Texas Wesleyan Law Review

Volume 9 | Issue 1 Article 4

10-1-2022

Cheeseheads and Longhorns: Why Texas Should Follow Wisconsin's Lead in the Treatment of Limited Liability Company Member Interests as Securities

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NOTES AND COMMENTS

CHEESEHEADS AND LONGHORNS: WHY TEXAS SHOULD FOLLOW WISCONSIN'S LEAD IN THE TREATMENT OF LIMITED LIABILITY COMPANY MEMBER INTERESTS AS SECURITIES

I. INTRODUCTION

The limited liability company business form has revolutionized the business association world, offering corporate liability protection and

partnership-like tax benefits to business owners.[1] "It is a perfect replacement for the joint venture, general partnership and in many cases the limited partnership [sic]. I would think a lot of entrepreneurs would use this," says George W. Coleman, a Dallas attorney who assisted in drafting Texas's LLC law.[2] Unfortunately, securities regulators say that scam artists have discovered the business form as well.[3]

The Securities and Exchange Commission and state regulators have focused on so-called "wireless cable"[4] LLCs in recent years.[5] In one recent case, California regulators found that a blind, sixty-six-year-old veteran invested his entire $35,000 life savings in a wireless cable television scheme when a "fast-talking promoter" approached him repeatedly at the VA hospital where he received daily oxygen therapy.[6]

> Adding insult to injury, many burned investors not only lose all their money, they owe taxes on it as well. If they transfer their IRAs to a promoter who takes the money and runs, the "transfer" will be construed by the IRS as a withdrawal, and investors will owe income taxes on the money, plus a 10% penalty if they [are] under age 59 ½.[7]

One of the first actions by the SEC against an LLC was *SEC v. Vision Communications, Inc.*[8] The action targeted a Texas LLC selling interests in a "wireless cable" enterprise in the Wilkes-Barre/Scranton, Pennsylvania area.[9] The SEC alleged that the defendants "raised approximately $1.25 million . . . using high pressure sales techniques, . . . offering and selling interests in [the LLC]," which the SEC argued constituted an unregistered sale of securities.[10] According to the SEC, the salespeople in Plano, Texas, telephoned "investors all over the United States using high-pressure and harassing telephone techniques," making "numerous false statements to investors."[11] Many of the investors were financially unsophisticated, including retirees and

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

2. *Id.*

3. *See id.*

4. "Wireless cable . . . refers to a method of transmitting video entertainment programming through the use of microwave radio technology . . . . [It] allows wireless networks to broadcast television programming similar to that offered by cable television companies." Elaine A. Welle, *Limited Liability Company Interests as Securities: An Analysis of Federal and State Actions Against Limited Liability Companies Under the Securities Laws*, 73 DENV. U. L. REV. 425, 431 n.23 (1996).

5. *See id.* at 431.

6. Ellen E. Schultz, *IRA Money May Attract Shady Deals*, WALL ST. J., Dec. 7, 1994, at C1.

7. *Id.*

8. *See* Vision Communications, Inc., Litigation Release No. 14,026, 56 SEC Docket (CCH) 880, 880 (D.D.C. Mar. 24, 1994).

9. *See id.*

10. *Id.*

11. *Alleged Boiler Room Sales of Interests in Cable Venture Subject of SEC Suit*, 26 SEC. REG. & L. REP. 662, 662 (1994).

blue-collar workers who were induced to invest their retirement funds in the LLC.[12] The District Court issued an injunction prohibiting the defendants from further sale of the unregistered securities.[13] Similar actions have been filed against other LLCs selling interests in "wireless cable" enterprises.[14] Because LLCs have traditionally not been treated as securities for securities laws purposes, the promoters of these schemes were able to entice investors who were without the protection of the securities laws.

The limited liability company has become one of the more attractive business associations, both for legitimate enterprises seeking flexibility in structure, shields from personal liability for company debts and obligations, and tax advantages, and for the not-so-legitimate enterprises seeking shelter from personal liability for taking advantage of the unwary. In order to assist and protect the investing public and to provide certainty and structure for business owners, Texas should amend its current statutory scheme to mandate the treatment of certain LLC interests as securities, modeling this legislation after the Wisconsin approach—a three-tiered method of defining an LLC as a security. Part II of this Comment will describe the LLC entity and its history, enumerate its advantages, and give a brief description of the 1997 IRS taxation changes. Part III will delve into the much-debated question whether LLC member interests are securities and will describe the benefits of treating them as such. Part IV will describe the Texas treatment of LLC member interests to date and the problems that accompany that treatment. Part V will describe some other states' treatment of LLC interests and how the Wisconsin approach is preferable. Part VI will enumerate the proposed changes to Texas law modeled after those states' regulations.

II. Characteristics and General Comments About the LLC Form

A. *History of the LLC in the United States*

It is important to understand the meteoric rise of the LLC in order to grasp the potential dangers to investors as its popularity grows. "[T]he LLC is a distinctly modern creation in the United States;"[15] thus, little case law surrounds the resolution of most of the issues related to it. In the 1970s, the Hamilton Brothers Oil Company of Den-

12. *Id.*

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

14. *See, e.g.*, SEC v. Shreveport Wireless Cable Television P'ship, No. Civ.A. 94-1781(HHG), 1998 WL 892948 (D.D.C. Oct. 20, 1998); SEC v. Parkersburg Wireless L.L.C., 991 F. Supp. 6 (D.D.C. 1997); Commission Obtains TRO Against Knoxville, LLC, et al., SEC Digest 94-130, July 12, 1994, *available at* 1994 WL 328317 (S.E.C.).

15. Robert W. Hamilton & Richard A. Booth, Business Basics for Law Students § 10.29, 283 (2d ed. 1998).

ver sought to form an entity in the United States similar to the *limitada* business form with which the company was familiar from its dealings in Central America.[16] The Company decided to focus on Wyoming, a state that was attempting to attract business.[17] The Wyoming Legislature subsequently passed the first limited liability company statute in the United States in 1977.[18] Florida, hoping to encourage businesses to move to that state, passed the second LLC Act in 1982.[19] In 1980, the IRS's Proposed Regulations denied partnership taxation to any business association in which no member was personally liable for the debts of the enterprise;[20] therefore, the LLC did not immediately attract much attention.[21] It appeared that the LLC was no better than a corporation: it offered limited liability, but it would still be subject to double taxation.[22] However, in 1988, the IRS issued Revenue Ruling 88-76 stating that an LLC created according to the Wyoming act would be treated as a partnership for tax purposes.[23] As a result, Colorado and Kansas enacted LLC statutes in 1990; Texas, Nevada, Utah, and Virginia followed in 1991, and most of the remaining states followed suit soon thereafter.[24]

16. *Id.*

17. *See id.*; Michael J. Garrison & Terry W. Knoepfle, *Limited Liability Company Interests as Securities: A Proposed Framework for Analysis*, 33 AM. BUS. L.J. 577, 580 (1996).

18. *See* HAMILTON & BOOTH, *supra* note 15, § 10.29, at 283; *see also* WYO. STAT. ANN. §§ 17-15-101 to 17-15-136 (Michie 1977).

19. Garrison & Knoepfle, *supra* note 17, at 580; *see also* FLA. STAT. ANN. §§ 608.401–.471 (2001).

20. *See* Prop. Treas. Reg. § 301.7701-2, 45 Fed. Reg. 75,709 (1980).

21. *See* Garrison & Knoepfle, *supra* note 17, at 580.

22. *See id.*; Michael S. Schadewald & Tracy A. Kaye, *Source of Income Rules and Treaty Relief from Double Taxation Within the NAFTA Trading Bloc*, 61 LA. L. REV. 353, 373 (2001) (citing I.R.C. §§ 61(a), 301(c)(1) (CCH 1999)). "Subchapter C Corporations" are subject to what is known as double taxation. The corporation itself is taxed at the entity level on income, and then the shareholders are taxed again when dividends are distributed. *Id.*

23. Jeffrey A. Maine, *Evaluating Subchapter S in a "Check-the-Box" World*, 51 TAX LAW. 717, 726–27 (1998). The issue in the Revenue Ruling was "whether a Wyoming limited liability company, none of whose members or designated managers are personally liable for any debts of the company, is classified for federal tax purposes as [a corporation] or as a partnership." Rev. Rul. 88-76, 1988-2 C.B. 360, *obsoleted by* Rev. Rul. 98-37, 1998-2 C.B. 133. The IRS listed the corporate characteristics as "(1) associates, (2) an objective to carry on a business and [derive profits from it], (3) continuity of life," (4) centralized management, (5) limited liability for corporate debt, "and (6) free transferability of interests." *Id.* The IRS ruled that "whether a particular [business association] is to be classified as a corporation for tax purposes must be determined by taking into account the presence or absence" of those characteristics. *Id.* at 360–61. "[I]f an unincorporated [association has] more corporate characteristics than noncorporate characteristics," then it is taxed as a corporation. *Id.* at 360–61. Though the limited liability company at issue had associates and an objective to carry on a business for profit, the IRS ruled that it did not possess the remaining corporate characteristics and would therefore be taxed as a partnership. *Id.* at 360–61.

24. Robert B. Keatinge, *New Gang in Town: Limited Liability Companies: An Introduction*, BUS. L. TODAY, Mar.–Apr. 1995, at 5, 6.

The LLC form was designed to escape corporate double taxation and to allow profits and losses to pass through to members for tax purposes.[25] In addition, it avoids the mandatory corporate formalities, such as required meetings, board of directors, voting rights, and officers.[26] In financial structure, the LLC can also avoid the application of corporate statutes' legal capital requirements.[27] Though a general partnership can also achieve the above goals, LLC members have shareholder-like limited liability, while general partners have unlimited personal liability for the debts and obligations of the partnership.[28] "Partnership/corporation hybrids," though, are not new: the limited partnership has been the business association of choice for many business people who wish to avoid personal liability and the formalities of a corporation.[29] The advantage of the LLC, though, is that there is no limit on the amount of control that each member can exercise over the enterprise, whereas limited partners must not exercise too much control over the partnership or risk losing their liability shield.[30] In addition, no one member needs to be subject to unlimited liability, as that of a general partner in a limited partnership—all LLC members can enjoy limited personal liability.[31] Today, many commentators assert that the LLC will largely replace the partnership and the closely held corporation, and that it will dominate the nonpublicly traded business form.[32] In fact, in Texas, 16,844 LLCs were formed, compared to 40,395 corporations, in just one year.[33] Therefore, steps must be taken as early as possible to prevent problems such as those witnessed in the "wireless cable" cases.

