispersed investors.[50] The solicited investors allegedly possessed little or no business experience and included clerical workers, blue-collar workers, and retirees, who were often induced to invest their retirement funds.[51] The SEC charged that the defendants made numerous false statements, including misrepresentations about immediate, exorbitant returns and the risks associated with the investment.[52] In response, the defendants argued that ownership interests

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(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

15 U.S.C. § 77q(a).

45. Plaintiff's Memorandum in Vision at 1-2, 1994 WL 326868 (No. 94-0615). Section 10(b) of the Exchange Act provides, in pertinent part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails . . . [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b).

46. Plaintiff's Memorandum in Vision at 1-2, 1994 WL 326868 (No. 94-0615). Rule 10b-5 promulgated under the Exchange Act provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> (a) to employ any device, scheme or artifice to defraud,
>
> (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1995).

47. Plaintiff's Memorandum in Vision at 1, 1994 WL 326868 (No. 94-0615).

48. *Id.* at 1, 5. The term "boiler room" is usually used to refer to

> a temporary operation established to sell a specific speculative security. Solicitation is by telephone to new customers, the salesman conveying favorable earnings projections, predictions of price rises and other optimistic prospects without a factual basis. The prospective buyer is not informed of known or readily ascertainable adverse information; he is not cautioned about the risks inherent in purchasing a speculative security; and he is left with a deliberately created expectation of gain without risk.

Hanly v. SEC, 415 F.2d 589, 596 n.14 (2d Cir. 1969) (citations omitted).

49. Plaintiff's Memorandum in Vision at 5, 1994 WL 326868 (No. 94-0615) (alleging the use of high pressure techniques, including "repeated telephone calls," that were "insistent and aggressive").

50. *Id.* at 2, 5, 7, 13. The defendants' allegedly raised at least $1.25 million from about 125 investors nationwide. *Id.* at 2.

51. *Id.* at 2, 7; Plaintiff's Reply Memorandum in Vision at 2-4, 1994 WL 326868 (No. 94-0615). According to the SEC, $759,000 in individual retirement account ("IRA") funds were transferred to the defendants to be invested in the LLC. Plaintiff's Memorandum in Vision at 7, 1994 WL 326868 (No. 94-0615).

52. Plaintiff's Memorandum in Vision at 5-7, 14-15, 1994 WL 326868 (No. 94-0615). The

in LLCs were not securities and therefore not subject to the federal securities laws or SEC jurisdiction.[53] The defendants also denied any misconduct.[54] They claimed that the investors were fully and accurately apprised of the risks associated with the venture in the promotional literature and operating documents.[55] The defendants pointed to carefully crafted operating provisions and procedures intended to insure that the LLC interests would not be deemed securities.[56]

On March 24, 1994, the day the SEC filed its complaint, the United States District Court granted the SEC's request for emergency relief.[57] The court froze all investor funds under the defendants' control and ordered that any new funds raised be placed in an interest-bearing escrow account.[58] After taking the matter under advisement, on April 13, 1994, less than a month after the SEC filed its complaint, the court ordered the defendants to immediately cease offering or selling interests in the LLC pending trial.[59]

On May 11, 1994, the United States District Court entered a final judgment permanently enjoining the defendants from future violations of the registration and antifraud provisions of the federal securities laws.[60] The court, however, made no findings of fact or conclusions of law.[61] The defendants agreed to the entry of a permanent injunction without admitting or denying the allegations.[62] The defendants also waived the entry of findings of facts and conclusions of law.[63] Although the SEC won its first battle and obtained a judgment, the federal court did not issue an opinion on the securities law issues. Nevertheless, the decision is significant because the granting of the injunction indicates that the LLC interests were securities.

SEC charged, among other things, that the defendants falsely stated that the LLC had an operational 20 channel wireless cable system, the LLC had obtained all necessary regulatory approvals, investors would receive 300% to 400% returns on their investment within three years, and the risks of an investment in the LLC were extremely low. *Id.* at 5-7.

53. Defendants' Memorandum in Vision at 1-2, 24, 1994 WL 326868 (No. 94-0615).

54. *See id.* at 2-3.

55. *Id.* at 3, 25-27.

56. *See id.* at 16-19.

57. SEC v. Vision Communications, Inc., Litigation Release No. 14026, 56 SEC Docket 880, 1994 WL 96945 (SEC) (Mar. 24, 1994); *Civil Action Against Vision Communications, Inc., supra* note 8; *SEC Enforcement: Alleged Boiler Room Sales of Interest in Cable Venture Subject to SEC Suit, supra* note 8.

58. *See supra* note 57.

59. SEC v. Vision Communications, Inc., Litigation Release No. 14054, 56 SEC Docket 1472, 1994 WL 148556 (SEC) (Apr. 18, 1994); *Civil Action Against Vision Communications Inc.*, SEC News Digest 94-72-3, 1994 WL 131465 (Apr. 18, 1994).

60. SEC v. Vision Communications, Inc., No. 94-0615 (CRR), 1994 WL 326868, at *1-*2 (D.D.C. May 11, 1994); SEC v. Vision Communications, Inc., Litigation Release No. 14081, 1994 WL 183414 (SEC), at *1 (May 11, 1994).

61. *See Vision Communications*, 1994 WL 326868, at *1 (final judgment); *see also Vision Communications*, 1994 WL 183414 (SEC), at *1 (litigation release).

62. *See Vision Communications*, 1994 WL 326868, at *1 (final judgment); *see also Vision Communications*, 1994 WL 183414 (SEC), at *1 (litigation release).

63. The defendants waived the entry of findings of fact and conclusions of law under Rule 52 of the Federal Rules of Civil Procedure. *See Vision Communications*, 1994 WL 326868, at *1 (final judgment).

2. *Parkersburg, Knoxville,* and Other SEC Actions

The SEC has taken action against a number of other wireless cable television and communications ventures purportedly selling LLC interests. In *SEC v. Parkersburg Wireless Limited Liability Co.*, the defendants allegedly sold LLC interests to raise capital to acquire or develop a wireless cable television system in Parkersburg, West Virginia.[64] In *SEC v. Knoxville, LLC*, the defendants allegedly sold LLC membership interests to acquire part of a wireless cable television system in Knoxville, Tennessee.[65]

Parkersburg and *Knoxville* are mirror images of the *Vision Communications* case. As in *Vision Communications*, the SEC sought temporary restraining orders, preliminary injunctions, and other relief for violation of the federal securities laws.[66] The SEC charged that the defendants violated the antifraud, securities registration, and broker-dealer registration provisions of the federal securities laws.[67] In each case, the United States District Court quickly issued temporary restraining orders.[68] The court later entered preliminary injunctions temporarily restraining and enjoining the defendants from violating the federal securities laws, pending resolution of the action on the merits.[69] In each case, the court entered final judgments permanently enjoining certain defendants from future violations of the securities laws.[70] However, because the defendants had agreed to the injunctions and waived the entry of findings of facts and conclusions of law, the federal court did not issue any opinion on the securities law issues.[71]

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64. Complaint, SEC v. Parkersburg Wireless Ltd. Liab. Co., (No. 94-1079) (SSH) (D.D.C. May 16, 1994) [hereinafter Parkersburg Complaint]; SEC v. Parkersburg Wireless Ltd. Liab. Co., Litigation Release No. 14085, 1994 WL 186833 (SEC) (May 16, 1994); *SEC Suit Alleges Boiler Room Scheme Involving Unregistered LLC Securities*, Sec. Reg. & L. Rep. (BNA) No. 26, at 775 (May 27, 1994); *SEC Enforcement: SEC Suit Alleges Boiler Room Scheme Involving Unregistered LLC Securities*, Sec. L. Daily (BNA) (May 24, 1994).

65. Complaint, SEC v. Knoxville, LLC, (No. 941073B) (RBB) (S.D. Cal. July 11, 1994) [hereinafter Knoxville Complaint]; *Commission Obtains TRO Against Knoxville, LLC, et al.*, SEC News Digest 94-130, 1994 WL 328317 (SEC) (July 12, 1994).

66. Parkersburg Complaint, (No. 94-1079); Knoxville Complaint, (No. 941073B).

67. Parkersburg Complaint, (No. 94-1079); Knoxville Complaint, (No. 941073B).

68. Temporary Restraining Order and Order Freezing Certain Assets and Granting Other Relief, and Setting Hearing for Motion for Preliminary Injunction, SEC v. Knoxville, LLC, (No. 941073B) (RBB) (S.D. Cal. July 11, 1994); SEC v. Parkersburg Wireless Ltd. Liab. Co., Litigation Release No. 14091, 1994 WL 194875 (SEC) (May 19, 1994); Temporary Restraining Order and Order Freezing Certain Assets and Granting Other Relief, SEC v. Parkersburg Wireless Ltd. Liab. Co., (No. 94-1079) (SSH) (D.D.C. May 18, 1994); *Commission Obtains TRO Against Knoxville, LLC, et al., supra* note 65; *SEC Suit Alleges Boiler Room Scheme Involving Unregistered LLC Securities, supra* note 64; *SEC Enforcement: SEC Suit Alleges Boiler Room Scheme Involving Unregistered LLC Securities, supra* note 64; *Temporary Restraining Order Entered Against Parkersburg Wireless LLC and Other Defendants*, SEC News Digest 94-95-3, 1994 WL 195526 (May 20, 1994).

69. SEC v. Knoxville, LLC, Litigation Release No. 14538, 1995 SEC LEXIS 1594 (June 21, 1995); SEC v. Parkersburg Wireless Ltd. Liab. Co., Litigation Release No. 14126, 56 SEC Docket 2534, 1994 WL 264301 (June 15, 1994); *Court Enters Preliminary Bar in Alleged LLC Boiler Room Scheme*, Sec. Reg. & L. Rep. (BNA) No. 26, at 982 (July 8, 1994); *Preliminary Injunction Entered Against Parkersburg Wireless LLC and Other Defendants*, SEC News Dig. 94-113, 1994 WL 262956 (SEC) (June 16, 1994).

70. SEC v. Parkersburg Wireless Ltd. Liab. Co., No. 94-1079 (JHP), 1994 U.S. Dist. LEXIS 15006, at *1-*6 (D.D.C. Oct. 19, 1994); SEC v. Knoxville, LLC, Litigation Release No. 14538, 1995 SEC LEXIS 1594 (June 21, 1995).

71. SEC v. Parkersburg Wireless Ltd. Liab. Co., No. 94-1079 (JHP), 1994 U.S. Dist. LEXIS

The SEC's allegations in *Parkersburg* and *Knoxville* parallel those in *Vision Communications*. The SEC maintained that the LLC interests constituted investment contracts and were, therefore, securities.[72] The SEC charged that the defendants in both cases used high pressure sales tactics to solicit numerous financially unsophisticated investors nationwide, who were induced to invest their retirement funds through the use of false and misleading statements.[73]

By the summer of 1995, the SEC had filed complaints against defendants in at least four other unrelated actions also alleging federal securities law violations for selling interests in LLCs.[74] One of the most publicized cases is an action against Irwin "Sonny" Bloch, a "self-styled consumer advocate" and nationally syndicated radio talk show host. Bloch has been charged in the United States District Court for the Southern District of New York with defrauding investors of $3.8 million in connection with the sale of LLC membership interests in radio stations.[75] Additional SEC enforcement actions against entities and individuals offering and selling LLC interests are bound to follow.[76]

B. *State Actions*

State securities commission actions against LLCs predate the SEC's first suit in *Vision Communications*.[77] Although federal cases tend to be more

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15006, at *1 (D.D.C. Oct. 19, 1994); SEC v. Knoxville, LLC, Litigation Release No. 14538, 1995 SEC LEXIS 1594 (June 21, 1995).

72. *See* Knoxville Complaint at 1, (No. 941073B); 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, (No. 941073B) (RBB) (S.D. Cal. July 11, 1994) [hereinafter Plaintiff's Memorandum in Knoxville]; Parkersburg Complaint at 2-3, (No. 94-1079); Plaintiff's Memorandum in Parkersburg at 11-16, (No. 94-1079).

73. Knoxville Complaint at 1, 7-8, (No. 941073B); Plaintiff's Memorandum in Knoxville at 1-2, 4-7, (No. 941073B). The SEC alleges that the defendants raised $12 million from more than 575 investors in 48 states. *Id.* at 2-3. More than $2 million in individual retirement account funds ("IRAs") were invested in the LLC. *Id.* at 3; Parkersburg Complaint at 2, 9-10, (No. 94-1079); Plaintiff's Memorandum in Parkersburg at 2, 4-7, (No. 94-1079). The SEC alleges that the defendants in Parkersburg raised at least $10 million from hundreds of investors. *Id.* at 2. At least 333 investors invested $3.6 million in Parkersburg through IRAs. *Id.*

74. SEC v. Irwin Harry Bloch, Litigation Release No. 14511, 59 SEC Docket 931, 1995 WL 317420 (SEC) (May 25, 1995); SEC v. United Communications, Ltd., Litigation Release No. 14477, 59 SEC Docket 424, 1995 WL 254714 (SEC) (Apr. 24, 1995); SEC v. American Interactive Group, LLC, Litigation Release No. 14462, 59 SEC Docket 203, 1995 WL 229088 (SEC) (Apr. 10, 1995); SEC v. Future Vision Direct Mktg., Inc., Litigation Release No. 14384, 58 SEC Docket 1716, 1995 WL 25731 (SEC) (Jan. 18, 1995).

75. SEC v. Irwin Harry Bloch, Litigation Release No. 14511, 59 SEC Docket 931, 1995 WL 317420 (SEC) (May 25, 1995).

76. *See supra* note 11 and accompanying text.

77. For example, the Indiana Cease and Desist Order in *In re Express Communications* states that North Dakota and South Dakota issued cease and desist orders against Express Communications on April 14, 1992, and February 27, 1992, respectively, two years before the SEC began to take action against such wireless communication companies. *Compare In re* Express Communictions, Inc., No. 93-0027 CD, 1993 Ind. Sec. LEXIS 46, at *8 (Mar. 23, 1993) (orders issued in 1992) *with* SEC v. Vision Communications, Inc., Litigation Release No. 14026, 56 SEC Docket 880, 1994 WL 96945 (SEC) (Mar. 24, 1994) (first SEC action filed March 24, 1994).

widely followed and carry more precedential value than similar state cases,[78] it appears the numerous state prosecutions of LLCs prompted the SEC to initiate actions against LLCs under the federal securities laws.[79] In fact, the SEC briefs in *Vision Communications*, *Parkersburg*, and *Knoxville* each catalog state actions against LLC offerings in support of the SEC's claims.[80]

Table I summarizes some of the actions taken under state securities laws against defendants offering or selling LLC interests.[81] Table I is organized by state and indicates the action taken, the securities law violations raised, and the theories of liability discussed.[82] Action has been taken against LLCs under state securities laws in Colorado, Georgia, Illinois, Indiana, Kansas, Minnesota, Missouri, North Dakota, Pennsylvania, South Dakota, Washington, and Wisconsin.[83] Many other states have also taken action, but such lower court and administrative securities decisions often are not reported.[84] As a result, the list in Table I may be only a small sampling of the state actions against defendants offering or selling LLC interests.

The vast majority of these state actions involve defendants offering LLC interests in wireless communication companies, such as cellular telephone businesses, interactive video ventures, and wireless cable television systems.[85] State regulators charge that many of these wireless communication companies are packaging their investment products as LLCs to avoid state and federal securities laws.[86] State actions against these LLCs have been aimed at closing down such wireless communication investment-sales operations.[87]

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78. Most state securities statutes parallel, or are patterned after, the federal Securities Act and the federal Exchange Act. Sauer v. Hays, 539 P.2d 1343, 1346 (Colo. Ct. App. 1975); *see also* People v. Schock, 199 Cal. Rptr. 327, 331 (Cal. Ct. App. 1984) (stating California law was patterned after the federal Securities Act). While state courts are not bound by federal law interpreting their state's securities statutes, state courts generally consider federal authority highly persuasive. *See, e.g.*, State v. Gunnison, 618 P.2d 604, 606-07 (Ariz. 1980); *Schock*, 199 Cal. Rptr. at 331; Lowery v. Ford Hill Inv. Co., 556 P.2d 1201, 1204 (Colo. 1976); *Sauer*, 539 P.2d at 1346-47; State v. Kershner, 801 P.2d 68, 69 (Kan. Ct. App. 1990).

79. A list of state actions is set forth in Table I, pp. 495-98 of this article. Four states brought action against Parkersburg Wireless Limited Liability Company before the SEC brought its action in the summer of 1994. *See* Plaintiff's Memorandum in Parkersburg at 9-10, (No. 94-1079). Two states brought action against the two named individual defendants in *Vision Communications* before the SEC brought its action against them in *Vision Communications*. *See* Plaintiff's Memorandum in Vision at 2-3, 1994 WL 326868 (No. 94-0615). At least three states, South Dakota, South Carolina, and Iowa, issued cease and desist orders against Knoxville, LLC before the SEC brought its action. Plaintiff's Memorandum in Knoxville at 7, (No. 941073B).

80. *See* Plaintiff's Memorandum in Parkersburg at 9-10, (No. 94-1079); Plaintiff's Memorandum in Vision at 2-3, 1994 WL 326868 (No. 94-0615); Plaintiff's Memorandum in Knoxville at 7, (No. 941073B).

81. *See infra* Table I pp. 495-98.

82. *Id.*

83. *Id.*

84. *See* JOSEPH C. LONG, 12 BLUE SKY LAW xi (1992). For example, a *Wall Street Journal* article reported that 16 states had filed actions against Express Communications, a company involved in offering LLC interests in wireless communications companies. Emshwiller, *supra* note 5, at B2. However, WESTLAW and LEXIS reported only three such actions against Express Communications. *See infra* Table I pp. 495-98, Illinois Express Action, Indiana Express Action, and Washington Express Action.

85. *See infra* Table I pp. 495-98.

86. Emshwiller, *supra* note 5; Emshwiller, *supra* note 11.

87. Emshwiller, *supra* note 5; Emshwiller, *supra* note 11.

In each of the cases listed in Table I, the state charged the defendants offering LLC interests with violating securities registration and broker-dealer registration provisions of state securities laws.[88] In some cases, the state charged the defendants with violating antifraud provisions as well.[89] In every case, the trier of fact found sufficient evidence to conclude that the defendants violated state securities laws in offering or selling LLC interests.[90] The defendants did not prevail in any of the actions reported.[91] Unfortunately, the majority of these cases involved the issuance of summary cease and desist orders.[92] Often the trier of fact either cited no legal theory, or simply made a conclusory finding that the LLC interest was an investment contract and therefore constituted a security.[93]

III. THEORIES OF LIABILITY AND POSSIBLE DEFENSES

The securities laws apply only if a transaction involves a security.[94] While there are some differences, the basic definition of a "security" in the Securities Act,[95] the Exchange Act[96] and under state securities laws[97] is the same.[98] The term "security" generally covers a broad range of transactions, but there is no single test for determining what constitutes a security.[99] Each

88. *See infra* Table I pp. 495-98 (see column labeled "Securities Law Violations Addressed").

89. *Id.*

90. *See infra* Table I pp. 495-98 (see column labeled "Action Taken").

91. *Id.*

92. *Id.*

93. *See infra* Table I pp. 495-98 (see column labled "Legal Theories Discussed"); *see also In re* UEG, L.C., No. 93E068, 1993 WL 208898 (Kan. Sec. Comm'r) (May 12, 1993) (no legal theory discussed); *In re* Hancock Communications Riverside PCS, No. 93E-058, 1993 WL 145928 (Kan. Sec. Comm'r) (Apr. 14, 1993) (conclusory finding that LLC interest was an investment contract).

94. HAROLD S. BLOOMENTHAL, 3 SECURITIES AND FEDERAL CORPORATE LAW § 2.02 (1990).

95. Securities Act of 1933 § 2(1), 15 U.S.C. § 77b(1) (1994).

96. Securities Exchange Act of 1934 § 3(a)(10), 15 U.S.C. § 78c(a)(10) (1994).

97. 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 (1988), 7B U.L.A. 87 (Supp. 1995). Therefore, forty-one jurisdictions have adopted acts modeled on the Uniform Securities Act. The 1956 Uniform Securities Act and the 1985 Uniform Securities Act shall be referred to collectively herein as the Uniform Securities Acts. The term "security" is defined in § 401(l) of the 1956 Uniform Securities Act and in § 101(16) of the 1985 Uniform Securities Act. UNIF. SEC. ACT § 401(l) (1958), 7B U.L.A. 580-81 (1985); UNIF. SEC. ACT § 101(16) (1988), 7B U.L.A. 94 (Supp. 1995).

98. *Compare* 15 U.S.C. § 77b(1); 15 U.S.C. § 78c(a)(10); UNIF. SEC. ACT § 101(16), 7B U.L.A. 94 (Supp. 1995); UNIF. SEC. ACT § 401(l), 7B U.L.A. 580-81 (1985). The definition of "security" in the Uniform Securities Act is modeled after the definition in § 2(1) of the federal Securities Act. UNIF. SEC. ACT § 401(l), 7B U.L.A. 583 cmt. (1985). The definition of "security" in § 3(a)(10) of the Exchange Act is virtually identical to the definition in § 2(1) of the Securities Act. *See infra* note 99. Further, the United States Supreme Court 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); United Hous. Found., Inc. v. Forman, 421 U.S. 837, 847 n.12 (1975); Tcherepnin v. Knight, 389 U.S. 332, 335-36, 342 (1967).

99. LOUIS LOSS & JOEL SELIGMAN, 2 SECURITIES REGULATION 871 (3d ed. 1989 & 1994 Supp.); *see also* statutory definitions of "security," *supra* note 98. For example, § 2(1) of the Securities Act, which is virtually identical to the definition in § 3(a)(10) of the Exchange Act and

of the acts sets forth a list of specific instruments that are considered securities, such as stocks, bonds, notes, and debentures.[100] The statutory definitions also include a number of catch-all phrases for instruments that do not fit into the conventional categories, such as "certificate of interest or participation in any profit-sharing agreement," "investment contract," and any "instrument commonly known as a 'security.'"[101]

Although a few states have amended their state law definition of a "security" to include interests in limited liability companies,[102] the federal acts and the securities laws in most states do not expressly list interests in limited liability companies.[103] Since LLC interests generally are not included in the enumerated list of interests and instruments that constitute securities under the federal securities acts or the Uniform Securities Acts,[104] LLC promoters and commentators argue that LLC interests are not securities.[105]

The SEC, state regulators, and commentators counter that LLC promoters may not use formalistic devices to insulate what is in substance a security from the application of the securities laws.[106] They argue that the United

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the definitions in the Uniform Securities Acts, 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).

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. 15 U.S.C. § 78c(a)(10).

100. *See supra* note 99, definition of security in § 2(1) of the Securities Act; 15 U.S.C. § 78c(a)(10); UNIF. SEC. ACT. § 401(l) (1958), 7B U.L.A. 580-81 (1985); UNIF. SEC. ACT. § 101(16) (1988), 7B U.L.A. 94 (Supp. 1995).

101. *See supra* note 100. These general catch-all phrases are not defined in the federal securities acts or the Uniform Securities Acts. As a result, the courts have been left to define these terms.

102. The legislatures in Alaska, California, Indiana, New Mexico, Ohio, Pennsylvania, Vermont, and Wisconsin amended the definition of security in their state securities laws to expressly include certain LLC interests. *See supra* note 14. The statutory language of these provisions is set forth *infra* Table II pp. 499-501. Commentators argue that the enumeration of certain LLC interests in the list of instruments constituting securities does not result in LLC interests becoming securities *per se*. For a discussion of this issue and the various defenses see *infra* parts III.E.2, III.E.3.

103. *See* statutory definitions of "security," *supra* notes 97-99.

104. *See* statutory definitions of "security," *supra* notes 97-99.

105. *See, e.g.*, Opposition to Plaintiff SEC's Application for Temporary Restraining Order and Other Relief and Memorandum of Points and Authorities at 11-12, SEC v. Parkersburg Wireless Ltd. Liab. Co., (No. 94-1079) (SSH) (D.D.C. filed May 16, 1994) [hereinafter Defendants' Memorandum in Parkersburg].

106. *See, e.g.*, Plaintiff's Memorandum in Vision at 10, 1994 WL 326868 (No. 94-0615) (citing Williamson v. Tucker, 645 F.2d 404, 422 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981)); Plaintiff's Memorandum in Parkersburg at 12, (No. 94-1079) (citing *Williamson*, 645 F.2d at 422);

States Supreme Court has rejected the use of rigid, formalistic analysis to determine whether an instrument constitutes a security.[107] Courts have broadly construed the securities acts to extend to "[n]ovel, uncommon or irregular devices"[108] in an attempt to reach the "countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."[109]

The SEC, state regulators, and commentators assert that LLC interests are securities because they fall into the general catch-all categories that have been left to the courts to define.[110] They argue that LLC interests are securities because they (i) constitute an investment contract;[111] (ii) meet the requirements of the risk capital test adopted by some states;[112] (iii) possess the characteristics of stock;[113] (iv) constitute an instrument commonly known as a security;[114] or (v) are subject to liability on state statutory grounds.[115] The following sections discuss these various theories, present possible defenses, and conclude with the author's evaluation of each theory.

A. *Investment Contract Theory*

1. Arguments Asserted

The SEC[116] and at least twenty-three state securities commissions[117] have taken the position that certain LLC interests constitute securities under the investment contract test set forth in *SEC v. W.J. Howey Co.*[118] Section 2(1) of the Securities Act,[119] section 3(a)(10) of the Exchange Act[120] and most state securities laws[121] provide that an "investment contract" is a security. In *Howey*, the United States Supreme Court set forth a four-prong test to

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Plaintiff's Memorandum in Knoxville at 10, (No. 941073B) (citing *Williamson*, 645 F.2d at 422).

107. *See* Tcherepnin v. Knight, 389 U.S. 332, 338 (1967).

108. SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943).

109. SEC v. W.J. Howey Co., 328 U.S. 293, 299 (1946).

110. *See supra* note 101 and accompanying text; *infra* parts III.A-D.

111. *See infra* part III.A.

112. *See infra* part III.B.

113. *See infra* part III.C.

114. *See infra* part III.D.

115. *See infra* part III.E.

116. *See, e.g.*, Plaintiff's Memorandum in Vision at 10-13, 1994 WL 326868 (No. 94-0615); Plaintiff's Memorandum in Parkersburg at 12-16, (No. 94-1079); Plaintiff's Memorandum in Knoxville at 10-14, (No. 941073B).

117. *See* 1 Blue Sky L. Rep. (CCH) ¶ 6551; *see also infra* Table I pp. 495-98 (see columns labeled "Legal Theories Discussed" and "Action Taken" for associated citations); *infra* Table III pp. 502-05 (discussion of Connecticut release, Indiana policy statement, Kansas interpretive opinion, Minnesota interpretive opinion, Montana opinion letter, Oklahoma exemption request, South Carolina statement of policy, South Dakota Division of Securities letter, Tennessee statement of policy, and Wyoming interpretative opinion).

118. 328 U.S. at 298-99.

119. 15 U.S.C. § 77b(1). For the text of § 2(1), see *supra* note 99.

120. 15 U.S.C. § 78c(a)(10). For a comparison of the text of § 2(1) of the Securities Act and § 3(a)(10) of the Exchange Act, see *supra* note 99.

