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Regulation LLC

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I. INTRODUCTION

In enacting the federal securities laws,[1] Congress, through registration, disclosure, and anti-fraud provisions, sought to protect investors in "securities" as the term is defined in section 2(a)(1) of the Securities Act of 1933 (the "1933 Act").[2] Over the last eighty years, courts have grappled with the term "security" by developing a variety of standards and frameworks to determine whether investments in anything ranging from stock to general partnerships constitute securities and are therefore subject to the requirements of the federal securities laws. This, however, has resulted in uncertain and inconsistent determinations for the financial interests in a Limited Liability Company (LLC), a modern favored choice of business entity.

Much of the analysis regarding what constitutes a security has stemmed from the umbrella term "investment contract" under which many financial investments may fall, and, specifically, the "investment contract" formulation developed by the Supreme Court in *Securities and Exchange Commission v. W.J. Howey Co.*[3] In that case, the Court determined that an investment in a "common enterprise" with profits to be derived "solely" through the efforts of others will be an investment contract and ultimately a security under the federal securities laws. Generally, courts employ the *Howey* test as the doctrinal starting point in determining whether a given financial instrument or interest, not explicitly mentioned in section 2(a)(1) of the 1933 Act, is a security. As the Supreme Court opined in *Howey*, the investment contract analysis "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."[4]

Over the last two decades, courts have applied the *Howey* investment contract analysis in determining whether LLC membership interests fall within the definition of a security and, in turn, are subject to the federal securities laws.[5] "LLCs are hybrid entities that combine desirable characteristics of corporations, limited partnerships, and general partnerships."[6] By offering many of the favorable features of both general

1. 15 U.S.C. §§ 77a–77bbbb (2006) (the 1933 Act provisions and protections focus on the offering and sale of securities); 15 U.S.C. §§ 78a–pp (2006) (the 1934 Act provides protection to investors once the securities are in the marketplace).

2. *See* 15 U.S.C. § 77b (Supp. 2010). In the enacting/introductory language of the 1933 Act, Congress stated its purpose was "[t]o provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes." Securities Act of 1933, Pub. L. No. 22, 48 Stat. 74 (1933).

3. 328 U.S. 293 (1946).

4. *Id.* at 299 (emphasis added).

5. *See* discussion, *infra* Part IV (examining a series of federal cases that have addressed this issue). This note's analysis focuses on the term security as defined in section 2(a)(1) of the 1933 Act only. However, as the Supreme Court noted in *Tcherepnin v. Knight*, the definitions of the term "security" in the 1933 Act and the 1934 Act, although semantically different, are "virtually identical." 389 U.S. 332, 335–36 (1967).

6. Great Lakes Chem. Corp. v. Monsanto Corp., 96 F. Supp. 2d 376, 383 (D. Del. 2000); *see also* 1 Larry E. Ribstein & Robert R. Keatinge, Ribstein and Keatinge on Limited Liability Companies § 1:2 (2d ed. 2010) [hereinafter Ribstein & Keatinge].

partnerships and corporations,[7] the LLC's hybrid nature and flexibility have led it to become a popular and attractive business form.[8] It is uncertain, however, whether an LLC membership interest sold to investors as a means of financing LLCs is a security under section 2(a)(1) and therefore subject to federal securities law regulation.[9] Securities regulation involves significant registration and disclosure requirements, and, as a result, increased compliance and transaction costs for the LLC issuer,[10] while offering both potential and actual investors disclosure and anti-fraud protection.[11] These rights and responsibilities of both the LLC issuer and the LLC investor are too important to be left to inconsistent and uncertain judicial interpretations.

While taking the position that the characteristics of each LLC membership interest will dictate whether it is in fact a security,[12] this note proposes that the

> [A]n LLC may be generally defined as an unincorporated entity that is formed or organized through a filing with the state under a state limited liability company statute, the members and managers of which do not have vicarious liability for the obligations of the entity, and the relationship of the members, managers and the entity is largely governed by an agreement among them or, where the parties have not agreed to the contrary, by the default rules of the state statute.

Id. § 1:3.

7. *See infra* Part III (discussing the LLC as a business entity and making comparisons between an LLC, general partnership, and corporation). Some of these favorable features include individual as opposed to "double taxation" or entity level taxation, limited liability for the debts and liabilities of LLC members, as well as flexibility in establishing an internal governance structure. *Id.*

8. *See* 1 Ribstein & Keatinge, *supra* note 6, § 1:1.

> Over the past several years, this form of organization has evolved as statutory drafting groups, legislatures, state and federal tax officials, judges and, most importantly, the business people themselves who are using and dealing with LLCs, have thought through the issues. Thus, the nation's leading business court, the Delaware Supreme Court, has endorsed the LLC as a relatively new entity that has emerged in recent years as an attractive vehicle to facilitate business relationships and transactions.

Id.

9. *See* Mark A. Sargent, *Are Limited Liability Company Interests Securities?*, 19 Pepp. L. Rev. 1069, 1071 (1992).

> The LLC raises fascinating questions on several levels. It introduces new complications into the traditional choice of business form analysis. . . . The question is obviously of great practical importance. If limited liability interests are securities, they cannot be offered or sold without registration or exemption therefrom under the securities laws. In addition, their status as securities would trigger substantial disclosure obligations and create the risk of liability under the antifraud provisions of the securities laws.

Id.

10. *See* Carol R. Goforth, *Why Limited Liability Company Membership Interests Should Not be Treated as Securities and Possible Steps to Encourage this Result*, 45 Hastings L.J. 1223, 1285 (1994) ("The real problem is that the cost of federal regulation can be tremendous.").

11. *Id.* at 1279–85.

12. *See* Robinson v. Glynn, 349 F.3d 166, 174–75 (4th Cir. 2003).

> *Precisely because LLCs lack standardized membership rights or organizational structures, they can assume an almost unlimited variety of forms.* It becomes, then, exceedingly difficult to declare that LLCs, whatever their form, either possess or lack the economic characteristics

Securities and Exchange Commission (SEC) promulgate a regulatory safe harbor, "Regulation LLC" ("Reg. LLC"), that would set forth the conditions under which an LLC membership interest would not be deemed a security for purposes of the federal securities law.[13] Reg. LLC would thereby provide business managers and business advisors certainty in forming an LLC and issuing LLC interests to investors with respect to whether the LLC membership interests are securities.

Part II of this note will discuss the structure of section 2(a)(1) of the 1933 Act as it defines the term "security." Further, this Part will briefly discuss how courts have interpreted certain terms found in this section and specifically address the term "investment contract." Part III will address the LLC from its inception over thirty years ago in Wyoming to the present, making comparisons between the LLC, the general partnership, and the corporation to set the background for why courts, business managers, and legal advisors have struggled in answering the question of whether an LLC membership interest is a security.

Part IV will begin with a discussion of relevant federal case law in an attempt to decipher the principles that should comprise the analytical framework for Reg. LLC. Part V will discuss and evaluate scholarly commentary and potential solutions to

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> associated with investment contracts. Even drawing firm lines between member-managed and manager-managed LLCs threatens impermissibly to elevate form over substance. Certainly the members in a member-managed LLC will often have powers too significant to be considered passive investors under the securities laws. And yet even members in a member-managed LLC may be unable as a practical matter to exercise any meaningful control, perhaps because they are too numerous, inexperienced, or geographically disparate. By the same token, while interests in manager-managed LLCs may often be securities, their members need not necessarily be reliant on the efforts on their managers. *We decline, therefore, the parties' invitation for a broader holding.*

Id. (emphasis added) (citations omitted).