B. *The Texas Limited Liability Company Act*

This Section will use the Texas Limited Liability Act's provisions to describe the basic characteristics of the LLC form. The Texas Limited Liability Company Act (hereinafter the TLLCA) was originally passed in 1991 and last revised in 2001.[34] It combines features from

25. MARK A. SARGENT & WALTER D. SCHWIDETZKY, LIMITED LIABILITY COMPANY HANDBOOK: LAW—SAMPLE DOCUMENTS—FORMS § 1.03, 1-3 (1994–1995 ed. 1994) [hereinafter SARGENT HANDBOOK].

26. *Id.*

27. *Id.*

28. *Id.* at 1-3 to 1-4.

29. *Id.* at 1-4.

30. *See id.*

31. *Id.*

32. Susan Pace Hamill, *The Limited Liability Company: A Catalyst Exposing the Corporate Integration Question*, 95 MICH. L. REV. 393, 446 (1996); *see also* Jonathan R. Macey, *The Limited Liability Company: Lessons for Corporate Law*, 73 WASH. U. L.Q. 433, 436–37 (1995); Maine, *supra* note 23, at 718–20.

33. E-mail from Tina Passell, Manager, Public Information & Technology, Corporations Section, Texas Secretary of State, to Kimberley Latham, Author (Oct. 29, 2001, 12:15:47 EST) (on file with the Texas Wesleyan Law Review) (referring to fiscal year 2000 statistics).

34. TEX. REV. CIV. STAT. ANN. art. 1528n (Vernon 1997 & Supp. 2002).

both the Texas Business Corporations Act (hereinafter the TBCA) and the Texas Revised Limited Partnership Act (hereinafter the TRLPA).[35] It uses some of the same broad language as that used in the TBCA, stating that an LLC formed under the Act "may engage in any lawful business,"[36] unless the LLC sets forth a more limited purpose in its Articles of Organization.[37] Further, the TLLCA dictates that "each [LLC] shall have the power provided for a corporation under the TBCA and a limited partnership under the [TRLPA]."[38] The Act includes both mandatory rules that must be followed by all LLCs and default rules that apply in the case that an LLC fails to specify otherwise in its Articles of Organization.[39]

1. Formation

The formation of an LLC can be accomplished with relative ease. To form an LLC, one or more organizers of the LLC must file Articles of Organization with the Secretary of State.[40] A natural person eighteen years of age and older "may act as an organizer of an [LLC], without regard to place of residence, domicile, or organization, [simply] by signing the Articles of Organization for" the LLC and filing the Articles with the Secretary of State.[41] The Articles of Organization for the LLC are very similar to the Articles of Incorporation used for the corporation.[42] They must give the name of the LLC,[43] "the period of duration, which may be perpetual,"[44] "[t]he purpose for which the LLC is organized which may be stated to be the transaction of any or all lawful business,"[45] "[t]he address of its registered office" and organizers,[46] and "[a]ny other provisions . . . that the members elect to set out . . . for the regulation of the internal affairs of the [LLC]."[47] Other additional information is required if the LLC is being organized pursuant to a plan of merger or conversion or is a professional LLC.[48] In addition, the Articles must indicate whether the

35. *Compare id.*, *with* TEX. BUS. CORP. ACT ANN. (Vernon 1980 & Supp. 2002) (TBCA), *and* TEX. REV. CIV. STAT. ANN. art. 6132a (Vernon 1970 & Supp. 2002) (TRLPA).

36. *Compare* TEX. REV. CIV. STAT. ANN. art. 1528n, § 2.01(A) (Vernon 1997), *with* TEX. BUS. CORP. ACT ANN. art. 2.01 § A (Vernon Supp. 2002).

37. TEX. REV. CIV. STAT. ANN. art. 1528n, § 2.01(A) (Vernon 1997).

38. *Id.* § 2.02(A) (Vernon Supp. 2002).

39. *Id. passim.*

40. *Id.* § 3.01(A) (Vernon 1997).

41. *Id.*

42. *Compare id.* § 3.02 (Vernon Supp. 2002), *with* TEX. BUS. CORP. ACT ANN. art. 3.02 § A (Vernon Supp. 2002).

43. TEX. REV. CIV. STAT. ANN. art. 1528n, § 3.02(A)(1) (Vernon Supp. 2002).

44. *Id.* § 3.02(A)(2).

45. *Id.* § 3.02(A)(3).

46. *Id.* § 3.02(A)(4), (6).

47. *Id.* § 3.02(A)(9).

48. *Id.* § 3.02(A)(6)–(8).

LLC will have managers, and must include the names and addresses of the managers or the "initial members."[49]

2. Regulations

The LLC may adopt "regulations," which are similar to corporate bylaws.[50] The regulations may detail the management and regulation of the LLC, so long as they are consistent with law and the Articles of Organization. The regulations may also articulate the method for admitting and expelling members,[51] allocation of profits and losses,[52] and the reasons and process for dissolving and winding up the LLC.[53] This allows the LLC substantial flexibility in structuring the affairs of the company according to members' wishes. According to Professor Sargent,[54] "[t]he flexibility allowed to LLCs deserves particular emphasis."[55] The LLC statutes in general, and Texas included,[56] contain no rules that govern the issuance of ownership interests, creation of classes of interests, or the allocation of equity contributions to any stated capital or capital surplus accounts, as is required with the corporate form.[57] "This hands-off approach," says Professor Sargent, "leaves virtually all of the essential elements of the capital structure to be determined by the parties, with results reflected in an 'operating agreement' that is roughly analogous to a general partnership agreement."[58] In addition, the LLC statutes contain none of the corporate statutes' requisite hierarchy of shareholders, directors, and officers, allowing the owners of the business to use the operating agreement and regulations to set up the management of the entity as they please.[59] Therefore, "[w]hole bodies of corporate law doctrine, such as the rule invalidating board-sterilizing agreements, are rendered irrelevant."[60]

3. Management

Unless otherwise specified in the Articles of Organization or regulations, "the business and affairs of [an LLC will] be managed under the

49. *Id.* § 3.02(A)(5).

50. *Compare id.* § 2.09, *with* TEX. BUS. CORP. ACT ANN. art. 2.23 (Vernon Supp. 2002). Both LLC regulations and corporate bylaws may include provisions dealing with management—the quantity, term, and titles of managers—meeting times and locations, dissolution procedures, and so forth.

51. *See* TEX. REV. CIV. STAT. ANN. art. 1528n, §§ 4.05, 5.05 (Vernon 1997).

52. *See id.* § 5.02-1(A).

53. *See id.* §§ 6.01 (Vernon 1997 & Supp. 2002), 6.03 (Supp. 2002).

54. Professor Mark A. Sargent, Professor of Law at the University of Maryland School of Law, is a leading commentator in the emerging LLC arena. He has published a number of law review articles and a book on the subject.

55. SARGENT HANDBOOK, *supra* note 25, § 1.03, at 1-4.

56. *See* TEX. REV. CIV. STAT. ANN. art. 1528n (Vernon 1997 & Supp. 2002).

57. SARGENT HANDBOOK, *supra* note 25, § 1.03, at 1-4.

58. *Id.* (footnote omitted).

59. *Id.*

60. *Id.*

direction of the manager or managers of the [LLC]."[61] If the members desire, though, management of the LLC may be reserved to the members in entirety, and no "managers" will be required.[62] This has led to the conceptual distinction made in academic circles between "member-managed" LLCs and "manager-managed" LLCs.[63] This distinction may be important for securities law purposes, as discussed below.[64]

4. Membership

In Texas, an LLC "may have one or more members."[65] "The [LLC] regulations may establish classes or groups of members . . . having certain . . . rights, powers, and duties, including voting rights," which may be senior to those of other classes of members.[66] Significantly, "a member or manager is not liable for the debts, obligations, or liabilities of [the LLC] including under a judgment decree, or order of a court," unless the regulations provide otherwise,[67] so owners of LLCs allegedly engaged in fraudulent promotion schemes or other unwise business practices may walk away unscathed. Similar to the Texas Revised Partnership Act, members do not have an interest in specific LLC property,[68] but the membership interest itself is personal property.[69] Membership interests are assignable,[70] but the assignment of a membership interest does not effect a dissolution of the LLC, "or entitle the assignee to participate in the management [or] affairs of the [LLC] or to become or exercise any rights of a member" unless the regulations otherwise provide.[71] The LLC's regulations may provide that a Certificate of Membership Interest issued by the LLC evidences a member's membership interest.[72]

5. Contribution and Distribution

A member's contribution to the LLC may consist of "any tangible or intangible benefit to the [LLC]."[73] Profits and losses of the LLC are allotted to the members according to the regulations, and if no regulation was set forth, the TLLCA provides that the profits and losses are to be allocated according to the percentage interest in the

61. TEX. REV. CIV. STAT. ANN. art. 1528n, § 2.12(A) (Vernon 1997).
62. *Id.*
63. *See, e.g.*, Keatinge, *supra* note 24, at 5.
64. *See infra* Part III.
65. TEX. REV. CIV. STAT. ANN. art. 1528n, § 4.01(A).
66. *Id.* § 4.02(A).
67. *Id.* § 4.03(A).
68. *Compare id.* § 4.04(A), *with id.* at art. 6132b, § 2.04 (Vernon Supp. 2002).
69. *Id.* at art. 1528n, § 4.04(A) (Vernon 1997).
70. *Id.* § 4.05(A)(1).
71. *Id.* § 4.05(A)(2).
72. *Id.* § 4.05(B).
73. *Id.* § 5.01(A) (Vernon Supp. 2002) (including a partial list of forms that contribution may take).