121. UNIF. SEC. ACT § 401(l) (1958), 7B U.L.A. 580-81 (1985); UNIF. SEC. ACT § 101(16) (1988), 7B U.L.A. 94 (Supp. 1995). For a discussion of the state law definitions of a "security," see *supra* notes 97-99.

determine whether an interest is an "investment contract."[122] 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 . . . ."[123]

The following is a discussion of each of the four elements of the *Howey* investment contract test, which includes an overview of how courts have interpreted each element and an analysis of whether an LLC interest is likely to meet each requirement. The analysis indicates that LLC interests typically meet the first three prongs of the *Howey* test; therefore, the key issue in determining whether an LLC interest is a security usually depends on whether profits are expected from the efforts of a promoter or a third party. Consequently, most of the discussion in this section focuses on the fourth prong of the *Howey* test, with particular emphasis on the arguments asserted by the SEC and state securities regulators, who have claimed that certain LLC interests are securities.

a. *Investment of Money*

Courts have broadly interpreted the investment of money requirement.[124] It is clear that the investor need not invest cash.[125] All that is required is that the purchaser give up some tangible and definable consideration.[126] Such consideration may be goods or services.[127] In fact, anything constituting legal consideration under contract law is probably sufficient to meet the investment of money requirement.[128]

An investment in an LLC normally would satisfy the first prong of the *Howey* investment contract test. While the LLC statutes do not require minimum contributions in exchange for membership interests,[129] members usually agree as to what and how much property or services each member will con-

122. *See W.J. Howey Co.*, 328 U.S. at 298-99.

123. *Id.* The definition of "security" in § 3(a)(10) of the Exchange Act is virtually identical to the definition in § 2(1) of the Securities Act. *See supra* note 99. 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. *Supra* note 98. 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 supra* notes 78, 98.

124. *See infra* note 127.

125. In International Bhd. of Teamsters v. Daniel, 439 U.S. 551 (1979), the United States Supreme Court expressly rejected the argument that to meet the definition of an "investment contract" the investment must take the form of cash. *Id.* at 560 n.12.

126. *Id.* at 560.

127. *See, e.g.*, Hector v. Wiens, 533 F.2d 429, 432 (9th Cir. 1976) (providing credit for a loan); 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); Harris v. Republic Airlines, Inc., Fed. Sec. L. Rep. (CCH) ¶ 93,772 (D.D.C. May 19, 1988) (specific wage concessions); Sandusky Land, Ltd. v. Uniplan Groups, Inc., 400 F. Supp. 440, 445 (N.D. Ohio 1975) (services).

128. Carl W. Schneider, *The Elusive Definition of a "Security," in* GLOBAL CAPITAL MARKETS AND THE DISTRIBUTION OF SECURITIES 105, 109 (Franklin E. Gill ed., 1991). *But see* American Grain Ass'n v. Canfield, Burch & Mancuso, 530 F. Supp. 1339 (W.D. La. 1982).

129. 1 RIBSTEIN & KEATINGE, *supra* note 1, § 5.03, at 5-4.

tribute to the enterprise.[130] Most LLC statutes are broadly phrased so that cash, property, or services constitute eligible contributions.[131] Member contributions are often important in determining each member's rights.[132] In the SEC actions and the state actions noted in Table I, investors contributed cash to the LLC ventures at issue.[133]

b. *Common Enterprise*

Generally all courts agree that the common enterprise prong of the *Howey* test[134] is satisfied when there is a pooling of interests of several investors who share an investment risk with each other.[135] This type of pooling of multiple investors' interests is known as "horizontal commonality."[136] Such an arrangement will usually satisfy any version of the *Howey* test.[137]

Courts disagree, however, on whether "vertical commonality" is sufficient.[138] Vertical commonality requires only that one investor and one promoter be involved in some common enterprise.[139] Some courts require a

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130. *Id.* at 5-4 to 5-5.

131. *Id.* § 5.04, at 5-5.

132. *Id.* § 1.04, at 1-4, § 5.02, at 5-2.

133. *See, e.g.*, Plaintiff's Memorandum in Vision at 2, 4, 1994 WL 326868 (No. 94-0615); Plaintiff's Memorandum in Parkersburg at 2, 5, 13, (No. 94-1079); Plaintiff's Memorandum in Knoxville at 3, 11, (No. 941073B); *In re* Express Communications, Inc., No. 9200106, 1993 WL 566300, at *17 (Ill. Sec. Dep't) (Dec. 13, 1993) [hereinafter Illinois Express Action]; Report and Recommendation of Referee at 51, Cleland v. Express Communications, Inc., No. 50-93-0075 (Ga. Mar. 23, 1994) [hereinafter Georgia Express Action].

134. For in-depth discussions of the common enterprise test and related case law, see 2 LOSS & SELIGMAN, *supra* note 99, at 927-35; Carl W. Schneider, *The Elusive Definition of a "Security": A 1990 Update, in* GLOBAL CAPITAL MARKETS AND THE DISTRIBUTION OF SECURITIES 119, 120-21 (Franklin E. Gill ed., 1991); Steinberg Article, *supra* note 7, at 1108-09 & nn.21-23, 26; John F. Wagner, Jr., Annotation, *"Common Enterprise" Element of Howey Test to Determine Existence of Investment Contract Regulable as "Security" Within Meaning of Federal Securities Act of 1933 (15 USCS §§ 77a et seq.) and Securities Exchange Act of 1934 (15 USCS §§ 78a et seq.)*, 90 A.L.R. FED 825 (1988).

135. MARC I. STEINBERG, UNDERSTANDING SECURITIES LAW § 2.02, at 22 (1989); Schneider, *supra* note 134, at 120; Steinberg Article, *supra* note 7, at 1108 n.22 (quoting STEINBERG, *supra*, at 250).

136. *See supra* note 135. The Third, Sixth, and Seventh Circuits hold that a showing of horizontal commonality is required to meet the common enterprise test. *See, e.g.*, Hart v. Pulte Homes of Mich. Corp., 735 F.2d 1001, 1004 (6th Cir. 1984) (citing Union Planters Nat'l Bank v. Commercial Credit Business Loans, Inc., 651 F.2d 1174, 1183 (6th Cir.), *cert. denied*, 454 U.S. 1124 (1981)); Salcer v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 682 F.2d 459, 460 (3d Cir. 1982); Milnarik v. M-S Commodities, Inc., 457 F.2d 274, 276-77 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972).

137. *See supra* note 135.

138. *See* Long v. Schultz Cattle Co., Inc., 881 F.2d 129, 140 & n.11 (5th Cir. 1989); 2 LOSS & SELIGMAN, *supra* note 99, at 928-35 & n.130; STEINBERG, *supra* note 135, § 2.02, at 22; Steinberg Article, *supra* note 7, at 1108-09. The Fifth, Ninth, and Eleventh Circuits have expressly rejected the view that horizontal commonality is required to meet the common enterprise test. *Long*, 881 F.2d at 140. These circuits have found vertical commonality sufficient. *See, e.g.*, 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); 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). 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 1995).

139. STEINBERG, *supra* note 135, § 2.02, at 22; Schneider, *supra* note 134, at 121; Steinberg

showing of horizontal commonality, rather than vertical commonality alone, to satisfy the common enterprise test.[140]

An investment in an LLC would normally meet the common enterprise requirement. Most LLC statutes require an LLC to have more than one owner or two or more members.[141] In the typical LLC venture, multiple investors pool their contributions and share the risk of the venture. Under such circumstances there is horizontal commonality and the common enterprise element of the *Howey* test is met.

Probably the only instance in which an LLC would not meet the horizontal commonality test is when it had only one owner or member. LLC statutes in at least seven states permit an LLC to be formed with only one owner and do not require the LLC to have more than one member.[142] Even though a number of statutes permit this structure, the typical LLC will usually have more than one member. Also, if there is at least one investor and one promoter, the venture may still meet the vertical commonality test which is sufficient to meet the common enterprise requirement in many circuits.[143] In the SEC actions, for example, prosecutors alleged both horizontal commonality and vertical commonality were present because each investor received a pro rata share of the profits generated through operation or sale of the LLC venture and, therefore, the common enterprise element was satisfied.[144]

c. *Expectation of Profits*

In *United Housing Foundation, Inc. v. Forman*,[145] the United States Supreme Court elaborated on the expectation of profits element of the *Howey* test.[146] The Court noted that in referring to profits it has meant either capital appreciation from the development of the initial investment,[147] or a participa-

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Article, *supra* note 7, at 1109.

140. *Long*, 881 F.2d at 140-41; STEINBERG, *supra* note 135, § 2.02, at 22; Steinberg Article, *supra* note 7, 1108-09 & n.23. The theoretical and practical problems presented by requiring only horizontal commonality are discussed in 2 LOSS & SELIGMAN, *supra* note 99, at 930-31; James D. Gordon III, *Common Enterprise and Multiple Investors: A Contractual Theory for Defining Investment Contracts and Notes*, 1988 COLUM. BUS. L. REV. 635, 660-63.

141. 1 RIBSTEIN & KEATINGE, *supra* note 1, § 4.03, at 4-3 to 4-4.

142. *Id.* at 4-3 n.8. At least one commentator, Allan Donn, warns that a single member LLC is not advisable, even if state LLC statutes permit such a structure. Mr. Donn notes that the Internal Revenue Service ("IRS") has not announced how a single member LLC will be taxed, therefore, there is a substantial risk that the IRS will classify such an LLC as a corporation for tax purposes. Donn, *supra* note 1, § 4.3, at PGLLC-17 to -18.

143. *See supra* notes 138-40 and accompanying text. The broader version of the vertical commonality approach only requires some relationship between the investor's success or failure and the promoter's efforts. Under a narrower version of the vertical commonality test, there must be a direct relationship between the investor's profit and loss and the promoter's profit and loss. *See id.*

144. *See, e.g.*, Plaintiff's Memorandum in Vision at 11-12, 1994 WL 326868 (No. 940615); Plaintiff's Memorandum in Parkersburg at 13-14, (No. 94-1079); Plaintiff's Memorandum in Knoxville at 11-12, (No. 941073B); *see also* Illinois Express Action at *16, 1993 WL 566300 (No. 9200106).

145. 421 U.S. 837 (1975).

146. *Forman*, 421 U.S. at 852-58.

147. *Id.* at 852. To illustrate the capital appreciation concept, the Court cited SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943), which involved the "sale of oil leases conditioned on [the] promoters' agreement to drill [an] exploratory well." *Forman*, 421 U.S. at 852.

tion in earnings resulting from the use of investors' funds.[148] The Court stressed that the critical inquiry is the motive of the purchaser.[149] If an investor is attracted by the prospect of a return on his investment, the expectation of profits element is met.[150] However, when a purchaser is motivated to use or consume the item purchased, the expectation of profits element is not met.[151]

In most situations, an investor contributes to an LLC venture expecting to make a profit from either capital appreciation or earnings.[152] Generally, there is no problem establishing the expectation of profits element.[153] For example, in the SEC actions, prosecutors presented evidence that promoters enticed investors by promises of enormous and immediate returns in brochures and sales calls, thereby demonstrating that purchasers were motivated to invest because of the expectation of profits.[154] Even though state LLC statutes do not expressly require LLCs to be operated for profit,[155] and some states even appear to permit not-for-profit LLCs,[156] the vast majority of LLCs are operated for profit.[157]

d. *Solely from the Efforts of Others*

The final element of the *Howey* test is that the investor must expect profits to be derived "solely from the efforts of a promoter or a third party."[158] In applying the *Howey* test, lower federal courts have rejected a literal inter-

148. *Forman*, 421 U.S. at 852. To illustrate the concept of participation in earnings, the Court cited Tcherepnin v. Knight, 389 U.S. 332, 338-39 (1967), where "dividends on the investment [were] based on a savings and loan association's profits." *Forman*, 421 U.S. at 852.

149. *Forman*, 421 U.S. at 852-53.

150. *Id.* at 852 (quoting SEC v. W.J. Howey Co., 328 U.S. 293, 300 (1946)). Lower court opinions have held that "the promotion of an investment 'largely for tax advantages'" may constitute an "expectation of profits." Also, "'the prospect of tax benefits resulting from initial losses does not necessarily detract from an expectation of profits.'" 2 LOSS & SELIGMAN, *supra* note 99, at 937 & nn.150-51.

151. *Forman*, 421 U.S. at 852-53. For example, in *Forman*, the Court held that the sale of stock to tenants in a cooperative housing project did not constitute the sale of securities since such tenants purchased the stock for "personal consumption, [as] living quarters for personal use." *Id.* at 858. Similarly, the Court noted that the purchase of real estate would not constitute the purchase of a security if the purchaser desired to "'occupy the land or develop it [himself].'" *Id.* at 852-53 (quoting SEC v. W.J. Howey Co., 328 U.S. 293, 300 (1946)).

152. Steinberg Article, *supra* note 7, at 1110.

153. 1 RIBSTEIN & KEATINGE, *supra* note 1, § 14.02, at 14-2; Peralta, *supra* note 7, at 41.

154. *See, e.g.*, Plaintiff's Memorandum in Vision at 5-6, 1994 WL 326868 (No. 94-0615); Plaintiff's Memorandum in Parkersburg at 6, (No. 94-1079); Plaintiff's Memorandum in Knoxville at 5-6, (No. 941073B).

155. 1 RIBSTEIN & KEATINGE, *supra* note 1, § 16.07, at 16-29; Donn, *supra* note 1, § 4.5, at PGLLC-18.

156. 1 RIBSTEIN & KEATINGE, *supra* note 1, § 16.07, at 16-29 & n.119; Donn, *supra* note 1, § 4.5, at PGLLC-18.

157. Commentator Allan Donn argues that even though some state LLC statutes do not expressly require LLCs to be operated for profit, there may be an implied "for profit" requirement if the statute sets forth the permitted businesses in which an LLC may engage. Mr. Donn cautions that even if not-for-profit LLCs are permitted by state law, an LLC that does not conduct a business and have a profit objective risks losing the tax advantages associated with an LLC. Donn, *supra* note 1, § 4.5, at PGLLC-18.

158. SEC v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946).

pretation of the word "solely." Ten circuits have adopted a more liberal and flexible interpretation, simply requiring 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."[159] As a result, 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.[160]

While the United States Supreme Court expressly reserved judgment on whether the term "solely" should be interpreted literally,[161] the Court deleted the term "solely" in its restated formulation of the *Howey* test.[162] Also, the Court's repeated direction to evaluate transactions in light of economic realities and the ease with which the securities laws could be circumvented if the "solely" language were interpreted literally suggests that when faced with the question, the Court will adopt the more liberal and flexible interpretation.[163]

Since most LLCs involve an investment of money in a common enterprise with the expectation of profits,[164] the pivotal issue in determining whether an LLC interest is a security becomes whether profits are expected "solely from the efforts of others." If profits are to come substantially from the efforts of others, the interest may be a security. On the other hand, if profits are to come from the joint efforts of the members, the interest may not be a security.[165] So whether an LLC interest is a security depends, in part, on the management structure of the LLC, the allocation of management control, and the relationship among investors and third parties.

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159. 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. Rivanna Trawlers, Unlimited v. Thompson Trawlers, Inc., 840 F.2d 236, 240 n.4 (4th Cir. 1988); SEC v. Professional Assocs., 731 F.2d 349, 357 (6th Cir. 1984); Goodwin v. Elkins & Co., 730 F.2d 99, 103 (3d Cir.), *cert. denied*, 469 U.S. 831 (1984); 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); Kim v. Cochenour, 687 F.2d 210, 213 n.7 (7th Cir. 1982); Baurer v. Planning Group, Inc., 669 F.2d 770, 778-79 (D.C. Cir. 1981); Williamson v. Tucker, 645 F.2d 404, 418 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981); Aldrich v. McCulloch Properties, Inc., 627 F.2d 1036, 1040 n.3 (10th Cir. 1980); Fargo Partners v. Dain Corp., 540 F.2d 912, 914-15 (8th Cir. 1976).

160. *See, e.g.*, SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 479, 485 (5th Cir. 1974); *Glenn W. Turner Enters.*, 474 F.2d at 482.

161. United Hous. Found., Inc. v. Forman, 421 U.S. 837, 852 n.16 (1975).

162. In *Forman*, the United States Supreme Court restated the *Howey* test as follows: "The touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others." *Id.* at 852. The restated test is repeated in International Bhd. of Teamsters v. Daniel, 439 U.S. 551, 561 (1979).

163. 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).

164. 1 RIBSTEIN & KEATINGE, *supra* note 1, § 14.02, at 14-2; SARGENT HANDBOOK, *supra* note 1, § 4.02[1], at 4-10.

165. *Cf.* 2 LOSS & SELIGMAN, *supra* note 99, at 961-63 (analogous discussion distinguishing partnership interests that are securities from those that are not).

[1] Management Structure

In literature promoting the use of LLCs, commentators have touted the LLC as a highly flexible entity which allows the owners of the business to set up management of the entity as they please.[166] While most LLC statutes provide that management is vested in the members of the LLC,[167] the statutes generally allow the members to opt out of the member-managed form and adopt a corporate-style centralized management structure by agreement.[168] In other words, the LLC members can choose to manage the LLC directly themselves or delegate full or partial responsibility for management to a manager or group of managers.[169] Typically, such managers are not required to be members.[170]

In a very closely held, member-managed LLC in which each member is financially sophisticated and participates actively in the venture, the LLC interest is probably not a security under the *Howey* investment contract test.[171] But not all LLCs are closely held or member-managed. Some LLCs have hundreds of members. In some cases, members have placed controlling power in the hands of promoters or third parties.[172] The structure of such LLCs often resembles a corporation or a limited partnership where investors are passive participants. The key inquiry in such situations becomes 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."[173] Given the flexibility of the LLC management structure, whether an LLC is a security under the investment contract test depends on the facts and circumstances of the particular investment arrangement.

[2] Allocation of Management Control

If, for example, an LLC's articles of organization or operating agreement allocate members' powers as in a limited partnership, the LLC interest may be a security.[174] Limited partnership interests are normally considered securities under the *Howey* investment contract test.[175] This is because limited partners

166. *See, e.g.*, SARGENT HANDBOOK, *supra* note 1, § 1.03, at 1-4.

167. Most LLC statutes provide that the entity will be managed by LLC members, unless the articles of organization provide otherwise. 1 RIBSTEIN & KEATINGE, *supra* note 1, § 1.05, at 1-4; SARGENT HANDBOOK, *supra* note 1, at 1-13 n.38; Donn, *supra* note 1, § 10, at PGLLC-36 to -37. Minnesota, North Dakota, Oklahoma, and Texas permit management by separate managers, as in corporations. 1 RIBSTEIN & KEATINGE, *supra* note 1, § 8.02, at 8-2, 1S-47 (Cum. Supp. 1995).

168. 1 RIBSTEIN & KEATINGE, *supra* note 1, § 1.05, at 1-4; Keatinge et al., *supra* note 1, at 390.

169. SARGENT HANDBOOK, *supra* note 1, at 1-4; Donn, *supra* note 1, § 10, at PGLLC-37.

170. Donn, *supra* note 1, § 10, at PGLLC-37; Keatinge et al., *supra* note 1, at 397.

171. 1 RIBSTEIN & KEATINGE, *supra* note 1, § 14.02, at 14-2.

172. *See, e.g.*, Emshwiller, *supra* note 11; Plaintiff's Memorandum in Vision at 2-4, 12-13, 1994 WL 326868 (No. 940615); Plaintiff's Memorandum in Parkersburg at 2, 14-15, (No. 94-1079).

173. *See supra* note 159 and accompanying text.

174. *Cf.* Williamson v. Tucker, 645 F.2d 404, 423 (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).

175. *See, e.g.*, L&B Hosp. Ventures, Inc. v. Healthcare Int'l, Inc., 894 F.2d 150, 151 (5th

have little or no authority to participate in the management of the partnership.[176] In fact, to insure their status as limited partners and to preserve their limited liability, it is essential that they not participate in the management of the partnership.[177] Also, limited partners cannot ordinarily dissolve a partnership nor do they have the power to bind other partners.[178] Limited partners, therefore, are presumed to depend on the efforts of others.[179] Consequently, if an LLC is structured as a limited partnership, it is likely that an interest in such an LLC is a security.[180]

But what about situations where the articles of organization or operating agreement allocates management powers to each member? LLC promoters argue that under such circumstances each member has the ability to protect his or her investment and exercise his or her managerial rights.[181] The mere delegation of certain powers does not undermine such rights.[182] Because the investors are ultimately in control and, therefore, not dependent on the efforts of others, there is no investment contract and no security.[183]

The SEC and state regulators argue that the grant of certain management powers in an operating document should not immunize an LLC from charges that its interests are securities. For example, the operating documents of some LLCs grant their members management powers, but those same LLCs have hundreds of geographically-dispersed, unsophisticated members who have delegated control of the entity to promoters or third parties.[184] The SEC and

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Cir.), *cert. denied*, 498 U.S. 815 (1990); Goodman v. Epstein, 582 F.2d 388, 406-08 (7th Cir. 1978), *cert. denied*, 440 U.S. 939 (1979); 3 BLOOMENTHAL, *supra* note 94, § 2.05[2] (citing numerous authorities).

176. Youmans v. Simon, 791 F.2d 341, 346 (5th Cir. 1986); *see, e.g.*, 3 BLOOMENTHAL, *supra* note 94, § 2.05[2], at 2-50.

177. *See, e.g.*, 3 BLOOMENTHAL, *supra* note 94, § 2.05[2].

178. *Youmans*, 791 F.2d at 346.

179. SARGENT HANDBOOK, *supra* note 1, § 4.02[1], at 4-10.

180. *Cf. supra* note 174. Limited partnership interests are considered securities under the investment contract test because of the limited partners' (1) lack of management control, (2) limited liability, (3) lack of dissolution powers, and (4) lack of power to bind. *See supra* notes 175-78. An LLC may be structured to resemble a limited partnership. As indicated in the text, an operating agreement can delegate substantial authority to managers, leaving LLC members with little or no control. *See supra* notes 166-69 and accompanying text; *see also* SARGENT HANDBOOK, *supra* note 1, § 4.02[1], at 4-11. Members of an LLC also have limited personal liability. SARGENT HANDBOOK, *supra* note 1, § 2.02[1], at 2-3; Donn, *supra* note 1, § 1, at PGLLC-6, § 6.2, at PGLLC-30. Dissolution provisions of LLC acts typically are modeled after the Revised Uniform Limited Partnership Act dissolution provisions. Donn, *supra* note 1, § 12.2, at PGLLC-45 to -46. Also, an LLC member's power to bind can be restricted by a provision in the articles of organization or elsewhere. 1 RIBSTEIN & KEATINGE, *supra* note 1, § 8.06, at 8-17.

181. *See, e.g.*, Defendants' Memorandum in Vision at 16-19, 1994 WL 326868 (No. 94-0615); *cf.* Banghart v. Hollywood Gen. Partnership, 902 F.2d 805, 808 (10th Cir. 1990) (stating that when a partnership agreement allocates powers to general partners and those powers provide the general partners with the ability to protect their investment, then the presumption is that the partnership is not a security).

182. *See, e.g.*, Defendants' Memorandum in Vision at 19, 1994 WL 326868 (No. 94-0615); *cf.* Williamson v. Tucker, 645 F.2d 404, 423 (5th Cir.) ("The 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).

183. *See, e.g.*, Defendants' Memorandum in Vision at 16-19, 24, 1994 WL 326868 (No. 94-0615); *cf. Banghart*, 902 F.2d at 808.

184. *See, e.g., supra* note 172.

state regulators charge that interests in such LLCs are securities since the members expect to receive profits from the efforts of others.[185] In making their case that such members are in fact relying on the efforts of others, the SEC and state prosecutors have focused on three factors: (1) the lack of sophistication of certain investors; (2) the special management or entrepreneurial skill supplied by promoters or third parties; and (3) the lack of control the investors have over the investment as a practical matter.[186]

For example, in many of the LLC communications ventures targeted by the SEC and state regulators, prosecutors claimed investors had little or no business experience.[187] Members included retirees, clerical workers, and blue-collar workers unfamiliar with business operations or communications technology.[188] The promotional materials distributed to investors often touted the experience and background of the management team and even informed investors that their roles would be similar to shareholders.[189] While the operating documents were carefully drafted so that members retained certain management powers,[190] prosecutors argued that the investors had no practical control over their investment.[191] Prosecutors maintained that because members were so inexperienced and unknowledgeable in business, they were incapable of intelligently exercising any managerial control.[192] As a result, members were dependent on the promoters or managers. The SEC also charged that the promoters solicited primarily unsophisticated, individual investors who were geographically dispersed. Given the number of investors, the comparatively small size of each investment, and the geographic distribution of investors, the SEC argued it was highly unlikely such investors could exercise any meaningful control over the LLC.[193] The SEC therefore concluded that the investors were required to rely on the efforts of others.[194]

(a) Partnership Case Law

In support of their position that such LLC interests are securities, prosecutors have relied on a line of cases that deals with when partnership interests

185. *See, e.g.*, Plaintiff's Memorandum in Vision at 14-15, 1994 WL 326868 (No. 94-0615); Plaintiff's Memorandum in Parkersburg at 14-15, (No. 94-1079).

186. Commentator Carl Schneider has noted that in applying the fourth prong of the *Howey* test, courts may examine any or all of these three factors. Schneider, *supra* note 134, at 122. In its briefs, the SEC has focused on all three factors. *See, e.g.*, Plaintiff's Memorandum in Vision at 12-13, 1994 WL 326868 (No. 94-0615); Plaintiff's Memorandum in Parkersburg at 14-15, (No. 94-1079); *see also* Illinois Express Action at *4, *14, 1993 WL 566300 (No. 9200106).

187. *See, e.g.*, Plaintiff's Memorandum in Vision at 2, 12, 1994 WL 326868 (No. 94-0615).

188. *See, e.g.*, Plaintiff's Reply Memorandum in Vision at 3-4, 1994 WL 326868 (No. 94-0615).

189. *See, e.g.*, Plaintiff's Memorandum in Vision at 4, 12, 1994 WL 326868 (No. 94-0615).

190. *Id.* at 13.

191. *Id.*

192. *Id.*

193. *Id.*; *cf.* Williamson v. Tucker, 645 F.2d 404, 423 (5th Cir.) (stating that with respect to partnership interests, "at some point there would be so many partners that a partnership vote would be more like a corporate vote, each partner's role having been diluted to the level of a single shareholder in a corporation"), *cert. denied*, 454 U.S. 897 (1981).

194. Plaintiff's Memorandum in Vision at 12, 1994 WL 326868 (No. 94-0615).

and joint ventures interests may be securities.[195] These cases focus primarily on the economic reality of the transaction and the relationship among investors. The seminal case in this area is *Williamson v. Tucker*.[196] In *Williamson*, the court noted that even if the investor retains some managerial control, the investment may still be a security if the investor can demonstrate "he was so dependent on the promoter or on a third party that he was in fact unable to exercise meaningful [managerial] powers."[197] The *Williamson* court described three situations where such an interest may constitute a security: (1) if the agreement among the parties leaves so little power in the hands of the investors that the arrangement distributes power as would a limited partnership; (2) if the investor is "so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising" his managerial powers; and (3) if the investor is "so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful" managerial power.[198] The *Williamson* court also recognized that other factors could give rise to dependence on the promoter or manager so that the exercise of control would be effectively precluded.[199]

In support of their contention that certain LLC interests may be securities, prosecutors cite cases[200] such as *Siebel v. Scott*,[201] *SEC v. Professional Associates*,[202] *SEC v. International Loan Network, Inc.*,[203] and *SEC v. Aqua-Sonic Products Corp.*[204] In *Siebel*, the Fifth Circuit held that limited partnership interests in a cable television system were securities because the limited partners did not plan or desire to participate in the operation of the system and viewed themselves as simply investors relying on the managerial skills of the general partner to bring in profits.[205] In *Professional Associates*, the Sixth Circuit held that there was sufficient evidence to support a finding that interests in a joint venture to exploit leased phonographic master tapes were securities because at least some of the investors were entirely passive and relied on the expected efforts and expertise of the venture's manager.[206] In *International Loan Network*, the Circuit Court for the District of Columbia held that an investment in a financial distribution network constituted a security because investors looked predominantly to others to generate profits.[207] In *Aqua-Sonic Products Corp.*, the Second Circuit held that licenses for the sale

195. *See, e.g.*, Plaintiff's Memorandum in Vision at 12-13, 1994 WL 326868 (No. 94-0615); Plaintiff's Memorandum in Parkersburg at 14-16, (No. 94-1079).