13. The Securities and Exchange Commission was created by section 4 of the 1934 Act. Specifically, section 23 of the 1934 Act provides the scope of the SEC's authority.

> The Commission . . . shall each have power to make such rules and regulations as may be necessary or appropriate to implement the provisions of this chapter for which they are responsible or for the execution of the functions vested in them by this chapter, and may for such purposes classify persons, securities, transactions, statements, applications, reports, and other matters within their respective jurisdictions, and prescribe greater, lesser, or different requirements for different classes thereof.

15 U.S.C. § 78w (2006).

As defined by Professor Hazen,

> [a] safe harbor rule sets forth conditions under which the SEC will take the position that the law has been complied with. A person's compliance with a safe harbor rule will thus assure that he or she is safe from SEC prosecution with regard to the transaction in question. The SEC safe harbor rules are designed to help provide for certainty in planning transactions in order to comply with the applicable securities laws.

Thomas Lee Hazen, Principles of Securities Regulation 24 (3d ed. 2009). An example of a SEC safe harbor is Regulation D. Regulation D provides registration exemptions for small issuances of securities and small issuers of securities, provided certain conditions are met. *See* Rules Governing the Limited Sale of Securities Without Registration Under the Securities Act of 1933, 17 C.F.R §§ 230.501–.508 (2011).

addressing the question of whether LLC membership interests are securities. Finally, Part VI will present the framework of Reg. LLC. It is envisaged that Reg. LLC will provide business managers and legal advisors, who in good faith have structured an LLC without the intent to improperly circumvent federal securities laws, a safe harbor for LLC membership interests exempting them from federal securities laws. The benefit of a safe harbor is that it will provide a level of certainty in the planning phase as opposed to the current regime under which a court may impose liability for violations of the federal securities laws with respect to the purchase or sale of LLC membership interests.[14]

II. THE STATUTORY STRUCTURE AND JUDICIAL INTERPRETATIONS OF SECTION 2(A)(1)

A. The Structure of Section 2(a)(1)

In response to the Great Depression and the stock market crash of October 1929, Congress passed the 1933 Act and the Securities Exchange Act of 1934 (the "1934 Act") "[t]o provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof."[15] As such, "[t]he federal securities laws apply to any investment described by the broad definition of a 'security' unless an exemption applies."[16] Specifically, section 2(a)(1) of the 1933 Act defines a security as follows:

> 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.[17]

The term security is defined in both specific and general terms, including specific terms such as "stock" or "bond," which each have commonly understood meanings, but also with general terms such as "investment contract" or "any interest or

14. Larry E. Ribstein, *Form and Substance in the Definition of a "Security": The Case of Limited Liability Companies,* 51 Wash. & Lee L. Rev. 807, 828 (1994) ("An 'economic reality'-type approach may impose significant costs by requiring an adjudicator to make a difficult act-specific inquiry in each case about the need for disclosure").

15. Securities Act of 1933, Pub. L. No. 22, 48 Stat. 74 (1933).

16. Ribstein, *supra* note 14, at 808.

17. 15 U.S.C. § 77b (2006).

instrument commonly known as a 'security,'" which over the years have required a judicial case-by-case interpretation to determine if a given financial instrument is a security.[18] Also, by including both general and specific terms, it is apparent that Congress did not intend all investments to be a security, giving courts great flexibility to determine what financial instruments or schemes fit within the statutory definition.[19]

One of the first cases to interpret the term security was *Securities and Exchange Commission v. C.M. Joiner Leasing Corp.*, in which the Supreme Court reversed the U.S. Court of Appeals for the Fifth Circuit determination that oil lease assignments fell outside the scope of section 2(a)(1) and were therefore not securities.[20] The Court provided some guidance on how broadly the term security should be read:

> In the Securities Act the term "security" was defined to include by name or description many documents in which there is common trading for speculation or investment. . . . Instruments may be included within any of these definitions, as a matter of law, if on their face they answer to the name or description. However, the reach of the Act does not stop with the obvious and commonplace. *Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as a matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as "investment contracts," or as "any interest or instrument commonly known as a 'security.'"*[21]

Early on, the Court recognized that many investments, unknown at the time of the passage of the securities laws, may fit within this definition of a security.

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18. John C. Coffee, Jr. & Hillary A. Sale, Securities Regulation 254 (11th ed. 2009).

> The purpose of the two-part test was to include within the definition the many types of instruments that in our commercial world fall within the ordinary concept of a security.
>
> . . . .
>
> Both the specific and general definitions in the Securities Acts are said to apply unless the context otherwise requires.

Id. (citations omitted) (internal quotation marks omitted). However, even if a given financial instrument appears to fall within one of the specific, enumerated categories of what Congress has termed a "security," the circumstances may not require the instrument to be registered with the SEC. Examples of those not requiring registration include Regulation A (a small offerings exemption), Regulation D (accredited investor exemption), and Regulation S (foreign issuances). *See* Conditional Small Issues Exemption, 17 C.F.R. §§ 230.251–.263 (2011); Rules Governing the Limited Sale of Securities Without Registration Under the Securities Act of 1933, 17 C.F.R §§ 230.501–.508 (2011); Rules Governing Offers and Sales Made Outside the United States Without Registration Under the Securities Act of 1933, 17 C.F.R §§ 230.901–.905 (2011).

19. *See* 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, 1600 nn.39–40 (1995).

20. 320 U.S. 344 (1943).

21. *Id.* at 351 (emphasis added).

B. Federal Courts' Interpretation of Security

Section 2(a)(1)'s broad definition of the term security has provided courts great latitude in determining what financial instruments constitute a security and fall within the coverage of the federal securities laws.[22] The focus of the discussion below is on the term "investment contract"[23] because the Supreme Court's investment contract analysis in *Howey* has withstood the test of time as the starting point for federal courts addressing the issue of whether LLC membership interests are securities.[24] Although courts have elaborated on the *Howey* test over the years,[25] it remains the bedrock principle to guide the analysis of what constitutes a security.[26]

At dispute in *Howey* was whether a citrus grove development contract offered to many potential investors constituted an "investment contract" and therefore a security under section 2(a)(1).[27] The substance of the Court's interpretation of "investment contract" that has been in effect for the last sixty-six years was stated as follows:

> [A]n investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person *invests* his money in a *common*

22. *See* Joseph, *supra* note 19, at 1599–1600 ("This 'open-textured' definition makes it clear that from the very beginning the securities laws were intended to apply wherever they were needed, and that the task of determining the scope of the acts, at least at the margins, would be left to the judiciary." (footnotes omitted)).

23. *See* SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

24. *See, e.g.*, Keith v. Black Diamond Advisors, Inc., 48 F. Supp. 2d 326, 328, 332 (S.D.N.Y. 1999) ("LLC membership interests are not 'securities' unless they meet the four criteria of an 'investment contract.'").

25. In a discussion of how to interpret the term "solely" in the fourth prong of the *Howey* test, the Fifth Circuit adopted the Ninth Circuit approach, stating, "the proper standard in determining whether a scheme constitutes an investment contract 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." SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 483 (5th Cir. 1974) (quoting SEC v. Glen W. Turner Enters., Inc., 474 F.2d 476, 482 (9th Cir. 1973)) (internal quotation marks omitted).

26. *See* 15 U.S.C. § 77b (2006). Other general terms found within the definition of a "security" include "instrument commonly known as a security" and a "certificate of interest or participation in any profit sharing agreement." *Id.* However, with respect to the phrase "instrument commonly known as a security," the Supreme Court has stated:

> [w]e perceive no distinction, for present purposes, between an "investment contract" and an "instrument commonly known as a 'security.'" In either case, the basic test for distinguishing the transaction from other commercial dealings is "whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others."