LLC.[74] Similarly, allocations of cash and other assets of the LLC are to be made in the manner set forth in the regulations, and "[i]f the regulations do not [so] provide [then the] distributions shall be made on the basis of the agreed value . . . of the contributions made by each member."[75]

6. Dissolution

An LLC shall be dissolved upon the first of the following to occur: 1) expiration of the period of duration of the LLC, if any; 2) the occurrence of an event specified in the Articles of Organization or regulations to cause dissolution; 3) the unanimous action of members to dissolve the LLC where capital contributions were made to the LLC; 4) the act of a majority of members or managers to dissolve the LLC where no capital contributions were made; 5) unless otherwise provided for in the regulations, the death, expulsion, withdrawal, bankruptcy, or dissolution of a member (unless there is at least one remaining member of the LLC and all remaining members vote to continue the business of the LLC); or 6) the entry of a judicial dissolution decree.[76] Upon dissolution, the LLC's affairs are to be wound up as soon as practically possible by the managers, members, or any other person specified to carry out the dissolution.[77] The assets of the LLC are then to be transferred to, in order, 1) creditors, including any member who is a creditor for an amount other than contributions to the LLC; 2) unless the regulations state otherwise, to past and present members to satisfy the LLC's distribution liability; and 3) unless provided otherwise, to members according to their respective rights and interests.[78]

C. *The "Check-the-Box" Revolution*

With the advent of the "check-the-box" regulations, unincorporated business associations such as the LLC became more attractive. Prior to the IRS's "check-the-box" regulations, the tax classification of an unincorporated business form depended on four corporate characteristics (known as the *Kintney* regulations): "continuity of life, free transferability of interests, centralized management, and limited liability."[79] If the entity possessed a preponderance of the corporate characteristics, it was taxed as a corporation, but if it did not, it was subject to the flow-through taxation similar to a partnership.[80] This led to numerous problems as business owners, tax practitioners, and the IRS

74. *Id.* § 5.02-1(A) (Vernon 1997).
75. *Id.* § 5.03(A).
76. *Id.* § 6.01(A) (Vernon Supp. 2002).
77. *Id.* § 6.03(A) (Vernon 1997).
78. *Id.* § 6.04(A) (Vernon Supp. 2002).
79. *See* Maine, *supra* note 23, at 730 & n.79.
80. *See id.* at 730 & n.81.

found themselves spending tremendous amounts of time and resources adhering to the formalistic factors.[81]

In May 1996, the Treasury Department proposed regulations,[82] coined "check-the-box" regulations, eliminating the four formalistic factors and allowing business owners to make an election regarding tax status.[83] The regulations permitted most unincorporated entities, such as limited partnerships and LLCs, to elect partnership taxation by simply filing an election form.[84] This allows the owners of the business to determine for themselves whether to be taxed as a partnership, where the profits and losses of the enterprise flow through to the owners themselves for tax consequences to attach, or to be taxed as a corporation, where the income of the enterprise is taxed at the entity level out of the business's assets and then taxed again if and when profits are distributed to the owners.[85] The regulations became effective on January 1, 1997.[86]

The states responded by amending their LLC statutes to eliminate statutory restrictions aimed at the *Kintney* test and to enhance LLC drafting flexibility.[87] State statutes no longer needed to include provisions aimed at avoiding continuity of life; instead, the LLC could enjoy the seemingly unlimited life of the corporation.[88] Texas amended the TLLCA to eliminate the thirty-year duration limitation, and now indicates that the period of duration "may be perpetual."[89] States could also eliminate restrictions intended to avoid management schemes possessing corporate characteristics of centralized management.[90] Under the check-the-box classification, whether management is vested in a small group of managers or in all members equally is irrelevant.[91] The TLLCA provides that the LLC's Articles of Organi-

81. *Id.* at 731 & n.83. Cautious attention to the regulatory scheme was mandatory because LLCs necessarily possess the corporate limited liability characteristic, so avoiding the remaining three factors to create the "majority" became arduous. *Id.* at 730.

> The problem with the old, formalistic classification regime was that clients and tax practitioners found themselves spending considerable resources in ensuring desirable classification, even though partnership classification was usually a foregone conclusion. On the other side, the Service found itself spending considerable amounts of time interpreting each factor and issuing private letter rulings to those seeking assurance as to classification.

Id. at 731.

82. Simplification of Entity Classification Rules, 61 Fed. Reg. 21,989 (May 13, 1996) (codified as amendments to Treas. Reg. §§ 301.7701-1 to -3).

83. *See* Maine, *supra* note 23, at 731; Simplification of Entity Classification Rules, 61 Fed. Reg. at 21,989.

84. *See* Simplification of Entity Classification Rules, 61 Fed. Reg. at 21,989.

85. *See* Maine, *supra* note 23, at 718; Schadewald & Kaye, *supra* note 22, at 373.

86. *See* Simplification of Entity Classification Rules, 61 Fed. Reg. at 21,989.

87. *See* Maine, *supra* note 23, at 733.

88. *Id.* at 733–34.

89. TEX. REV. CIV. STAT. ANN. art. 1528n, § 3.02(A)(2) (Vernon Supp. 2002).

90. Maine, *supra* note 23, at 733–34.

91. *Id.* at 734.

zation can "reserve management of the [LLC] to the members in whole or in part" or can provide for managers who are not even members of the LLC.[92] This particular aspect of the aftermath of the check-the-box regulations supports the presumption that interests in certain LLCs are securities, as discussed in Part III below. Finally, the free transferability of interests is no longer cause for concern, and states can and did eliminate provisions designed to avoid it and now allow management voting rights to be transferred along with the LLC ownership interests without jeopardizing pass-through taxation.[93] The TLLCA was amended to eliminate the restriction requiring the consent of all members to any transfer of a member's interest.[94] It now provides that "a membership interest is assignable in whole or in part"[95] and that the Articles of Organization may allow for the assignee to automatically become a member, with or without the consent of other members.[96]

As a consequence of all these changes, "LLC statutes are looking increasingly similar to their corporate counterparts;"[97] they now "offer limited liability, perpetual existence, corporate dissolution provisions, centralized management, and free transferability—[all of which] can be tailored in the operating agreement, [making the LLC] more attractive than the less flexible true corporate form."[98]

III. Is the LLC Member Interest a Security, and Why Does It Matter?

The issue of whether members' interests in LLCs are securities has been the topic of much debate, many law review articles,[99] and some litigation.[100] Because the LLC is an unincorporated business form that seems to be a hybrid between the corporation and the partnership, there is little consensus to date.

92. Tex. Rev. Civ. Stat. Ann. art. 1528n, § 2.12 (Vernon 1997).
93. Maine, *supra* note 23, at 734.
94. *See* Tex. Rev. Civ. Stat. Ann. art. 1528n, § 4.07(A)(1).
95. *See id.* § 4.05(A)(1).
96. *Id.* § 4.07(A)(1).
97. Maine, *supra* note 23, at 735.
98. *Id.*
99. *See, e.g.*, Mark A. Sargent, *Are Limited Liability Company Interests Securities?*, 19 Pepp. L. Rev. 1069 (1992) [hereinafter Sargent, *Securities?*]; Marc I. Steinberg & Karen L. Conway, *The Limited Liability Company as a Security*, 19 Pepp. L. Rev. 1105 (1992); Welle, *supra* note 4; David L. Cohen, Comment, *Theories of the Corporation and the Limited Liability Company: How Should Courts and Legislatures Articulate Rules for Piercing the Veil, Fiduciary Responsibility and Securities Regulation for the Limited Liability Company?*, 51 Okla. L. Rev. 427 (1998).
100. *See, e.g.*, SEC v. Parkersburg Wireless L.L.C., 991 F. Supp. 6 (D.D.C. 1997); Nutek Info. Sys., Inc. v. Ariz. Corp. Comm'n, 977 P.2d 826 (Ariz. Ct. App. 1998), *cert. denied sub nom.*, AKS Daks Communications, Inc. v. Ariz. Corp. Comm'n, 528 U.S. 932 (1999); Vision Communications, Inc., Litigation Release No. 14,026, 56 SEC Docket (CCH) 880 (D.D.C. Mar. 24, 1994).

A. *Why Does the Designation as a "Security" Matter?*

The issue of whether an LLC interest is a security has been described as a "double-edged sword."[101] That is, on one hand, if the interests are designated as securities, "the investing public may benefit from protection from securities fraud;" on the other, "investment and entrepreneurship may be stymied if LLC interests are subject to securities laws."[102]

If LLC interests do constitute "securities," then several consequences follow. First, offerings of such membership interests may have to be registered under federal and state securities laws,[103] unless an exemption from registration can be found and utilized.[104] Under federal law, the registration process would require that the LLC file a Registration Statement with the SEC and deliver prospectuses to potential investors.[105] The failure to do so can lead to a private right of rescission or civil and criminal liability.[106] Under Texas law, the registration process would require that the LLC file a Registration Statement with the State Securities Board as well.[107] Failure to do so at the state level can lead to additional civil and criminal liability.[108]

The second consequence of the designation of LLC interests as securities is the antifraud provisions of the federal and state securities laws, regardless of whether the security is exempt from registration.[109] If LLC membership interests are not designated as securities, an investor's only remedy for material misstatements or omissions in connection with the purchase or sale of those membership interests will fall under either common law fraud[110] or the Texas Deceptive Trade Practices Act.[111] While the Texas Deceptive Trade Practices Act ap-

101. Garrison & Knoepfle, *supra* note 17, at 579.

102. *Id.*

103. Robert R. Joseph, Comment, *Should Interests in Limited Liability Companies Be Deemed Securities?: The Resurgence of Economic Reality in Investment Contract Analysis*, 44 EMORY L.J. 1591, 1592 (1995).

104. Exemptions from registration can be on the transaction level, which exempts only the specific transaction in question. Examples of transaction exemptions include private placements where securities are offered and sold only to a limited number of informed investors, intrastate offerings where securities are offered and sold only to residents of the state in which the issuer has its principal place of business, and insolvency or bankruptcy sales. Exemptions from registration can also be on the security level, which exempts the security itself from registration forever. Examples of exempt securities include government bonds, securities issued by nonprofit issuers, and insurance policies. *See* 15 U.S.C. §§ 77c, 77d (2000); TEX. REV. CIV. STAT. ANN. arts. 581-5, 581-6 (Vernon Supp. 2002).

105. 15 U.S.C. §§ 77f, 77j.

106. *Id.* §§ 77*l*, 77t.

107. TEX. REV. CIV. STAT. ANN. art. 581-7(B), (C).

108. *Id.* at arts. 581-29, 581-33.

109. Joseph, *supra* note 103, at 1592–93.

110. *See* Keith A. Rowley, *The Sky Is Still Blue in Texas: State Law Alternatives to Federal Securities Remedies*, 50 BAYLOR L. REV. 99, 124–31 (1998).

111. *See* Mark C. Watler, *The Applicability of the Texas Deceptive Trade Practices Act to Securities Cases*, 64 TEX. B.J. 542, 543–44 (2001).

pears to be a beneficial remedy for the defrauded investor in an LLC, it has not been tested in the security arena, and it is unclear how the courts would handle such investments under that law.[112]

However, if LLC membership interests are designated as securities, the defrauded investor will have the additional protection of the Texas Securities Act and the Texas Business and Commerce Code.[113] The benefit to the defrauded investor here is that under the Texas Securities Act, it is not necessary, as it is with a common law fraud case, that the plaintiff prove *scienter*—that the offending party either knew that the representation he made was false or that he made the statement with reckless disregard for its truth or falsity.[114] In addition, the plaintiff does not have to prove *reliance* on the seller's misstatement or omission as he would in a common law fraud case; in other words, the Securities Act does not mandate that the buyer prove that he would not have purchased the interest if he knew of the misstated or omitted facts.[115] Under the Texas Business and Commerce Code, the plaintiff is similarly not required to prove scienter in conjunction with statutory stock fraud in order to recover.[116] In order to protect the investing public best, therefore, it is desirable to designate LLC membership interests as securities and open the avenues of protection that the Texas Securities Act and Texas Business and Commerce Code provide.