196. 645 F.2d 404 (5th Cir.) (analyzing whether the purchase of joint venture interests in parcels of undeveloped real estate were securities), *cert. denied*, 454 U.S. 897 (1981).

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

198. *Id.*

199. *Id.* at 424 n.15.

200. *See supra* note 195.

201. 725 F.2d 995 (5th Cir.), *cert. denied*, 467 U.S. 1242 (1984).

202. 731 F.2d 349 (6th Cir. 1984).

203. 968 F.2d 1304 (D.C. Cir. 1992).

204. 687 F.2d 577 (2d Cir.), *cert. denied sub nom.* Hecht v. SEC, 459 U.S. 1086 (1982).

205. *Siebel*, 725 F.2d at 998-99.

206. *Professional Assocs.*, 731 F.2d at 357.

207. *International Loan Network*, 968 F.2d at 1308.

of certain dental devices were securities, even though investors retained some legal rights over distribution, because the promoters of the scheme sought to attract only passive investors.[208]

(b) State Interpretative Opinions

Prosecutors' arguments are bolstered further by interpretative opinions issued by state securities regulators. A 1993 survey of state securities regulators indicated that as many as fourteen state securities agencies had taken the position, either formally or informally, that LLC interests may be investment contracts under their state securities laws.[209] A more recent survey of state securities regulators and state policy statements indicates that now at least twenty state securities agencies have taken that position, either formally or informally.[210] Of these, at least ten state regulatory agencies have issued formal opinions stating that LLC interests may be securities under their state laws.[211] State securities agencies in nine states have stated in policy statements, opinions or no-action letters that whether an LLC interest is a security in their state turns on the facts-and-circumstances investment contract analysis.[212] Specifically, the key issue is whether profits are expected to be derived substantially through the efforts of others.[213] These opinions indicate

208. *Aqua-Sonic Prods. Corp.*, 687 F.2d at 585.

209. *See* Sargent Blue Sky, *supra* note 7, at 431 & n.14.

210. *See* 1 Blue Sky L. Rep. (CCH) ¶ 6551.

211. 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. Comm'r) (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]; Interpretive Opinion, Lindquist, Vennum Professional Ltd. Liab. Co. (Minn. Dep't Comm.) (Dec. 27, 1993) [hereinafter Minnesota Interpretive Opinion]; Opinion Letter, H-I Missoula, LLC (Mont. Sec. Dep't) (June 15, 1995) [hereinafter Montana Opinion Letter]; 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. Dep't of Sec.) (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. Secretary of State and Sec. Comm'r) (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]. See *infra* Table III pp. 502-05 for a summary of state policy statements, interpretative opinions and no-action letters.

212. *See* Connecticut Release, *supra* note 211, at 10,554; Indiana Policy Statement, *supra* note 211, at 19,569-70; Kansas Interpretative Opinion, *supra* note 211, at *2; Minnesota Interpretive Opinion, *supra* note 211; Montana Opinion Letter, *supra* note 211; Oklahoma Exemption Request, *supra* note 211, at 41,655-56; Letter from Debra M. Bollinger, Director, S.D. Div. of Sec., to Hon. Thomas C. Barrett, Executive Director of State Bar of S.D. (May 16, 1995) [hereinafter South Dakota Letter]; Tenessee Statement of Policy, *supra* note 211, at 48,559-60; Draft Interpretative Opinion Letter, Are Limited Liability Company Memberships Securities?, at 1 (Wyo. Secretary of State) (July 16, 1993) (in-house opinion drafted by staff members of the Wyoming Securities Division and has not been released as a formal legal opinion of the Wyoming Attorney General's office) [hereinafter Wyoming Draft Opinion].

213. *See* Connecticut Release, *supra* note 211, at 10,554; Indiana Policy Statement, *supra* note 211, at 19,570-71; Kansas Interpretative Opinion, *supra* note 211, at *2; Minnesota Interpre-

that the determination depends not only on the legal control granted in the operating documents but also on the member's actual ability and opportunity to exercise such powers in a meaningful way.[214]

(c) State Litigation

In addition, at least twelve states have ordered certain LLC promoters to cease and desist from offering or selling LLC interests in violation of state securities acts.[215] The majority of these cases involved the issuance of summary cease and desist orders, where no opinion was issued, but sufficient evidence was found to conclude a violation of the securities laws occurred.[216] Often the trier of fact either cited no legal theory[217] or simply made a conclusory finding that the LLC interest constituted an investment contract.[218] Nevertheless, these decisions are significant because the sanctions applied indicate the state court or state administrative authority found that the LLC interests constituted securities and usually made such findings based on an investment contract analysis.[219]

(d) State Administrative Decisions

While there have been no reported judicial decisions analyzing the grounds upon which LLC interests have been found to be securities,[220] administrative decisions issued by hearing officers in Illinois and Georgia provide detailed analysis and reasoned opinions that preview the battleground for future litigation.[221] In those state enforcement proceedings, the hearing officers found the LLC interests constituted securities under state securities law by

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tive Opinion, *supra* note 211, at 2; Montana Opinion Letter, *supra* note 211, at 2; Oklahoma Exemption Request, *supra* note 211, at 41,655-56; South Dakota Letter, *supra* note 212, at 2; Tennessee Statement of Policy, *supra* note 211, at 48,559-60; Wyoming Draft Opinion, *supra* note 212, at 1, 4.

214. *See* Connecticut Release, *supra* note 211, at 10,554; Indiana Policy Statement, *supra* note 211, at 19,570-71; Kansas Interpretative Opinion, *supra* note 211, at *2; Oklahoma Exemption Request, *supra* note 211, at 41,656; South Dakota Letter, *supra* note 212, at 2; Tennessee Statement of Policy, *supra* note 211, at 48,560; Wyoming Draft Opinion, *supra* note 212, at 5.

215. *See infra* Table I pp. 495-98 for a summary of state actions under state securities laws against defendants offering or selling LLC interests (see columns labeled "Action" and "Action Taken" for citations to applicable authorities).

216. *See, e.g.*, Feigin v. Infotech Group, Inc., No. 94 CV 1756, 1994 Colo. Sec. LEXIS 1, at *1-*6 (Apr. 8, 1994); *In re* Express Communications, Inc., No. 93-0027 CD, 1993 Ind. Sec. LEXIS 46, at *1-*12 (Mar. 23, 1993).

217. *See, e.g., In re* Replen-K, Inc., Nos. SE 9209063, SE 9301897, SE 9304735, 1993 WL 451199 (Minn. Dep't Comm.) (Oct. 7, 1993); *In re* UEG, L.C., No. 93E068, 1993 WL 208898 (Kan. Sec. Comm'r) (May 12, 1993).

218. *See, e.g., In re* Hancock Communications Riverside PCS, No. 93E-058, 1993 WL 145928 (Kan. Sec. Comm'r) (Apr. 14, 1993); *In re* Parkersburg Wireless, LLC, No. 9403-11, 1994 WL 125846 (Pa. Sec. Comm'n) (Apr. 6, 1994).

219. *See infra* Table I pp. 495-98 (see columns labeled "Action," "Action Taken," and "Legal Theories Discussed").

220. SARGENT HANDBOOK, *supra* note 1, § 4.03[1][b], at 4-18; Georgia Express Action at 40, (No. 50-93-0075).

221. Georgia Express Action at 34-64, (No. 50-93-0075); Illinois Express Action at *9-*17, 1993 WL 566300 (No. 9200106).

applying the investment contract test.[222] Both hearing officers applied the definition of investment contract set forth in *Howey* and its progeny as adopted in each state[223] and focused primarily on the element of reliance on the efforts of others.[224] Both hearing officers discussed general partnership cases,[225] including the language and exceptions stated in *Williamson v. Tucker*.[226] In the 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 control because they lived in diverse geographic areas, and lacked technical expertise and business experience.[227] Because the members were incapable of exercising the illusory powers granted to them, they were placed in the position of relying on the expertise and managerial abilities of others.[228] Similarly, in the 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 himself to be in the hands of an expert that would take care of matters for him.[229] As a result, he could effectively exercise his managerial rights only with the expert advice of others.[230]

[3] Summary

Under the *Howey* investment contract test, an LLC interest is a security if a person invests money in a common enterprise with the expectation of profits from the entrepreneurial or managerial efforts of others.[231] In the cases to date involving LLC interests, the battle has been waged over whether investors expected profits from the efforts of others.[232] To support their position that certain LLC interests are securities, prosecutors have focused on the economic realities of the transaction to demonstrate that LLC members relied on the efforts of others.[233] Prosecutors have pointed to: (1) the lack of sophistication of certain investors; (2) the special management or entrepreneurial skills supplied by third parties; and (3) the lack of control investors had over the invest-

222. Georgia Express Action at 61, (No. 50-93-0075); Illinois Express Action at *8, 1993 WL 566300 (No. 9200106).

223. Georgia Express Action at 51-61, (No. 50-93-0075); Illinois Express Action at *9, *15-*16, 1993 WL 566300 (No. 9200106).

224. Georgia Express Action at 57-61, (No. 50-93-0075); Illinois Express Action at *13-*14, *16, 1993 WL 566300 (No. 9200106).

225. Georgia Express Action at 58-60, (No. 50-93-0075); Illinois Express Action at *11-*13, 1993 WL 566300 (No. 9200106).

226. Georgia Express Action at 58-60, (No. 50-93-0075); Illinois Express Action at *12, 1993 WL 566300 (No. 9200106).

227. Georgia Express Action at 60, (No. 50-93-0075).

228. *Id.* at 60-61.

229. Illinois Express Action at *16, 1993 WL 566300 (No. 9200106).

230. *Id.*

231. *See supra* notes 122-23, 161-62 and accompanying text.

232. *See, e.g.*, Defendants' Memorandum in Vision at 12-24, 1994 WL 326868 (No. 94-0615) (contending that the LLC interests at issue are not investment contracts only because they do not meet the profits from the efforts of others element of the *Howey* test); Defendants' Memorandum in Parkersburg at 13-30, (No. 94-1079) (contending the LLC interests at issue are not investment contracts, but focusing only on the efforts of others element of the *Howey* test).

233. *See supra* notes 184-94 and accompanying text.

ment as a practical matter.[234] Prosecutors have relied on the *Williamson* case and its progeny which detail the circumstances whereby partnership interests and joint venture interests may be securities.[235] Prosecutors' arguments have been bolstered by interpretative opinions issued by state securities regulators, the many cease and desist orders issued in state enforcement actions, and the two administrative decisions that were issued in state enforcement actions.[236]

2. Possible Defenses

Commentators and even LLC promoters concede that typically LLC interests meet the first three prongs of the *Howey* investment contract test.[237] The purchase of LLC interests generally involve an investment of money in a common enterprise with an expectation of profits. As a result, the critical issue in determining whether an LLC interest is a security becomes whether profits are expected solely or substantially from the efforts of others.[238]

But some commentators and LLC promoters contend that there should be a presumption against characterizing LLC interests as securities.[239] They argue courts have held that general partners in a general partnership are not solely or substantially dependent on the efforts of others when, under state partnership law or a partnership agreement, partners retain the ultimate power to control the business.[240] Several courts have stated there is a strong presumption that general partnership interests are not securities under the *Howey* test.[241] Further, courts have stated that an investor who claims a general part-

234. *See supra* notes 186-94 and accompanying text.

235. *See supra* notes 195-208 and accompanying text.

236. *See supra* notes 209-30 and accompanying text.

237. 1 RIBSTEIN & KEATINGE, *supra* note 1, § 14.02, at 14-2; SARGENT HANDBOOK, *supra* note 1, § 4.02[1], at 4-10; Defendants' Memorandum in Vision at 12-24, 1994 WL 326868 (No. 94-0615) (contending that the LLC interests at issue are not investment contracts only because they fail to meet the profits from the efforts of others element of the *Howey* test); Defendants' Memorandum in Parkersburg at 13-30, (No. 94-1079) (contending that the LLC interests at issue are not investment contracts, but focusing only on the efforts of others element of the *Howey* test). The *Howey* test for an investment contract is set forth in the text accompanying *supra* notes 122-23.

238. See text accompanying *supra* notes 158-63 for court interpretations of the *Howey* test's "solely from the efforts of others" prong.

239. *See, e.g.*, 1 RIBSTEIN & KEATINGE, *supra* note 1, § 14.02, at 14-5; SARGENT HANDBOOK, *supra* note 1, § 4.02[1], at 4-11.

240. *See, e.g.*, 1 RIBSTEIN & KEATINGE, *supra* note 1, § 14.02, at 14-3 to 14-4; SARGENT HANDBOOK, *supra* note 1, § 4.02[1], at 4-10; Defendants' Memorandum in Vision at 13, 1994 WL 326868 (No. 94-0615); Defendants Memorandum in Parkersburg at 13-14, (No. 94-1079). Commentators and LLC promoters cite cases such as Banghart v. Hollywood Gen. Partnership, 902 F.2d 805, 808 (10th Cir. 1990) (whether the interest is a security turns on the partnership agreement); Reeves v. Teuscher, 881 F.2d 1495, 1500 (9th Cir. 1989) (observing that "the proper focus must be on the partnership agreement and not how . . . the entity functioned"); 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); 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); Odom v. Slavik, 703 F.2d 212, 216 (6th Cir. 1983) (indicating that the issue is whether the general partner had power under the partnership agreement and state partnership laws).

241. Defendants' Memorandum in Parkersburg at 14, (No. 94-1079) (citing *Banghart*, 902 F.2d at 808); *see also* Youmans v. Simon, 791 F.2d 341, 346 (5th Cir. 1986); 1 RIBSTEIN & KEATINGE, *supra* note 1, § 14.02, at 14-3 to 14-4 (the general partnership form is close to a per se

nership interest is an investment contract has a difficult burden to overcome.[242] These commentators and LLC promoters assert that LLCs are closely analogous to general partnerships.[243] They claim LLCs share the same critical features as general partnerships.[244] In both entities, investors have the power to participate in the management of the entity.[245] Most LLC statutes, for example, provide that the LLC will be member-managed unless the articles of organization provide otherwise.[246] LLC members normally have the power to elect and remove managers.[247] LLC members also have the authority to bind the entity.[248] Moreover, there are tax risks associated with delegating authority to managers which create an incentive for member-management.[249] Since both LLCs and general partnerships allow for investor participation in management decision-making, they argue that profits are not expected solely or substantially from the efforts of others; therefore, there should be a strong presumption against characterizing LLC interests as securities under the *Howey* investment contract test.[250]

In support of their position that LLC interests should not be treated as securities, LLC promoters have relied on cases that have held that general partnership interests were not securities because the partners had the power to manage the business either under the state partnership statute or the partnership agreement.[251] These courts reason that such investors do not require the protection of the securities laws because the investors have the ability to take care of their own interests due to the inherent powers such investors have

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nonsecurity); SARGENT HANDBOOK, *supra* note 1, § 4.02[1], at 4-10 ("General partnership interests are virtually presumed not to be securities . . . .").

242. *See, e.g.*, *Youmans*, 791 F.2d at 346; Williamson v. Tucker, 645 F.2d 404, 425 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981).

243. *See, e.g.*, 1 RIBSTEIN & KEATINGE, *supra* note 1, § 14.02, at 14-3 to 14-4; SARGENT HANDBOOK, *supra* note 1, § 4.02[1], at 4-11.

244. *See supra* note 243.

245. *See supra* note 243.

246. 1 RIBSTEIN & KEATINGE, *supra* note 1, § 1.05, at 1-4; SARGENT HANDBOOK, *supra* note 1, § 4.02[1], at 4-11; Keatinge et al., *supra* note 1, at 390.

247. SARGENT HANDBOOK, *supra* note 1, § 4.02[1], at 4-11.

248. *Id.*

249. Internal Revenue Service Treasury Regulations use certain characteristics to distinguish entities treated as partnerships for federal income tax purposes from entities treated as associations taxable as corporations. Those characteristics include: (i) continuity of life; (ii) centralized management; (iii) limited liability; and (iv) free transferability of interests. Treas. Reg. § 301.7701-2 (as amended in 1993). A business organization is treated as a corporation and not a partnership for federal income tax purposes if it has at least three of these characteristics. *See id.*; *see also* Ribstein, *supra* note 7, at 820-21. As a result, to be classified as a partnership, the entity must lack at least two of these characteristics. Daniel S. Goldberg, *The Tax Treatment of Limited Liability Companies: Law in Search of Policy*, 50 BUS. LAW. 995, 1000 (1995). Since LLCs have limited liability, a centrally-managed LLC would have to lack both continuity of life and free transferability for partnership tax treatment. Given the uncertainty surrounding these characteristics, centrally-managed LLCs would run a greater risk of being denied partnership tax treatment. *See* Ribstein, *supra* note 7, at 820-21; Sargent Article, *supra* note 7, at 1077-78.

250. *See* SARGENT HANDBOOK, *supra* note 1, § 4.02[1], at 4-11; Defendants' Memorandum in Parkersburg at 13-14, (No. 94-1079).

251. *See, e.g.*, Defendants' Memorandum in Vision at 13-22, 1994 WL 326868 (No. 94-0615); Defendants' Memorandum in Parkersburg at 13-14, (No. 94-1079). For the cases typically cited by such LLC promoters, see *supra* note 240.

under state law or the partnership agreement.[252] For example, general partners may act on behalf of the partnership and bind other partners by their actions.[253] General partners are personally liable for the liabilities of the partnership, and they may dissolve the partnership.[254]

Citing general partnership cases, LLC promoters argue that the *power* to exercise managerial control is determinative, regardless of the control actually exercised.[255] The mere delegation of management control does not create a security.[256] So even if the LLC member does not participate in the management of the business, the retention of control under a statute, the articles of organization, or the operating agreement precludes finding a security. LLC promoters often set forth a litany of examples to illustrate LLC members retained the legal right to manage the entity, despite the delegation of authority to a management group. In *Vision Communications*, for example, the LLC promoters cited, among other things, the fact that members had the express authority under the operating agreement: (i) to convert the manager-managed LLC to a member-managed LLC; (ii) to terminate the management agreement; (iii) to elect managers; and (iv) to participate in the management and control of the LLC in proportion to the number of membership interests owned.[257] In *Parkersburg*, the LLC promoters cited, among other things, that the operating agreement provided: (i) each member had the right to participate in the management and control of the company in proportion to the number of membership interests owned; (ii) members had the power to remove managers; (iii) unanimous consent of the members was required for dissolution; and (iv) majority consent was required for acquisition or disposition of any license or equity interest in entities owning and operating wireless cable systems.[258]

Prosecutors counter that the grant of certain management powers to members should not immunize an LLC from charges that its interests are securities.[259] Even if there were a presumption that such interests were not securities, in the general partnership cases courts have held that the presumption may be overcome when a *Williamson*-type analysis indicates the investor is so unsophisticated, inexperienced, uninformed, or dependent on others that the investor is unable to exercise meaningful control.[260] As a result, the

252. *See, e.g.*, Youmans v. Simon, 791 F.2d 341, 346 (5th Cir. 1986).

253. *Id.*

254. *Id.*

255. *See, e.g.*, Banghart v. Hollywood Gen. Partnership, 902 F.2d 805, 808 (10th Cir. 1990); Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc., 840 F.2d 236, 240-41 (4th Cir. 1988) (quoting *Williamson*); Goodwin v. Elkins & Co., 730 F.2d 99, 107 (3d Cir.), *cert. denied*, 469 U.S. 831 (1984).

256. *See, e.g., Rivanna*, 840 F.2d at 240-41; New York Stock Exchange, Inc. v. Sloan, 394 F. Supp. 1303, 1314 (S.D.N.Y. 1975) ("The fact that a partner may choose to delegate his day-to-day managerial responsibilities to a committee does not diminish in the least his legal right to a voice in partnership matters, nor his responsibility under state law for acts of the partnership.").

257. *See* Defendants' Memorandum in Vision at 17-19, 1994 WL 326868 (No. 94-0615).

258. *See* Defendants' Memorandum in Parkersburg at 15-18, (No. 94-1079).

259. *See supra* notes 184-208 and accompanying text.

260. SARGENT HANDBOOK, *supra* note 1, § 4.02[1], at 4-11; *see* Williamson v. Tucker, 645 F.2d 404, 424 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981).

investor's *ability* to exercise meaningful control is determinative, not merely the grant of such control.

LLC promoters respond that the knowledge and sophistication of an individual member should not determine whether an interest is a security.[261] First, if the knowledge and sophistication of an individual member is determinative, whether a promoter is selling a security would turn on the identity of the purchaser.[262] This would unduly burden promoters by requiring them to investigate the business experience and knowledge of all potential investors. Such a litmus test would create uncertainty. Also, the promoter could find himself offering a security to some investors (the "unsophisticated" investors), but offering a nonsecurity to other investors (the "knowledgeable and sophisticated" investors). Second, in the general partnership cases, courts have indicated that investors who lack financial sophistication or expertise may still exercise meaningful control, because they are free to consult with more knowledgeable investors or third persons, or to employ accountants and lawyers.[263] Consequently, an individual's business sophistication should not be determinative.

On theoretical grounds, Professor Larry Ribstein argues that courts should strongly presume LLC interests are not securities.[264] Professor Ribstein criticizes the *Howey* approach and other cases which emphasize "economic reality" and "substance-over-form" because such tests require courts to conduct a fact-specific inquiry into each transaction.[265] Such tests become subjective and often lead to anomalous results.[266] Consequently, neither investors nor issuers know without litigation whether the securities laws apply.[267] This unpredictability increases litigation, makes it difficult for parties to make and price contracts, decreases the probability of settling disputes without litigation, and inhibits capital formation.[268] Professor Ribstein asserts that the form of the investment, rather than the substance or economic reality, should determine whether an interest is a security.[269] A strong presumption that LLC interests are not securities would provide a clear and predictable rule, reduce litigation, and decrease associated costs.[270] Moreover, a presumption based on the form

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261. *See, e.g.*, Defendants' Memorandum in Vision at 20-21, 1994 WL 326868 (No. 94-0615).

262. Matek v. Murat, 862 F.2d 720, 729 (9th Cir. 1988) (discussing this issue in connection with whether a general partnership interest is a security); *Rivanna*, 840 F.2d at 241 n.7 (also in connection with general partnership interests).

263. *See, e.g.*, Defendants' Memorandum in Vision at 21 n.5, 1994 WL 326868 (No. 94-0615); *see also Banghart*, 902 F.2d at 808 n.5 (citing *Rivanna*); *Rivanna*, 840 F.2d at 242 n.10.

264. Ribstein, *supra* note 7, at 810.

265. *Id.* at 809, 828-29.

266. *See* Schneider, *supra* note 128, at 107-08 (noting the results-orientation of courts); Schneider, *supra* note 134, at 122-27 (noting that the *Howey* test gives courts the power to reach any outcome the court desires in a given case and detailing the various factors that appear to affect court decisions).

267. Ribstein, *supra* note 7, at 809.

268. *Id.* at 809, 828-31.

269. *Id.* at 810, 824.

270. *Id.* at 824-32; *see also* Park McGinty, *What Is a Security?*, 1993 WIS. L. REV. 1033, 1082 (noting that "[p]resumptions are the most effective method for providing predictability" and creating settled expectations).

of the transaction allows the parties themselves to determine the amount of disclosure necessary and whether the securities laws apply.[271]

3. Conclusions

Clearly, LLC interests can be securities under the *Howey* investment contract test.[272] Whether a particular LLC interest is a security under the *Howey* test is a factual question which must be analyzed on a case-by-case basis that typically will focus on whether profits are expected from the efforts of others.[273]

By comparing LLCs to general partnerships, limited partnerships, and corporations, commentators and litigators appear to have missed the mark. The LLC is a hybrid entity that is highly tailorable and flexible.[274] LLC statutes permit promoters to structure an entity so that it may have the characteristics of a general partnership, limited partnership, or corporation, sometimes with characteristics of each.[275] The LLC statutes purposefully permit a wide spectrum of member participation and control.[276] As a result, any attempt to generalize or base presumptions on comparisons to other types of legal entities is doomed to be inaccurate and lead to undesirable results.

In particular, the preoccupation with applying general partnership case law[277] to LLCs appears misguided. While LLC promoters and some commentators would have us believe all LLCs are analogous to general partnerships,[278] LLCs differ from general partnerships in at least two critical repects.[279] First, an LLC member has only limited liability for the debts and obligations of the LLC,[280] whereas a general partner has unlimited personal liability for the debts and obligations of the general partnership.[281] Unlimited personal liability gives a general partner the incentive to be highly informed about the business and the motivation to be actively involved in the management of the general partnership. The risk of unlimited personal liability also discourages involvement by unsophisticated investors.[282] In comparison, an LLC member's liability is limited to his or her investment.[283] Members are not personally liable for the debts and obligations of the LLC. In this respect, members are more like corporate shareholders[284] than general partners. So

271. Ribstein, *supra* note 7, at 812.
272. *See supra* part III.A.1.
273. *See supra* notes 164-73 and accompanying text.
274. SARGENT HANDBOOK, *supra* note 1, § 1.03, at 1-3 to 1-4.
275. *Id.*
276. *Id.* § 4.02[1], at 4-11.
277. Both prosecutors and LLC promoters cite general partnership case law in support of their respective positions. *See supra* notes 195-208, 251-56 and accompanying text.
278. *See supra* notes 243-50 and accompanying text.
279. Ribstein, *supra* note 7, at 816-17 (discussing the differences between general partnerships and LLCs, including investor liability and management structure).
280. LLC members normally are not liable for obligations of the LLC, except to the extent that they personally guarantee the debts of the LLC. SARGENT HANDBOOK, *supra* note 1, § 3.06[1][b]; *see also* 1 RIBSTEIN & KEATINGE, *supra* note 1, § 12.02.
281. SARGENT HANDBOOK, *supra* note 1, § 3.02[2][a].
282. Keatinge et al., *supra* note 1, at 404.
283. *See supra* note 280.
284. *See* SARGENT HANDBOOK, *supra* note 1, § 3.04[1][a] (noting that "[s]hareholders are not

LLC members have less incentive than general partners to investigate or actively participate in the management of the business.[285] LLC members therefore are more likely than general partners to be passive investors, less informed, less sophisticated, and more dependent on the efforts of others.[286]

Second, the LLC statutes provide a formal structure that permits centralized management.[287] LLCs can easily adopt a corporate or limited partnership centralized-management structure in lieu of an investor-managed general partnership structure. An investor in an LLC with centralized management would not expect to participate in management to the same extent as he would in a general partnership.[288] These differences between LLCs and general partnerships promote passive investment and reliance on the efforts of others, major factors that affect whether an interest is a security. Moreover, the enforcement actions to date demonstrate that even when an LLC adopts a member-managed structure, all investors may not be actively involved in the management of the LLC. Courts therefore should not assume that all LLCs are analogous to general partnerships and that all investors are actively involved in the management of the LLC.

In addition, the legal powers granted LLC members do not necessarily bestow meaningful management control. The legal powers granted to LLC members may be no more than the legal powers granted to corporate shareholders.[289] In the *Vision Communications* and *Parkersburg* cases, LLC promoters claimed LLC members had the power to control the entity because, among other things, LLC members could vote to elect or remove managers and vote on extraordinary decisions, such as amending the articles of organization, dissolution, and the sale of all or substantially all the LLC's assets.[290]

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liable for the debts of the corporation").

285. *See* Ribstein, *supra* note 7, at 816-17.