United Hous. Found., Inc. v. Forman, 421 U.S. 837, 851–52 (1975) (citation omitted). Although the Supreme Court in *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551 (1979), did not address whether "certificate of interest or participation in any profit-sharing agreement" has any broader meaning under the 1933 Act than an "investment contract," the Court stated that the *Howey* test "embodies the essential attributes that run through all of the Court's decisions defining a security." *Id.* at n.11 (quoting *Forman*, 421 U.S. at 852). As a result, for present purposes at least, the *Howey* investment contract analysis is the standard for defining a general term found in the definition of a security. *See id.*

27. *See Howey*, 328 U.S. at 294 ("an offering of units of a citrus grove development coupled with a contract for cultivating, marketing and remitting the net proceeds to the investor").

> *enterprise* and is led to *expect* profits *solely* from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise.[28]

This definition of an investment contract originated under state law as the states attempted to formulate definitions for the term "investment contract" under their respective "Blue Sky" laws.[29] In accepting the state law formulation, the Supreme Court believed that it was "permit[ting] the fulfillment of the statutory purpose of compelling full and fair disclosure relative to the issuance of 'the many types of instruments that in our commercial world fall within the ordinary concept of a security.'"[30]

The *Howey* test is understood to have four factors: (1) that an investor provide "some tangible and definable consideration," (2) for an investment in a "common enterprise," (3) with "an expectation of profit by the investor[,] and (4) that the expectation of profit be derived from the entrepreneurial efforts of others."[31] In applying this test, the Supreme Court has clarified that the substance of the given financial investment should govern the analysis and not merely the name of the underlying instrument.[32] In a discussion of the *Howey* factors, Professor Ribstein contends that the factors are best understood "in terms of the economic rationales for mandatory federal disclosure."[33]

The first factor, "tangible and definable consideration," has been deemed to include money, property, or in some instances sweat equity.[34] With respect to the

28. *Id.* at 298–99 (emphasis added).

29. *Id.* at 298 ("[T]he term [investment contract] was common in many state 'blue sky' laws in existence prior to the adoption of the federal statute and, although the term was also undefined by the state laws, it had been broadly construed by state courts so as to afford the investing public a full measure of protection."). "Blue sky laws" is the colloquial term for the securities laws of an individual state. These laws were in effect in many states prior to the enactment of the federal securities laws. In discussing the origins of the term "blue sky," Professor Hazen writes, "[t]here are a number of explanations for the derivation of the 'blue sky' appellation, the most common of which was because of the Kansas statute's [the first state to develop a securities law regime] purpose to protect the Kansas farmers against the industrialists selling them a piece of the blue sky." *See* HAZEN, *supra* note 13, at 14.

30. *Howey*, 328 U.S. at 299 (quoting H.R. REP. No. 73-85, at 11 (1933)). Further, the Court opined that the investment contract analysis "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." *Id.*

31. Keith v. Black Diamond Advisors, Inc., 48 F. Supp. 2d 326, 332 (S.D.N.Y. 1999).

32. Ribstein, *supra* note 14, at 811 (quoting Tcherepnin v. Knight, 389 U.S. 332, 336 (1967)). *See* SEC v. Shreveport Wireless Cable Television P'ship, No. 94-1781 (HHG), 1998 U.S. Dist. LEXIS 23086, at *11 (D.D.C. 1998) ("In determining whether a particular interest or investment constitutes an 'investment contract,' a court's focus is on the '*economic realities* of the underlying transaction and not on the name it carries.'" (emphasis added) (quoting United Hous. Found., Inc. v. Forman, 421 U.S. 837, 849 (1975))).

33. Ribstein, *supra* note 14, at 811.

34. *See* HAZEN, *supra* note 13, at 29 ("Subsequent case law has taken the position that the investment of services or property, as opposed to money, can also suffice."); *see also United Hous. Found., Inc.*, 421 U.S.

second element of *Howey*, the "common interest" or "common enterprise" prong, courts have not been entirely clear about what constitutes a "common enterprise." However, it is generally understood that "[t]he common enterprise requirement focuses on the question of the extent to which the success of the investor's interest rises and falls with others involved in the enterprise."[35] To interpret this second prong, courts have developed two concepts: horizontal commonality and vertical commonality.[36] Courts have found that horizontal commonality exists where multiple investments by different investors are pooled together by a promoter in the same enterprise. Under the court's interpretation of vertical commonality, an individual investor and the enterprise promoter's funds are pooled together.[37] Horizontal commonality clearly meets the *Howey* standard for a common enterprise because each investor's potential for profitability is linked with those of other investors within the same enterprise whereas courts are split on whether vertical commonality meets the common enterprise element of the *Howey* test because the investor is simply linked with the promoter and is not involved in a common enterprise with other investors.[38] The Supreme Court has found the third requirement, "expectation of profit," to be satisfied by a sharing in the profits and proceeds of the business entity[39] which includes the "promise of a fixed income stream."[40]

The fourth and final element of *Howey*, "profits solely from the efforts of the promoter or a third party,"[41] as discussed below, is the element primarily at issue in the LLC context. It has subsequently been interpreted by courts to mean that expected profits are to be "derived *primarily or substantially* from the efforts of others."[42] Under this reading, profits no longer need to be derived *solely* from the efforts of others, as the *Howey* court initially articulated. The level of control and discretion exercised by the individual investor plays a crucial role in determining whether an investment contract,

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at 852 n.16.

35. Hazen, *supra* note 13, at 30.

36. *See id.*

37. Great Lakes Chem. Corp. v. Monsanto Co., 96 F. Supp. 2d 376, 389–90 (D. Del. 2000).

> To determine whether a party has invested funds in a common enterprise, courts look to whether there is horizontal commonality between investors, or vertical commonality between a promoter and an investor. Horizontal commonality requires a pooling of investors' contributions and distribution of profits and losses on a pro-rata basis among investors. The vertical commonality test is less stringent, and requires that an investor and promoter be engaged in a common enterprise, with the "fortunes of the investors linked with those of the promoters."

Id. (citation omitted) (internal quotation marks omitted).

38. *See* Hazen, *supra* note 13, at 30.

39. *See United Hous. Found., Inc.*, 421 U.S. at 837; Int'l Bhd. of Teamsters v. Daniel, 439 U.S. 551 (1979).

40. *See* Hazen, *supra* note 13, at 30 (citing SEC v. Edwards, 540 U.S. 389 (2004)).

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

42. *See* Hazen, *supra* note 13, at 31 (emphasis added) (internal quotation marks omitted).

and thus a security, exists.[43] As a result, the key question that must be satisfied to determine the existence of a security 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."[44] As the cases discussed below indicate, this last element is particularly important in determining whether the LLC membership interests are securities.

III. THE HYBRID LLC

A. The Limited Liability Company

The first Limited Liability Company statute was enacted in Wyoming in 1977.[45] While states began to enact their own versions of LLC statutes,[46] it was not until over a decade later, when the tax code was rewritten to allow LLCs to be taxed as a partnership instead of as a corporation, that the LLC became a popular choice of entity for business managers.[47] LLCs are a popular choice of entity because they offer many of the advantageous or "desirable characteristics" of other entities, such as limited liability of members afforded by corporations as well as individual taxation, as opposed to entity-level tax treatment.[48] The formation of an LLC requires an agreement and a filing with the Secretary of State, but there is great latitude in

43. *See* discussion *infra* Part IV.

44. SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 476, 482 (9th Cir. 1973); *see also* United Hous. Found., Inc. v. Forman, 421 U.S. 837, 852 (1975) ("The touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others."); Shirley v. JED Capital, 714 F. Supp. 2d 904, 910 (2010) ("The word 'solely' should not be interpreted strictly, but rather realistically, and should turn on whether the actions of those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise." (internal quotation marks omitted)).