The third consequence of designating the LLC interest as a security involves continuous disclosure.[117] Continuous disclosure requirements mandate that reporting companies register with the SEC and make regular filings of reports to the SEC and the public.[118] "The most significant of the compelled reports is the annual report on Form 10-K, which is required to include an extensive description of the company's business, audited financial statements for the fiscal year, and management's discussion and analysis of the position and performance of the company."[119] In addition, quarterly filings using Form 10-Q are required.[120] Both the federal Securities Exchange Act of 1934 and the Texas Securities Act list among their purposes the protection

112. *See id.* at 543–44, 551.

113. *See* Rowley, *supra* note 110, at 148–81. *See also* TEX. REV. CIV. STAT. ANN. arts. 581-1 to -39 (Vernon 1964 & Supp. 2002) (The Texas Securities Act); TEX. BUS. & COM. CODE ANN. § 27.01 (Vernon 2002).

114. Rowley, *supra* note 110, at 151–52.

115. *Id.* at 151–52.

116. *Id.* at 169–70.

117. *See generally* 15 U.S.C. §§ 77b–77aa (2000); TEX. REV. CIV. STAT. ANN. art. 581-10-1 (Supp. 2002).

118. JAMES D. COX, ET AL., SECURITIES REGULATION: CASES AND MATERIALS 9 (3d ed. 2001).

119. *Id.*

120. *Id.*

of investors through this process.[121] "The Acts were designed to protect the American public from speculative or fraudulent schemes of promoters."[122] Therefore, Congress broadly defined the term "security," and the U.S. Supreme Court has liberally applied that definition.[123] The Court has stated that "the reach of the Act does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices . . . are also reached if it be proved . . . that they were . . . 'investment contracts,' or . . . 'any interest or instrument commonly known as a "security,"' "[124] in order to reach "the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."[125] The theory behind the Acts is that having access to all relevant information about a company best protects investors.[126] The "efficient market hypothesis" is that "a variety of forces impound available information into stock prices fast enough that arbitrage opportunities cannot be exploited systematically."[127] The SEC, securities lawyers, and the judiciary have expounded this theory for many years to say that the essence of an accurately valued stock market is the availability of accurate and complete information about the companies involved.[128] According to the efficient market hypothesis, with a fast-growing number of LLCs being opened and operated, if the securities laws do not require the release of information about them, the market as a whole will become less efficient.[129] In Texas in the year 2000, nearly half as many LLCs were formed as corporations,[130] leading to the obvious conclusion that these businesses are coming to occupy a large segment of the Texas business world.

As stated earlier, the LLC has been an attractive new entity for business owners.[131] One of the strongest features of the LLC is the comparatively low interference from state regulations, and some will argue that treating even some LLC interests as securities will erode that feature.[132] In addition, some will argue that treating LLC interests as securities will ravage the limited liability of LLCs.[133] However, as the number of LLCs increases, so does the potential for harm to the

121. *See* 15 U.S.C. § 77f(a), (g)(2); TEX. REV. CIV. STAT. ANN. art. 581-10-1(B) (Vernon Supp. 2002).
122. SEC v. Glenn W. Turner Enters., 474 F.2d 476, 481 (9th Cir. 1973).
123. *Id.*
124. SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943).
125. *Glenn W. Turner*, 474 F.2d at 481.
126. *See* COX, ET AL., *supra* note 118, at 1.
127. Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851, 851 (1992).
128. *See id.* at 851, 881, 889.
129. *See id.* at 851, 881–89.
130. *See* E-mail from Tina Passell, *supra* note 33.
131. *See supra* text accompanying notes 1–2, 17–19.
132. *See* Cohen, *supra* note 99, at 464.
133. *See id.* at 467 & n.225.

investing public by unscrupulous promoters. Some commentators have said that while the LLC was created to circumvent the bureaucratic costs of corporations, the protection provided to LLC investors outweighs costs associated with compliance with the securities laws.[134] Consequently, it is imperative that the states use the securities laws to fulfill their designed purpose and protect those investors.

B. *Does an Interest in an LLC Meet the Definition of a "Security"?*

The Federal Security Act of 1933 and the Securities Exchange Act of 1934 do not mention LLC member interests in the definition of a "security."[135] The term "security" includes "commonly known documents traded for speculation or investment," as well as "'securities' of a more variable character," such as a "'certificate of interest or participation in any profit-sharing agreement,' 'investment contract,' and 'in general, any interest or instrument commonly known as a "security."'"[136] The statutes' definitions of a "security," the clause limiting coverage of the Acts if the "context otherwise requires," and the ambiguous items listed (such as "notes," "stock," and "investment contracts") have resulted in case law described as "both vast and disorderly."[137]

The definition of what constitutes an "investment contract" was the subject of the landmark Supreme Court case, *SEC v. W.J. Howey Co.*[138] Because LLC member interests are not included in the federal Acts' or many states' statutory definitions of a "security" and most

134. *See id.* at 465; Welle, *supra* note 4, at 494.

135. *See* 15 U.S.C. §§ 77b(a)(1), 78c(a)(10) (2000). The definition of a "security" in the Security Act of 1933, which is substantially the same as that in the Securities Exchange Act of 1934, reads:

> The term "security" means any note, stock, treasury stock, security future, 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.

Id. § 77b(a)(1).

136. SEC v. W.J. Howey Co., 328 U.S. 293, 297 (1946) (quoting 15 U.S.C. §§ 77b(a)(1), 78c(a)(10)).

137. *See* 15 U.S.C. §§ 77b(a), 77b(a)(1), 78c(a), 78c(a)(10); COX, ET AL., *supra* note 118, at 117. For a statistical analysis of the case law surrounding the definition of a security and use of the *Howey* test, see Theresa A. Gabaldon, *A Sense of a Security: An Empirical Study*, J. CORP. L. 307 (Winter 2000).

138. 328 U.S. 293 (1946).

LLCs do not title member interests as "stock" or "notes," most commentators focus on the *Howey* test to determine whether the members' interests are "investment contracts."[139]

In that case, the SEC brought an action to restrain W.J. Howey Company "from using the mails and instrumentalities of interstate commerce in the offer and sale of unregistered . . . securities in violation of § 5(a) of the [Security] Act [of 1933]."[140] The company owned acres of citrus groves in Florida and offered 250 acres to the public each year to finance additional development.[141] Howey-in-the-Hills Service was a service company under the same control and management as W.J. Howey Company, and it was involved in developing and cultivating many of the groves.[142] Each potential customer was told that investment in a grove was not feasible without a service arrangement and then each was offered a land sales contract and a service contract.[143] The purchaser was free to make service arrangements with another company, though the "superiority of Howey-in-the-Hills Service, Inc., [was] stressed."[144] The tracts of land were not separately fenced, and the only indications that they were separately owned were land marks in a plat book.[145] The purchasers, for the most part, were not residents of Florida.[146] They lacked the knowledge, skill, and equipment necessary for fruit tree cultivation and were "attracted by the expectation of substantial profits."[147] Many of the purchasers were patrons of a nearby Howey Company hotel resort.[148]

The issue facing the Court was whether "the land sales contract, the warranty deed [delivered to the purchasers], and the service contract together constitute an 'investment contract' within the meaning of § 2(1) [of the Security Act of 1933]."[149] The Court pointed out that the term is not defined in the Act or by the legislative reports, but that the term "investment contract" was pervasive in many state "blue sky" laws prior to passage of the Act.[150] The term had been broadly construed by state courts to provide the investing public with "a full measure of protection."[151] "Form was disregarded for substance and

139. *See, e.g.*, Sargent, *Securities?*, *supra* note 99, at 1082–84; Steinberg & Conway, *supra* note 99, at 1107–11; Welle, *supra* note 4, at 441–65.
140. *Howey*, 328 U.S. at 294.
141. *See id.* at 295.
142. *Id.* at 294–95.
143. *Id.* at 295.
144. *Id.*
145. *Id.*
146. *Id.* at 296.
147. *Id.*
148. *Id.*
149. *Id.* at 297.
150. *Id.* at 298. "Blue Sky Laws" is the term generally used to refer to state securities laws. The term originated from the original objective of curbing promoters who would sell interests having no more substance than "'so many feet of "blue sky."'" Hall v. Geiger-Jones Co., 242 U.S. 539, 550 (1917).
151. *Howey*, 328 U.S. at 298.

emphasis was placed upon economic reality."[152] The Court found that when Congress included "investment contract" in the definition of a "security" in the Act, it was using the term as it had been defined by previous judicial interpretation.[153] The Court then laid down the test for determining the existence of an "investment contract."[154]

> [A]n investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby [1] a person 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, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise.[155]

This definition had "been enunciated and applied many times by lower federal courts, [and fulfills] the statutory purpose of compelling full and fair disclosure [relating] to the issuance of 'the many types of instruments that in our commercial world fall within the ordinary concept of a security.'"[156] In addition, the definition "embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."[157] This can arguably be the case with LLCs, as they are a relatively new scheme used by some as the vehicle through which investors are attracted by the promise of future profits, such as in *SEC v. Vision Communications*,[158] in which the SEC claimed that the promoters involved used the LLC form to funnel over one million dollars from unsophisticated investors.[159]

The *Howey* Court went on to find that the purchase and service agreements were "investment contracts."[160] The Court held that the purchasers were involved in a common enterprise managed by the Howey Company, and that they were led to expect profits from the efforts of the Howey Company and Howey-in-the-Hills, not having the skill, knowledge, or desire to put in the efforts themselves.[161]

The *Howey* test "has posed severe analytical and policy problems,"[162] both in the application to LLCs and to many other schemes dreamed up by clever promoters.[163]

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152. *Id.*
153. *Id.*
154. *See id.* at 298–99.
155. *Id.* at 298–99.
156. *Id.* at 299 (quoting H.R. REP. No. 72-85, at 11 (1933)).
157. *Id.*
158. Vision Communications, Inc., Litigation Release No. 14,026, 56 SEC Docket (CCH) 880 (D.D.C. Mar. 24, 1994).
159. *See id.*
160. *Howey*, 328 U.S. at 299.
161. *Id.* at 299–300.
162. Sargent, *Securities?*, *supra* note 99, at 1082.
163. *See id.* at 1082–83.