286. Professor Mark Sargent dismisses the liability distinction argument as merely a formalistic distinction:

> As a practical matter, investors in such enterprises—whatever the form of business organization—all have substantial incentives "to be highly informed about the business" because their investment is likely to represent a large percentage of their personal wealth, because their position is illiquid since there is no real secondary market for their interests, and because they have often personally guaranteed the business's obligations. It is also by no means clear that the general partnership's lack of limited liability either encourages or discourages "unsophisticated investors." Many unsophisticated investors are attracted to the general partnership form because of its relative simplicity. This purported distinction between the incentives of general partners and LLC investors thus has little bearing on the question of whether LLC members are more or less dependent on the efforts of others, and thus does not undermine our basic conclusion: LLC interests should be presumed not to be investment contracts under the *Howey* test.

SARGENT HANDBOOK, *supra* note 1, § 4.02[1], at 4-13; *see also* Ribstein, *supra* note 7, at 822-23 (arguing that the differences in liability should not make a critical difference in applying the securities laws).

287. *See* Ribstein, *supra* note 7, at 817. "Some LLC statutes provide for corporate-type centralized management." *Id.* Other LLC statutes allow LLC members to "elect to be centrally-managed in their articles of organization or operating agreement." *Id.*; *see supra* notes 167-69 and accompanying text.

288. Ribstein, *supra* note 7, at 817.

289. *See, e.g.*, Long, *supra* note 7, at 112-13 (discussing the rights possessed by the members of Cellvision, a Texas limited liability company).

290. Defendants' Memorandum in Vision at 17-19, 1994 WL 326868 (No. 94-0615);

Such legal rights do not necessarily constitute management control. In effect, these LLC members have no greater rights than most corporate shareholders. Corporate shareholders are allowed to vote to remove directors and are typically granted the right to vote on similar extraordinary corporate matters.[291] A shareholder's possession of such rights usually is not viewed as constituting legal control or participation in the management of the corporation, particularly when he is only one of many shareholders. His shares of stock are securities. Why then should the grant of such rights change an LLC interest from a security to a nonsecurity?

Courts should resist playing into the hands of LLC promoters by applying general partnership case law to determine whether an LLC interest is a security. If you start with the premise that general partnership cases are controlling, prosecutors and civil plaintiffs begin with three strikes against them: (i) a "strong presumption" the interests are not securities;[292] (ii) a "difficult burden to overcome";[293] and (iii) a narrow *Williamson*-type exception that allows the presumption to be overcome in only limited circumstances by showing the member is so unsophisticated, uninformed, or dominated that he is wholly dependent on the manager, or by showing deferral of authority to the manager is so extreme that members essentially have no control.[294] Since LLCs differ from general partnerships in several important repects and the legal powers granted to members may be no more than the corporate power granted to shareholders, there is no reason to saddle prosecutors and plaintiffs with the burdens and baggage of general partnership case law. The *Howey* investment contract test requires a case-by-case analysis.[295] There are no presumptions. There are no narrow exceptions. The test is simply whether there is an investment of money in a common enterprise with the expectation of profits from the efforts of others.

Moreover, the presumptions used in partnership cases, that an interest in a general partnership is not a security and an interest in a limited partnership is a security,[296] are proving less and less useful to courts. Under a *Williamson*-type analysis, courts may find general partnership interests are securities.[297] Revisions to state limited partnership laws now allow limited partners to enjoy some of the same rights traditionally possessed only by general partners.[298] As a result, certain limited partnership interests may not be securities.[299]

Defendants' Memorandum in Parkersburg at 15-18, (No. 94-1079).

291. HARRY G. HENN & JOHN R. ALEXANDER, LAW OF CORPORATIONS 511-12, 957 (3d ed. 1983); Long, *supra* note 7, at 113.

292. *See supra* note 241 and accompanying text.

293. *See supra* note 242 and accompanying text.

294. SARGENT HANDBOOK, *supra* note 1, § 4.02[1], at 4-11.

295. *See supra* notes 123, 165 and accompanying text.

296. *See supra* notes 175-80 (limited partnership interests), 241-42 (general partnership interests) and accompanying text.

297. *See supra* notes 195-99 and accompanying text; *see also* 2 LOSS & SELIGMAN, *supra* note 99, at 958-59 & n.203.

298. Conrad E.J. Everhard, *The Limited Partnership Interest: Is It a Security? Changing Times*, 17 DEL. J. CORP. L. 441, 482 (1992); *see also* 2 LOSS & SELIGMAN, *supra* note 99, at 959 n.203, 960 & n.204, 961 n.211.

299. Everhard, *supra* note 298, at 466-68.

These presumptions are losing their relevance. Instead, courts must analyze each partnership on a case-by-case basis. So why attempt to impose presumptions that are not determinative or necessarily useful in partnership cases in LLC cases? Furthermore, the courts' inability to clearly specify the characteristics which can overcome such presumptions creates practical problems in terms of application and anomalous results.

Applying general partnership case law to LLCs does not appear to be a satisfactory solution on theoretical grounds either. The strict literalist approach some federal courts have taken in general partnership cases has been criticized for focusing on the form of the transaction and legal powers retained by investors, rather than the economic reality of the transaction.[300] LLC promoters tend to cite cases such as *Rivanna*, *Banghart*, and *Goodwin* in support of their contention that the legal power to control an entity should determine whether an interest is a security.[301] But such cases look to the form of the transaction,[302] which is contrary to the Supreme Court's constant admonishments to look at substance rather than form.[303] Courts have begun to reject or limit the prior authority that focused on form and restricted the scope of the "efforts of others" inquiry to the legal powers retained by investors.[304] Now the trend is to recognize that investor control depends not only on the form of the transaction and legal powers granted in the documents, but the investor's actual ability and opportunity to exercise management powers.[305] Courts have begun to return to this case-by-case "economic realities" approach.

To date, commentators, prosecutors, and LLC promoters have all overemphasized the provisions in the articles of organization and the operating agreements.[306] The undue emphasis on the grant of power is not only at odds with prior Supreme Court precedent,[307] but invites promoters to try to escape the securities laws by merely parceling out duties to investors and using

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300. *See, e.g.*, Douglas M. Branson & Karl S. Okamoto, *The Supreme Court's Literalism and the Definition of "Security" in the State Courts*, 50 WASH. & LEE L. REV. 1043, 1076-77 (1993).

301. *See supra* notes 255-56 and accompanying text.

302. *See supra* note 255.

303. *See, e.g.*, Tcherepnin v. Knight, 389 U.S. 332, 336 (1967); SEC v. W.J. Howey Co., 328 U.S. 293, 298 (1946).

304. *See, e.g.*, Koch v. Hankins, 928 F.2d 1471, 1475-81 (9th Cir. 1991) (rejecting the district court's reliance on Matek v. Murat, 862 F.2d 720 (9th Cir. 1988), and stating, "[t]he question of investor's control . . . is decided in terms of practical as well as legal ability to control"); Bailey v. J.W.K. Properties, Inc., 904 F.2d 918, 921-25 & n.6 (4th Cir. 1990) (questioning the district court's application of Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc., 840 F.2d 236 (4th Cir. 1988) and holding that the district court improperly limited its examination to the language of the contracts and should have considered the practical limitations on the investor's ability to exercise meaningful control). Also, the Tenth Circuit case, *Banghart*, relies on the *Matek* decision which has been undercut and discredited by more recent Ninth Circuit opinions such as Holden v. Hagopian, 978 F.2d 1115, 1119 (9th Cir. 1992); *Koch*, 928 F.2d at 1475-81; Hocking v. Dubois, 885 F.2d 1449, 1460 (9th Cir. 1989), *cert. denied*, 494 U.S. 1078 (1990). *See Banghart*, 902 F.2d at 808 (citing *Matek* and *Rivanna*). For a discussion of the trends in general partnership case law, see Branson & Okamoto, *supra* note 300, at 1076-88.

305. *See* Everhard, *supra* note 298, at 448-49; Steinberg Article, *supra* note 7, at 1111-12.

306. For example, see the following discussions focusing on provisions in the articles of organization and operating agreements: Defendants' Memorandum in Vision at 17-19, 1994 WL 326868 (No. 94-0615); Defendants' Memorandum in Parkersburg at 15-18, (No. 94-1079); Steinberg Article, *supra* note 7, at 1112-13.

307. *See supra* note 303 and accompanying text.

boilerplate provisions to protect against securities law violations.[308] Promoters should not be allowed to hide behind documents that grant powers that are not intended to be used, cannot practically be used, or have never been used.[309] A strict contractual interpretation of documents results in a mechanical, underinclusive, and unduly restrictive view of a security that frustrates the remedial purposes of the securities laws.[310] The key issue in the *Howey* test is whether the investor in the LLC is led to expect profits from the entrepreneurial or managerial efforts of others, not the legal power retained.

The United States Supreme Court has not yet considered whether general partnership interests are securities or whether any presumptions are warranted. Given the limited usefulness of these presumptions in partnership cases,[311] the inappropriate focus they place on the form of the transaction and the legal rights retained by investors,[312] the practical problems with clearly specifying the characteristics which can overcome such presumptions, and the potential to frustrate the remedial purposes of the securities laws,[313] it appears applying general partnership case law to LLCs does not present a satisfactory solution from either a practical or theoretical standpoint. For the securities laws to keep pace with ever-changing investment structures, the courts must return to the basic premise of the *Howey* test which requires case-by-case analysis and a focus on the economic realities.[314]

Professor Ribstein advocates on theoretical grounds that there should be a strong presumption LLCs are not securities.[315] He claims such a presumption would provide a clear and predictable rule, reduce litigation, decrease the cost of capital formation, and allow parties themselves to determine whether the securities laws apply by their choice of entity.[316] But such a presumption sacrifices investor protection to save costs and provide docket control. Legislatures passed securities acts to provide broad investor protection.[317] In *Howey*, the Supreme Court stated investor protection should not be thwarted by formulas[318] and instead adopted a case-by-case analysis approach.[319] A strong presumption for convenience and cost-cutting is the type of formula the Supreme Court attempted to avoid with *Howey*.

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308. *See* SEC v. Aqua-Sonic Prods. Corp., 687 F.2d 577, 584 (2d Cir.) (discussion in connection with analysis of licenses for sale), *cert. denied sub nom.* Hecht v. SEC, 459 U.S. 1086 (1982); Probst v. State, 807 P.2d 279, 284 (Okla. Crim. App. 1991) (discussion in connection with analysis of limited partnership interest).

309. *Probst*, 807 P.2d at 285.

310. *Id.* at 288 (Lane, J., concurring).

311. *See supra* notes 296-99 and accompanying text.

312. *See supra* notes 300-04 and accompanying text.

313. *See supra* notes 300-10 and accompanying text.

314. *See* United Hous. Found., Inc. v. Forman, 421 U.S. 837, 851-52 (1975) (stating that in applying *Howey* and determining what is an investment contract we "must examine the substance—the economic realities of the transaction—rather than the names that may have been employed by the parties"); *accord* International Bhd. of Teamsters v. Daniel, 439 U.S. 551, 558 (1979); *see also supra* note 303.

315. *See supra* notes 264-67 and accompanying text.

316. *See supra* notes 268-71 and accompanying text.

317. *See, e.g.*, SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946).

318. *Id.*

319. *See id.* at 298-301.

A strong presumption that LLCs are not securities would allow promoters to choose to avoid the securities laws by choosing the form of the legal entity.[320] Such a presumption could affect a promoter's choice of entity decision by providing promoters with an incentive to form an LLC rather than a corporation. Moreover, such a presumption would encourage every dishonest promoter to structure his transactions as an LLC.[321] State regulators already charge that many promoters are now packaging their investment products as LLCs in an attempt to avoid state and federal securities laws.[322] If, as Professor Ribstein advocates, the courts allow private ordering,[323] who will suffer? Private ordering invites fraudulent promoters to prey on the unsophisticated and uninformed. The effect of such a presumption is to leave those investors who are least able to protect themselves vulnerable to the schemes of clever promoters.

If there is a need for a clear, predictable rule to reduce litigation and decrease the cost of capital formation, a presumption that LLC interests *are* securities would better serve the purposes of the securities laws than a presumption that LLC interests are not securities. The hybrid nature of the entity, the wide variations in the number of investors and management structure, and the potential for abuse compel such a conclusion. A presumption that LLC interests are securities would provide a clear, predictable rule.[324] Parties could better predict the outcome of litigation. This would reduce litigation and make it easier for parties to make and price contracts. As for the cost of complying with the securities laws, for many ventures the cost would be minimal. If the number of LLC members are limited and all members are active and well-informed, such an offering usually would qualify for an exemption from the registration provisions of the securities acts.[325] In many situations, the

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320. *See* Ribstein, *supra* note 7, at 810, 812 (advocating a "private ordering" approach where parties could determine whether the securities laws applied by selecting the form of the transaction).

321. *Cf.* Branson & Okamoto, *supra* note 300, at 1081 (observing that once courts began presuming general partnership interests were not securities, "[e]very promoter who knew what she was doing, or who had a decently schooled transactional lawyer, structured their deal as a general partnership").

322. Emshwiller, *supra* note 5; Emshwiller, *supra* note 11.

323. For a discussion of the "private ordering approach" advocated by Professor Ribstein which would allow private parties to determine whether the securities laws apply, see Ribstein, *supra* note 7, at 812; Larry E. Ribstein, *Private Ordering and the Securities Laws: The Case of General Partnerships*, 42 CASE W. RES. L. REV. 1 (1992).

324. *See* Ribstein, *supra* note 7, at 838-40 (recognizing that changing the definition of a security to include LLCs would reduce predictability problems and litigation costs).

325. Such LLC interests would probably be exempt from registration requirements under the Securities Act as a nonpublic offering, limited offering, or intrastate offering. For a discussion of federal registration exemptions and related disclosure requirements, see STEINBERG, *supra* note 135, §§ 3.01-3.12. For a discussion of state registration exemptions and related disclosure requirements, see 12 LONG, *supra* note 84, at 4-1 to 5-185. As equity securities, the LLC interests would only be subject to the registration provisions of the Exchange Act if there are 500 or more record holders. Registration is required under the Exchange Act only for firms that are listed on an exchange or have total assets exceeding $5 million and equity securities held by more than 500 persons. 15 U.S.C. § 78l(a) (1994) (making it unlawful to effect any transaction in a security on a national exchange unless the security is registered under the Exchange Act); 15 U.S.C. § 78l(g)(1) (requiring registration for companies with assets of more than $1 million and held of record by more than 500 persons); 17 C.F.R. § 240.12g-1 (1995) (exempts issuers with total assets under $5

disclosure requirements of the securities acts would either not apply or the acts would require only limited disclosure.[326] Purchases and sales of LLC interests, however, would be subject to the antifraud provisions of the securities laws.[327] The antifraud provisions provide investors with remedies in the event of misrepresentation, fraud, or deceit.[328] So in most instances, the cost of complying with the securities laws would be minimal, but the protection and safeguards provided to investors would be great.[329] Also, even with the presumption that LLCs are securities, investors would still be allowed to determine whether the securities laws apply. If they did not want the securities laws to apply, they could select the general partnership form, rather than the LLC form. But more importantly, such a presumption would discourage promoters from packaging their investment products as LLCs to avoid the securities laws, encourage compliance with the securities laws, and provide investors greater protection against fraudulent schemes.

LLC interests clearly can be securities under the *Howey* investment contract test.[330] Because the LLC is a hybrid entity, any attempt to generalize or base presumptions on comparisons to other types of legal entities is doomed to be inaccurate and lead to undesirable results.[331] For example, LLCs differ from general partnerships in a number of critical respects that affect whether an interest is a security.[332] Courts should resist applying general partnership case law and its associated presumptions to LLCs.[333] Courts should return to the case-by-case analysis dictated by the *Howey* investment contract test and focus on the economic realities of the transaction.[334] If there is a need for presumptions to provide a clear, predictable rule, courts should presume LLC interests are securities.[335] The costs associated with such a presumption

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million from registration). *Cf.* 3 BLOOMENTHAL, *supra* note 94, § 2.05[3], at 2-51 (suggesting that if all partnership interests were classified as securities, in most instances, the principal impact would be that the purchase and sale was subject to the antifraud provisions of the securities laws).

326. For a discussion of the federal disclosure requirements associated with various exemptions, see STEINBERG, *supra* note 135, §§ 3.01-3.12. For a discussion of the state disclosure requirements associated with various exemptions, see 12 LONG, *supra* note 84, at 4-1 to 5-185.

327. "The anti-fraud provisions . . . [of the federal securities laws] apply to all sales of securities involving interstate commerce or the mails, whether or not the securities are exempt from registration." STEINBERG, *supra* note 135, ch. 1 app. at 6 (quoting "The Work of the SEC," published by the SEC in 1982).

328. For a discussion of the antifraud provisions of the Securities Act and the Exchange Act, see STEINBERG, *supra* note 135, §§ 6.01-7.12.

329. *Contra* Goforth, *supra* note 7, at 1278-88; *see also* Sargent Blue Sky, *supra* note 7, at 438-39. After a thoughtful discussion of the benefits and costs of federal securities law regulation, Professor Goforth concludes that the likely costs of regulation and other potential consequences far exceed any potential benefits. Goforth, *supra* note 7, at 1278-88. Professor Sargent argues that a "rule defining all LLC interests as securities would be overinclusive. It is difficult to justify imposing all of the consequences of securities status on an entity with a small number of members, all of whom are legally and practically capable of participating in control." Sargent Blue Sky, *supra* note 7, at 438-39.

330. *See supra* part III.A.1.

331. *See supra* notes 274-76 and accompanying text.

332. *See supra* notes 279-88 and accompanying text.

333. *See supra* notes 292-314 and accompanying text.

334. *See supra* notes 303-14 and accompanying text.

335. *See supra* notes 324-29 and accompanying text.

would be minimal in most situations, but the benefits in terms of investor protection would prove great.

B. *Risk Capital Tests*

1. Arguments Asserted

A 1993 survey of state securities regulators indicated that some state securities agencies may have already taken the position, either formally or informally, that LLC interests may be investment contracts under a risk capital analysis.[336] A number of states[337] have adopted the risk capital test by case law,[338] statute,[339] or administrative ruling.[340] In some jurisdictions, the risk capital test is used as an alternative to the *Howey* test to determine what constitutes an "investment contract."[341] In other jurisdictions, the risk capital test serves as an independent means of defining a security.[342] There is no one formulation of the test.[343] There are many variations. Regardless of the version used, the risk capital test is considered broader in scope than the *Howey*

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336. *See* Sargent Blue Sky, *supra* note 7, at 431.

337. The United States Supreme Court has not adopted the risk capital test. In United Hous. Found., Inc. v. Forman, 421 U.S. 837 (1975), the Court stated that "[e]ven if we were inclined to adopt . . . a 'risk capital' approach we would not apply it in the present case." *Id.* at 857 n.24. Also, the federal courts have not generally adopted the risk capital test. STEINBERG, *supra* note 135, § 2.02, at 24; *see, e.g.*, SEC v. Glenn W. Turner Enters., 474 F.2d 476, 483 & n.10 (9th Cir.) (refusing to apply risk capital test), *cert. denied*, 414 U.S. 821 (1973); *see also* Annotation, *"Risk Capital" Test for Determination of Whether Transaction Involves Security, Within Meaning of Federal Securities Act of 1933 (15 USCS §§ 77a et seq.) and Securities Exchange Act of 1934 (15 USCS §§ 78a et seq.)*, 68 A.L.R. FED. 89 (indicating the disagreements in the federal courts regarding the formulation of the risk capital test, its application, and its applicability) [hereinafter Annotation].

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

339. *See, e.g.*, ALASKA STAT. § 45.55.990(12) (1994); GA. CODE ANN. § 10-5-2(a)(26) (1994); MICH. COMP. LAWS ANN. § 451.801(l) (West Supp. 1995); N.D. CENT. CODE § 10-04-02(13) (Supp. 1993); OKLA. STAT. ANN. tit. 71, § 2(s)(16) (West 1995); WASH. REV. CODE ANN. § 21.20.005(12) (West 1989).

340. *See, e.g.*, ILL. ADMIN. CODE tit. 14, § 130.201(d) (Mar. 26, 1990), 1A Blue Sky L. Rep. (CCH) ¶ 22,614; Op. Cal. Att'y Gen. No. 66-284 (June 2, 1967), [1961-1971 Transfer Binder] Blue Sky L. Rep. (CCH) ¶ 70,747 (applying risk capital test to sale of a franchise); Okla. Sec. Comm'n Interpretive Op., 2A Blue Sky L. Rep. (CCH) ¶ 46,641 (July 3, 1980) (applying risk capital test to a franchise agreement).

341. *See, e.g.*, GA. CODE ANN. § 10-5-2(a)(26) (1994) ("The term 'investment contract' shall include but is not limited to an investment which holds out the possibility of return on risk capital . . . ."); *Healy*, 482 P.2d at 554 ("We hold that the *Howey* test is not exclusive and that the 'risk capital' test is also to be used in determining whether a particular financial activity constitutes an offer of an 'investment contract'. . . .").

342. A number of states define the term "security" to include, among other things, an investment contract and a form of the risk capital test. *See, e.g.*, ALASKA STAT. § 45.55.990(12) (1994); MICH. COMP. LAWS ANN. § 451.801(l) (West Supp. 1995); N.D. CENT. CODE § 10-04-02(13) (Supp. 1993); OKLA. STAT. ANN. tit. 71, § 2(s)(11), (16) (West 1995); WASH. REV. CODE ANN. § 21.20.005(12) (West 1989).

343. For example, compare the forms of the risk capital test *infra* notes 352, 354, 356.

test.[344] Application of the risk capital test often leads to finding a "security" where the *Howey* test would hold that no security is present.[345]

At least one state no-action letter[346] and four state administrative decisions[347] have cited the risk capital test as possible grounds for finding that an LLC interest is a security.[348] In states that have adopted the risk capital test, the test may prove particularly important when LLC interests may not be securities under the *Howey* test.[349] In such states, the risk capital test will usually provide prosecutors and plaintiffs with an alternative theory for arguing that certain LLC interests are securities.[350]

Justice Traynor of the California Supreme Court first articulated the risk capital theory in a 1961 opinion, *Silver Hills Country Club v. Sobieski*.[351] Simply stated, the opinion indicated that a "security" is present under the California Corporation Code when investors provide "risk capital" for a business.[352] The Hawaii Supreme Court applied and modified the risk capital theory in a 1971 opinion, *State v. Hawaii Market Center, Inc.*[353] The modified test required not only a finding of risk capital, but findings that the value given was induced by an offeror's representations of a valuable benefit, and

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344. *See infra* notes 360-82 and accompanying text.

345. STEINBERG, *supra* note 135, § 2.02, at 24; *see also infra* notes 360-90 and accompanying text.

346. Exemption request—Membership interests in a limited liability company, 2A Blue Sky L. Rep. (CCH) ¶ 46,664 (Okla. Dep't of Sec.) (Aug. 28, 1992) (citing OKLA. STAT. ANN. tit. 71, § 2(s)(16) (Oklahoma's risk capital test)).

347. Georgia Express Action at 44-61, (No. 50-93-0075) (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, and finding that the LLC interests constituted securities); Illinois Express Action at *11, 1993 WL 566300 (No. 9200106) (noting Illinois Administrative Code Rule 130.201(d) provides a broad risk capital test, but analyzing the facts and holding that the LLC interests were securities under the *Howey* test as applied in Illinois); *In re* Third Mobile Ltd. of Las Vegas, No. 94-03-0018, 1996 WL 28692 (Wash. Sec. Div.) (Jan. 18, 1996) (stating that the offer and/or sale of investments in the LLC constituted the offer and/or sale of "an investment contract and/or risk capital"); *In re* Dallas MobileComm L.C., No. 94-03-0018, 1995 WL 431589 (Wash. Sec. Div.) (July 10, 1995) (stating that the offer and/or sale of investments in the LLC constituted the offer and/or sale of "an investment contract and/or risk capital").

348. The authors of the no-action letter and two administrative decisions applied the *Howey* test and its progeny to determine whether the LLC interests constituted a security. Because 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. However, by citing the risk capital test in each of these opinions, the authors are indicating that the risk capital test may be possible grounds for finding that an LLC interest is a security. *See supra* notes 346-47.

349. *See supra* notes 344-45, *infra* notes 360-90 and accompanying text.

350. *See supra* notes 341-42 and accompanying text.

351. 361 P.2d 906, 908-09 (Cal. 1961).

352. LOUIS LOSS, FUNDAMENTALS OF SECURITIES REGULATION 203 (1988). In concluding a membership interest in a country club was a "security," the California Supreme Court stated:

> Since the [California Corporation Code] does not make profit to the supplier of capital the test of what is a security, it seems all the more clear that its objective is to afford those who risk their capital at least a fair chance of realizing their objectives in legitimate ventures whether or not they expect a return on their capital in one form or another.

Silver Hills, 361 P.2d at 908-09. The court's emphasis on the investor's advance of "risk capital" caused the theory to be referred to as the "risk capital" test.

353. 485 P.2d 105, 109 (Haw. 1971).

that the investor did not receive the right to exercise practical or actual control over the managerial decisions of the enterprise.[354]

Since 1971, a number of state courts and state legislatures have adopted various versions of the risk capital test.[355] 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 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."[356]

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354. The Hawaii Supreme Court's version of the risk capital test is based on the risk capital test suggested by Professor Ronald Coffey in his seminal article, *The Economic Realities of a "Security": Is There a More Meaningful Formula?*, 18 W. RES. L. REV. 367, 377 (1967). In *Hawaii Market Center*, the Hawaii Supreme Court articulated its version of the risk capital test:

> [W]e hold that for the purposes of the Hawaii Uniform Securities Act (Modified) an investment contract is created whenever:
>
> (1) An offeree furnishes initial value to an offeror, and
>
> (2) a portion of this initial value is subjected to the risks of the enterprise, and
>
> (3) the furnishing of the initial value is induced by the offeror's promises or representations which give rise to a reasonable understanding that a valuable benefit of some kind, over and above the initial value, will accrue to the offeree as a result of the operation of the enterprise, and
>
> (4) the offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise.

Hawaii Mkt. Ctr., 485 P.2d at 109 (footnote omitted).

355. There are a number of different versions of the risk capital test. For example, compare the California test set forth *supra* note 352, the Hawaiian test set forth *supra* note 354, and the other various formulations set forth in the cases cited at *supra* note 338. For an overview of state applications of the risk capital test see 12 LONG, *supra* note 84, § 2.04[3].

356. ALASKA STAT. § 45.55.990(12) (1994); *see also* N.D. CENT. CODE § 10-04-02(13) (1995) (differs only in that it provides "expectation of profit or some other form of benefit to the investor"); OKLA. STAT. ANN. tit. 71, § 2(s)(16) (West 1995) (differs only in that it provides goods furnished "and/or" services performed); WASH. REV. CODE ANN. § 21.20.005(12) (West 1989) (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").

The Georgia and Michigan formulations of the risk capital test differ from the more common statutory version. Georgia defines the term "security" to include, among other things, an investment contract and provides further:

> The term "investment contract" shall include but is not limited to an investment which holds out the possibility of return on risk capital even though the investor's efforts are necessary to receive such return if:
>
> (A) Such return is dependant upon essential managerial or sales efforts of the issuer or its affiliates; and
>
> (B) One of the inducements to invest is the promise of promotional or sales efforts of the issuer or its affiliates in the investor's behalf; and
>
> (C) The investor shall thereby acquire the right to earn a commission or other compensation from sales of rights to sell goods, services, or other investment contracts of the issuer or its affiliates.