45. *See* 1 Ribstein & Keatinge, *supra* note 6, § 1:2 ("The first limited liability company act was passed in Wyoming in 1977."); *see also* 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 (1996).

46. *See* 1 Ribstein & Keatinge, *supra* note 6, § 1:2 ("Florida adopted an LLC act in 1982. . . . Presumably as a result of the uncertainty as to both tax treatment and the members' protection from personal liability, no other state enacted an LLC statute until 1990."). Today, all states and the District of Columbia have their own LLC statutes. *Id.*

47. *See* Treas. Reg. §§ 301.7701-1 to .7701-3 (2011); *see also* Treas. Reg. § 301.6231(a)(7)-2 (2011); *see also* Great Lakes Chem. Corp. v. Monsanto Co., 96 F. Supp. 2d 376, 383 (D. Del. 2000) ("LLCs are entitled to partnership status for federal income tax purposes under certain circumstances, which permits LLC members to avoid double taxation, i.e., taxation of the entity as well as taxation of the members' incomes."); 1 Ribstein & Keatinge, *supra* note 6, § 1:2 ("After 1988, when the Service stated clearly that properly organized limited liability companies would be treated as partnerships, all of the remaining states adopted limited liability company statutes.").

48. *See Great Lakes Chem. Corp.*, 96 F. Supp. 2d at 383; *see also* 1 Ribstein & Keatinge, *supra* note 6, § 1:2.

> [A]n LLC may be generally defined as an unincorporated entity that is formed or organized through a filing with the state under a state limited liability company statute, the members and managers of which do not have vicarious liability for the obligations of the entity, and the relationship of the members, managers and the entity is largely

setting up the LLC's internal structure.[49] As part of this latitude, LLCs generally take one of two forms, as member-managed LLCs, which provide for management by the LLC members, or as manager-managed LLCs, which provide for management by others "who may or may not be members," similar to a corporation.[50] In both structures, a member has financial rights and, depending on what the Operating Agreement provides, "may also have governance rights."[51]

Through operation of statute, in terms of limited liability, an owner of an LLC is a member and all members have limited liability.[52] This means that although members face the risk of losing their investment, creditors cannot go after the members' personal assets.[53] In addition, under the Revised Uniform Limited Liability Company Act (RULLCA), section 304(b),

> [t]he failure of a[n] [LLC] to observe any particular formalities relating to the exercise of its powers or management of its activities is not a ground for imposing liability on the members or managers for the debts, obligations, or other liabilities of the company.[54]

> governed by an agreement among them or, where the parties have not agreed to the contrary, by the default rules of the state statute.

Id. § 1:3.

49. Melvin Aron Eisenberg, Corporations and Other Business Organizations 494–95 (9th ed. 2005); *see also* 1 Ribstein & Keatinge, *supra* note 6, § 2:1 ("The inherent flexibility in most LLC statutes . . . enhances a firm's ability to adopt features that best serve its objectives.").

50. Eisenberg, *supra* note 49, at 494; *see* 1 Ribstein & Keatinge, *supra* note 6, § 2:3.

> [T]here are three fundamental structures: (1) the corporate structure (representative management) in which management is periodically elected by the owners; (2) the limited partnership structure (entrenched management) in which one or more persons are designated as managers at the outset and generally continue as managers unless removed for cause; and (3) the general partnership structure (direct management) in which the owners exercise management control directly.

Id.

51. Eisenberg, *supra* note 49, at 497.

52. *See id.* at 494; *see also* 1 Ribstein & Keatinge, *supra* note 6, § 2:7.

> There are two types of liability that should be considered with respect to the liability structure of the firm. The first is vicarious individual liability of the owner for the obligations of the organization. This is the concern that a member or shareholder will be held personally liable for the debts of the LLC or corporation. The second liability concern is that the creditors of an owner may be able to reach the assets of an organization in which the debtor/owner has an interest. This is the concern of an owner of an organization that the creditors of some other owner may be able to disrupt the operation of the organization to satisfy the debts of the other owner.

Id.

53. *See* Eisenberg, *supra* note 49, at 498. However, an exception to this rule may be if a court rules to pierce the corporate veil of the LLC and hold all or certain members personally liable. *See, e.g.*, Kaycee Land & Livestock v. Flahive, 46 P.3d 323 (Wyo. 2002).

54. Revised Unif. Ltd. Liab. Co. Act § 304(b) (2006).

Under the model statute, section 304(b) provides great flexibility for the internal structure and governance of an LLC, which may provide a significant advantage over the corporate form.[55] Also, unless otherwise provided in the Operating Agreement, all members of an LLC are entitled to equally participate in management and control of the entity.[56] Finally, a member of an LLC will have a financial stake and financial rights in the entity, and, depending on the internal governance structure provided in the Operating Agreement, a member may also have governance rights.[57] Generally, with respect to transferability, a member of an LLC can freely transfer the financial rights in the LLC, but statutes vary on how, if at all, the governance rights in the LLC can be transferred.[58] As mentioned above, LLCs typically receive pass-through tax treatment as opposed to double-taxation at both the entity and individual level.[59] With regard to capitalization, LLCs are generally able to bring in new members, as well as vary the entity's capital structure, by providing within the Operating Agreement different rights and privileges of ownership.[60]

B. LLCs and General Partnerships

"LLCs are similar to general partnerships in that most LLC statutes, like the Uniform Partnership Act (UPA), provide for a default rule of direct management by members."[61] Additionally, "[l]ike partnerships, LLCs are noncorporate firms whose members commonly participate directly in management and . . . unlike partners, LLC members have limited liability and sometimes do not participate directly in management unless the agreement provides otherwise."[62] However, the general partnership and the LLC differ in a few ways as well. First, LLC members have limited liability for the debts of the LLC,[63] whereas general partners are liable for the debts of the entity.[64] Second, as Professor Ribstein states, "LLCs are more conducive to centralized management than general partnerships."[65] Many statutes provide for

55. *See* 1 Ribstein & Keatinge, *supra* note 6, § 2:1 ("The inherent flexibility in most LLC statutes further enhances a firm's ability to adopt features that best serve its objectives.").

56. *See* Eisenberg, *supra* note 49, at 495.

57. *See id.* at 497.

58. *See id.* at 497–98.

59. *See supra* note 47 and accompanying text (discussing tax treatment of LLCs).

60. *See* Eisenberg, *supra* note 49, at 495.

61. *See* Ribstein, *supra* note 14, at 816; *see also* 1 Ribstein & Keatinge, *supra* note 6, § 4.20 (discussing filing requirement, number of owners, execution, purposes and powers, etc.).

62. Ribstein, *supra* note 14, at 810.

63. *See id.* at 816; *see also* 2 Ribstein & Keatinge, *supra* note 6, § 12:8 ("General partners are liable jointly or jointly and severally for debts of the partnership. However, the creditor usually must exhaust remedies against the firm, particularly under RUPA [Revised Uniform Partnership Act], which requires exhaustion of remedies for all types of debts, whether contract or tort.").

64. *See* Ribstein, *supra* note 14, at 816–17.

65. *Id.* at 817. *See generally supra* note 50 (discussing different types of corporate structure).

the LLC Articles of Organization to determine its management structure, while other statutes provide for "corporate-type centralized management."[66] General partnerships, through agreement of the partners, provide for managing partners, while "LLC statutes go further by providing a formal structure for centralized management."[67] As it directly relates to the focus of this note, "this structural difference between LLCs and partnerships means that some LLC investors may not expect to participate in control to the same extent as general partners"[68] and thus may rely on the substantial "efforts of others" to derive a return on their investment.