> For example, must there be an investment of cash in order to meet the investment of "money" criterion? Is a "common enterprise" present when a relationship exists only between the promoter and a single investor (vertical commonality), or must there be more than one investor whose investments are somehow pooled (horizontal commonality)? What exactly is meant by "profits"? All of these questions have occupied the courts and commentators for decades. The most vexed question, however, and the one most determinative of whether LLC interests are securities, is generated by *Howey*'s apparent requirement that the investor's expectation of profits be dependent "solely" on the efforts of others.[164]

Nevertheless, it is the test used by the Court today to determine the existence of an "investment contract," though it has been slightly modified as discussed below. Each element of the *Howey* test will be applied to LLCs in the following subparts to show that, in general, an interest in an LLC satisfies each one.

1. Investment of Money

The Supreme Court addressed the question of what constitutes an "investment of money" in *International Brotherhood of Teamsters v. Daniel*.[165] In that case, employees participated in a compulsory pension plan but made no payment into the fund; they merely accepted employment with that condition attached.[166] The respondent argued that by contributing his labor to his employer and by allowing his employer to pay money into the fund, that he made an investment under the definition of the Securities Acts.[167]

The Court found that in determining whether one invests, "it is necessary to look at the entire transaction" and whether the person "chose to give up a specific consideration in return for a separable financial interest with the characteristics of a security."[168] The Court held that, even in cases where the acquired interest has aspects of a security and a non-security, in all cases the purchaser must give up "some tangible and definable consideration in return for an interest that had substantially the characteristics of a security."[169] The Court went on to say that "[t]his is not to say that a person's 'investment,' in order to meet the definition of an investment contract, must take the form of cash only, rather than of goods and services."[170]

Normally, a member's investment in an LLC will meet the requirements of the first prong of the *Howey* test because interest holders

164. *Id.* at 1082–83 (footnotes omitted).
165. 439 U.S. 551, 559–61 (1979).
166. *See id.* at 559.
167. *Id.*
168. *Id.*
169. *Id.* at 560.
170. *Id.* at 560 n.12 (citation omitted).

usually contribute monetary amounts.[171] The TLLCA merely requires that the contribution of a member consist of "any tangible or intangible benefit to the limited liability company or other property of any kind or nature,"[172] which will likely meet the definition, because anything that constitutes contractual consideration would probably be sufficient to fulfill the "investment of money" requirement.[173] Though the TLLCA does not require a minimum contribution,[174] members will usually agree on the property or services that each member will contribute to the LLC.[175] Because "[c]ourts have broadly interpreted the investment of money requirement,"[176] it is unlikely any LLC membership interest would therefore fail to satisfy this requirement.

2. Common Enterprise

The federal circuits are split as to the definition and application of this element, and the Supreme Court has thus far declined to clarify the disagreement.[177] According to Justice White, the crux of the disparity in treatment revolves around "horizontal" and "vertical" commonality.[178] Horizontal commonality requires a pooling of investments, and it is required to meet the "Common Enterprise" prong of the *Howey* test in the Third, Sixth, and Seventh Circuits.[179] Vertical commonality requires only the existence of a relationship between an investor and a broker, and it is required to meet the "Common Enterprise" prong in the Fifth, Eighth, and Tenth Circuits.[180] The Fifth Circuit has stated that the "critical inquiry" is whether the

171. Welle, *supra* note 4, at 442–43; Steinberg & Conway, *supra* note 99, at 1107–08.

172. TEX. REV. CIV. STAT. ANN. art. 1528n, § 5.01 (Vernon Supp. 2002).

173. Welle, *supra* note 4, at 442; *see also* Sargent, *Securities?*, *supra* note 99, at 1096; Steinberg & Conway, *supra* note 99, at 1107–08.

174. *See* TEX. REV. CIV. STAT. ANN. art. 1528n, § 5.01.

175. Welle, *supra* note 4, at 442–43.

176. *Id.* at 442 (citing Harris v. Republic Airlines, Inc., Fed. Sec. L. Rep. (CCH) ¶ 93,772 (D.D.C. May 19, 1988); Hector v. Wiens, 533 F.2d 429, 432 (9th Cir. 1976); Sandusky Land, Ltd. v. Uniplan Groups, Inc., 400 F. Supp. 440, 445 (N.D. Ohio 1975); El Khadem v. Equity Sec. Corp., 494 F.2d 1224, 1228 (9th Cir. 1974)).

177. *See* Mordaunt v. Incomco, 469 U.S. 1115, 1115–16 (1985) (White, J., dissenting) (arguing that certiorari should be granted).

178. *See id.* at 1115–16 (White, J., dissenting).

179. *Id.* at 1115–16 (White, J., dissenting) (citing Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 622 F.2d 216, 222 (6th Cir. 1980), *aff'd*, 456 U.S. 353 (1982); Hirk v. Agri-Research Council, Inc., 561 F.2d 96, 100–01 (7th Cir. 1977); Wasnowic v. Chicago Bd. of Trade, 352 F. Supp. 1066, 1068 (M.D. Pa. 1972), *aff'd*, 491 F.2d 752 (3d Cir. 1973)).

180. *Mordaunt*, 469 U.S. at 1116 (White, J., dissenting) (citing SEC v. Cont'l Commodities Corp., 497 F.2d 516 (5th Cir. 1974); Commercial Iron & Metal Co. v. Bache & Co., 478 F.2d 39 (10th Cir. 1973); Booth v. Peavey Co. Commodity Servs., 430 F.2d 132 (8th Cir. 1970)).

investment's success or failure of the collective investments is necessarily dependent on the expertise of the promoter.[181]

In either case, LLC member interests will normally satisfy the requirement.[182] In general, interests in an LLC will satisfy the horizontal commonality requirement because the members are all interested in the financial success of the LLC.[183] It should be noted that the TLLCA allows LLCs to have only one member,[184] in which case the horizontal commonality requirement would not be met, but this is likely to arise only on an occasional basis.[185] Similarly, the LLC will likely meet the vertical commonality requirement, because in the typical scheme, the promoters and investors have a mutual goal.[186] In several SEC actions, for example, the prosecutors alleged both horizontal and vertical commonality were present because each investor shared pro rata in the profits generated through operation of the LLC.[187]

3. Expectation of Profits

The leading case defining this element is *United Housing Foundation, Inc. v. Forman*.[188] In this case, the tenants in a low-income cooperative housing project brought suit alleging violations of the federal securities laws arising from the sale of shares in "common stock" of the housing corporation.[189] In order to purchase an apartment, the United Housing Foundation required that tenants purchase stock in Riverbay, a not-for-profit housing corporation.[190] Riverbay was organized by the United Housing Foundation as an owner and operator of the buildings and land.[191] The shares did not possess the usual characteristics of "stock," such as voting rights based on the number owned or free transferability.[192] Upon termination of occupancy, the tenant was obligated to offer the shares back to Riverbay, and in the unlikely event that Riverbay did not repurchase the shares, the tenant could offer them to a prospective tenant who satisfied the statutory

181. *Cont'l Commodities Corp.*, 497 F.2d at 522.
182. *See* Steinberg & Conway, *supra* note 99, at 1108–09.
183. *Id.* at 1108–09.
184. TEX. REV. CIV. STAT. ANN. art. 1528n, § 4.01(A) (Vernon 1997).
185. Steinberg & Conway, *supra* note 99, at 1109.
186. *Id.*
187. Welle, *supra* note 4, at 444; *see also, e.g.*, SEC v. Parkersburg Wireless L.L.C., 991 F. Supp. 6, 8 (D.D.C. 1997).
188. 421 U.S. 837 (1975).
189. *Id.* at 837, 841, 844–45.
190. *Id.* at 841–42.
191. *Id.* at 841.
192. *See id.* at 851. The characteristics "traditionally associated with stock" are a right to receive "'dividends contingent upon an apportionment of profits,'" negotiability, an ability to be pledged, "voting rights in proportion to the number of shares owned," and capability of appreciating in value. *Id.* (quoting Tcherepnin v. Knight, 389 U.S. 332, 339 (1967)).

income requirements.[193] However, the shares could not be sold for more than the original price plus a fraction of the mortgage amortization that the tenant paid during his occupancy.[194] As mentioned earlier, the federal Securities Acts of 1933 and 1934 include "stock" in the definition of a security,[195] thus the tenants claimed that because the shares purchased were called "stock," the antifraud provisions of the securities acts applied.[196]

The U.S. Supreme Court pointed out that "[t]he primary purpose of the Acts of 1933 and 1934 was to eliminate serious abuses in a largely unregulated securities market,"[197] and that "[t]he focus of the Acts is on . . . the sale of securities to raise capital for profit-making purposes, the exchanges on which securities are traded, and the need for regulation to prevent fraud and to protect the interest of investors."[198] In oft-quoted language, the Court stated that "Congress intended the application of these statutes to turn on the economic realities underlying a transaction, and not on the name appended thereto."[199] The Court held that calling the shares "stock" was not dispositive and then analyzed the transactions under the *Howey* investment contract test.[200]

The Court found that the tenants purchased the shares to acquire a low-cost living space, not to invest for profit.[201] The Court uses the term "profit" to mean "either capital appreciation resulting from the development of the initial investment" or "a participation in earnings resulting from the use of [the] investors' funds."[202] An investor in securities is attracted by the prospect of a profitable return, not by a desire to use or consume the item purchased.[203] In addition, the Court found that because the shares could not be sold for more than their purchase and investment price, there was no possible profit from a resale of the stock, and that the tax deductibility of the monthly rental charge and the comparatively low rent do not sufficiently constitute "profit" within the meaning of the *Howey* test.[204] In short, the Court held that "[w]hat distinguishes a security transaction—and what is absent [in this case]—is an investment where one parts with his money in the hope of receiving profits from the efforts of others, and

193. *Id.* at 842–43.
194. *Id.*
195. 15 U.S.C. §§ 77b(a)(1), 78c(a)(10) (2000).
196. *See Forman*, 421 U.S. at 844–45.
197. *Id.* at 849.
198. *Id.*
199. *See id.*
200. *Id.* at 851–60.
201. *Id.* at 853.
202. *Id.* at 852 (citing SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943); Tcherepnin v. Knight, 389 U.S. 332 (1967)).
203. *Id.* at 852–53 (citing SEC v. W.J. Howey Co., 328 U.S. 293, 300 (1946); SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943)).
204. *See id.* at 854–55.

not where he purchases a commodity for personal consumption or living quarters for personal use."[205]

Applying the above holding to LLCs, many commentators agree that this element is likely met.[206] In most situations, investors will contribute hoping for a return on their investment,[207] and LLC members will ordinarily not be expecting an unconventional benefit.[208] In SEC actions taken against various LLCs, "prosecutors presented evidence that promoters enticed investors [with] brochures and sales calls" promising "enormous and immediate returns" on investment, demonstrating that subsequent purchasers were enticed to invest because of the expectation of profits.[209] Even though some state statutes appear to allow for nonprofit LLCs, including the TLLCA,[210] "the vast majority of LLCs [is] operated for profit, [because] an LLC that does not conduct a business and have a profit objective risks losing the [LLC] tax advantages."[211] In addition, Professor Sargent points out that LLC members may be hoping simply "to take advantage of the pass-through of losses for tax purposes."[212] The potential for tax losses has been held to satisfy the "expectation of profits" requirement in other situations.[213] Therefore, the LLC member interest likely meets this element of the *Howey* test in most circumstances.