GA. CODE ANN. § 10-5-2(a)(26) (1994). Michigan defines the term "security" to include, among other things, an investment contract and:

> [A]ny contractual or quasi contractual arrangement pursuant to which: (1) a person furnishes capital, other than services, to an issuer; (2) a portion of that capital is subjected to the risks of the issuer's enterprise; (3) 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; (4) the person furnishing the capital does not intend to be actively involved in the management of the enterprise in a meaningful way; and (5) a promoter or its affiliates anticipate at the time the capital is fur-

In essence, the risk capital tests are a refinement and an extension of the *Howey* investment contract test. Courts adopting the risk capital tests were seeking a more flexible approach to the definition of a security.[357] They were seeking a formulation that would recognize economic reality and reach the various schemes whereby promoters go to the public to solicit capital that will be risked in a business venture.[358] They hoped to protect the public by requiring registration so that promoters would disclose to potential investors that their investment would be at risk, and by providing remedies to investors if promoters failed to comply.[359]

The risk capital tests are expressly broader in scope than the *Howey* test.[360] First, the *Howey* test literally requires an investment of money.[361] Courts have loosely construed this requirement and found it to include investments of goods, services, and probably anything that constitutes legal consideration.[362] The risk capital tests differ from the *Howey* test in that they expressly require only a contribution of something of value.[363] Some tests even explicitly state nonmonetary contributions, such as goods and services, are sufficient.[364] So, the tests differ in that the risk capital tests often contain an expressly broader statement of the type of investment sufficient to meet the requirement.[365]

Second, the *Howey* test requires a court to find a "common enterprise."[366] Courts have interpreted "common enterprise" as requiring some pooling of interests or some form of profit-sharing, referred to as horizontal commonality or vertical commonality.[367] The risk capital tests do not use the phrase "common enterprise."[368] As a result, prosecutors and plaintiffs may

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nished, that financial gain may be realized as a result thereof.
MICH. COMP. LAWS ANN. § 451.801(l) (West Supp. 1995)

357. *See, e.g.*, State *ex rel.* Healy v. Consumer Business Sys., Inc., 482 P.2d 549, 554 (Or. Ct. App. 1971).

358. *See, e.g.*, State v. Hawaii Mkt. Ctr., Inc., 485 P.2d 105, 109 (Haw. 1971); Silver Hills Country Club v. Sobieski, 361 P.2d 906, 908-09 (Cal. 1961).

359. *See, e.g.*, *Healy*, 482 P.2d at 554.

360. In SEC v. W.J. Howey Co., 328 U.S. 293 (1946), the United States Supreme 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 the promoter or a third party . . . ." *Id.* at 298-99. For an extensive discussion of each of the elements of the *Howey* test, see *supra* part III.A.1.

361. *Howey*, 328 U.S. at 298-99.

362. *See supra* notes 124-28 and accompanying text.

363. *See, e.g.*, *Hawaii Mkt. Ctr.*, 485 P.2d at 109.

364. *See, e.g.*, ALASKA STAT. § 45.55.990(12) (1994).

365. At least two commentators maintain that the investment requirement in *Howey* and the investment requirement in the risk capital tests are essentially equivalent. 12 LONG, *supra* note 84, § 2.04[3], at 2-156; SARGENT HANDBOOK, *supra* note 1, § 4.01[2], at 4-8. While the *Howey* test and the risk capital tests may prove equivalent in application, the tests differ in that the applicability of the *Howey* test to ventures where the investment is in a form other than money depends on a court's continued broad construction of the *Howey* investment of money requirement. On the other hand, the applicability of the risk capital test to such a situation is dictated by the express terms of the test.

366. *Howey*, 328 U.S. at 298-99.

367. For a discussion of the *Howey* common enterprise requirement, see *supra* notes 134-40 and accompanying text.

368. *See, e.g.*, ALASKA STAT. § 45.55.990(12) (1994); *Hawaii Mkt. Ctr.*, 485 P.2d at 109.

argue there is no pooling of interest requirement or profit-sharing requirement.[369] So, the risk capital tests are broader than the *Howey* test in that a court may find an interest is a security even if there is no horizontal or vertical commonality, as long as the investor has transferred value to the seller.[370]

Third, the *Howey* test provides that the investor must expect "profits" from the investment.[371] The United States Supreme Court has interpreted this requirement as meaning the investor must be motivated to invest by an anticipated return on investment through either capital appreciation or earnings, not by a desire to use or consume the item purchased.[372] The risk capital tests are more liberal. They represent a departure from *Howey* in that they generally require only that investors be motivated by the expectation of a benefit.[373] The benefit can be monetary or nonmonetary, tangible or intangible.[374] The investor can even use or consume the anticipated benefit. For example, courts and state regulators have found club memberships, hotel reservations, and condominium time-share agreements to involve the sale of a security under risk capital tests.[375] The broader benefit concept means the risk capital tests apply to transactions that the *Howey* test may not cover due to the *Howey* test's more restrictive "profits" requirement.

Finally, the *Howey* test literally requires the investor to expect profits "solely from the efforts of the promoter or a third party."[376] Lower federal courts have rejected a literal interpretation of the word "solely" and simply require proof that the efforts made by those other than the investors are the undeniably significant efforts.[377] The risk capital tests, on the other hand, expressly adopt the more liberal version of the efforts of others requirement. The

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369. Most commentators agree that under the risk capital tests there is no horizontal commonality requirement, and thus no requirement that multiple investors pool their interests. *See, e.g.*, THOMAS L. HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 1.5, at 42 (2d ed. 1990); SARGENT HANDBOOK, *supra* note 1, § 4.01[2], at 4-9; STEINBERG, *supra* note 135, § 2.02, at 24. Several commentators have also observed that there is no vertical commonality requirement, and therefore, no requirement that the promoter and investor share the profits or losses of the enterprise. HAZEN, *supra*; *see also* William J. Carney & Barbara G. Fraser, *Defining a "Security": Georgia's Struggle with the "Risk Capital" Test*, 30 EMORY L.J. 73, 111-13 (1981). *But see*, 12 LONG, *supra* note 84, § 2.04[3], at 2-156 (asserting that the concept of "risk capital of an enterprise" should be treated the same as the concept of the common enterprise in the *Howey* test).

370. Carney & Fraser, *supra* note 369, at 113.

371. *Howey*, 328 U.S. at 298-99.

372. United Hous. Found., Inc. v. Forman, 421 U.S. 837, 852-58 (1975). For a discussion of the *Howey* expectation of profits requirement, see *supra* notes 145-51 and accompanying text.

373. *See, e.g.*, MICH. COMP. LAWS ANN. § 451.801(l) (West. Supp. 1995) ("a reasonable understanding that a valuable tangible benefit will accrue"); OKLA. STAT. ANN. tit. 71, § 2(s)(16) (West 1995) ("with the expectation of some benefit to the investor"); *Hawaii Mkt. Ctr.*, 485 P.2d at 109 ("a reasonable understanding that a valuable benefit of some kind, over and above the initial value, will accrue").

374. 12 LONG, *supra* note 84, § 2.04[3][a], at 2-156 to 2-157.

375. *Id.* at 2-157; *see, e.g.*, Silver Hills Country Club v. Sobieski, 361 P.2d 906, 908-09 (Cal. 1961) (memberships in country clubs); *In re* Alaska v. Vacation Int'l, Ltd., [1971-1978 Transfer Binder] Blue Sky L. Rep. (CCH) ¶ 71,294 (Alaska Sec. Div. 1976) (condominium time-share units); *see also* Nev. Op. Att'y Gen. No. 186 (Mar. 18, 1975), [1971-1978 Transfer Binder] Blue Sky L. Rep. (CCH) ¶ 71,200 (prepaid hotel accommodations).

376. *Howey*, 328 U.S. at 298-99.

377. *See, e.g.*, SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973). For a discussion of the *Howey* test's solely from the efforts of others requirement, see *supra* notes 158-63 and accompanying text.

risk capital tests do not utilize the qualifier "solely." They require that the investor either have no direct control or that the investor have no right to exercise practical or actual control.[378] Again, the risk capital tests are expressly broader than the *Howey* test and eliminate the need for courts to interpret the *Howey* "solely" from efforts of others requirement. The risk capital tests make it clear that the key to finding a security is the amount of practical or actual control the investor has over the managerial decisions of the venture.

To summarize, the risk capital tests generally are considered more expansive than the *Howey* investment contract test because: (1) nonmonetary investments are expressly recognized as sufficient;[379] (2) the "common enterprise" requirement is eliminated;[380] (3) the expectation of "profits" is not required, only the expectation of a benefit;[381] and (4) the efforts of others standard is expressly relaxed.[382]

Given that certain LLC interests can clearly qualify as securities under the *Howey* test,[383] there is an even greater probability that a court would characterize an LLC interest as a security under the risk capital theory. Investments in an LLC typically meet the first three elements of the risk capital tests. Under the risk capital tests, an investor must risk money, property, or services in a venture with the expectation of some benefit.[384] An investment in an LLC normally involves contributing money, property, or services,[385] and it is unlikely an investment in an LLC venture would be risk free. As one commentator noted, LLC investments usually are not collateralized, nor do promoters generally provide fixed rates of return, a guarantee, or priority over creditors.[386] Also, in most situations, an investor contributes to an LLC expecting some form of benefit in return.[387] Like the *Howey* test, the key issue often will be whether the investor exercises practical or actual control over the managerial decisions of the enterprise.[388] However, given the risk capital theory's focus on economic reality and investor protection,[389] courts are likely to construe the control element more liberally under the risk capital tests than under *Howey*. Due to its broader application and the more liberal con-

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378. *See, e.g.*, MICH. COMP. LAWS ANN. § 451.801(l) (West Supp. 1995) ("the person furnishing the capital does not intend to be actively involved in the management of the enterprise in a meaningful way"); N.D. CENT. CODE § 10-04-02(13) (1995) ("the investor has no direct control over the investment or policy decisions of the venture"); *Hawaii Mkt. Ctr.*, 485 P.2d at 109 ("the offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise").

379. *See supra* notes 361-65 and accompanying text.

380. *See supra* notes 366-70 and accompanying text.

381. *See supra* notes 371-75 and accompanying text.

382. *See supra* notes 376-78 and accompanying text.

383. *See supra* part III.A.1.

384. *See* STEINBERG, *supra* note 135, at 257; *see also* ALASKA STAT. § 45.55.990(12) (1994); *Hawaii Mkt. Ctr.*, 485 P.2d at 109.

385. *See supra* notes 129-33 and accompanying text.

386. SARGENT HANDBOOK, *supra* note 1, § 4.02[2], at 4-14.

387. *See supra* notes 152-57 and accompanying text.

388. *See* SARGENT HANDBOOK, *supra* note 1, § 4.02[2], at 4-14; *see also* ALASKA STAT. § 45.55.990(12) (1994); *Hawaii Mkt. Ctr.*, 485 P.2d at 109.

389. *See supra* notes 357-59 and accompanying text.

struction, there is an even better chance that courts will characterize LLC interests as securities under the risk capital theory.[390]

2. Possible Defenses

Some commentators contend that the risk capital test is not substantially different than the *Howey* test.[391] First, some commentators argue the investment element under the risk capital tests is basically equivalent to courts' liberal construction of the *Howey* investment of money requirement.[392] Second, although the risk capital tests do not use the phrase "common enterprise," the investment must be risked in some sort of venture.[393] At least one commentator has argued that the venture or enterprise requirement under the risk capital tests is essentially the same as the *Howey* common enterprise requirement.[394] Third, even though the expectation of a benefit element under the risk capital tests is broader than the expectation of profits element under *Howey*,[395] the benefits element only impacts the few extraordinary situations where investors do not expect profits in the narrow sense.[396] Finally, to the extent the risk capital tests require that the investor have no direct control over the investment or policy decisions of the venture,[397] some commentators claim the risk capital tests are simply adopting the liberal construction of the case law interpreting the phrase "efforts of others" that has developed under *Howey*.[398] Consequently, application of the broader risk capital tests might affect a few marginal cases, but essentially the issues and the analysis are the same.[399] Therefore, there should be no greater chance of LLC interests being characterized as securities in risk capital jurisdictions than under the *Howey* test.[400]

Very few jurisdictions have adopted the risk capital test to determine the existence of a security.[401] Critics of the risk capital test charge that the test is plagued by limited acceptance, lack of uniformity in its application, and uncertainty about its meaning.[402] For example, the exact meaning of the key term "risk capital" still remains unclear.[403] Does the risk capital test apply when-

390. *See* STEINBERG, *supra* note 135, § 2.02, at 24.

391. *See, e.g.*, SARGENT HANDBOOK, *supra* note 1, § 4.01[2], at 4-8.

392. *Id.*; *see also* 12 LONG, *supra* note 84, § 2.04[3], at 2-156.

393. *See, e.g.*, OKLA. STAT. ANN. tit. 71, § 2(s)(16) (West 1995) ("investment . . . in the risk capital of a venture"); *Hawaii Mkt. Ctr.*, 485 P.2d at 109 ("a portion of this initial value is subjected to the risks of the enterprise").

394. 12 LONG, *supra* note 84, § 2.04[3], at 2-156 ("The concept of an enterprise under the risk capital test will be essentially the same as the concept of common enterprise as outlined under the *Howey* test.").

395. *See supra* notes 371-75 and accompanying text.

396. SARGENT HANDBOOK, *supra* note 1, § 4.01[2], at 4-9.

397. *See, e.g.*, N.D. CENT. CODE § 10-04-02(13) (1995); *Hawaii Mkt. Ctr.*, 485 P.2d at 109.

398. 12 LONG, *supra* note 84, § 2.04[4], at 2-166; SARGENT HANDBOOK, *supra* note 1, § 4.01[2], at 4-8.

399. SARGENT HANDBOOK, *supra* note 1, § 4.02[2], at 4-14.

400. *Id.*

401. See *supra* notes 338-40 and accompanying text indicating adoption of the risk capital test in only eleven states. Also, the risk capital test generally is not adopted by the federal courts. *See supra* note 337.

402. *See, e.g.*, SARGENT HANDBOOK, *supra* note 1, § 4.01[2], at 4-7 to 4-8.

403. 12 LONG, *supra* note 84, § 2.04[3], at 2-155 to 2-156; SARGENT HANDBOOK, *supra* note

ever a person invests capital with less than a fair chance of receiving a return or does the test only apply when capital is invested in a highly risky or unstable venture?[404] Does the test only apply when a venture is seeking its initial capitalization[405] or does the test apply when an on-going concern is seeking additional capital?[406] Decisions are split on the answers to these questions.[407] There is no universal understanding as to the tests' application. LLC promoters therefore may argue that given the ambiguity created by the risk capital tests, the relative lack of case law, and the fact that the tests are merely a refinement of the *Howey* test, courts should be guided by the *Howey* line of cases. Specifically, courts should draw on the *Howey* general partnership cases to interpret the control element and adopt a strong presumption against characterizing LLC interests as securities.[408] LLC promoters may contend that courts have no basis for adopting a more liberal interpretation of the control element under the risk capital tests than under the *Howey* test.[409] Further, on theoretical grounds, a strong presumption that LLC interests are not securities would provide a clear and predictable rule, reduce litigation, and decrease associated legal compliance costs.[410]

3. Conclusions

Clearly, certain LLC interests may be securities under a risk capital analysis.[411] In states that have adopted risk capital tests,[412] the tests will usually provide prosecutors and plaintiffs with an alternative theory for arguing certain LLC interests are securities.[413] While the risk capital tests focus

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1, § 4.01[2], at 4-9; Louis C. Novak & Howard Rosten, Note, *Franchise Regulation Under the California Corporate Securities Law*, 5 SAN DIEGO L. REV. 140, 152-55 (1968).

404. Novak & Rosten, *supra* note 403, at 152-55. *Compare* Silver Hills Country Club v. Sobieski, 361 P.2d 906, 908-09 (Cal. 1961) (stating that the objective of the risk capital test is "to afford those who risk their capital at least a fair chance of realizing their objectives") *with* Mr. Steak, Inc. v. River City Steak, Inc., 324 F. Supp. 640, 647 (D. Colo. 1970) (arguing that the better view is to limit the applicability of the risk capital test to exceptionally high risk, speculative ventures), *aff'd*, 460 F.2d 666 (10th Cir. 1972). For other cases interpreting the risk requirement, see Annotation, *supra* note 337, § 3[a].

405. *See, e.g.*, State *ex rel.* Healy v. Consumer Business Sys., Inc., 482 P.2d 549, 555 (Or. Ct. App. 1971) ("Under the 'risk capital' test we are concerned with whether the franchisor is dependent upon the franchisees' capital to initiate his operations, not just manufacture his product.").

406. *See, e.g.*, State *ex rel.* Park v. Glenn Turner Enters., Inc., [1971-1978 Transfer Binder] Blue Sky L. Rep. (CCH) ¶ 71,023 (Idaho Dist. 1972).

407. *See supra* notes 404-06 and accompanying text.

408. For a discussion of the *Howey* line of cases dealing with general partnership interests and related presumptions see *supra* notes 240-54 and accompanying text.

409. LLC promoters may argue that the language in some risk capital tests is even more restrictive than the more liberal control test adopted by most courts under *Howey*. *Compare* WASH. REV. CODE ANN. § 21.20.005(12) (West 1989) (stating that "the investor does not receive the right to exercise practical or actual control over the managerial decisions of the venture") *with* SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 476, 482 (9th Cir.) (requiring 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"), *cert. denied*, 414 U.S. 821 (1973).

410. For a discussion of the arguments that on theoretical grounds there should be a strong presumption that LLC interests are not securities, see *supra* notes 264-71 and accompanying text.

411. *See supra* notes 384-88 and accompanying text.

412. *See supra* notes 338-40 and accompanying text.

413. *See supra* notes 341-42 and accompanying text.

on some of the same criteria as the *Howey* test, they are explicitly broader in scope.[414] The risk capital tests expressly apply to transactions that the *Howey* test does not reach.[415] The risk capital tests also eliminate the need for liberal judicial construction, which is often required to find that a security is present under the *Howey* test.[416] As a result, application of the risk capital tests may lead to finding an LLC interest is a security, where the *Howey* test would hold no security is present.

In most cases, an investment in an LLC will satisfy the first three elements of the risk capital tests.[417] Most LLC investors risk money, property, or services in an LLC venture, expecting a benefit in return. Like *Howey*, the critical issue will be whether the investor exercises practical or actual control over the managerial decisions of the enterprise.[418] Since there is lack of uniformity and some ambiguity in applying the risk capital tests,[419] courts have the opportunity to refine and develop the definition of a security under these tests. In applying the risk capital tests to LLCs, courts are not required to follow the general partnership case law that evolved under *Howey* nor adopt the associated presumptions. Courts are free to construe the risk capital tests liberally and adopt flexible constructions designed to protect investors against fraud and clever new schemes devised by promoters to evade the securities laws.

C. *Characteristics of Stock Test*

1. Arguments Asserted

Commentators[420] and at least two state securities commissions[421] have asserted that certain LLC interests may be securities under the characteristics of stock test set forth in *Landreth Timber Co. v. Landreth*.[422] In *Landreth*, the United States Supreme Court held that if an instrument bears the label

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414. *See supra* notes 360-82 and accompanying text.
415. *See supra* notes 361-82 and accompanying text.
416. *See supra* notes 362-65, 371-78 and accompanying text.
417. *See supra* notes 384-87 and accompanying text.
418. *See supra* notes 388, 397-98 and accompanying text.
419. *See supra* notes 402-07 and accompanying text.
420. Steinberg Article, *supra* note 7, at 1116; *see also* Peralta, *supra* note 7, at 36-40.
421. Limited liability company interests as securities, 2A Blue Sky L. Rep. (CCH) ¶ 54,521 (Tenn. Mar. 7, 1995) (stating that if an LLC interest possesses the characteristics of stock set forth in *Landreth*, it is the Tennessee Division of Securities' position that the interest is a security) [hereinafter Tennessee Statement of Policy]; *see* Georgia Express Action at 46, (No. 50-93-0075) (stating that 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 interpretive 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. 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. Comm'r) (Apr. 25, 1994). The Maryland Securities Division stated that 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. *Id.*
422. 471 U.S. 681 (1985). The SEC did not raise this argument in *Vision Communications*, *Parkersburg*, or *Knoxville*.

"stock" and possesses all the characteristics typically associated with stock, the securities laws apply.[423] The Court did note, however, that the instrument's label is not determinative.[424] The key inquiry is whether the instrument bears the attributes usually associated with stock, meaning: (i) the right to receive dividends upon an 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.[425]

Professor Marc Steinberg maintains that LLC interests ordinarily possess the five attributes commonly associated with stock.[426] First, since LLC statutes generally provide for the distribution of profits to members based on capital contribution,[427] owners of an LLC often have the right to receive dividends upon the apportionment of profits. Second, LLC statutes allow members to transfer or assign their LLC interests, therefore LLC interests are negotiable.[428] Third, an LLC interest is personal property and as such may be pledged.[429] Fourth, most LLC statutes vest management in the members, unless the LLC operating documents provide otherwise.[430] Voting rights are usually determined in proportion to the member's capital contribution, so members have voting rights.[431] Fifth, LLC interests may increase in value.[432] Professor Steinberg and other commentators have argued that because "companies" issue LLC interests and companies typically issue stock to evidence an equity interest, investors expect such interests to be governed by the securities laws.[433] They assert substance should prevail over form and labels.[434] If LLC interests possess the five attributes usually associated with stock, such interests should be deemed securities.[435]

At least one state securities commission has taken the position that 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

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423. *Landreth*, 471 U.S. at 686; *see also* Gould v. Ruefenacht, 471 U.S. 701, 704 (1985) (applying the standard from *Landreth*).

424. *Landreth*, 471 U.S. at 686; *see also* United Hous. Found., Inc. v. Forman, 421 U.S. 837, 848-51 (1975) (stating that the emphasis should be on "economic reality").

425. *Landreth*, 471 U.S. at 686; *see also Gould*, 471 U.S. at 704; *Forman*, 421 U.S. at 851.

426. Steinberg Article, *supra* note 7, at 1119; *see also* Peralta, *supra* note 7, at 37-39.

427. Steinberg Article, *supra* note 7, at 1116-17; *see also* 1 RIBSTEIN & KEATINGE, *supra* note 1, § 5.02, at 5-2 (stating that financial rights in LLCs are generally based on members' capital contributions).

428. Steinberg Article, *supra* note 7, at 1117-19; *see also* 1 RIBSTEIN & KEATINGE, *supra* note 1, § 7.04, at 7-4 (stating that LLC statutes provide for transfer and assignment of membership interests).

429. Steinberg Article, *supra* note 7, at 1119; *see also* Donn, *supra* note 1, § 12, at PGLLC-40 (stating that the general rule in all the state LLC acts is that an LLC interest is personal property).

430. Steinberg Article, *supra* note 7, at 1117; *see also* Donn, *supra* note 1, § 10, at PGLLC-36 (stating that generally management is vested in the members).

431. Steinberg Article, *supra* note 7, at 1117; *see also* 1 RIBSTEIN & KEATINGE, *supra* note 1, § 8.03, at 8-8.

432. Steinberg Article, *supra* note 7, at 1119.

433. Steinberg Article, *supra* note 7, at 1116; *see also* Peralta, *supra* note 7, at 31-33, 36-40 (on their face LLCs appear to be nothing more than traditional corporations with a different set of descriptive terms).

434. Steinberg Article, *supra* note 7, at 1116; *see also* Peralta, *supra* note 7, at 31-33, 36-40.

435. Steinberg Article, *supra* note 7, at 1116; *see also* Peralta, *supra* note 7, at 31-33, 36-40.

that it believes LLC interests should be analyzed under *Landreth*.[436] The Division takes the position that if an LLC interest possesses the five attributes usually associated with stock, the LLC interests could be labeled "stock" which is a security under Tennessee law.[437] If an LLC interest possesses the five attributes usually associated with stock, prosecutors and plaintiffs may argue, citing *Landreth* and the authorities and arguments outlined above, such LLC interests should be deemed securities.

2. Possible Defenses

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.[438] "Stock" is one of the many financial instruments listed expressly in the statutory definitions of a "security."[439] Commentators argue that each statutory term is susceptible to separate analysis, based on separate analytical concepts.[440] In *Landreth*, the United States Supreme Court made it clear that stock may be viewed as being in a category by itself for purposes of interpreting the scope of the definition of a security.[441]

In *Landreth*, as in the other United States Supreme Court decisions dealing with the characteristics of stock test, the interest the Court considered was labeled "stock."[442] LLCs do not issue "stock,"[443] and LLC statutes do not refer to LLC interests as "stock."[444] Also, commentators and others do not refer to LLC interests as "stock."[445] The issue therefore becomes whether an instrument not labeled "stock" could constitute a security under the separate test the Court devised for "stock."[446] LLC issuers may argue that *Landreth* and the related cases apply only to instruments that are labeled "stock." Nowhere, in either *Landreth* or the other United States Supreme Court decisions, did the Court indicate that any instrument that possessed the characteristics of stock constituted a security.[447]

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436. Tennessee Statement of Policy, *supra* note 421.

437. *Id.*

438. Interpretive Opinion Orchards Drug, L.C., 1991 WL 101804, at *3 (Kan. Sec. Comm'r) (May 1, 1991); Georgia Express Action at 46, (No. 50-93-0075).

439. *See* Securities Act of 1933 § 2(l), 15 U.S.C. § 77b(1) (1994); Securities Exchange Act of 1934 § 3(a)(10), 15 U.S.C. § 78c(a)(10) (1994); UNIF. SEC. ACT § 401(l) (1958), 7B U.L.A. 580-81 (1985); UNIF. SEC. ACT § 101(16) (1988), 7B U.L.A. 94 (Supp. 1995).

440. 2 LOSS & SELIGMAN, *supra* note 99, at 871.

441. Landreth Timber Co. v. Landreth, 471 U.S. 681, 694 (1985).

442. *See id.* at 683; Gould v. Ruefenacht, 471 U.S. 701, 702 (1985); United Hous. Found., Inc. v. Forman, 421 U.S. 837, 848 (1975).

443. Sargent Article, *supra* note 7, at 1095; Steinberg Article, *supra* note 7, at 1116.

444. *See, e.g.*, Donn, *supra* note 1, § 1, at PGLLC-6 to -7; *see generally* state limited liability company statutes, *supra* note 4.

445. *See generally supra* note 1 (commentaries on limited liability companies).

446. *See* Interpretive Opinion Orchards Drug L.C., 1991 WL 101804, at *3 (Kan. Sec. Comm'r) (May 1, 1991); *see also* Peralta, *supra* note 7, at 36.

447. Ribstein, *supra* note 7, at 832-33; *see, e.g.*, Gould v. Ruefenacht, 471 U.S. 701 (1985); Landreth Timber Co. v. Landreth, 471 U.S. 681 (1985); United Hous. Found., Inc. v. Forman, 421 U.S. 837, 848 (1975). *But see* Peralta, *supra* note 7, at 36-37 (citing United States Supreme Court authority and arguing that for an investment to constitute a security as "stock," the word "stock" itself need not be used).

Professor Steinberg maintains that the characteristics of stock test should be applied to LLC interests because "companies" issue such interests and investors expect such interests to be governed by the securities law.[448] Critics assert that the statutory definition of a security does not contain the term "company."[449] Further, entities that might be thought of by investors as "companies" issue most, if not all, financial instruments. The logical extension of Professor Steinberg's theory would result in applying the characteristics of stock test to all instruments issued by "companies." Applying the characteristics of stock test to all instruments in the statutory definition of a "security" that are issued by companies would make the definition's enumeration of the various types of instruments superfluous.[450] The Supreme Court has also made it clear that there is no universal or generic test for what constitutes a security.[451] Nevertheless, taking Professor Steinberg's argument to its logical conclusion would result in a generic test applied to all interests issued by "companies."