C. LLCs and Corporations

Both LLCs and corporations offer limited liability to their members and shareholders, respectively.[69] A major difference between corporations and LLCs is that corporate law statutes provide for control and management in a board of directors.[70] In contrast, the default rule in LLC statutes, including RULLCA, is that management is by the LLC members themselves unless the LLC Operating Agreement provides otherwise.[71] Further, LLCs in most instances are subject to partnership level taxation instead of corporate taxation,[72] which occurs in the case of a C Corporation at both the entity and the individual level.[73]

IV. YES, NO, AND MAYBE: FEDERAL CASES ADDRESSING WHETHER THE LLC IS A SECURITY

Courts have developed standards to determine whether stock[74] or partnership interests[75]—the principal financial and ownership units of corporations and partnerships, respectively—are securities, but there is no clear answer as to whether

66. Ribstein, *supra* note 14, at 817.

67. *Id.*

68. *Id.*

69. *See* 1 Ribstein & Keatinge, *supra* note 6, § 4.19; *see also* 2 Ribstein & Keatinge, *supra* note 6, § 12:1 ("All the LLC statutes explicitly provide that neither the members nor managers of an LLC are liable for debts, obligations, or other liabilities of the LLC. Indeed, the ability to combine limited liability with partnership features is one of the most important advantages of the LLC.").

70. *See* Ribstein, *supra* note 14, at 819.

71. *See* Revised Unif. Ltd. Liab. Co. Act § 407(a)(1) (2006). This section provides, "[a] limited liability company is a member-managed limited liability company unless the operating agreement: (1) expressly provides that: (A) the company is or will be 'member-managed'; (B) the company is or will be 'managed by managers'; or (C) management of the company is or will be 'vested in managers.'" *Id.*

72. *See supra* note 46 and accompanying text (discussing the tax treatment of LLCs).

73. *See* Eisenberg, *supra* note 49, at 482–83; "[A] C corporation is recognized as a separate taxpaying entity. . . . The profit of a corporation is taxed to the corporation when earned, and then is taxed to the shareholders when distributed as dividends. This creates a double tax." *Corporations, Business,* IRS.gov, http://www.irs.gov/businesses/small/article/0,,id=98240,00.html (last updated June 3, 2011).

74. *See* Landreth Timber Co. v. Landreth, 471 U.S. 681 (1985) discussed *infra* Part IV.C.

75. *See* Williamson v. Tucker, 645 F.2d 404 (5th Cir. 1981) discussed *infra* Part IV.A.

LLC membership interests are securities. While LLCs are similar in many ways to these other business forms, their ownership interests do not fit neatly in either category according to the standards courts have developed for determining whether general partnership interests and stock are securities. This Part provides an examination of several cases analyzing the issue. Courts deciding the issue begin by applying the *Howey* test to these LLC interests.[76] Although the courts' analytical approaches may be similar, the answers they arrive at are not, leading to a lack of predictability.[77] And because the LLC has emerged as a favored choice of business entity, a consistent answer and a guiding framework are necessary to provide business managers and business advisors certainty in forming an LLC and issuing LLC interests to investors. Part IV.A. reviews SEC enforcement actions in which federal courts were faced with the issue of whether an LLC interest was a security. Part IV.B. discusses cases in which courts have found that LLC interests were securities. And Part IV.C. reviews cases in which courts found that the interest was not a security.

A. SEC Enforcement Actions

The SEC has brought a number of enforcement actions alleging violations of federal securities law because an LLC failed to register its LLC interests—allegations that would require a finding that the LLC interests in those cases constituted securities.[78] This can be discerned from three of these cases which are discussed below.[79]

Securities and Exchange Commission v. Vision Communications, Inc.[80] represents the first case in which the SEC challenged the offer and sale of LLC interests under federal securities laws.[81] In seeking a judgment against the LLC, the SEC presented "an issue of first impression in the federal courts."[82] It was alleged that the defendant,

76. *See* discussion *infra* Part IV.A–C.

77. 2 Ribstein & Keatinge, *supra* note 6, §14:2 ("The cases on LLC interests are split.").

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

79. *See* Elaine A. Welle, *Limited Liability Company Interests as Securities: Planning and Drafting Strategies Related to Securities Law Considerations*, 31 Land & Water L. Rev. 153, 154–55 (1996) (discussing seven lawsuits brought by the SEC "against LLC promoters alleging violations of the federal securities laws in connection with the offer or sale of ownership interests in LLCs").

80. SEC v. Vision Commc'n, Inc., No. 94-0615 (CRR), 1994 WL 326868 (D.D.C. May 11, 1994); *see also Vision Commc'n,* Litigation Release No. 14026, 1994 WL 96945.

81. *See* Welle, *supra* note 45, at 432.

82. *Id.*

Vision Communications, raised approximately $1.25 million by selling LLC interests to various investors throughout the United States while in the process of developing a wireless cable television system.[83] The SEC alleged, *inter alia*, that Vision failed to register the LLC interests with the SEC.[84] Ultimately, the district court granted the SEC's request for a temporary restraining order to enjoin the defendants from future securities violations.[85] The court made no findings as to whether the LLC interests were securities.[86] However, the court's issuance of the temporary restraining order suggests that, under the facts, the court may have determined that the LLC interests were securities.[87]

Three years later, the U.S. District Court for the District of Columbia rendered an opinion on the question of whether LLC interests were securities. In *Securities and Exchange Commission v. Parkersburg Wireless Limited Liability Company*, the court held that the interests in Parkersburg Wireless Limited Liability Company (PWLLC) were securities.[88] PWLLC sold its interests through both mail and telephone solicitations to over seven hundred individuals in forty-three states.[89] Each member was required to purchase at least two units in PWLLC at $5000 per unit, effectively requiring a minimum investment of $10,000.[90] Management was controlled by a named defendant, and only one management issue, the purchase of another wireless cable operation, had ever been submitted to the members of PWLLC for discussion.[91] The court's analysis began with the *Howey* test.[92] From these facts, the court determined that all four elements of the *Howey* test were satisfied[93] because each investor invested money for a

83. *See Vision Commc'n,* Litigation Release No. 14026, 1994 WL 96945; Welle, *supra* note 45, at 433.

84. *See Vision Commc'n,* Litigation Release No. 14026, 1994 WL 96945; Welle, *supra* note 45, at 433–34.

85. *See Vision Commc'n,* Litigation Release No. 14026, 1994 WL 96945; Welle, *supra* note 45, at 435.

86. *See* Welle, *supra* note 45, at 435.

87. *See id.*

88. 991 F. Supp. 6, 8 (D.D.C. 1997) ("The interests in PWLLC, therefore, assuredly were 'securities.'").

89. *Id.* at 7.

90. *Id.* at 7–8.

91. *Id.* at 8.

92. *Id.* at 8.

93. *Id.* at 8–9.

> They were told that they would receive a *pro rata* share of the revenues generated from the wireless cable operation. This establishes that the members of the LLC shared "horizontal commonality," meaning that the fates of all investors in PWLLC were bound together with the profit or the loss of the entire group. Members of the LLC also had "vertical commonality" with the fate of the corporation itself, meaning that the investors' success or failure was linked inextricably to the success or failure of the corporation. . . .
>
> Finally, PWLLC investors' hoped-for profits clearly were to be derived from the efforts of individuals other than the investors themselves; the investors had little, if any, true input into the company.