4. Solely from the Efforts of Others

Most lower federal courts, when applying the *Howey* test, have adopted a liberal definition of the "solely from the profits of others" element.[214] In *SEC v. Glenn W. Turner Enterprises*,[215] the Ninth Cir-

205. *Id.* at 858.

206. *See, e.g.*, Sargent, *Securities?*, *supra* note 99, at 1096; Steinberg & Conway, *supra* note 99, at 1109–10; Welle, *supra* note 4, at 444–45.

207. Steinberg & Conway, *supra* note 99, at 1110.

208. Sargent, *Securities?*, *supra* note 99, at 1096.

209. Welle, *supra* note 4, at 445.

210. TEX. REV. CIV. STAT. ANN. art. 1528n, § 2.01 (Vernon 1997) (stating that an LLC formed under the TLLCA "may engage in any lawful business"); *id.* § 2.02 (Vernon Supp. 2002) (stating that each LLC "shall have the power provided for a corporation under the TBCA and a limited partnership under the Texas Revised Limited Partnership Act").

211. Welle, *supra* note 4, at 445 & n.157.

212. Sargent, *Securities?*, *supra* note 99, at 1096 n.177.

213. *Id.*; *see* SEC v. Aqua-Sonic Prods. Corp., 687 F.2d 577, 583 & n.5 (2d Cir. 1982) (licensing to sell product); Kolibash v. Sagittarius Recording Co., 626 F. Supp. 1173, 1178 (S.D. Ohio 1986) (a recording lease program).

214. Welle, *supra* note 4, at 445–46 (citing SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 476, 482 (9th Cir. 1973); Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc., 840 F.2d 236, 240 n.4 (4th Cir. 1988); SEC v. Prof'l Assocs., 731 F.2d 349, 357 (6th Cir. 1984); Goodwin v. Elkins & Co., 730 F.2d 99, 103 (3d Cir. 1984); SEC v. Aqua-Sonic Prods. Corp., 687 F.2d 577, 582 (2d Cir. 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. 1981); Aldrich v. McCulloch Props., 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)).

cuit enumerated a more flexible test than the strict wording of *Howey*.[216] In this case, the defendant corporation was offering "Adventures" and "Plans" to purchasers.[217] The purchaser, in return for his investment of $300–$5,000, received training and materials related to self-motivation and sales ability.[218] With the purchase of certain plans, the purchaser received the opportunity to help sell the courses to others and earn a commission if he is successful.[219] The court acknowledged that what was being sold was not the typical business motivation course, but the opportunity to derive profits from the sale of plans to new customers brought to the company.[220] The court held that the sale of these plans constituted a sale of investment contracts within the meaning of the Securities Acts.[221]

The court had difficulty, though, with the portion of the *Howey* test which required that the profits come *solely* from the efforts of others.[222] Because the purchasers in this case must exert some personal effort to bring additional purchasers to the company, it was argued that the expectation of profits was not coming solely from the efforts of others.[223] The court held, though, due to the Securities Acts' remedial character, the Acts' policy of protecting the public, and the Supreme Court's repeated reminders that the definition of "security" should be flexible, that the Acts should be applied to "those schemes which involve in substance, if not in form, securities."[224] The court stated that the test is "whether the efforts made by those other than the investor are the undeniably significant ones, those *essential managerial efforts* which affect the failure or success of the enterprise."[225] Therefore, the court held that though the purchasers in this case were required to contribute something more than mere money, the crucial efforts affecting the enterprise's failure or success were those of the company, not of the investor.[226]

While no language of the Supreme Court has directly indicated that "solely" has been removed from the *Howey* test, its omission on two separate occasions is a significant indicator that the "solely" standard is being relaxed. The Supreme Court observed in *Forman* and *Daniel* that "[t]he touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived

215. 474 F.2d 476 (9th Cir. 1973).
216. *See id.* at 482.
217. *Id.* at 477–78.
218. *See id.* at 478.
219. *Id.* at 478–79.
220. *Id.* at 478–79.
221. *See id.* at 480, 483.
222. *See id.* at 481–83.
223. *Id.* at 482.
224. *Id.*
225. *Id.* (emphasis added).
226. *Id.* at 483.

from the entrepreneurial or managerial efforts of others."[227] In light of the Court's constant instructions to view "transactions in light of economic realities," and that promoters could easily circumvent the securities laws if the term "solely" were interpreted literally, the Court will likely adopt the more flexible and liberal interpretation when presented with the question.[228]

As an alternative to the *Glenn Turner* analysis, the Fifth Circuit enumerated a different test in *Williamson v. Tucker*,[229] and held that the substance of the transaction must be the guiding factor.[230] The court stated that "the mere fact that an investment takes the form of a general partnership or joint venture does not inevitably insulate it from the reach of the federal securities laws."[231] That court set forth three factors to determine whether a general partnership interest was a security:

> A general partnership or joint venture interest can be designated a security if the investor can establish, for example, that (1) an agreement among the parties leaves *so little power* in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership; or (2) the partner or venturer is *so inexperienced and unknowledgeable* in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or (3) the partner or venturer 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 partnership or venture powers.[232]

This test has been uniformly applied by many courts to partnership interests,[233] and more importantly, it has also been applied by some courts to LLC interests.[234]

As applied to LLCs, academic commentators are split in this analysis. The crucial distinction is how the LLC itself is organized.[235] If the LLC is very closely held and member-managed, the LLC interest is probably not a security as the profits will be expected from the efforts of all of the members.[236] However, many LLCs are not closely held

227. United Hous. Found., Inc. v. Forman, 421 U.S. 837, 852 (1975); *see also* Int'l Bhd. of Teamsters v. Daniel, 439 U.S. 551, 561 (1979).

228. Welle, *supra* note 4, at 446.

229. 645 F.2d 404 (5th Cir. 1981).

230. *See id.* at 422–23.

231. *Id.* at 422.

232. *Id.* at 424 (emphasis added).

233. *See, e.g.*, Garcia v. Copenhaver, Bell, & Assocs., M.D.s, P.A., 104 F.3d 1256, 1263 (11th Cir. 1997); Koch v. Hankins, 928 F.2d 1471, 1478–80 (9th Cir. 1991).

234. *See* SEC v. Shreveport Wireless Cable Television P'ship, No. Civ.A. 94-1781(HHG), 1998 WL 892948, at *5–7 (D.D.C. Oct. 20, 1998); SEC v. Parkersburg Wireless L.L.C., 991 F. Supp. 6, 8 (D.D.C. 1997); Tschetter v. Berven, 621 N.W.2d 372, 376–78 (S.D. 2001).

235. *See* Welle, *supra* note 4, at 446.

236. *See id.* at 447.

and may have hundreds of members, resembling corporations or limited partnerships where the members are passive participants.[237] The SEC has 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."[238] However, the drawback to this approach is that it requires an independent investigation into each LLC's structure to determine if its membership interests constitute securities.[239] With limited partnerships, the presumption is that they are securities,[240] and this should arguably be the case with manager-managed LLCs and LLCs with a large number of members.

C. Nutek Information Systems, Inc. v. Arizona Corp. Commission: *Applying the* Howey *Test to Limited Liability Companies*

An important recent case dealing with a Texas LLC, and one of the first to analyze the LLC-as-security issue, came from the Arizona state courts. The Arizona Corporation Commission charged that the defendants were selling unregistered securities by marketing membership interests in LLCs.[241] The president and member-owner of SMR Advisory Group, L.L.C., a Texas limited liability company, marketed interests in several LLCs formed in Texas.[242] The LLCs were to secure licenses and build and operate communications systems.[243] The defendants used telephone and written solicitations to recruit investors who would purchase "units" in a particular LLC.[244] The defendants amassed over $10.4 million from approximately 920 investors, combining those funds into a single account.[245] The Securities Division of the Arizona Corporation Commission initiated proceedings against the company and its president for violations of the Arizona Securities Act's registration and anti-fraud provisions.[246] The Commission found that the membership interests in the LLCs constituted securities.[247]

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237. *Id.*

238. *Id.* at 449; *see also* Williamson v. Tucker, 645 F.2d 404, 424 (5th Cir. 1981); *Parkersburg Wireless L.L.C.*, 991 F. Supp. at 8.

239. *See Williamson*, 645 F.2d at 424.

240. *See* Steinberg & Conway, *supra* note 99, at 1110; Welle, *supra* note 4, at 449–50.

241. Nutek Info. Sys., Inc. v. Ariz. Corp. Comm'n, 977 P.2d 826, 827–28 (Ariz. Ct. App. 1998), *cert. denied sub nom.*, AKS Daks Communications, Inc. v. Ariz. Corps. Comm'n, 528 U.S. 932 (1999).

242. *Id.* at 828.

243. *Id.*

244. *Id.*

245. *Id.*

246. *Id.* at 829.

247. *Id.*

The Arizona Court of Appeals pointed out that the issue of whether such LLC membership interests constituted securities was a question of first impression in the state.[248] The court held that an LLC should not benefit from the presumption that LLC membership interests are not securities, as general partnership interests do, because the nature of limited liability for all members encourages unsophisticated investors to become involved, and it gives members less incentive to be informed about or take an active role in the business.[249] The court enumerated the *Howey* test, as described above, and then applied the elements.[250] The parties agreed that the first two elements–investment of money and common enterprise–were met.[251]

The court went on to examine the third and fourth prongs–the expectation of profits solely from the efforts of others.[252] After analyzing the *Williamson v. Tucker* reasoning,[253] the court stated that to determine whether investors had control over the profitability of the enterprise, it must "look at both legal and practical control."[254] Here, the LLC Articles of Organization provided that the members had legal control, but the court held that they had little, if any, ability to exercise actual effective control over the LLCs.[255] All principal management function was turned over to the managing LLC, the members had little or no input in the decision whether to enter construction agreements, and because the member base was large in number and geographically dispersed, the management power was diluted to such an extent that the members were prevented from exercising any effective control.[256] Further, the typical investor in this type of business arrangement would lack the technical expertise necessary to actually manage the LLCs.[257] This court adopted a previous Fifth Circuit holding mandating that to meet the "knowledge" requirement in *Williamson*, the investors must have *meaningful* knowledge of the specific business being operated.[258] The court pointed out that "[t]he securi-

248. *Id.*
249. *Id.* at 833–34 (quoting Robert R. Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 Bus. Law. 378, 404 (1992)).
250. *Id.* at 830–31; *see supra* text accompanying notes 138–227.
251. *Nutek*, 977 P.2d at 830.
252. *Id.*
253. *See supra* text accompanying notes 229–40.
254. *See Nutek*, 977 P.2d at 831.
255. *Id.* at 831–32.
256. *Id.* at 831–32.
257. *Id.* at 832.
258. *Id.* The court refers to *Long v. Shultz Cattle Co.*, in which the Fifth Circuit court stated:

> In *Williamson* . . . our discussion made clear that the knowledge inquiry must be tied to the nature of the underlying venture. . . . *Williamson* . . . clearly requires that the investors' knowledge and experience be evaluated with reference to the nature of the underlying venture. . . . [A]ny holding to the contrary would be inconsistent with *Howey* itself.