Furthermore, many business people use the term "company" loosely to refer to partnerships and other joint ventures.[452] If the characteristics of stock test were applied to all such ventures, including general partnerships, most or at least many of the elements of the characteristics of stock test would be met.[453] Such a result is not consistent with prior precedent holding that certain general partnership and joint venture interests are not securities.[454] Some commentators charge that investors do not expect LLC interests to be "stock" merely because limited liability companies have the term "company" in their title,[455] thus allowing LLC issuers to argue that investors do not necessarily expect LLC interests to be covered by the securities laws.[456]

Professor Larry Ribstein asserts that, even if the *Landreth* test applies, LLC interests do not meet the characteristics of stock test.[457] Professor

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448. Steinberg Article, *supra* note 7, at 1116.

449. 1 RIBSTEIN & KEATINGE, *supra* note 1, § 14.02, at 14-5; *see also supra* notes 98-99 (statutory definitions of a security).

450. *Cf. Landreth*, 471 U.S. at 692 (applying the *Howey* investment contract test to all instruments would make the statutory enumeration superfluous).

451. 2 LOSS & SELIGMAN, *supra* note 99, at 871 & n.5; *see also Landreth*, 471 U.S. at 691-92.

452. *See, e.g.*, Ribstein, *supra* note 7, at 833.

453. *See* Interpretive Opinion Orchards Drug L.C., 1991 WL 101804, at *3 (Kan. Sec. Comm'r) (May 1, 1991).

454. Generally, courts do not treat a general partnership interest as a security, unless the general partner is expected to be a passive investor who will not participate in the management of the business. Schneider, *supra* note 134, at 138; *see, e.g.*, Banghart v. Hollywood Gen. Partnership, 902 F.2d 805, 807-08 (10th Cir. 1990); Goodwin v. Elkins & Co., 730 F.2d 99, 102-03 (3d Cir.), *cert. denied*, 469 U.S. 831 (1984); Williamson v. Tucker, 645 F.2d 404, 424-25 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981). Joint ventures are subject to the same analysis as partnership interests. 2 LOSS & SELIGMAN, *supra* note 99, at 956 n.200 (citing numerous authorities). The United States Supreme Court has not considered whether interests in general partnerships or joint ventures constitute securities.

455. Ribstein, *supra* note 7, at 833.

456. *See id.*; *see also* Georgia Express Action at 46, (No. 50-93-0075) (LLC interests do not appear on their face to be what is commonly known as traditional "stock"); *infra* discussion part III.D (explaining arguments and defenses regarding instruments commonly known as securities).

457. Ribstein, *supra* note 7, at 833; *see also* Goforth, *supra* note 7, at 1242-47 (arguing LLC interests are no more akin to stock than general partnership interests, which have not been found

Ribstein maintains that LLC statutes do not generally provide for dividend rights, they invariably restrict transferability of management rights, and they allow allocation of voting rights per capita rather than pro rata.[458] Based on the arguments and authorities discussed in this section, LLC issuers have a strong argument that LLC interests should not be deemed securities under the *Landreth* characteristics of stock test.

3. Conclusions

Professor Steinberg's argument that LLC interests should be analyzed as stock because companies issue the interests[459] is a novel approach. Nevertheless, there appears to be no authority to support the application of the characteristics of stock test to instruments other than those labeled "stock."[460] The argument is also at odds with the Supreme Court's statement that stock should be viewed as being in a category by itself.[461] Moreover, the logical extension of this argument would lead to results inconsistent with prior precedent.[462]

Commentators have criticized the characteristics of stock test on theoretical grounds. Commentators argue the formalistic five-factor *Landreth* test elevates form over substance,[463] therefore conflicting with many United States Supreme Court decisions stating that form should be disregarded for substance and emphasis placed upon economic reality.[464] *Landreth* is viewed as an anomaly. Some argue that *Landreth's* precedential value is limited since it represents a situation where the Court ignored traditional considerations because it was unwilling to rule that common stock was not a security.[465] In light of such criticism, there is little reason to broaden the test's application beyond its narrow purpose to determine whether stock is a security.

From a practical standpoint, if a court applies the characteristics of stock test to determine whether an LLC interest is a security, the determination would depend on whether the LLC interest satisfies the *Landreth* five-factor test. Professor Steinberg maintains that LLC interests ordinarily satisfy the test.[466] Professor Ribstein, on the other hand, asserts that LLC interests normally do not meet the test.[467] Given that LLC statutes provide members the flexibility to tailor the characteristics of the entity,[468] application of the

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to possess the characteristics of stock).

458. Ribstein, *supra* note 7, at 833; *see also* Goforth, *supra* note 7, at 1242-47.

459. *See supra* notes 433-35 and accompanying text.

460. *See supra* note 447 and accompanying text.

461. *See supra* note 441 and accompanying text.

462. *See supra* notes 450-54 and accompanying text.

463. *See, e.g.*, Lewis D. Lowenfels & Alan R. Bromberg, *What Is a Security Under the Federal Securities Laws?*, 56 ALB. L. REV. 473, 559 (1993).

464. *Id.*; *see, e.g.*, International Bhd. of Teamsters v. Daniel, 439 U.S. 551, 558 (1979); United Hous. Found., Inc. v. Forman, 421 U.S. 837, 851-52 (1975); Tcherepnin v. Knight, 389 U.S. 332, 336 (1967).

465. *See, e.g.*, Lowenfels & Bromberg, *supra* note 463, at 559-60.

466. *See supra* notes 426-32 and accompanying text.

467. *See supra* notes 457-58 and accompanying text.

468. Sargent Article, *supra* note 7, at 1073-77. For example, LLC distribution provisions, transfer restrictions, and voting rights allocations may vary depending upon the state of formation or the provisions in the articles of organization or the operating agreement. *See* 1 RIBSTEIN &

Landreth test to LLC interests would result in a case-by-case analysis. A court would need to review an LLC's operating agreement and articles of organization to determine whether the LLC interest satisfies the test.[469]

Not only would use of the characteristics of stock test lead to litigation, but more importantly, it would result in carefully drafted LLC documents designed to escape the reach of the securities laws by insuring that one of the elements in the five-factor test is not met. Application of the *Landreth* test to LLCs would create an environment where formalistic devices could become determinative due to the way the test is structured. Moreover, if an LLC interest did not satisfy the elements of the *Landreth* test, nothing would preclude a court from applying the investment contract test.[470] As such, application of the *Landreth* test to LLC interests does not appear to be a satisfactory solution from either a theoretical or practical standpoint.

D. *Commonly Known as a Security*

1. Arguments Asserted

The federal securities acts and most state securities acts define the term "security" to include any "instrument commonly known as a 'security.'"[471] At least one commentator has argued that an interest in an LLC constitutes an interest or instrument "commonly known as a 'security.'"[472] The phrase "commonly known as a 'security'" has not generated much litigation[473] and neither the United States Supreme Court nor other federal courts have provided much guidance on how to interpret the phrase.[474] Professor Marc

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KEATINGE, *supra* note 1, § 6.02, at 6-2 (distribution provisions may be customized), § 7.04, at 7-4 to 7-5 (some LLC statutes permit variation of transferability restrictions by contrary provisions in the articles of organization or operating agreement), and § 8.03, at 8-8 (most states allocate voting rights according to capital contribution, but several states allocate voting rights per capita).

469. *See* Steinberg Article, *supra* note 7, at 1119.

470. *See* United Hous. Found., Inc. v. Forman, 421 U.S. 837, 851-58 (1975) (concluding that the interest did not satisfy the characteristics of stock test, the Court then considered whether the interest constituted an investment contract).

471. Securities Act of 1933 § 2(l), 15 U.S.C. § 77b(1) (1994); Securities Exchange Act of 1934 § 3(a)(10), 15 U.S.C. § 78c(a)(10) (1994); UNIF. SEC. ACT § 401(l) (1958), 7B U.L.A. 580-81 (1985); UNIF. SEC. ACT § 101(16) (1988), 7B U.L.A. 94 (Supp. 1995). 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. However, this distinction appears to have little practical effect due to the expansiveness of other terms in the Exchange Act. ARNOLD S. JACOBS, 5B LITIGATION AND PRACTICE UNDER RULE 10b-5, § 38.03[a][i], at 2-155 to 2-156 (1994).

472. Steinberg Article, *supra* note 7, at 1120-22 (arguing that one can classify an LLC interest as "any interest or instrument commonly known as a security"). The SEC did not make this argument in its complaints or memorandums to the court in *Vision Communications, Parkersburg*, or *Knoxville*. The triers of fact in the state actions summarized and cited *infra* Table I did not expressly address this argument either.

473. 2 LOSS & SELIGMAN, *supra* note 99, at 209 (Supp. 1994); Geu, Part Two, *supra* note 1, at 514.

474. *See* Tcherepnin v. Knight, 389 U.S. 332, 343-44 (1967) (criticizing court of appeal's conclusion that withdrawable capital shares were not an instrument commonly known as a security); 5B JACOBS, *supra* note 471, § 38.03[q] (discussing how to determine whether an instrument is "commonly known" as a security)

Steinberg suggests[475] 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*.[476]

a. *Public's Expectations*

Alluding to the phrase any instrument "commonly known as a 'security,'" the United States Supreme Court stated, "Congress intended the securities laws to cover those instruments ordinarily and commonly considered to be securities in the commercial world . . . ."[477] In *Forman*,[478] *Landreth*,[479] and *Reves*,[480] the Court indicated the investing public's expectations or perceptions are relevant in determining whether an instrument is a security.[481] Commentators argue that an investor purchasing an LLC interest would reasonably expect the transaction to be governed by the securities laws.[482] Investors are purchasing an equity interest in a "company" and such transactions are typically subject to the securities laws.[483] Additionally, LLC interests generally possess the characteristics associated with securities such as stock.[484] Thus, a reasonable investor would be justified in assuming the securities laws apply,[485] especially since nothing indicates that the securities laws do not apply. Courts, therefore, should deem an LLC interest to be an interest "commonly known as a 'security,'" considering the public's expectation.[486]

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475. *See* Steinberg Article, *supra* note 7, at 1120-22.

476. 494 U.S. 56 (1990).

477. Marine Bank v. Weaver, 455 U.S. 551, 559 (1982).

478. United Hous. Found., Inc. v. Forman, 421 U.S. 837 (1975). In *Forman*, there is dicta stating that the name given to an instrument might reasonably lead an investor to believe the federal securities laws apply. The Court noted that the use of traditional names such as "stocks" or "bonds" will lead the purchaser to justifiably assume the securities laws apply. *Id.* at 850. But, the Court held that although the instrument was called "stock," it had none of the characteristics of stock. The purchaser, therefore, could have no reasonable expectation that his transaction was covered by the securities law. *Id.* at 851.

479. Landreth Timber Co. v. Landreth, 471 U.S. 681 (1985). In *Landreth*, the Court held that because the instrument was called "stock" and bore the usual characteristics of stock, the purchaser was justified in assuming the federal securities laws governed the purchase. *Id.* at 687. The Court, relying on public expectations, held common stock is a security. *Id.* at 687, 694.

480. Reves v. Ernst & Young, 494 U.S. 56 (1990). In *Reves*, the Court stated that in deciding whether a transaction involves a "security" it will examine the "reasonable expectations of the investing public." *Id.* at 66. The Court said it "will consider instruments to be 'securities' on the basis of such public expectations." *Id.*

481. *See* Lowenfels & Bromberg, *supra* note 463, at 555-57; Steinberg Article, *supra* note 7, at 1120; *supra* notes 478-80.

482. Steinberg Article, *supra* note 7, at 1116, 1120; *see* Peralta, *supra* note 7, at 31.

483. Steinberg Article, *supra* note 7, at 1116, 1120; *see also* Peralta, *supra* note 7, at 31-33, 36-40; *supra* note 433 and accompanying text.

484. Steinberg Article, *supra* note 7, at 1116-19; *see also* Peralta, *supra* note 7, at 31-33, 36-40; *supra* notes 426-32 and accompanying text.

485. Steinberg Article, *supra* note 7, at 1116, 1120; *see* Peralta, *supra* note 7, at 31-33.

486. *Cf.* Reves v. Ernst & Young, 494 U.S. 56, 66-67 (1990).

b. *Family Resemblance Test*

One can also argue an LLC interest is a security under the family resemblance test set forth in *Reves*.[487] In *Reves*, the United States Supreme Court analyzed when a "note" is a security.[488] The Court stated that in deciding whether a transaction involves a security, the Court 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.[489] The Court uses these four factors to identify those instruments that bear a strong "family resemblance" to items previously identified as securities.[490] If, based on these factors, an LLC interest bears a strong "family resemblance" to other items previously identified as securities, at least one commentator has argued courts should deem such LLC interests securities.

In discussing the first factor, motivations, the Court stated that if the seller's purpose is to raise money for general business operations or to finance a substantial investment and if the buyer is interested primarily in profit, the instrument is likely to be a security.[491] Often LLC interests are sold to raise seed capital for a venture. Also, LLC investors ordinarily expect a return on their investment from capital appreciation, earnings, or tax benefits.[492] Applying this analysis, the sale of an LLC interest is likely to meet the first test.

With respect to the second factor, plan of distribution, the Court stated that if there is common trading for speculation or investment, the instrument is more likely to be a security.[493] Based on the Court's application of this factor in *Reves*, the test apparently is satisfied if the instrument is offered to the general public, even if no secondary trading market exists.[494] As a result, if an LLC interest is offered to the general public, even if there were few offerees or purchasers, this element apparently is satisfied.[495]

The Court noted in discussing the third factor, public expectations, that it will consider instruments to be securities based on the reasonable expectations or perceptions of the investing public.[496] As discussed previously, investors may be justified in expecting the securities laws to apply to the purchase and sale of LLC interests.[497] Therefore, the public expectation requirement may be met.

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487. *Id.* at 65-67. For additional commentary on *Reves*, see James D. Gordon III, *Interplanetary Intelligence About Promissory Notes as Securities*, 69 TEX. L. REV. 383 (1990); Janet Kerr & Karen M. Eisenhauser, 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).

488. *Reves*, 494 U.S. at 60-73.

489. *Id.* at 66-67.

490. *Id.* at 65-67.

491. *Id.* at 66.

492. Steinberg Article, *supra* note 7, at 1121 & n.100.

493. *Reves*, 494 U.S. at 66.

494. *See id.* at 68; *see also* Schneider, *supra* note 134, at 130.

495. Steinberg Article, *supra* note 7, at 1121 & nn.101-02.

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

497. *See supra* notes 482-86 and accompanying text; *see also supra* text accompanying note 433.

Finally, the Court noted that the existence of another regulatory scheme reducing the investor's risk would make the application of the securities laws unnecessary and militates against the Court finding the interest a security.[498] Since no other regulatory scheme governs the offer or sale of LLC interests or significantly reduces the risk to LLC investors, application of the securities laws appears necessary.[499] Given that LLC interests generally appear to satisfy each element of the family resemblance test, prosecutors and plaintiffs may argue courts should deem LLC interests to be interests "commonly known as a 'security.'"

2. Possible Defenses

LLC promoters can make a strong argument that neither the public's expectations nor the family resemblance test should determine whether an interest is an interest "commonly known as a 'security.'" As previously indicated, the phrase "commonly known as a 'security'" has not generated much litigation and there is little guidance from the courts on how to interpret the phrase.[500] There is no precedent indicating the public's expectations *alone* should dictate whether an interest is one that is "commonly known as a 'security.'"[501] Nor is there any precedent stating that a court should apply the *Reves* family resemblance test to determine whether an interest is one "commonly known as a 'security.'"[502] In fact, the United States Supreme Court indicated that, at least under the facts in *Forman*, it perceived no distinction between the test for "investment contract" and the test for "an instrument commonly known as a 'security.'"[503] The Court noted that in either case, the *Howey* test[504] should be used to determine whether the transaction involved a security.[505] Therefore, courts should use the *Howey* test, rather than a public expectations test or family resemblance test, to determine whether an interest or instrument is one "commonly known as a 'security.'"[506]

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498. *Reves*, 494 U.S. at 67.

499. Steinberg Article, *supra* note 7, at 1122.

500. *See supra* notes 473-74 and accompanying text.

501. For example, in *Reves*, *Landreth*, and *Forman*, the public's expectations were only one of a number of factors considered by the Court. *See Reves*, 494 U.S. at 66-67 (adopting the family resemblance test and stating that the courts look to the buyers and seller's motivations, the plan of distribution, and the reasonable expectations of the investing public); Landreth Timber Co. v. Landreth, 471 U.S. 681, 685-97 (1985) (stating that the Court often looks to the language of the statute, the definition of security, the characteristics of the instrument, and the circumstances surrounding the transaction); United Hous. Found., Inc. v. Forman, 421 U.S. 837, 848-58 (1975) (considering the statutory definition of security, the purpose of the statute, and the public's expectations).

502. *See, e.g.*, *Reves*, 494 U.S. at 65-67 (stating that courts are to apply the family resemblance test to determine whether a "note" is a "security").

503. *Forman*, 421 U.S. at 852.

504. The *Howey* test, also known as the investment contract test, is set forth and discussed *supra* part III.A.

505. *Forman*, 421 U.S. at 852.

506. For a discussion of the *Howey* investment contract test and an analysis of when an LLC interest constitutes a security under the *Howey* test, see *supra* part III.A.

a. *Public's Expectations*

While the Court has indicated the investing public's expectations are relevant to determining whether an instrument is a security,[507] the Court has never stated the public's expectations are determinative.[508] The public's expectations were only one of many factors considered by the Court in these cases.[509] As a result, the public's expectations *alone* do not dictate whether an interest is a security.

Even if the public's expectations determined what interests were "commonly known as a 'security,'" LLC promoters may still argue that LLC interests are not securities. Commentators maintain, given the relatively recent origin of LLCs, it is unlikely that an LLC interest has reached the status of an interest "commonly known as a 'security.'"[510] Many investors do not even know about the LLC form of business organization, let alone whether the securities laws govern. The phrase "commonly known as a 'security'" appears more applicable to widely-used instruments, such as stock options.[511] Also, given the variety of business arrangements that may utilize the LLC form and the flexibility under the LLC statutes to vary the structure of the entity,[512] it is difficult to generalize about such entities. It seems ironic that entities which cannot be easily characterized because of their uniqueness would be treated as offering an interest "commonly known as a 'security.'"[513]

There is no evidence to indicate that investors expect LLC interests to be securities. Court documents filed in cases where the SEC alleged that LLC interests constituted securities indicate that the offering documents in these cases expressly disclosed that the interests did not constitute securities, were not registered under any securities laws, and were not subject to the protection of the securities laws.[514] Consequently, a reasonable investor would not expect the protection of the securities laws. Of course, the counter argument is that a seller may not effect a waiver of the securities laws by simply disclosing that the securities laws do not apply.[515] If the instrument is a security, the securities laws apply regardless of the disclosures made by the seller.

LLC promoters may also argue that LLCs share many of the characteristics of a general partnership.[516] Ordinarily, general partnership interests are

507. *See supra* notes 478-80 and accompanying text.
508. *See supra* note 501 and accompanying text.
509. *See supra* note 501.
510. Geu, Part Two, *supra* note 1, at 514.
511. *See id.*; 3 BLOOMENTHAL, *supra* note 94, § 2.04 [14]; 2 LOSS & SELIGMAN, *supra* note 99, at 1070-71.
512. *See, e.g., supra* note 468 and accompanying text.
513. *Cf.* 3 BLOOMENTHAL, *supra* note 94, § 2.04 [14], at 2-44 to 2-45.
514. *See, e.g.*, Defendants' Memorandum in Parkersburg at 9-11, (No 94-1079); Defendants' Memorandum in Vision at 3, 26, 1994 WL 326868 (No. 94-0615).
515. Securities Act of 1933 § 14, 15 U.S.C. § 77n (1994) ("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) (1994).
516. 1 RIBSTEIN & KEATINGE, *supra* note 1, § 14.02, at 14-4.

not considered securities.[517] Since LLCs and general partnerships share many of the same features, a reasonable investor would not assume the securities laws apply to LLCs. For these reasons, LLC promoters may argue an LLC interest may not be an interest "commonly known as a 'security.'"

b. *Family Resemblance Test*

The *Reves* Court adopted the family resemblance test to determine when an instrument denominated a "note" is a security.[518] The Court developed the test to expand the enumerated categories of instruments that are not securities.[519] There is no indication that the Court was attempting to develop a broader test or develop a test to determine whether an interest is one "commonly known as a 'security.'"[520] Additionally, each term in the definition of "security" is susceptible to a separate analysis, based on separate analytical concepts.[521] Therefore, an argument can be made that the family resemblance test only applies to notes.

As commentators have noted, the *Reves* test has created as much, if not more, confusion than it has eliminated.[522] The four-factor family resemblance test has been criticized by commentators as ambiguous enough to lead to a variety of interpretations.[523] In part, this is because the expectations of the investing public are not easily discernible.[524] Also, it is not clear what is meant by the term the "investing public."[525] Does it mean an average reasonable investor, a particular segment of the investing public, or those individuals who were offered the investment opportunity?[526] The *Reves* opinion provides little guidance.[527] In addition, the motivations of the buyer and seller are not easily discernible, and any interpretation of motivations tends to be highly subjective.[528] There is no indication in the *Reves* opinion how a court is to determine such motivations.[529] It is not clear whether a court should use a subjective or an objective test.[530] As a result, courts are left to consider self-serving testimony and are allowed to find the factors mean whatever the court decides they mean.[531]

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517. *See supra* note 454.
518. Reves v. Ernst & Young, 494 U.S. 56, 65-70 (1990).
519. *Id.* at 65-67.
520. *See id.*
521. *See supra* note 440 and accompanying text; *cf. supra* note 441 and accompanying text.
522. Gordon, *supra* note 487, at 402-04; Kerr & Eisenhauser, *supra* note 487, at 1124 & n.6, 1133-57, 1162; Steinberg, *supra* note 487, at 678-85.
523. *See, e.g.*, Gordon, *supra* note 487; Kerr & Eisenhauser, *supra* note 487, at 1153; Schneider, *supra* note 134, at 129-36; Steinberg, *supra* note 487.
524. Lowenfels & Bromberg, *supra* note 463, at 560.
525. Kerr & Eisenhauser, *supra* note 487, at 1156.
526. *Id.*
527. *Id.*; *see* Reves v. Ernst & Young, 494 U.S. 56, 66 (1990).
528. Lowenfels & Bromberg, *supra* note 463, at 559-60.
529. *See Reves*, 494 U.S. at 66-67; Kerr & Eisenhauser, *supra* note 487, at 1153.
530. *See* Kerr & Eisenhauser, *supra* note 487, at 1153.
531. *Id.*; Schneider, *supra* note 134, at 135-36.

An analysis of court decisions applying the *Reves* test notes inconsistencies and ambiguities abound.[532] There is no agreement as to the meaning of each factor, or the ranking or relative weight of each factor.[533] The test creates a situation where courts may determine for other reasons what the outcome should be and then use the various factors of the family resemblance test to justify the result reached.[534]

Commentators have also criticized the family resemblance test on philosophical grounds.[535] To what extent should the application of the securities laws depend upon private impressions and personal motivations of those involved in a transaction?[536] The *Reves* test has been criticized for affording too much weight to private impressions and personal motivations, rather than emphasizing the public policy goals of the securities laws to protect the investing public and prevent fraud.[537]

3. Conclusions

The phrase "commonly known as a 'security'" appears applicable to interests more widely-used than LLCs.[538] Given the relatively recent origin of the LLC form,[539] the variety of organizational structures available,[540] and the fact it shares many of the same features as a general partnership,[541] it is doubtful that the LLC has reached the status of an interest "commonly known as a 'security.'"

The public's expectations are only one of many factors a court should consider in determining whether an interest is one that is "commonly known as a 'security.'"[542] Because the public's expectations are not easily discernible and such a highly subjective and speculative test would lead to inconsistent and unpredictable results, a determination should not rest on that factor alone.[543] Rather, the public's expectations should be considered as one of many relevant factors, as the Court has done to date.[544]

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532. Kerr & Eisenhauser, *supra* note 487, at 1133-57, 1162.

533. *Id.* at 1153; Schneider, *supra* note 134, at 132-36.

534. Schneider, *supra* note 134, at 136.

535. *See* Lowenfels & Bromberg, *supra* note 463, at 559-60 (taking issue with whether the public's expectations and the motivations of the buyer and seller should be determinative on whether the federal securities laws apply).

536. *Id.* at 560.

537. *Id.* Professor Goforth argues that even if courts analyze LLC interests under the family resemblance test, LLC issuers can argue the interests are not securities under the test on the grounds that: (i) LLC interests are not expected to be traded for speculation or investment, since LLC interests typically have limited transferability; (ii) given that LLCs have been viewed principally as a replacement for general partnerships and general partnership interests are not securities, investors might not expect the securities laws to apply to LLCs; and (iii) there are at least two possible alternative regulatory schemes that reduce the risk of the investment, including various LLC statutes that offer investor protection and the Internal Revenue Code requirements that protect investors. Goforth, *supra* note 7, at 1254-70.

538. *See supra* note 511 and accompanying text.

539. *See supra* note 510 and accompanying text.

540. *See supra* notes 512-13 and accompanying text.

541. *See supra* notes 516-17 and accompanying text.

542. *See supra* notes 507-09 and accompanying text.

543. *See supra* notes 524-27, 531 and accompanying text.

544. *See supra* note 501 and accompanying text.

Nor should the courts use the family resemblance test in *Reves* to determine whether an interest is one that is "commonly known as a 'security.'" In light of the practical and philosophical problems with the *Reves* test,[545] there is little reason to broaden its application beyond its current narrow purpose to determine whether an instrument constitutes a "note." Given the criticism of the *Reves* test and the confusion it has caused, the *Reves* test appears an unlikely candidate for courts to use in determining whether an interest is one that is "commonly known as a 'security.'" For these reasons, neither the public's expectations test nor the *Reves* family resemblance test provides a satisfactory test from either a practical or philosophical standpoint for determining whether an LLC interest is a security.

E. *State Statutory Grounds for Liability*

1. Arguments Asserted

State legislatures have begun to take the initiative by passing legislation that either expressly states or implies that certain LLC interests are securities. For example, legislatures in eight states have amended their securities laws to expressly state certain LLC interests are securities.[546] Seven states have amended their securities laws to include references to LLCs.[547] 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.[548] All of these statutes provide prosecutors and civil plaintiffs with state law grounds for arguing that certain LLC interests are securities.

States have adopted three different types of securities law statutes to expressly address whether LLC interests are securities. The first type of statute specifically lists LLC interests in the state securities act definition of a "security."[549] If the legislature expressly lists LLC interests in the definition of a

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545. *See supra* notes 522-37 and accompanying text.

546. ALASKA STAT. § 45.55.990(12) (1994); CAL. CORP. CODE § 25019 (West Supp. 1995); IND. CODE ANN. § 23-2-1-1(k) (West 1995); N.M. STAT. ANN. § 58-13B-2(V) (Michie Supp. 1995); 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. 1995). Table II of this article contains a listing of the state statutes that expressly address whether LLC interests are securities under state law. Table II is organized alphabetically by state and provides the statutory citation, a short summary of the statutory provision, and quotes the relevant language.

547. *See, e.g.*, CONN. GEN. STAT. ANN. § 36b-1 (West Supp. 1995) (general statement); 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. 1995) (exempt transactions); N.D. CENT. CODE § 10-04-05 (1995) (exempt securities); N.H. REV. STAT. ANN. § 421-B:17(II)(k) (Supp. 1994) (registration exemption); VA. CODE ANN. § 13.1-514(B)(7)(b) (Michie Supp. 1995) (exempt transactions).

548. GA. CODE ANN. § 14-11-1107(n) (1994); MICH. COMP. LAWS ANN. § 450.5103 (West Supp. 1995); MO. ANN. STAT. § 347.185 (Vernon Supp. 1994); WIS. STAT. ANN. § 183.1303 (West Supp. 1995). Table II of this article sets forth the relevant statutory language of the Georgia, Michigan, Missouri, and Wisconsin statutes.