Id. at 8 (citations omitted).

promise of a pro rata share of revenues from the operation, which satisfied the *Howey* "common enterprise" prong because "the fates of all investors . . . were bound together."[94] In addition, the court determined that the expected profits were to be derived entirely through "the efforts of individuals other than the investors themselves" because "the investors had little, if any, true input into the company."[95] Thus, the court held that the LLC interests were securities.[96]

A third case, *Securities and Exchange Commission v. Shreveport Wireless Cable TV Partnership*, involved an analysis of two partnership interests and one LLC interest in three wireless cable operators: Reading Partnership, Baton Rouge LLC, and Shreveport Partnership.[97] Reading Partnership engaged Champion Communications Corporation to provide it with construction, system development, interim management, and consulting services in exchange for a five percent non-voting interest in Reading Partnership.[98] Additionally, Champion solicited members of the public to invest in Reading Partnership.[99] Similarly, Baton Rouge LLC brought in B.R. Cable to provide the same services that Champion provided.[100] In return for providing its services, B.R. Cable was also to receive a five percent non-voting interest in Baton Rouge LLC and solicited investments on behalf of Baton Rouge LLC.[101] Similar to Champion and B.R. Cable, Complete, a Nevada corporation, was to provide the same services for the Shreveport System, and also was to receive a five percent non-voting interest in Shreveport Partnership.[102] In total, over $10 million and approximately seven hundred general partnership units were sold in Reading Partnership, over $17 million and 1200 limited liability company interests were sold to 1489 investors in Baton Rouge LLC, and Shreveport LLC raised over $11 million through the sale of 740 general partnership units in Shreveport Partnership to 998 investors.[103]

In response to a motion for summary judgment, the court did not decide whether the LLC interests were securities, finding that "a genuine issue of material fact exists as to whether the ownership interests in the wireless cable entities . . . are

94. *Id.* at 8.

95. *Id.* For discussion of the *Howey* test, see George A. Burke, Jr., *Limited Liability Companies and the Federal Securities Laws: Congress Should Amend the Securities Laws to Avoid Coverage*, 76 Ind. L.J. 749, 752–59 (2001); Carol R. Goforth, *Why Limited Liability Company Membership Interests Should Not Be Treated as Securities and Possible Steps to Encourage This Result*, 45 Hastings L.J. 1223, 1274–78 (1994); Park McGinty, *The Limited Liability Company: Opportunity for Selective Securities Law Deregulation*, 64 U. Cin. L. Rev. 369, 385–92 (1996).

96. *See Parkersburg Wireless LLC*, 991 F. Supp. at 10–11.

97. 1998 Fed. Sec. L. Rep. (HHG) ¶ 90, 322, *1 (D.D.C. Oct. 20 1998).

98. *Id.* at *2.

99. *Id.*

100. *Id.*

101. *Id.*

102. *Id.*

103. *Id.*

'securities.'"[104] However, as in *Parkersburg*, the starting point in the court's analysis was the *Howey* test.[105] The court's analysis under *Howey*, and the determination of whether these interests constituted securities turned in this case on the fourth prong: "whether the investors expected to earn profits from the efforts of others."[106] The defendants argued that the investors purchased interests in general partnerships and a limited liability company and that, by doing so, "the investors were expected to and, in fact, agreed to participate significantly in the management and operation of the cable entities in which they invested."[107]

Although the court found that a genuine issue of material fact existed,[108] it nevertheless delved further into an analysis of whether the interests were securities.[109] To interpret the final *Howey* elements, the district court looked to the Fifth Circuit's decision in *Williamson v. Tucker*, addressing whether general partnership interests constituted investment contracts.[110] The Fifth Circuit stated that a general partnership interest will be considered a security if the SEC is able to "demonstrate that, in spite of the partnership form which the investment took, [the investors were] so dependent on the promoter or on a third party that [they were] in fact unable to exercise *meaningful* partnership powers."[111]

Thus, the Fifth Circuit recognized that limited circumstances may allow for a general partnership interest to constitute a security, focusing on the level of control and level of dependence of the "general partner" as an investor on the managerial or entrepreneurial efforts of others.[112]

Applying *Williamson*, the district court in *Shreveport Wireless* concluded that each of the investors held "the powers of general partners" but, by choosing not to exercise

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104. *Id.* at *21.

105. *Id.* at *11–12. Moreover, for the purposes of the analysis, the court treated the two general partnership interests and the LLC interests as the same kind of interest because "the powers granted to the investors" are the same. *Id.* at *13 n.3 (citing Marc I. Steinberg & Karen L. Conway, *The Limited Liability Company as a Security*, 19 Pepp. L. Rev. 1105, 1110–12 (1992)).

106. *Id.* at *12.

107. *Id.* at *13.

108. *Id.* at *21.

109. *Id.* at *14.

110. *See id.* (citing Williamson v. Tucker, 645 F.2d 404 (5th Cir. 1981)).

111. *Williamson*, 645 F.2d 404, 424 (emphasis added).

112. *See id.* Specifically, for a general partnership interest to be a security the SEC must establish 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 . . . powers; or (3) the partner . . . 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 . . . powers.

Id. at 424.

those powers, they did "not make their interests securities."[113] The court noted, however, that if "the investor's profits after the time of sale are primarily dependent upon the promoter's efforts, the investor should have the protection of the federal securities laws."[114] This line of reasoning reflects an adherence to *Howey* and the principle that the economic reality, i.e., the substance and not the form of the transaction, dictates whether or not an LLC interest is deemed a security.[115]

B. The LLC Membership Interest is a Security

In the Northern District of Illinois case *Shirley v. JED Capital LLC*, a member of JED Capital, LLC, an investment company, brought an action against his former employer alleging, *inter alia*, a violation of the federal securities laws.[116] While working at other investment companies, Plaintiff developed many programs that allowed for "automated securities trading, including a Liquidity Replenishment Program ('LRP')."[117] This LRP produced large profits for JED Capital.[118] As a result of this profitability, JED asked Plaintiff to become an equity owner by becoming a member of JED Capital LLC.[119] However, Plaintiff alleged that he was promised his equity stake would be used to support the further development of LRP and that JED Capital had failed to disclose to him "that JED could not pay its bills and had no revenues except those brought in by [Plaintiff]."[120] Finally, Plaintiff alleged that if he did not invest and become a member of JED, "JED would fire him and continue to use LRP without him."[121] Subsequently, Plaintiff became a member, having been issued membership interests in the LLC, but he did not have any control over the direction and decisions of the LLC.[122] A little over a year later, Plaintiff was

113. SEC v. Shreveport Wireless Cable Television P'ship, Fed. Sec. L. Rep. (HHG) ¶ 90, 322, *20 (D.D.C. Oct. 21, 1996) (citing Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc., 840 F.2d 236, 240–41 (4th Cir. 1988)).

114. *Id.* (citing SEC v. Life Partners, Inc., 87 F.3d 536, 547 (D.C.C. 1996)).

115. *See* United Hous. Found., Inc. v. Forman, 421 U.S. 837, 851–52 (1975) ("In considering these claims we again must examine the substance—the *economic realities* of the transaction—rather than the names that may have been employed by the parties." (emphasis added)).

116. 724 F. Supp. 2d 904, 908 (N.D. Ill. 2010).

117. *Id.*

118. *See id.*

119. *See id.* ("In July 2007, John Harada ('Harada'), JED'S manager, persuaded [Plaintiff] to convert $200,000 owed to him by JED, plus up to $100,000 in future earnings, into equity in JED, making Shirley a 10% owner-member of the LLC.").