Long v. Shultz Cattle Co., 881 F.2d 129, 134 n.3 (5th Cir. 1989) (citations omitted).

ties laws are designed to protect less-than-prudent investors from giving their money to irresponsible or unscrupulous businessmen."[259] Therefore, the court held that the members did rely on the efforts of others in order to make any profit, and that this prong of the *Howey* test was met as well.[260] Because all of the *Howey* factors of an investment contract were met, the court held that these membership interests were securities.[261]

The U.S. Supreme Court denied certiorari in this case[262] and has yet to rule on whether an LLC membership interest constitutes a security. This case, though, will most likely serve as a benchmark and provide the leading analysis for cases that require the application of the securities laws to LLCs.

IV. Texas's Treatment of LLC Member Interests Under Blue Sky Laws and the Problems Accompanying that Treatment

The definition of a security in section 4 of the Texas Securities Act is quite similar to the definition of a security in the federal Securities Acts of 1933 and 1934.[263] It includes

> any limited partner interest in a limited partnership, share, stock, treasury stock . . . note, bond, debenture, mortgage certificate or other evidence of indebtedness, any form of commercial paper, certificate in or under a profit sharing . . . agreement, . . . *or any certificate or instrument representing or secured by an interest in any or all of the capital, property, assets, profits or earnings of any company*, investment contract, or any other instrument commonly known as a security, whether similar to those herein referred to or not.[264]

According to David Weaver, General Counsel at the Texas State Securities Board, the Board's view is that all LLC membership interests fall within the italicized language above or under the investment contract (*Howey*) test.[265] The State Securities Board's position is that LLCs fall within the statutory definition of a "security," though this is not expressed in any rule or regulation.[266] Investors should see the broad language of section 4 above and see that the LLC falls within that definition, says the Board, even though LLCs are not required to

259. *Nutek*, 977 P.2d at 833.
260. *Id.* at 834–35.
261. *Id.* at 835.
262. AKS Daks Communications, Inc. v. Ariz. Corps. Comm'n, 528 U.S. 932 (1999), *denying cert. to Nutek*, 977 P.2d 826.
263. *Compare* Tex. Rev. Civ. Stat. Ann. art. 581-4(A) (Vernon Supp. 2002), *with* 15 U.S.C. § 77b(a)(1) (2000), *and id.* § 78c(a)(10).
264. Tex. Rev. Civ. Stat. Ann. art. 581-4(A) (emphasis added).
265. Telephone Interview with David Weaver, General Counsel, Texas State Securities Board (Sept. 25, 2001) (transcript on file with the Texas Wesleyan Law Review); *see also supra* text accompanying notes 138–227.
266. Telephone Interview with David Weaver, *supra* note 265.

issue certificates or instruments, as discussed in Part II.B.4. above.[267] In fact, most items that look like securities are statutory securities with the exception of annuity insurance contracts, which must be registered with the Texas Department of Insurance.[268] The Board has not advocated amending the Texas Securities Act to include LLC member interests, as many states have done, because it is nearly impossible to capture all new investment vehicles.[269] Every year, new investment vehicles are invented, and as the Texas Legislature only meets every two years, it is impracticable to capture them all.[270] Therefore, in the State Securities Board's view, LLCs must comply with the Texas Securities Act unless the offer of member interests meets one of the exemptions set out in section 5 or the rules in Chapter 139 of the Act.[271]

The Act provides exemptions for a number of enumerated transactions so long as certain conditions are met.[272] Some of those pertinent exemptions are: judicial sales or bankruptcy proceedings,[273] sales from the personal inventory of a vendor whose business is not the sale of securities so long as the sale is an isolated transaction,[274] sales by insurance companies,[275] sales "made without any public solicitation or advertisements" 1) by an "issuer . . . so long as the total number of security holders of the issuer thereof does not exceed thirty-five . . . persons;" 2) by an employer of a security under a "thrift, savings, stock purchase, retirement, pension, profit-sharing, . . . bonus, . . . incentive, or similar . . . plan;" or 3) "the sale by an issuer of its securities during the . . . twelve months ending with the date of the sale in question to not more than fifteen . . . persons . . . provided [those] persons purchased such securities for their own account and not for distribution,"[276] and "[t]he execution by a dealer of [a] purchase of securities, where the initial offering of such securities has been completed and . . . the dealer [is acting] solely as an agent for the purchaser, has no . . . interest in the sale, . . . and receives no . . . compensation from any other source than the purchaser."[277] The Texas Securities Act defines "issuer" to "include every company or person who proposes to issue, has issued, or shall hereafter issue any security."[278]

267. *Id.*
268. *Id.*
269. *Id.*
270. *Id.*
271. *Id.*; *see also* TEX. REV. CIV. STAT. ANN. art. 581-5 (Vernon Supp. 2002).
272. TEX. REV. CIV. STAT. ANN. art. 581-5.
273. *Id.* at art. 581-5(A).
274. *Id.* at art. 581-5(C)(1).
275. *Id.* at art. 582-5(C)(2).
276. *Id.* at art. 581-5(I).
277. *Id.* at art. 581-5(P).
278. *Id.* at art. 581-4(G).

In its 2001 Session, the Texas Legislature appears to have overruled the State Securities Board and amended the state Blue Sky laws to categorically *exclude* limited liability companies from the definition of a security.[279] The statute now reads:

> An interest in a partnership or limited liability company is not a security unless it is dealt in or traded on securities exchanges or in securities markets, its terms expressly provide that it is a security governed by this chapter, or it is an investment company security. However, an interest in a partnership or limited liability company is a financial asset if it is held in a securities account.[280]

Therefore, it appears that the Legislature has overruled *Williamson* and its progeny to allow for the owners of partnerships or limited liability companies to "opt-in" to the securities laws by trading on the securities exchanges or by expressly providing in the partnership or operating agreement that owners' interests are securities.[281]

The problem with both approaches is that LLCs are becoming increasingly popular. In 2000 alone, 16,844 LLCs were formed in Texas.[282] The LLC has surpassed the characterization of being "just another over-clever tax dodge doomed to a brief career,"[283] and it has emerged as a "viable, mainstream alternative to the corporation or partnership."[284] Investors must not be required to read complicated statutory language to determine whether the investment opportunity being offered to them comes with the protection of the state securities laws, as the Board would have them do. The Legislature's approach fails to account for the increasingly popular nature of the LLC and fails to protect the investing public. In addition, using the traditional common law approach to solve the problems associated with LLCs will not provide the most speedy and efficient solution for the investing public. A statutory solution provides more immediate protection for potential investors and more certainty for business owners, leading to an efficient market and a more attractive atmosphere in Texas for foreign investors. Uncertainty and the threat of litigation only discourage business owners from attempting to reside in this jurisdiction.

V. Other States' Treatment of LLC Member Interests

State legislatures and state securities boards have approached the issue of whether LLC membership interests are securities in a number of ways.[285] This Part will examine those approaches, will weigh their

279. *See* Tex. Bus. & Com. Code Ann. § 8.103(c) (Vernon 2002).
280. *Id.*
281. *See id.* § 8.103(c) & cmt. 4; *supra* notes 228–39 and accompanying text.
282. E-mail from Tina Passell, *supra* note 33.
283. *See* Sargent, *Securities?*, *supra* note 99, at 1069.
284. Hamill, *supra* note 32, at 393.
285. Garrison & Knoepfle, *supra* note 17, at 630–35.

benefits and drawbacks, and will suggest the best method for Texas to adopt.

In a majority of the states, no attempt to define the nature of the LLC membership interests has been made.[286] This leaves the issue to be resolved through the application of the *Howey* test, discussed above,[287] in the courts and commissions.[288] Some state securities administrators have attempted to guide the courts in their application of the *Howey* test to LLCs.[289] "In New York and South Carolina, the primary factor will be the structure of the limited liability company [especially noting] whether the members are passive investors."[290] In Connecticut and Tennessee, the securities boards have indicated that with member-managed LLCs, the *Williamson* factors[291] should be used.[292] In Michigan, the legislature indicates that "[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."[293] The import of this language is unclear,[294] but the implication seems to be that LLC interests will be subject to the standard investment contract analysis, using the *Howey* test outlined above.[295] Leaving the determination to the courts, though, provides little certainty for investors and business planners. The cost of litigation, just to decide whether compliance with the securities laws is necessary, is the least desirable solution. Given that the LLC is new and burgeoning, the legislatures of the several states should make formal findings and set parameters to resolve the issue.

The approach taken by the Texas Securities Board—an informal, unpublished opinion that LLC membership interests are securities[296]—is also the approach used by Louisiana and New Hampshire.[297] These states express an opinion that "essentially all LLC interests are securities," but this position is not formally articulated in any regulation, interpretive release, advisory opinion, or no-action let-

286. *See id.* at 633–34. Examples of such states include Delaware, D.C., Florida, Hawaii, Idaho, Kansas, Kentucky, Maryland, Massachusetts, Mississippi, Oklahoma, Oregon, Rhode Island, West Virginia, and Wyoming. *See* Mark A. Sargent, *State Treatment of LLC Interests as Securities (as of 11/18/96)*, 3 J. LIMITED LIABILITY COS. 137 (1996).

287. *See supra* text accompanying notes 138–227.

288. Garrison & Knoepfle, *supra* note 17, at 633–34.

289. *Id.* at 634.

290. *Id.*

291. *See supra* text accompanying notes 229–40.

292. Garrison & Knoepfle, *supra* note 17, at 634.

293. MICH. COMP. LAWS ANN. § 450.5103 (West Supp. 2002).

294. *See* Mark A. Sargent, *Blue Sky Law: Will Limited Liability Companies Punch a Hole in the Blue Sky?*, 21 SEC. REG. L.J. 429, 437 (1994) [hereinafter Sargent, *Blue Sky*].

295. *See supra* text accompanying notes 138–227.

296. *See supra* text accompanying notes 263–78.