549. *See, e.g.*, ALASKA STAT. § 45.55.990(12); N.M. STAT. ANN. § 58-13B-2(V); OHIO REV. CODE ANN. § 1707.01(B); VT. STAT. ANN. tit. 9, § 4202a(14). For example, the Ohio statute provides "'security' means any . . . membership interests in limited liability companies . . . ." For the

"security," prosecutors and plaintiffs may argue that state securities laws apply to *all* LLC interests offered and sold in that state. In such states, courts no longer need to determine whether LLC interests are securities under the investment contract test or a risk capital analysis.[550] A court's inquiry is limited to whether the interest being offered or sold is an LLC interest.[551] Prosecutors and plaintiffs can assert that by explicitly enumerating LLC interests in the list of items that are "securities," the legislature mandated all LLC interests are securities and all LLC investors are entitled to the protection of the state's securities laws. They may assert that by including LLC interests in the definition the legislature effectively eliminated all judicial interpretation and discretion.

The second type of statute also lists 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.[552] For example, some statutes state that an LLC interest is not a security when all of the members of the LLC are actively engaged in the management of the LLC.[553] Moreover, some of the exclusionary provisions shift the burden of proof.[554] In states adopting this statutory structure, prosecutors and plaintiffs would also be able to argue that LLC interests are securities without having to apply the investment contract test or any risk capital analysis.[555] Litigants will battle instead over whether the LLC interests meet the exclusionary conditions. But these statutory conditions are subject to judicial interpretation. Courts may draw on the *Howey* and risk capital lines of cases to interpret exclusionary conditions such as "actively engaged in the management of the LLC."[556] With the new, specific statutory language, however, the issues are more limited and courts are not bound by precedent relating to the investment contract test or risk capital test. Prosecutors and plaintiffs can argue that courts are free

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relevant text of the Alaska, New Mexico, and Vermont statutes, see *infra* Table II.

550. In *Reves, Landreth,* and *Gould,* the United States Supreme Court held that the *Howey* investment contract test and the economic reality approach do not apply in cases involving instruments specifically listed in the statutory definition of a "security," other than to cases involving the catch-all category of "investment contracts." *See* Reves v. Ernst & Young, 494 U.S. 56, 64 (1990); Landreth Timber Co. v. Landreth, 471 U.S. 681, 691-92 & n.5 (1985); Gould v. Ruefenacht, 471 U.S. 701, 704 (1985). If LLC interests are expressly listed in the definition of a "security," prosecutors and plaintiffs can argue similarly that the investment contract test, the economic reality approach, and the risk capital analysis do not apply. For a discussion of the investment contract test and risk capital tests, see *supra* parts III.A and III.B, respectively.

551. Ribstein, *supra* note 7, at 838-39 & n.110. The court need only determine whether the firm was a properly formed LLC. *Id.* at n.110.

552. *See, e.g.*, CAL. CORP. CODE § 25019; IND. CODE ANN. § 23-2-1-1(k); PA. STAT. ANN. tit. 70, § 1-102(t). For the relevant text of these statutes, see *infra* Table II.

553. *See, e.g.*, CAL. CORP. CODE § 25019; IND. CODE ANN. § 23-2-1-1(k).

554. *See, e.g.*, IND. CODE ANN. § 23-2-1-1(k) ("'Security' does not include . . . an interest in a limited liability company if the person claiming that the interest is not a security can prove that all of the members of the limited liability company are actively engaged in the management of the limited liability company.").

555. *See supra* note 550.

556. Courts may draw on the *Howey* "efforts of others" analysis or the risk capital test control analysis. For a discussion of the cases dealing with these issues, see *supra* parts III.A and III.B, respectively.

to adopt narrower interpretations crafted to reflect the legislature's intent to provide greater protection for LLC investors.

The third type of statute sets forth certain presumptions in its definition of a "security."[557] For example, such statutes may 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 specified number.[558] Similarly, such statutes may also state a "security" is not presumed to include an interest in an LLC if the aggregate number of members is below a specified number.[559] If the LLC interest in question meets the statutory conditions that give rise to the presumption that the interest is a security, prosecutors and plaintiffs can claim the legislature provided the court with clear guidance—practically a bright-line test.[560] However, if the LLC interest in question does not meet the conditions giving rise to the presumption, all is not lost. The presumptions are rebuttable, although they may shift the burden of proof.[561] Prosecutors and plaintiffs can probably present a *Howey*-type analysis in an attempt to overcome the presumptions.[562] Litigation can also focus on interpreting the language of the statute. For example, when is the right to manage the LLC vested in one or more managers?[563] In an attempt to provide guidance, the legislature may have added simply another layer of analysis and more confusion. Nevertheless, such statutes provide additional grounds to argue that an LLC interest is a security. Moreover, because the presumption is rebuttable, the statute does not preclude arguments on other grounds.

In addition, a number of states have amended their securities laws to include references to LLCs[564] and several states have included provisions in their limited liability company act that raise the securities law issues.[565] Prosecutors and plaintiffs may claim these provisions evidence legislative intent. They may argue that by passing such provisions, the legislature indicated that LLC interests are securities and that LLC investors are to be afforded the protection of the state's securities laws. All of the statutes discussed in this

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557. *See, e.g.*, WIS. STAT. ANN. § 551.02(13)(c) (West Supp. 1995). For the relevant text of this statute, see *infra* Table II.

558. *Id.*

559. *Id.*

560. Sargent Blue Sky, *supra* note 7, at 437 (discussing the Wisconsin approach). Prosecutors and plaintiffs may assert that the presumptions indicate legislative intent. Interests in an LLC with less than the specified number of members are not securities, while interests in an LLC with more than the specified number of members are securities. *Id.*

561. *See, e.g.*, FED. R. EVID. 301. The federal rules of evidence, for example, provide that a "presumption imposes on the party against whom it is directed the burden of going forward with evidence to rebut or meet the presumption." *Id.*

562. A discussion of the *Howey* analysis is presented *supra* part III.A.

563. Is the "right to manage" satisfied by an operating agreement that vests management of the LLC in its members, even if some members do not actually participate in its management? Or does the "right to manage" not only require the vesting of management rights in its members, but also actual exercise of those rights? Louis R. Briska, *When Does a Member's Interest in an LLC Become a Security?*, 67 WIS. LAW., Sept. 1994, at 18, 20.

564. *See supra* note 547 and accompanying text.

565. *See, e.g.*, GA. CODE ANN. § 14-11-1107(n) (1994); MICH. COMP. LAWS ANN. § 450.5103 (West Supp. 1995). For the relevant text of these statutes, see *infra* Table II.

section provide prosecutors and plaintiffs with state law grounds for arguing certain LLC interests are securities.

2. Possible Defenses

LLC issuers can challenge state statutory provisions, that either expressly state or imply certain LLC interests are securities, on a number of grounds. They may argue that a statutory characterization of an LLC interest as a "security" is not necessarily conclusive, since the clause preceding many definitional sections provides "unless the context otherwise requires," thereby mandating a review of the surrounding factual circumstances.[566] Also, several of these statutory provisions may be vulnerable to attack on constitutional grounds for discriminating between domestic and foreign LLCs.[567] Moreover, all such statutory provisions are subject to judicial interpretation.[568]

LLC issuers can argue that including LLC interests in the statutory laundry list of interests deemed "securities" does not mean all LLC interests are automatically "securities."[569] They can contend that such statutory characterizations are not conclusive. Inclusion in the list merely tilts the analytical scale by creating a kind of presumption that simply makes it more difficult to establish the interest is not a security, but not impossible.[570]

This argument is premised on the fact that the definitional sections of the federal securities acts[571] and most state securities acts[572] begin with the qualifying language "unless the context otherwise requires." Courts have interpreted the context clause as authorizing judicial exclusion of certain instruments on the basis of factual circumstances, even if an instrument falls within the statutory definition of a security.[573] For example, the United States Supreme Court held in *Reves v. Ernst & Young*[574] that the phrase "any note" in the federal securities acts should not be interpreted to mean literally "any note," but must be interpreted in light of what Congress was attempting to accomplish.[575] The Court concluded that Congress was concerned with regulating the investment markets, not with creating a general cause of action for

566. *See infra* notes 569-82 and accompanying text.
567. *See infra* notes 583-85 and accompanying text.
568. *See infra* notes 586-96 and accompanying text.
569. Sargent Blue Sky, *supra* note 7, at 436 (discussing New Mexico's statutory definition of a "security").
570. *Id.*
571. Securities Act of 1933 § 2, 15 U.S.C. § 77b (1994); Securities Exchange Act of 1934 § 3, 15 U.S.C. § 78c(a) (1994).
572. UNIF. SEC. ACT § 401 (1958), 7B U.L.A. 578 (1985); UNIF. SEC. ACT § 101 (1988), 7B U.L.A. 91 (Supp. 1995); *see also* ALASKA STAT. § 45.55.990 (1994); CAL. CORP. CODE § 25001 (West 1977); IND. CODE ANN. § 23-2-1-1 (West 1995); PA. STAT. ANN. tit. 70, § 1-102 (Supp. 1995); WIS. STAT. ANN. § 551.02 (West Supp. 1995).
573. *See, e.g.*, Reves v. Ernst & Young, 494 U.S. 56 (1990) (excluding certain notes); Marine Bank v. Weaver, 455 U.S. 551, 558-59 (1982) (excluding certain certificates of deposit). For an excellent critique of the United States Supreme Court's interpretation of the context clause, see Marc I. Steinberg & William E. Kaulbach, *The Supreme Court and the Definition of a "Security": The "Context" Clause, "Investment Contract" Analysis, and Their Ramifications*, 40 VAND. L. REV. 489 (1987); *see also* 2 LOSS & SELIGMAN, *supra* note 99, at 873-75.
574. 494 U.S. 56 (1990).
575. *Reves*, 494 U.S. at 63.

all fraud.[576] Therefore, courts must look at the surrounding factual circumstances, including the offering context,[577] to determine if a particular note is a "security." The Court then held that many types of notes would not be treated as securities, despite inclusion of the phrase "any note" in the statutory definition of a "security."[578]

Citing a context clause, LLC issuers can argue courts are permitted to carve out a relatively broad category of LLC interests as not constituting securities.[579] They can claim the context clause is intended to provide courts some latitude to use judicial discretion and to avoid mindless, literal interpretation.[580] They can also argue that categorically defining all LLC interests as securities is undesirable because it is over-inclusive.[581] While certain interests may be within the letter of the statute, such broad coverage is not within the spirit or intent. For instance, there is no justification for imposing all of the consequences of the securities laws on a closely held LLC where all the members are actively engaged in the management of the LLC.[582]

Also, at least two of the statutes that include LLC interests in the definition of a "security" may be subject to attack on constitutional grounds. The definition of a "security" in Alaska provides that a "security" means an LLC interest as defined in title 10, chapter 50 of the Alaska Statutes.[583] The definition of a "security" in Wisconsin includes presumptions about interests in LLCs organized under chapter 183 of the Wisconsin Statutes.[584] Both provisions appear to apply only to domestically organized LLCs. Presumably, LLCs organized in other jurisdictions would be subject to an investment contract or risk capital analysis. Professor Mark Sargent charges that this differential treatment of domestic and foreign LLCs may be vulnerable to constitutional attack under the Commerce Clause as either being discriminatory against or placing an undue burden on interstate commerce.[585]

Even if a state has adopted a statute that lists LLC interests in the definition of a "security," many of the statutes contain exclusionary conditions[586] or the statute may merely set forth a presumption.[587] Since the exclusionary conditions and presumptions often turn on whether members are engaged in the management of the LLC,[588] the conditions and presumptions are subject

576. *Id.* at 65.
577. *See id.* at 62-67.
578. *Id.* at 64-67.
579. Sargent Blue Sky, *supra* note 7, at 436 (discussing the New Mexico securities statute).
580. 3 BLOOMENTHAL, *supra* note 94, § 2.01, at 2-5.
581. McGinty, *supra* note 270, at 1039; Sargent Blue Sky, *supra* note 7, at 438.
582. Sargent Blue Sky, *supra* note 7, at 438-39.
583. ALASKA STAT. § 45.55.990(12) (1994). Title 10, chapter 50 of the Alaska Statutes includes provisions dealing with the formation of LLCs. *See* ALASKA STAT. § 10.50 (Supp. 1995). For a definition of "limited liability company" and "limited liability company interest," see ALASKA STAT. § 10.50.990. Both definitions refer to LLC entities organized under Alaska law. *Id.*
584. WIS. STAT. ANN. § 551.02(13)(c) (West Supp. 1995). For the relevant text of the Wisconsin statute see *infra* Table II. Chapter 183 of the Wisconsin Statutes deals with LLCs organized in Wisconsin. *See* WIS. STAT. ANN. § 183 (West Supp. 1995).
585. SARGENT HANDBOOK, *supra* note 1, § 4.03[1][a], at 4-16 to 4-17.
586. *See* CAL. CORP. CODE § 25019; IND. CODE ANN. § 23-2-1-1(k); PA. STAT. ANN, tit. 70, § 1-102(t).
587. *See* WIS. STAT. ANN. § 551.02(13)(c).
588. See, for example, the language of the California, Indiana, Pennsylvania, and Wisconsin

to interpretation. LLC issuers can argue for a broad interpretation of what constitutes member management.[589] They can continue to assert that LLCs are closely analogous to general partnerships,[590] thus courts should draw on the *Howey* line of cases dealing with general partnership interests to determine who has the right to manage the LLC or whether members are engaged in the management of the LLC.[591] Interpretation of these conditions and presumptions open the door for LLC issuers to cite case law dealing with general partnership interests and argue for a strong presumption that LLC interests are not securities.[592]

LLC issuers can also argue provisions in LLC acts that raise the securities law issue[593] and the various references to LLCs in state securities law statutes[594] are not evidence of legislative intent to treat all LLC interests as securities. Most of the provisions in the LLC acts simply raise the securities law issue and leave it to the courts to decide whether an LLC interest is a security.[595] LLC issuers can argue that references to LLCs in state securities law registration and exemption provisions simply indicate that the legislature recognized a court *may* find an LLC interest to be a security under the investment contract test or a risk capital analysis.[596] By adding references to LLCs, the legislature was merely making certain that registration and exemption provisions are available for LLC offerings. If the legislature intended that all LLC interests be treated as securities, then it would have amended the state laws to provide so, rather than including sporadic references to LLCs. As a result, such provisions are not dispositive of legislative intent.

Challenges to state statutory provisions on the basis of a context clause, constitutionality, interpretation, or legislative intent may serve to undercut the

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statutes set forth *infra* Table II.

589. Such statutes tend to exclude LLC interests if the members are actively engaged in the management of the LLC. *See, e.g.*, IND. CODE ANN. § 23-2-1-1(k)(iii). Therefore, a broad definition of what constitutes management would tend to exclude more LLC interests from coverage under the securities laws.

590. *See supra* notes 243-50 and accompanying text.

591. For a discussion of the *Howey* line of cases dealing with partnership interests and a discussion of the arguments LLC issuers may make, see *supra* part III.A.2.

592. Several courts have stated there is a strong presumption that general partnership interests are not securities under the *Howey* investment contract test. *See supra* note 241 and accompanying text.

593. *See, e.g.*, GA. CODE ANN. § 14-11-1107(n) (1994); MICH. COMP. LAWS ANN. § 450.5103 (West Supp. 1995); WIS. STAT. ANN. § 183.1303 (West Supp. 1995). For the relevant text of the Georgia, Michigan, and Wisconsin statutes, see *infra* Table II.

594. *See, e.g.*, CONN. GEN. STAT. ANN. § 36b-1 (West Supp. 1995); IOWA CODE ANN. § 502.207A(2)(a) (West Supp. 1995); KAN. STAT. ANN. § 17-1262(l) (Supp. 1994); LA. REV. STAT. ANN. § 51:709(12) (West Supp. 1995); N.D. CENT. CODE § 10-04-05(4), (10), (11), (13) (1995); N.D. CENT. CODE § 10-04-06(4), (6), (10), (14) (1995); N.D. CENT. CODE § 10-04-07(2)(b)(3) (1995); N.H. REV. STAT. ANN. § 421-B:11(II) (Supp. 1994); N.H. REV. STAT. ANN. § 421-B:13(I) (Supp. 1994); N.H. REV. STAT. ANN. § 421-B:17(II)(k) (Supp. 1994); VA. CODE ANN. § 13.1-514(B)(7)(b) (Michie Supp. 1995).

595. *See, e.g.*, GA. CODE ANN. § 14-11-1107(n) ("Nothing in this chapter shall be construed as establishing that a limited liability company interest is not a 'security'. . . ."); WIS. STAT. ANN. § 183.1303 ("An interest in a limited liability company may be a 'security'. . . .").

596. For a discussion of the grounds for finding that an LLC interest is a security under the investment contract test or risk capital analysis, see *supra* parts III.A and III.B.

statutory arguments made by prosecutors and plaintiffs. If nothing else, such challenges provide grounds for increased litigation.

3. Conclusions

Prosecutors and plaintiffs have a very strong argument that all LLC interests are securities in states that specifically list LLC interests, without any qualifications or conditions, in the state securities law definition of a "security."[597] Several states do not have context clauses preceding the statutory definitions.[598] Clearly all LLC interests are securities in such states.

Even in states where the definitional section begins with a context clause qualification, prosecutors and plaintiffs have strong arguments that all LLC interests in such states are securities. They may argue that the United States Supreme Court has repeatedly said that the "starting point in every case involving construction of a statute is the language itself."[599] The context clause usually does not modify the term "security" in particular, but generally precedes a long list of general definitions.[600] Early drafts of the proposed federal securities laws show the context clause language was intended to refer to the context in which the defined terms appeared in the statute itself.[601] The context clause only meant that the same words may have different meanings in different parts of the same act. Parties may argue the context clause was not meant to refer to the context of the underlying transaction.[602] Given the legislative intent, prosecutors and plaintiffs may contend that courts should not use the context clause to justify excluding any LLC interests from the definition of a "security" on the basis of the offering context.

The *Landreth*[603] case also provides prosecutors and plaintiffs with grounds for arguing that the plain meaning of the statutory language should control. In *Landreth*, the United States Supreme Court held that since the term "stock" was plainly within the statutory definition of a "security," the plain meaning of the statute mandated that the stock in question be treated as a security.[604] There was no reason to examine the offering context or underlying transaction.[605] Similarly, prosecutors and plaintiffs can argue that inclusion of LLC interests in the definition of a "security" mandates that all LLC interests must be treated as securities.

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597. *See, e.g.*, OHIO REV. CODE ANN. § 1707.01 (Baldwin Supp. 1995); VT. STAT. ANN. tit. 9, § 4202a (1993 & Supp. 1995).

598. *See, e.g.*, OHIO REV. CODE ANN. § 1707.01; VT. STAT. ANN. tit. 9, § 4202a.

599. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 756 (1975) (Powell, J., concurring); *accord* Landreth Timber Co. v. Landreth, 471 U.S. 681, 685 (1985); International Bhd. of Teamsters v. Daniel, 439 U.S. 551, 558 (1979).

600. *See, e.g.*, Securities Act of 1933 § 2, 15 U.S.C. § 77b (1994); Securities Exchange Act of 1934 § 3, 15 U.S.C. § 78c(a) (1994); UNIF. SEC. ACT § 401 (1958), 7B U.L.A. 578 (1985); UNIF. SEC. ACT § 101 (1988), 7B U.L.A. 91 (Supp. 1995).

601. For a discussion of early drafts of the federal securities laws and the context clause language, see Steinberg & Kaulbach, *supra* note 573, at 504-05 & n.91; *see also* Gary S. Rosin, *Functional Exclusions from the Definition of a Security*, 28 S. TEX. L. REV. 333, 363-64 (1986).

602. Steinberg & Kaulbach, *supra* note 573, at 504.

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

604. *Id.* at 687, 697.

605. *Id.* at 690.

Even though the United States Supreme Court excluded certain notes and certificates of deposits from the definition of a "security" based on factual context,[606] prosecutors and plaintiffs can argue that such cases are distinguishable. Changes in the usage of notes and certificates of deposits by the financial community over time and significant variations in the character of these instruments resulted in changes in their meanings.[607] Although both terms are listed in the definition of a "security,"[608] the terms no longer have well-settled meanings.[609] The Court therefore looked behind the labels to the offering context to determine if instruments labeled notes and certificates of deposits should be treated as securities.[610] Prosecutors and plaintiffs, however, may argue LLC interests are different. LLC interests are not some unusual type of financial instrument.[611] Neither the meaning of the term nor the character of LLC interests have changed. There is no need to look beyond the characteristics of the instrument. The legislature meant what it said: LLC interests are securities. The plain meaning of the statute should control. No justification exists for judicial modification of the statutory terms based on the factual situation because legislative intent is clear.

By including LLC interests in the statutory definition of a "security," the legislature presumably intended to provide some certainty and predictability.[612] The legislature wished to make clear that certain LLC interests are securities. If courts begin to use the context clause to exclude interests that clearly fit within the statutory definition, courts will undermine the legislative purpose. Such exclusions create uncertainty.[613] When courts do not apply the law according to its express terms, they reduce the public's ability to understand what the law requires of them. Without lawyers, discovery, and litigation, neither LLC issuers nor investors will know whether their transaction is covered by the securities laws. In the interest of predictability and clarity, courts should resist judicially excluding interests expressly listed in the definition. Moreover, the statutes neither define nor even suggest the scope of the context clause.[614] Nor have courts ever really elaborated on the precise

606. *See* Reves v. Ernst & Young, 494 U.S. 56 (1990) (stating that a note may or may not be a security); Marine Bank v. Weaver, 455 U.S. 551 (1982) (holding that a certificate of deposit purchased from a federally regulated bank is not a security).

607. *See Reves*, 494 U.S. at 62-63 (discussing notes); *Landreth*, 471 U.S. at 694 (discussing notes); *Marine Bank*, 455 U.S. at 557-58 & n.5 (discussing certificates of deposit); *see also* 2 LOSS & SELIGMAN, *supra* note 99, at 875 n.18 (tracing changes in the meaning of the term note).

608. *See, e.g.*, Securities Act of 1933 § 2, 15 U.S.C. § 77b(1); Securities Exchange Act of 1934 § 3, 15 U.S.C. § 78c(a)(10); UNIF. SEC. ACT § 401(l) (1958), 7B U.L.A. 578 (1985).

609. *See supra* note 607 and accompanying text.

610. *See Reves*, 494 U.S. at 64-70 (addressing notes); *Marine Bank*, 455 U.S. at 555-59 (discussing certificates of deposit).

611. *Cf. Landreth*, 471 U.S. at 689-90 n.4 (noting that cases where the Court looked at the economic reality of the transaction usually "involved unusual instruments that did not fit squarely within one of the enumerated specific kinds of securities listed in the definition").

612. If a securities act does not list LLC interests in its definition of a security, courts generally must conduct a case-by-case investment contract or risk capital analysis to determine if the interest is a security. *See* discussion *supra* parts III.A and III.B.

613. *See* Gary S. Rosin, *Historical Perspectives on the Definition of a Security*, 28 S. TEX. L. REV. 575, 618 (1987); Steinberg & Kaulbach, *supra* note 573, at 490.

614. McGinty, *supra* note 270, at 1039.

role of the context clause.[615] Courts should not expand the use of this vague concept which creates uncertainty and allows for unbounded judicial discretion.[616] Courts should apply the statute according to its express terms, rather than using the context clause to embark down the road of judicial activism.

Courts should also resist LLC issuer efforts to draw on the *Howey* line of cases dealing with general partnership interests in interpreting statutory phrases dealing with LLC interests. If the legislature intended courts simply to apply the *Howey* investment contract test, any references to LLCs in the definition would be superfluous. It may be argued that by including a reference to LLCs in the definition of a "security," the legislature intended to provide greater guidance to the courts than the *Howey* test provides, and possibly more certainty and increased investor protection. Following a *Howey* line of cases would undermine the legislature's intent. The new statutory language frees the courts to adopt judicial interpretations that provide greater investor protection and more certainty. As a result, state statutes that address the issue of whether LLC interests are securities may provide prosecutors and plaintiffs with some very powerful weapons in arguing that LLC interests are securities.

IV. CONCLUSIONS

While commentators are divided on the issue of whether LLC interests should be treated as securities,[617] the SEC and at least thirty-five state securities commissions have taken the position that certain LLC interests may be securities.[618] Commentators, the SEC, and state securities agencies have advanced five different legal theories in their attempts to bring LLC offerings within the ambit of the securities laws. These theories include the investment contract test, the risk capital test, the characteristics of stock test, the commonly known as a security test, and state statutory grounds. Clearly certain LLC interests can be securities under the *Howey* investment contract test and a risk capital analysis.[619] While prosecutors and plaintiffs may make colorable arguments that LLC interests are securities under the characteristics of stock test or the commonly known as a security test,[620] such arguments probably will not prevail. In light of both practical and philosophical problems, there is little reason to broaden the application of the characteristics of stock test or the commonly known as a security test to cover LLC interests.[621] The recent passage of state statutes defining certain LLC interests as securities provides prosecutors and plaintiffs with additional state law grounds for arguing LLC interests are securities.[622] While such statutes are subject to judicial interpre-

615. *See* Steinberg & Kaulbach, *supra* note 573, at 490-91.
616. McGinty, *supra* note 270, at 1039; Rosin, *supra* note 601, at 361-64; Steinberg & Kaulbach, *supra* note 573, at 511-12.
617. *See supra* note 7.
618. *See supra* notes 8-19 and accompanying text.
619. *See supra* parts III.A.1, III.A.3, III.B.1, and III.B.3.
620. *See supra* parts III.C.1 and III.D.1.
621. *See supra* parts III.C.2, III.C.3, III.D.2, and III.D.3.
622. *See supra* parts III.E.1 and III.E.3.

tation, these statutes may prove to be a powerful weapon for prosecutors and plaintiffs attempting to apply the securities laws to LLC offerings.

As courts grapple with these various legal theories to determine whether LLC interests are securities, they will have the opportunity to refine and develop the definition of a security. How the courts apply the securities laws to the offer and sale of LLC interests will determine the degree of protection afforded investors. Absent legislative action, courts will use the *Howey* investment contract test and the risk capital tests to determine whether an LLC interest is a security.[623] The formulation of the *Howey* test and the risk capital tests, the remedial purpose of the securities laws,[624] the hybrid nature of the LLC entity, and the recent proliferation of fraudulent LLC schemes,[625] all compel the conclusion that each LLC offering must be analyzed on a case-by-case basis. Courts must focus on the substance, not the form, of each transaction and examine the economic realities of the transaction, not just the operating documents.[626] Applying general partnership case law and its related presumptions to LLC offerings is inappropriate and will lead to undesirable results.[627] If the courts determine there is a need for presumptions to provide clear, predictable rules, they should presume that LLC interests are securities.[628] The costs associated with such a presumption would be minimal in most situations, but the protection provided investors would be great. However, if the goal is truly clarity, predictability, and maximizing investor protection, the best approach would be for legislatures to enact legislation expressly stating that all LLC interests are securities.[629]

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623. *See supra* parts III.A.3 and III.B.3.

624. *See, e.g.*, Tcherepnin v. Knight, 389 U.S. 332, 336 (1967); SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 479-80 (5th Cir. 1974); Fortier v. Ramsey, 220 S.E.2d 753, 755 (Ga. Ct. App. 1975).

625. *See supra* notes 81-87 and accompanying text; *see also Division of Enforcement Warns of Fraud in the Sale of Unregistered Securities of Telecommunications Technology Ventures*, News Release, SEC 94-105, 1994 WL 507361 (SEC) (Sept. 16, 1994) (explaining that fraudulent telecommunications technology ventures frequently take the form of LLCs); Jim McTague, *Regulators Say Cable-TV Investment Scams Are Rampant*, BARRON'S, Sept. 5, 1994, at 15 (explaining that "scamsters" try to steer clear of securities regulators by using LLCs); Ellen E. Schultz, *IRA Money May Attract Shady Deals*, WALL ST. J., Dec. 7, 1994, at C1 (reporting that many of the deals are packaged as LLCs).