120. *Id.*

121. *Id.*

122. *Id.*

"persuaded" to invest additional capital into JED.[123] In 2009, Plaintiff had agreed with another manager of JED to wind up JED and close the LRP program.[124]

The court found that "the crux of this debate is whether Plaintiff's investments in JED constitute[d] an 'investment contract.'"[125] Once again, the doctrinal starting point for the court was *Howey's* investment contract analysis.[126] The final element of *Howey*, the expectation of profits to be derived from the efforts of others, was the only contested issue[127] and, as the court stated, "[w]hether an LLC interest is a security depends on the particular facts of the investment arrangement and is a question that courts must determine on a case-by-case basis after taking into account the particular facts and circumstances of the investment arrangement."[128]

In determining that the LLC interests held by Plaintiff were an "investment contract" and thus a security,[129] the court noted that although Plaintiff was responsible for the day-to-day operations of the LRP (the most profitable business of JED), he still remained a passive investor in the LLC because he was considered merely as an employee (although an equity-member) in a manager-managed LLC, and effectively "had no voice in controlling the LLC as a whole."[130]

C. The LLC Membership Interest Is Not a Security

Keith v. Black Diamond Advisors, Inc. provided the Southern District of New York its first opportunity to address the issue.[131] Plaintiff, along with other investors, formed "a sub-prime mortgage lender."[132] After becoming profitable, Plaintiff was

123. *Id.* at 908–09.

> In September 2008, Harada persuaded [Plaintiff] to invest an additional $250,000 into JED in order to expand the LRP trade to London, making [Plaintiff] a 20% member. [Plaintiff] made the investment on the specific agreement that the money would be used solely to expand the company's trading capabilities on the London stock exchange. [Plaintiff] alleges that Harada failed to tell him that JED was in the process of repaying an investment whereby it would become insolvent, that JED could not pay its bills, that Harada had "sucked" money out of JED to finance other ventures, and that JED needed [Plaintiff's] money for its daily survival. After [Plaintiff] made the additional investment, Harada allegedly failed to expand the company into the London market. [Plaintiff] alleges that this failure cost him and JED $3,000 daily in lost profits.

Id.

124. *Id.*

125. *Id.* at 910.

126. *Id.*

127. *Id.*

128. *Id.* (citing Cogniplex, Inc. v. Ross, No. 00 C 7463, 00 C 7933, 2001 WL 436210, *10 (N.D. Ill. Apr. 27, 2001)).

129. *Id.* at 911.

130. *Id.*

131. 48 F. Supp. 2d 326 (S.D.N.Y. 1999).

132. *Id.* at 328.

approached by Black Diamond, a venture capital firm, to form Pace, a New York-based LLC.[133] The LLC Operating Agreement created a member-managed LLC in which the members holding interests in the LLC actually managed the entity.[134] Plaintiff alleged violations under federal securities law, namely, that Black Diamond used its majority position "to squeeze him out" of control, bringing a Rule 10b–5 action concerning the purchase and sale of his interest in Pace.[135]

Like the analysis contained in the decisions discussed above, the court began with the *Howey* analysis.[136] The court determined that the Plaintiff met the first three *Howey* elements on the face of the complaint, but that the fourth element—profits to be derived from the efforts of others—required analysis.[137] Plaintiff argued that although the LLC Operating Agreement and the New York LLC statute[138] provided him with the ability to manage Pace, the economic reality was that he had minimal involvement with Pace as a result of Black Diamond attempting to "squeeze him out."[139]

In order to determine the degree of control under the fourth prong, the court looked to the Fifth Circuit's general partnership analysis in *Williamson*, making an analogy between general partnership interests and LLC membership interests to determine whether or not Plaintiff was "so dependent" on the efforts of others.[140] In addition, the court, relying on the Fourth Circuit in *Rivanna Trawlers*, noted that the critical inquiry was "whether the powers possessed by the [LLC members] under the [Operating Agreement] were so significant that, regardless of the degree to which such

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133. *Id.*

134. *See id.* at 332–33 (discussing the rights granted Plaintiff under the New York LLC statute).

135. *Id.* at 327–28.

136. *See id.* at 332 ("LLC membership interests are not 'securities' unless they meet the four criteria of an 'investment contract.'").

137. *Id.* at 332. The court determined that Plaintiff satisfied the first three elements of *Howey* through the allegations of his complaint and determined that "[t]he critical inquiry here involves the fourth prong of Howey—whether [Plaintiff] invested . . . with the intention of deriving profit from the managerial or entrepreneurial efforts of others." *Id.*

138. N.Y. Ltd. Liab. Co. Law § 401 (2011).

139. *Keith*, 48 F. Supp. 2d at 328, 333 ("On the basis of these allegations, Keith argues that his investment in Pace resulted in so little control, notwithstanding the statute and the Agreement, that he deserves to be protected by the securities laws.").

140. *Id.* at 333–34.

> In *Williamson v. Tucker*, 645 F.2d 404 (5th Cir. 1981), the court recognized that although general partnership interests, in contrast to limited partnership interests, are ordinarily not securities because of the level of managerial control exercised by a general partner, in some limited circumstances a general partnership interest may be a "security." By analogy, an LLC membership interests may be considered a security if the Plaintiff can "demonstrate that, in spite of the partnership form which the investment took, [the investor was] so dependent on the promoter or on a third party that [he was] in fact unable to exercise meaningful partnership powers."

Id.

powers were exercised, the investments could not have been premised on a reasonable expectation of profits to be derived from the management efforts of others."[141]

The court concluded that Plaintiff intended to be an active investor in the business when he made his investment.[142] And although his actual level of control "was less than [Plaintiff] expected to exercise," the court found that the failure to meet that expectation did not convert the interests Plaintiff purchased into a security and afford Plaintiff the protections offered by the federal securities laws.[143] Thus, the court's analysis confirms that the relevant inquiry into and determination of the investor's "degree of control" must be an analysis of the investor's "expectation" and not the amount of control actually exercised.[144]

In *Great Lakes Chemical Corp. v. Monsanto Co.*, the issue of whether LLC interests constitute securities arose in the context of a sale of a business.[145] Great Lakes purchased NSC Technologies Company, a Delaware LLC, from Monsanto and STI.[146] Great Lakes alleged violations of section 10(b) for a failure "to disclose material information in conjunction with the sale of NSC."[147] Great Lakes argued that "NSC was the functional equivalent of a corporation, and therefore the interests

141. *Id.* at 334 (alterations in original) (citation omitted) (internal quotation marks omitted) ("Furthermore, 'the mere choice by a partner to remain passive is not sufficient to create a security interest.'" (quoting Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc., 840 F.2d 236, 241 (4th Cir. 1988))).

142. *Id.*

143. *Id.* ("[I]f at the time of his investment in Pace, Keith did not intend to be a passive investor, as he clearly did not, the Pace interests could not be securities. Furthermore, although the degree of control he actually exercised was less than he expected to exercise, that fact does not convert his interests into securities."). *Nelson v. Stahl* provided the Southern District of New York a second opportunity to revisit the question of whether LLC interests are securities. *See generally* 173 F. Supp. 2d 153 (S.D.N.Y. 2001). However, the result turned out the same and the court found that the LLC interests were not securities. Similarly to *Keith*, the court began by looking to *Howey's* investment contract analysis for guidance. *See id.* at 163–64. Also, like *Keith*, the issue that arose was with respect to the fourth prong of *Howey*—whether profits were to be derived through the efforts of others. *See id.* at 165. The court stated that "[a]n LLC membership interest can be considered a security 'when the partners are so dependent on a particular manager that they cannot replace him or otherwise exercise ultimate control.'" *Id.* (citing *Williamson* 645 F.2d 404). Further, "[t]he delegation of rights and duties standing alone does not give rise to the sort of dependence on others which underlies the [fourth] prong of the *Howey* test." *Id.* (first alteration in original). In analyzing the level of control, the court wrote, "[s]o long as the member retains ultimate control, he has the power over the investment and the access to information about it which is necessary to protect against any unwilling dependence on the manager." *Id.* (internal quotation marks omitted). In concluding its discussion of the control prong, the court stated, "the mere choice by a [member] to remain passive is not sufficient to create a security interest." *Id.* (citation omitted). The court concluded that the LLC interests were not securities because plaintiffs owned sixty percent of the membership interests, the LLC Operating Agreement provided for membership management, and the terms of the LLC Agreements implied "that plaintiffs did not intend to be passive investors." *Id.* at 166.