297. Garrison & Knoepfle, *supra* note 17, at 634 & n.356; Sargent, *Blue Sky*, *supra* note 294, at 431 & n.11.

ter.[298] While this approach may allow for flexibility in dealing with new investment schemes, it provides little certainty for business planners and investors.

Other states have amended their statutes to include LLC membership interests, without qualification, in the definition of a "security." Ohio, for example, states that a "'[s]ecurity' . . . includes shares of stock, certificates for shares of stock, *membership interests in limited liability companies* . . . [and] any investment contract. . . ."[299] The owners of LLCs may then be exempt from registration because of the limited number of investors, or the intrastate offering,[300] but it would be up to the business owners to find such an exemption and ensure that the sales of membership interests fall within it. This approach may provide the needed certainty desired, but in either case, categorically deciding in advance that *all* interests in LLCs are securities may be over-inclusive, "despite its apparent virtue of simplicity."[301] Small, partnership-like LLCs with a few members who share control of the enterprise need not deal with the formalities of the securities laws and exemptions.[302] In addition, because Texas allows for single member LLCs,[303] it would be anomalous indeed to require such an LLC to deal with securities regulation at all.

California has attempted to list standards for public LLCs by adopting a new definition of securities.[304] The legislature expressed its concern with the previous status of the law: "It is a concern of the Legislature that, while this act is designed to assist the formation and operation of small or closely held . . . business arrangements, limited liability companies may become a format for a publicly held business entity to transact business without adequate provision for governance standards, including rights of securities holders."[305] The definition of a "security" in California now includes:

> any . . . interest in a limited liability company and any class or series of those interests (including any fractional or other interest in that

298. Sargent, *Blue Sky*, *supra* note 294, at 431.

299. OHIO REV. CODE ANN. § 1707.01(B) (Anderson Supp. 2001) (emphasis added); *see also* N.M. STAT. ANN. § 58-13B-2(X) (Michie Supp. 2002) (defining a security as "a note; stock; treasury stock . . . [or] any interest in a limited liability company"); VT. STAT. ANN. tit. 9 § 4202a(16) (Lexis through Sept. 2001) (defining a security as "any note, stock, treasury stock . . . [or] any membership interest in a limited liability company").

300. *See supra* text accompanying notes 272–78 (discussing typical exemptions). Similar exemptions exist in other states' and the federal securities laws.

301. Sargent, *Blue Sky*, *supra* note 294, at 438.

302. *See* Garrison & Knoepfle, *supra* note 17, at 637–38.

303. TEX. REV. CIV. STAT. ANN. art. 1528n, § 4.01(A) (Vernon 1997).

304. *See* CAL. CORP. CODE § 25019 (West Supp. 2002); Mark A. Sargent, *LLCs as Securities—California Style*, J. LIMITED LIABILITY COMPANIES 181, 181, 183 (1995) [hereinafter Sargent, *California*].

305. S.B. 469, § 95, 1993–94 Reg. Sess. (Cal. 1994), *available at* http://info.sen.ca.gov/pub/93-94/bill/sen/sb_0451-0500/sb_469_bill_940930_Chaptered (last visited Feb. 11, 2003) (on file with the Texas Wesleyan Law Review).

> interest), except a membership interest in a limited liability company in which the person claiming this exception 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 . . . .[306]

This exception seems to be a straightforward adoption by the legislature of the "Efforts of Others" element of the *Howey* test as the dividing line between that which is a security and that which is not.[307] Significantly, the statute clearly states that *all* members must be actively engaged in the management of the LLC, suggesting that a single passive investor would force the LLC to fall outside the exception.[308] The problem associated with California's approach is that the exception may be hard to prove until the courts have had occasion to interpret this language. For example, "contractual rights to participate in management, to vote, or to receive information . . . '*without more*'" do not establish active involvement in management.[309] The question becomes how much "more" must be shown.[310] It appears that the members would need to prove that they have materially exercised those contractual rights or that they have a real opportunity to do so in the future.[311] One factor that is likely to come into play is "whether the members have the sophistication and experience needed to exercise those rights[, especially] if the LLC has a complicated [management] structure or if it is engaged in [any] complex, technical, or heavily-regulated [industry]."[312] California has avoided the simplistic approach of adding LLC membership interests to their statutory definition of a "security" without exception, but the scheme still requires a case-by-case determination.[313] Compliance with the statutory exception will produce costs of its own in attempting to define the elements and strictly tailoring one's business to ensure each is met.[314]

Likely the best solution adopted thus far is found in Wisconsin,[315] where a three-tiered approach has been codified. First, Wisconsin law states that an LLC interest is *presumed* to be a security if "the articles

306. CAL. CORP. CODE § 25019 (West Supp. 2002).
307. Sargent, *California*, *supra* note 304, at 181; *see supra* Part III.B.4. (discussing the "Efforts of Others" element).
308. Sargent, *California*, *supra* note 304, at 181.
309. CAL. CORP. CODE § 25019 (emphasis added); Sargent, *California*, *supra* note 304, at 182.
310. Sargent, *California*, *supra* note 304, at 182.
311. *Id.*
312. *Id.*
313. *Id.*
314. *See id.*
315. *See* Sargent, *Blue Sky*, *supra* note 294, at 440.

of organization vest management of the limited liability company in . . . one or more managers who are not members, *or* if the aggregate number of members of the limited liability company, after the interest is sold, exceeds 35."[316] Second, if the LLC vests managerial authority in persons who are members and the number of members does not exceed 35, then the LLC interest is *presumed not* to be a security.[317] Finally, if the total number of members is 15 or fewer and the right to manage is vested in the members, then the LLC interests are *not* securities, and no further analysis is required.[318] Professor Sargent points out that this scheme "takes a subtle and balanced approach to the question that avoids a simplistic either/or treatment of the member-managed/manager-managed dichotomy."[319] Wisconsin's approach has several advantages, he says:

> Most importantly, it draws a bright line establishing the clear case—interests in an LLC with relatively few members and all members holding management authority are not securities. It also avoids the trap of declaring interests in all manager-managed LLC securities, and . . . creat[es] a well-balanced pair of opposing presumptions. If an LLC is manager-managed or has a large number of members (more than 35), a rebuttable presumption that its interests are securities will arise. If the LLC is member-managed, and has only a middling number of members, a rebuttable presumption that the interests are not securities will apply.[320]

This flexible approach will provide the much-needed notice and certainty for investors and business planners alike. It avoids the over-inclusion of states like Texas and Ohio, while providing some structure and avoiding the litigation trap inherent in the New York, Connecticut, and Tennessee schemes. If the LLC is small and closely-held, no additional proof will be required in order to escape the reach of the securities laws. This is appropriate, because in the typical LLC with less than fifteen members, all members will be actively engaged in the enterprise, a point recognized in the Texas exemptions from registration.[321] On the other hand, large LLCs with numerous investors will be presumed to constitute securities vehicles, requiring compliance with registration and anti-fraud rules. The LLC owners can rebut this presumption by proving to the State Securities Board that all members are truly actively engaged in managing the affairs of the enterprise. This approach protects investors and provides business owners with the certainty and low risk of litigation they desire.

316. WIS. STAT. ANN. § 551.02(13)(c) (West Supp. 2001) (emphasis added).
317. *Id.*
318. *Id.* § 551.02(13)(b).
319. Sargent, *Blue Sky*, *supra* note 294, at 437.
320. *Id.*
321. *See supra* text accompanying note 276.

In *Nutek Information Systems, Inc. v. Arizona Corp. Commission*,[322] if a law similar to Wisconsin's had been in place, litigation could have been avoided. Once the promoters solicited more than 35 investors, the membership interest sales would have been presumed to be the sale of securities. In that case, the promoters collected more than $10 million from 920 investors.[323] Therefore, they would have been required to comply with the securities laws as to registration and disclosure, and they would have had exposure to strict liability for the fraud alleged by the Arizona Corporation Commission.[324]

Similarly, in *Vision Communications, Inc.*,[325] where dozens of investors (significantly over thirty-five members) were enticed to invest in a Texas "wireless cable" LLC, the presumption would have been that the promoters were selling securities.[326] Unless the promoters could convince the State Securities Board that all of the members were actively engaged in managing the enterprise, the sales would have to be registered, and the company would have to make full and accurate disclosure under the law. In both cases, the issue could have been decided without the parties going to the expense and time to go to court. More importantly, if the disclosure requirements under securities laws were met, it is far less likely that the investors would have given their money to these unscrupulous businessmen in the first place.

VI. Conclusions

As the number of limited liability companies organized in Texas continues to grow at a rapid rate, the issue of whether to treat them as securities will become increasingly important. While some will still argue that treating any LLC member interests as securities will stymie entrepreneurship and make the LLC form less desirable, the reality is that many LLCs are quite large with hundreds, if not thousands, of members who deserve the protection of the securities laws. Avoiding problems such as those associated with the "wireless cable" schemes and those associated with the potential of endless litigation regarding definitional issues is important for both investor groups and business owners. It is likely that the Texas State Securities Board is correct, that many LLC membership interests do constitute securities, but at the same time, many do not. The LLC is an attractive business form for both large conglomerates and the "Mom and Pop" operation.

322. 977 P.2d 826 (Ariz. Ct. App. 1998), *cert. denied sub nom.*, AKS Daks Communications, Inc. v. Ariz. Corp. Comm'n, 528 U.S. 932 (1999).

323. *Id.* at 828.

324. *See id.* at 828–29; *see also* Wis. Stat. Ann. § 551.02(13)(c) (West Supp. 2001).

325. Litigation Release No. 14,026, 56 SEC Docket (CCH) 880 (D.D.C. Mar. 24, 1994).

326. *Compare Alleged Boiler Room Sales of Interests in Cable Venture Subject of SEC Suit*, 26 Sec. Reg. & L. Report 662 (1994), *with* Wis. Stat. Ann. § 551.02(13)(c).

Characterizing all of these as securities will only detract from those features of the LLC that have made it so attractive—the ease of creating it, the relative informality, and the limited liability. However, those same attractions have led the unsophisticated and unwary investor to become involved with failing or fraudulent LLC schemes with hundreds of members and no one to hold liable for their lost money. Therefore, a rebuttable presumption approach, such as that adopted by the legislature in Wisconsin, is the best created thus far to accommodate all of these competing concerns. A concrete, three-tiered approach takes into account the varying nature of LLCs and provides the structure that is necessary to a certain business plan. The Domino's Pizzas and Vision Communications of the world will be treated as securities, requiring compliance with securities laws, but the corner grocery store or neighborhood plumber will not have to deal with the issue at all. The Texas Legislature should follow Wisconsin's lead and amend the Texas statutes to deal with this issue sooner, rather than later, to avoid any more investor loss and unnecessary litigation, and to protect the integrity of the market as a whole.

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