626. *See supra* parts III.A.3 and III.B.3.

627. *See supra* part III.A.3.

628. *See supra* notes 324-29 and accompanying text.

629. *See, e.g.*, OHIO REV. CODE ANN. § 1707.01(B) (Baldwin Supp. 1995); VT. STAT. ANN. tit. 9, § 4202a(14) (Supp. 1995).

TABLE I: SUMMARY OF STATE ACTIONS UNDER STATE SECURITIES LAWS AGAINST DEFENDANTS OFFERING OR SELLING LLC INTERESTS[630]

State	Action	Business	Action Taken	Findings	Securities Law Violations Addressed	Legal Theories Discussed
Colo.	Feigin v. Infotech Group, Inc., No. 94 CV 1756, 1994 Colo. Sec. LEXIS 1 (Apr. 8, 1994)	wireless cable television system	Temporary Restraining Order Issued	· Summary Order, restating state allegations	· unregistered securities · unregistered broker-dealers and sales representatives · antifraud violations	· investment contract theory[631]
Ga.	Report and Recommendation of Referee, Cleland v. Express Communications, Inc., No. 50-93-0075 (Ga. Mar. 23, 1994)	wireless telecommunication services	Hearing Officer Recommended Entry of Cease and Desist Order	· Findings of Fact · Conclusions of Law · Reasoned Opinion and Analysis of Law	· unregistered securities · unregistered issuer, salesperson, and dealer	· investment contract theory · risk capital test · certificate of interest or participation in profit sharing *agreement* · characteristics of stock test[632]
Ill.	*In re* Express Communications, Inc., No. 9200106, 1993 WL 566300 (*Ill. Sec. Dep't*) (Dec. 13, 1993) [Illinois Express Action]	wireless telecommunication services	Order of Prohibition Issued	· Findings of Fact · Conclusions of Law · Reasoned Opinion and Analysis of Law	· unregistered securities · unregistered dealer and salesperson	· investment contract theory · risk capital test
Ind.	*In re* Express Communications, Inc., No. 93-0027 CD, 1993 Ind. Sec. LEXIS 46 (Mar. 23, 1993) [Indiana Express Action]	interactive and wireless telecommunication services	Cease and Desist Order Issued	· Summary Order, restating state allegations	· unregistered securities · unregistered broker-dealer or agent · antifraud violations	· investment contract theory
Ind.	*In re* Wireless Cable Fin. Consultants, No. 93-0094 CD, 1993 Ind. Sec. LEXIS 170 (Nov. 19, 1993)[633]	wireless cable television system	Cease and Desist Order Issued	· Summary Order, restating state allegations	· unregistered securities · unregistered broker-dealer or agent · antifraud violations	· no legal theory addressed, only statutory definition of "security" cited

[630] Table I does not purport to be a complete listing of all state actions under state securities laws against defendants offering or selling LLC interests. *See supra* notes 13 and 84.

[631] Legal theory asserted by state in Complaint.

[632] Legal theory rejected by hearing officer.

[633] For resolution of this matter see *In re* Wireless Cable Fin. Consultants, No. 93-0094 CD, 1994 Ind. Sec. LEXIS 45 (May 9, 1994) (setting forth Consent Agreement, Compliance Agreement, and Order of Withdrawal with respect to certain named defendants).

State	Action	Business	Action Taken	Findings	Securities Law Violations Addressed	Legal Theories Discussed
Ind.	*In re* Knoxville Ltd. Liab. Co., No. 95-0023 CD, 1995 Ind. Sec. LEXIS 38 (Mar. 24, 1995) [Indiana Knoxville Action]	wireless cable industry	Cease and Desist Order Issued	· Summary Order, based on state allegations	· unregistered securities · unregistered agents and/or broker-dealers · antifraud violations	· investment contract theory · IND. CODE ANN. § 23-2-1-1(k) which defines certain LLC interests as securities
Ind.	*In re* Spectrum Resources Group, Ltd., No. 94-0050 CD, 1994 Ind. Sec. LEXIS 96 (Sept. 15, 1994) [Indiana Spectrum Action]	wireless television system	Cease and Desist Order Issued	· Summary Order, based on state allegations	· unregistered securities · unregistered agents and/or broker-dealers · antifraud violations	· IND. CODE ANN. § 23-2-1-1(k) which defines certain LLC interests as securities
Kan.	*In re* Wireless Solutions, Inc., No. 95E011, 1994 WL 480778 (Kan. Sec. Comm'r) (Aug. 18, 1994)	wireless cable system	Emergency Cease and Desist Order Issued	· Summary Order, restating state allegations	· unregistered securities · unregistered agents and/or broker-dealers · antifraud violations	· no legal theory addressed, only statutory definition of a "security" cited
Kan.	*In re* Parkersburg Wireless, L.L.C., No. 94E068, 1994 WL 245870 (Kan. Sec. Comm'r) (May 18, 1994) [Kansas Parkersburg Action]	wireless cable television system	Emergency Cease and Desist Order Issued	· Summary Order, restating state allegations	· unregistered securities · unregistered broker-dealer or agent · antifraud violations	· no legal theory addressed, only statutory definition of "security" cited
Kan.	*In re* UEG, L.C., No. 93E068, 1993 WL 208898 (Kan. Sec. Comm'r) (May 12, 1993)	wireless cable television system	Emergency Cease and Desist Order Issued	· Summary Order, restating state allegations	· unregistered securities · unregistered broker-dealer or agent · antifraud violations	· no legal theory addressed, only statutory definition of "security" cited
Kan.	*In re* Hancock Communications Riverside PCS, No. 93E-058, 1993 WL 145928 (Kan. Sec. Comm'r) (Apr. 14, 1993)	wireless and wireline telecommunication services	Emergency Cease and Desist Order Issued	· Summary Order, restating state allegations	· unregistered securities · unregistered broker-dealer	· investment contract referenced · statutory definition of "security" cited
Minn.	*In re* Replen-K, Inc., Nos. SE 9209063, SE 9301897, SE 9304735, 1993 WL 451199 (Minn. Dept. Comm.) (Oct. 7, 1993)	not stated	Cease and Desist Order Issued	· Summary Order	· unregistered securities · unregistered sales	· no legal theory addressed, summary conclusion stated
Mo.	*In re* Wireless Cable Fin. Consultants, No. CD-94-08, 1994 Mo. Sec. LEXIS 31 (Mar. 3, 1994) [Missouri Wireless Cable Action]	wireless cable television station	Cease and Desist Order Issued	· Summary Order, restating state allegations	· unregistered securities · unregistered agents and/or broker-dealers	· investment contract theory

State	Action	Business	Action Taken	Findings	Securities Law Violations Addressed	Legal Theories Discussed
N.D.	*In re* United Communications Ltd. (Dec. 22, 1993)[634]	not stated	Consent Order Issued	· Summary Order	· unregistered securities · unregistered broker-dealers or salesmen	· investment contract theory
N.D.	*In re* Parkersburg Wireless, LLC (Feb. 4, 1994) [North Dakota Parkersburg Action]	not stated	Cease and Desist Order Issued	· Summary Order	· unregistered securities	· no legal theory addressed, summary conclusions stated
Pa.	*In re* Parkersburg Wireless, LLC, No. 9403-11, 1994 WL 125846 (Pa. Sec. Comm'n) (Apr. 6, 1994) [Pennsylvania Parkersburg Action]	wireless cable television system	Summary Cease and Desist Order Issued	· Summary Order, with stated findings and conclusions	· unregistered securities · unregistered broker-dealer	· investment contract theory
S.D.	*In re* Parkersburg Wireless, LLC (Mar. 28, 1994)[635] [South Dakota Parkersburg Action]	wireless cable television system	Order to Cease, Desist and Refrain Issued	· Summary Order, with stated findings and conclusions	· unregistered securities	· investment contract theory
Wash.	*In re* Express Communications, Inc., No. 94-03-0018, 1995 WL 307000 (Wash. Sec. Div.) (May 2, 1995) [Washington Express Action]	telecommunications systems	Summary Cease and Desist Order Issued	· Summary Order, with stated findings and conclusions	· unregistered securities · unregistered brokers · antifraud violations	· investment contract theory
Wash.	*In re* Dallas MobileComm L.C., No. 94-03-0018, 1995 WL 431589 (Wash. Sec. Div.) (July 10, 1995)	mobile radio system	Consent Order	· Consent Order, with findings of fact and conclusions of law	· unregistered securities · antifraud violations	· investment contract theory · risk capital theory
Wash.	*In re* Third Mobile Ltd. of Las Vegas, No. 94-03-0018, 1996 WL 28692 (Wash. Sec. Div.) (Jan. 18, 1996)	mobile radio system	Consent Order	· Consent Order, with findings of fact and conclusions of law	· unregistered securities · antifraud violations	· investment contract theory · risk capital theory

[634] 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. 94 CV 1756, 1994 Colo. Sec. LEXIS 1 (Apr. 8, 1994).

[635] 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. 94 CV 1756, 1994 Colo. Sec. LEXIS 1 (Apr. 8, 1994).

State	Action	Business	Action Taken	Findings	Securities Law Violations Addressed	Legal Theories Discussed
Wis.	*In re* Knoxville Limited Liability Company, No. X-94044(E), 1994 WL 424373 (Wis. Comm'r Sec.) (Aug. 4, 1994)	wireless cable television system	Summary Order of Prohibition Issued	· Summary Order, based on state allegations	· unregistered securities · unregistered agent	· investment contract theory
Wis.	*In re* Baton Rouge Wireless Cable Television Co., No. X-93078(E), 1994 WL 361581 (Wis. Comm'r Sec.) (June 24, 1994)	wireless cable television system	Summary Order of Prohibition Issued	· Summary Order, based on state allegations	· unregistered securities · unregistered agent and broker-dealers	· investment contract theory
Wis.	*In re* Windgate Fund LLC, No. S-95120(EX), 1995 WL 561541 (Wis. Comm'r Sec.) (Aug. 2, 1995)	not stated	Summary Order of Prohibition Issued	· Summary Order, based on state allegations	· unregistered securities · unregistered agent · antifraud violations	· WIS. STAT. ANN. § 551.02(13) which defines certain LLC interests as securities · WIS. ADMIN. CODE § 1.02(6) which defines investment contract

TABLE II: SUMMARY OF STATE STATUTES EXPRESSLY ADDRESSING WHETHER LLC INTERESTS ARE SECURITIES

State	Statutory Citation	Summary	Statutory Language
Alaska	ALASKA STAT. § 45.55.990(12) (1994)	LLC expressly included in list of interests that are securities	"[S]ecurity" means . . . a limited liability company interest under [title 10, chapter 50 of the Alaska Statutes]*
Cal.	CAL. CORP. CODE § 25019 (West Supp. 1995)	security, unless all members are actively engaged in management	"Security" means any . . . interest in a limited liability company and any class or series of such interests (including any fractional or other interest in such interest), except a membership interest in a limited liability company in which the person claiming this exemption can prove that all of the members are actively engaged in the management of the limited liability company; provided that evidence that members vote or have the right to vote, or the right to information concerning the business and affairs of the limited liability company, or the right to participate in management, shall not establish, without more, that all members are actively engaged in the management of the limited liability company . . . .*
Ga.	GA. CODE ANN. § 14-11-1107(n) (1994)	do not construe as not a security	Nothing in this chapter shall be construed as establishing that a limited liability company interest is not a "security". . . .
Ind.	IND. CODE ANN. § 23-2-1-1(k) (West 1995)	security, unless all members are actively engaged in management	"Security" means . . . an interest in a limited liability company and any class or series of an interest in a limited liability company (including any fractional or other interest in an interest in a limited liability company) . . . . "Security" does not include . . . an interest in a limited liability company if the person claiming that the interest is not a security can prove that all of the members of the limited liability company are actively engaged in the management of the limited liability company.*
Mich.	MICH. COMP. LAWS ANN. § 450.5103 (West Supp. 1995)	security to the same extent as interest in corporation, partnership, or limited partnership	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.	MO. ANN. STAT. § 347.185 (Vernon Supp. 1995)	rebuttable presumption, not a security, if management is not vested in one or more managers	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.

* The definitional section of these state securities acts begin with the qualification that the definitions in this act, chapter, or part apply "unless the context otherwise requires." ALASKA STAT. § 45.55.990 (1994); CAL. CORP. CODE § 25001 (West 1977); IND. CODE ANN. § 23-2-1-1 (West 1995); PA. STAT. ANN. tit. 70, § 1-102 (Supp. 1995); WIS. STAT. ANN. § 551.02 (West Supp. 1995).

State	Statutory Citation	Summary	Statutory Language
N.M.	N.M. STAT. ANN. § 58-13B-2(V) (Michie Supp. 1995)	security, unless the context requires otherwise	[U]nless the context requires otherwise, "security" means . . . any interest in a limited liability company . . . .
Ohio	OHIO REV. CODE ANN. § 1707.01(B) (Baldwin Supp. 1995)	LLC expressly included in list of interests that are securities	"Security" means any . . . membership interest in limited liability companies . . . .
Pa.	PA. STAT. ANN. tit. 70, § 1-102(t) (Supp. 1995)	security, unless specified conditions satisfied	"Security" means any . . . membership interest in a limited liability company of any class or series, including any fractional or other interest in such interest unless excluded by clause (v) . . . . "Security" does not include . . . (v) A membership interest in a limited liability company where all of the following conditions are satisfied: (A) The membership interest is in a company that is not managed by managers; (B) The purchaser of the membership interest enters into a written commitment to be engaged actively and directly in the management of the company; and (C) The purchaser of the membership interest, in fact, does participate actively and directly in the management of the company.*
Vt.	VT. STAT. ANN. tit. 9, § 4202a(14) (Supp. 1995)	LLC expressly included in list of interests that are securities	"Security" includes . . . any membership interest in a limited liability company . . . .
Wis.	WIS. STAT. ANN. § 183.1303 (West Supp. 1995)	may be a security	An interest in a limited liability company may be a "security". . . .
Wis.	WIS. STAT. ANN. § 551.02(13)(c) (West Supp. 1995)	security presumed, if manager or more than 35 members	"Security" is presumed to include an interest in a limited liability company [organized under Wisconsin law] if the right to manage the limited liability company is vested in one or more managers or if the aggregate number of members of the limited liability company, after the interest is sold, exceeds 35. "Security" is not presumed to include an interest in a limited liability company [organized under Wisconsin law] if the aggregate number of members of the limited liability company, after the interest is sold, does not exceed 35 and the right to manage the limited liability company is vested in its members.*

* The definitional section of these state securities acts begin with the qualification that the definitions in this act, chapter, or part apply "unless the context otherwise requires." ALASKA STAT. § 45.55.990 (1994); CAL. CORP. CODE § 25001 (West 1977); IND. CODE ANN. § 23-2-1-1 (West 1995); PA. STAT. ANN. tit. 70, § 1-102 (Supp. 1995); WIS. STAT. ANN. § 551.02 (West Supp. 1995).

State	Statutory Citation	Summary	Statutory Language
Wis.	WIS. STAT. ANN. § 551.02(13)(b) (West Supp. 1995).	not a security, if 15 or less members and right to manage is vested in members	"Security" does not include . . . any interest in a limited liability company [organized under Wisconsin law] if the aggregate number of members of the limited liability company, after the interest is transferred, does not exceed 15 and the right to manage the limited liability company is vested in its members.*

* The definitional section of these state securities acts begin with the qualification that the definitions in this act, chapter, or part apply "unless the context otherwise requires." ALASKA STAT. § 45.55.990 (1994); CAL. CORP. CODE § 25001 (West 1977); IND. CODE ANN. § 23-2-1-1 (West 1995); PA. STAT. ANN. tit. 70, § 1-102 (Supp. 1995); WIS. STAT. ANN. § 551.02 (West Supp. 1995).

TABLE III: SUMMARY OF STATE POLICY STATEMENTS, INTERPRETIVE OPINIONS, AND NO-ACTION LETTERS RELATING TO LLC INTERESTS AS SECURITIES[636]

State	Administrative Opinion	Legal Theories Discussed	Summary of Findings
Ark.	No-action Letter, Pro Pick LLC (Ark. Sec. Dep't) (Feb. 15, 1994)	· none	The Arkansas Securities Department stated that it would take no action to enforce registration provisions with respect to LLC interests in Pro Pick LLC, where: (1) the LLC had seven members; (2) the LLC was member-managed; (3) each member had one vote, and all members would vote on business matters; and (4) all of the members would be "actively engaged in making significant business decisions."
Conn.	Limited liability company interpretative release, 1A Blue Sky L. Rep. (CCH) ¶ 14,562 (Conn. Aug. 24, 1994)	· investment contract theory	Connecticut Department of Banking stated that it intends to undertake a case-by-case analysis applying the *Howey* investment contract test and focusing on the degree to which members participate in the management and operational decisions of the entity. The Department ordinarily will presume interests in a "manager-member" form of LLC are securities. The Department intends to apply the *Williamson* analysis to interests in a "member-member" form of LLC. The Department cautions it will not merely look at the organizational documents, but it will also consider the economic realities and the actual functions and expertise of those involved in the operation of the entity.
Ind.	Statement of Policy on classification of limited liability company interests as securities, 1A Blue Sky L. Rep. (CCH) ¶ 24,681 (Ind. Sept. 20, 1993)	· investment contract theory	After applying an investment contract analysis, specifically partnership case law, the Indiana Securities Division will focus on two issues: (1) whether the members of the LLC have the right to participate significantly in management, and (2) if they do, whether they have the ability, knowledge and skill necessary to exercise that authority in a meaningful way. If the answer to either of these questions is no, the LLC interest would be a security (assuming the other elements of an investment contract are present).
Kan.	Interpretive Opinion Orchards Drug, L.C., 1991 WL 101804 (Kan. Sec. Comm'r) (May 1, 1991)	· investment contract theory · characteristics of stock test[637]	After applying the *Howey* test for investment contract, the Kansas Securities Commissioner concludes that if members elect managing members on an annual basis, who manage the business affairs of the LLC on an ongoing basis or otherwise delegate management authority to a select group, the LLC interest would be a security.
Me.	Exemption of offers and sales, 2 Blue Sky L. Rep. (CCH) ¶ 29,432 (Me. Jan. 8, 1995)	· none	Rule of the Securities Division of the Maine Bureau of Banking exempts from state registration requirements certain small LLC issuers organized under Maine law or having their principal executive offices in Maine.

[636] Table III does not purport to be a complete listing of all state administrative opinions relating to LLC interests as securities. *See supra* notes 13 and 84.

[637] Commissioner considered, but then rejected, the characteristics of stock test.

State	Administrative Opinion	Legal Theories Discussed	Summary of Findings
Md.	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. Comm'r) (Apr. 25, 1994); *see also* Anne Arundel Physicians' Cooperative LLC, 1994 WL 385059 (Md. Sec. Div.) (Mar. 8, 1994).	· investment contract theory[638] · characteristics of stock test[639]	The Maryland Division of Securities stated that it would take no action to require registration of the membership interests in an LLC formed under the Maryland LLC Act where one to two hundred physicians would become members and render physician services on behalf of the LLC.
Md.	770 Lexington Assocs. L.L.C., 1995 WL 535160 (Md. Sec. Comm'r) (June 8, 1995)	· none	In response to a request for an interpretative opinion, the Maryland Division of Securities stated that it would take no action to require the registration of securities issued by the LLC in connection with a commercial real estate venture. The Division, however, stated that it did not concur with claims that the proposed transaction did not involve the offer or sale of a security.
Mich.	Exemption for professional limited liability companies, 2 Blue Sky L. Rep. (CCH) ¶ 32,630 (Mich. Mar. 24, 1994); *see also* Oakland Physician Network, L.L.C., No. 500817, 1994 Mich. Sec. LEXIS 1 (Mich. Dep't of Comm., Corp. & Sec. Bureau) (Jan. 12, 1994)	· none	Order states the offer and sale of interests in a limited liability company may constitute the offer and sale of a security. Exempts from registration, transactions involving the offer and sale of LLC interests in professional limited liability companies formed under the Michigan Limited Liability Company Act to provide the professional services expressly described in the Act, such as services provided by accountants, physicians, architects, engineers and attorneys.
Mich.	Michigan Limited Liability Companies, Release No. 94-2-S, 2 Blue Sky L. Rep. (CCH) ¶ 32,632 (Mich. Corp. and Sec. Bureau) (Jan. 20, 1995)	· none	Release defines how the Michigan Corporations and Securities Bureau will apply the counting provisions in the transactional securities exemption for persons who are members of LLCs.
Minn.	Interpretive Opinion, Lindquist & Vennum Professional Ltd. Liab. Co. (Minn. Dep't Comm.) (Dec. 27, 1993)	· investment contract theory	In response to a request for an interpretive opinion on whether an interest in a proposed professional LLC would be a security, the Minnesota Commissioner of Commerce applied the *Howey* investment contract test and noted that the decision would "ultimately turn on the extent to which the . . . members rely on the efforts of others to generate firm profits."

[638] Theory discussed in LLC's exemption request, but the theory was not addressed in the Maryland Division of Securities' no-action letter. The no-action letter did not state the theory or theories upon which the Maryland Division of Securities based its conclusion.

[639] Theory discussed in LLC's exemption request, but the theory was not addressed in the Maryland Division of Securities' no-action letter. The no-action letter did not state the theory or theories upon which the Maryland Division of Securities based its conclusion.

State	Administrative Opinion	Legal Theories Discussed	Summary of Findings
Mont.	Opinion Letter, H-I Missoula, LLC (Mont. Sec. Dep't) (June 15, 1995)	· investment contract theory	The Montana Securities Department stated that it will treat an LLC as a security if it meets the *Howey* investment contract test. In discussing the reliance on the efforts of others element, the Department stated that it believes a crucial factor in the analysis is the number of LLC members. If the LLC has ten or fewer members, the Department will presume such interests are not securities. This presumption, however, is rebuttable. If the LLC has more than ten members, the Department will review the particular situation to determine whether the members are actively involved in the LLC's business or relying on the efforts of others.
N.C.	Rule .1510, Limited liability company membership interests as securities, 2A Blue Sky L. Rep. (CCH) ¶ 43,474 (N.C. Dec. 1, 1994)	· none	Membership interests in an LLC formed under the North Carolina Limited Liability Company Act shall be presumed to be securities (1) where the articles of organization provide that all members of the LLC are not necessarily managers, or (2) where all members by virtue of their status as members are managers and the number of members is greater than 15. Among the factors that the North Carolina Securities Division will consider as evidence to rebut or support the presumption are: (1) whether investors retain the right to exercise practical and actual control, (2) whether the number of members is so great as to render the managerial powers afforded insignificant and meaningless, (3) whether the promoter has some particular or special skill which is necessary for successful operation, and (4) whether special circumstances render meaningless the managerial powers given to members.
N.J.	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)	· none	In response to an inquiry as to the applicability of certain exemptions to the offer of interests in an LLC, the New Jersey Bureau of Securities stated LLC interests are considered securities and subject to the New Jersey securities laws. The Bureau went on to find that under the specific facts stated in the inquiry the registration exemptions at issue would apply.
Okla.	Exemption request—Membership interests in a limited liability company, 2A Blue Sky L. Rep. (CCH) ¶ 46,664 (Okla. Dep't of Sec.) (Aug. 28, 1992)	· investment contract theory · risk capital test	In response to a request for a no-action position in connection with the offer and sale of membership interests in an LLC, the Oklahoma Department of Securities applied the *Howey* investment contract test and noted that Oklahoma has adopted the "substantial" approach, rather than the "solely" approach. Further, the Department indicated that in light of Oklahoma case law the Department would consider investor sophistication and dependency, not merely the provisions in the operating documents.
S.C.	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. Comm'r) (June, 1995)	· investment contract theory	The South Carolina Securities Commissioner will require compliance with the South Carolina securities act and will make recommendations about enforcement actions based upon rebuttable presumptions: (1) that membership interests in manager-managed LLCs with any members who are not equally participating managers are securities; and (2) membership interests in member-managed LLCs in which each member has practical and meaningful participation in and control over the managerial decisions of the enterprise are not securities. The Securities Commission also provides "safe harbor" relief for interests in LLCs formed in South Carolina when (1) the articles of organization and operating agreement do not appoint managers or cause members to delegate managerial control, (2) all members retain the right to exercise practical and actual control over managerial decisions, (3) the number of members is not so great as to render members' managerial powers substantially meaningless, (4) the promoter does not have a peculiar or special skill necessary for successful operation, and (5) there are no other special facts or circumstances which render members' managerial powers meaningless.

State	Administrative Opinion	Legal Theories Discussed	Summary of Findings
S.D.	Letter from Debra M. Bollinger, Director, S.D. Div. of Sec., to Hon. Thomas C. Barnett, Executive Director of State Bar of S.D. (May 16, 1995)	· investment contract theory	The South Dakota Division of Securities indicated it would apply the *Howey* investment contract test to determine if an LLC interest was a security. The Division stated that it would look at three elements to determine if the "solely through the efforts of others" element of *Howey* is present: (1) the contractual power of the members to effect management decisions; (2) the actual ability (in practice) to effect management decisions: (a) distance between the investors and the entity, (b) knowledge and/or experience of the members, and/or (c) presence of professional management or management team; and (3) the number and location of the members.
Tenn.	Limited liability company interests as securities, 2A Blue Sky L. Rep. (CCH) ¶ 54,521 (Tenn. Mar. 7, 1995)	· investment contract theory · characteristics of stock test	After discussing *Howey*, *Williamson* and *Landreth*, the Tennessee Securities Division takes the position that an interest in an LLC is a security when: (1) An LLC member invests money or value in a common scheme or enterprise and is led to an expectation of profits through the entrepreneurial or managerial efforts of others in that: (a) some agreement among the LLC members leaves so little power in the hands of the member that the arrangement distributes power as would a limited partnership; or (b) the member is so inexperienced and unknowledgeable about the business of the LLC that he is incapable of intelligently exercising his powers; or (c) the member is so dependent on the unique entrepreneurial or managerial ability of the promoter or manager that the member cannot replace the manager of the enterprise or otherwise exercise meaningful membership powers; or (2) Membership interests are sold to large numbers of the general public, with the result that there are so many members that a membership vote is more like a corporate vote, each member's role having been diluted to the level of a single shareholder in a corporation. The Division also states if an LLC interest possesses the characteristics of stock set forth in *Landreth*, the LLC interest could be labeled stock which under the Tennessee securities act is a security.
Wyo.	Draft Interpretive Opinion Letter, Are Limited Liability Company Memberships Securities? (Wyo. Sec. of State, July 16, 1993)[140]	· investment contract theory	The interpretive opinion letter concludes that LLC membership interests are presumptively not securities, but notes that in certain circumstances they may be deemed "investment contract securities" depending on whether anticipated profits of the enterprise are derived substantially through a third party's efforts. The determination depends not only on the legal control granted to the members by the articles of organization and operating agreement, but on the members' actual ability and opportunity to exercise those powers. Applying the *Williamson* general partnership analysis, the letter states that an LLC interest may be a security if (1) the documents leave the members with no management power similar to a limited partner, or (2) the member is incapable of exercising the powers granted because of limited knowledge or inexperience in business matters, or (3) the members depend on an ability of a manager or promoter that cannot be replaced, or (4) some other factor demonstrates the member's anticipated profit relies "substantially" on another's efforts.

[140] In-house opinion drafted by staff members of the Wyoming Securities Division and not a formal opinion issued by the Wyoming Attorney General's office. The informal opinion was drafted in response to the many inquiries the office received and has not been released as a formal legal opinion.