144. *See Keith*, 48 F. Supp. 2d at 334.

145. 96 F. Supp. 2d 376, 377 (D. Del. 2000).

146. *Id.*

147. *Id.*

should be treated as stock."[148] To bolster this argument, Great Lakes asserted that the LLC Agreement describes the LLC interests as "equity securities" and thus the functional equivalent of stock.[149] Unlike the aforementioned decisions, the district court first looked to the Supreme Court's decisions in *United Housing Foundation, Inc. v. Forman* and *Landreth Timber Co. v. Landreth*, where the Court articulated the test that would govern stock or "equity securities," which are the ownership unit of corporations.[150] However, the district court noted that the Court in *Landreth* expressly limited its test to transactions involving "traditional stock."[151] Thus *Landreth* was ultimately inapplicable to an analysis of LLC interests.[152] The court reasoned that "the LLC Interests, although they are 'stock-like' in nature, are not traditional stock. *Landreth*, thus, is inapplicable to this case, and the court must determine whether the sale of NSC was essentially an investment transaction."[153]

After rejecting Great Lakes's argument that the LLC interests should be analyzed as stock under *Landreth Timber Co. v. Landreth*, the court applied the *Howey* test. The court determined that LLC interests failed to satisfy the *Howey* test on two prongs: common enterprise (the second prong) and expectation of profits to be derived from the efforts of others (the fourth prong).[154] With respect to the common enterprise prong, the court found that (1) there was no horizontal commonality because the challenged transaction was the outright purchase of NSC by Great Lakes and its contributions were not pooled with those of other investors; and (2) there was no vertical commonality because "the fortunes of Great Lakes were [not] linked" with those of Monsanto Corp. or STI.[155] With respect to the fourth prong, expectation of profits to be derived from the efforts of others, the court looked to, *inter alia*, *Williamson v. Tucker*'s analysis of general partnership interests.[156] The court determined that, although the LLC agreement provided that members have no direct authority to manage NSC, Great Lakes had "the power to directly affect the profits it received from NSC" because Great Lakes had purchased all of the interests in NSC and therefore had the ability to remove management without cause.[157] As a

148. *Id.* at 387.

149. *Id.*

150. *Id.* at 387. ("[T]he five most common characteristics of stock [are] (1) the right to receive dividends contingent upon an apportionment of profit; (2) negotiability; (3) the ability to be pledged or hypothecated; (4) the conferring of voting rights in proportion to the number of shares owned; and (5) the capacity to appreciate in value." (citing Landreth Timber Co. v. Landreth, 471 U.S. 681, 686 (1985))).

151. *Id.* at 385–86, 389.

152. *Id.* (citing *Landreth Timber Co.*, 471 U.S. at 694).

153. *Id.* at 389.

154. *Id.* at 389–92.

155. *Id.* at 390.

156. *See id.* at 391–92.

157. *Id.*

result, the court found that the members "profits . . . did not come solely from the efforts of others" and thus also failed the fourth prong of the *Howey* test.[158]

The court continued its analysis by looking to one of the general terms found in section 2(a)(1) of the 1933 Act: "any interest or instrument commonly known as a security . . . ."[159] But the court determined that the *Howey* test "embodies the essential attributes that run through all of the Court's decisions defining a security."[160] Consequently, the court concluded that, although the LLC was the functional equivalent of a corporation and the LLC Agreement described the membership interests as "equity securities," the interests were "neither 'stock,' nor an 'investment contract,' nor 'an instrument commonly known as a security.'"[161]

Robinson v. Glynn represents the first time a federal circuit court of appeals reviewed the issue of whether LLC interests are securities.[162] Plaintiff, an executive within GeoPhone Company, LLC, alleged federal securities fraud in connection with the purchase and sale of a partial LLC interest he had purchased in GeoPhone.[163] Plaintiff argued that his LLC interest constituted either stock or an investment contract under the definition of security in section 2(a)(1) of the 1933 Act.[164] The district court determined that the partial membership interest was not a security, and the Fourth Circuit affirmed, reasoning that "Robinson was an active and knowledgeable executive" as opposed to a casual, "passive investor."[165] The court further stated that it did not find it appropriate to "unjustifiably expand the scope of the federal securities laws by treating an ordinary commercial venture as an investment contract."[166]

In reaching this conclusion, as in the cases discussed above, *Howey* was the doctrinal starting point[167] and the disputed element concerned whether Robinson expected profits to be derived solely from the efforts of others.[168] The court determined that because Robinson served as GeoPhone's Treasurer, holding powers pursuant to the LLC Operating Agreement, and acted as a member of the board of managers, the final *Howey* prong requiring an expectation of profits derived from the efforts of others could not be met, and thus the partial membership interest was

158. *Id.* (citation omitted).

159. *Id.* at 393. (internal quotation marks omitted).

160. *See id.* (quoting United Hous. Found., Inc. v. Forman, 421 U.S. 837, 852 (1975)); *see also Forman*, 421 U.S. at 852 ("We perceive no distinction, for present purposes, between an 'investment contract' and an 'instrument commonly known as a security.'").

161. *Id.* at 394.

162. 349 F.3d 166 (4th Cir. 2003).

163. *Id.* at 168.

164. *Id.* at 170.

165. *Id.* at 168.

166. *Id.*

167. *Id.* at 170.

168. *Id.*

not a security.[169] Further, for reasons similar to those articulated by the *Great Lakes* court, the court in *Robinson* determined that the partial membership interest was not defined as traditional stock nor did it bear stock's usual characteristics.[170] The court specifically stated that it was only deciding the narrow issue of whether Robinson's partial membership interest in GeoPhone, LLC was a security and not the broader issue of whether LLC interests are securities under section 2(a)(1). Despite both parties' invitations that the court do so, the court declared that

> [p]recisely because LLCs lack standardized membership rights or organizational structures, they can assume an almost unlimited variety of forms. It becomes, then, exceedingly difficult to declare that LLCs, whatever their form, either possess or lack the economic characteristics associated with investment contracts. . . . *We decline, therefore, the parties' invitation for a broader holding.*[171]

As such, the Fourth Circuit recognized that the circumstances will dictate whether or not an LLC membership interest is a security.

D. Does Howey Fall Short?

As the cases indicate above, although the courts employ a similar analysis, the decisions rendered do not provide a definitive answer as to whether LLC interests are securities.[172] However, four broad generalizations—based on the cases discussed—can be made about the existing analytical framework for determining whether LLC interests are securities under the 1933 Act. First, the analysis is fact-specific to the individual LLC interest, governed by the "economic realities" of the transaction;[173] second, the Supreme Court's investment contract analysis in *Howey* is the doctrinal

169. *Id.* at 170–72.

170. *Id.* at 173–74 ("Thus the securities laws apply when an instrument is both called stock and bears stock's usual characteristics. Yet Robinson's membership interest was neither denominated stock by the parties, nor did it possess all the usual characteristics of stock.") (citation omitted) (internal quotation marks omitted).

171. *Id.* at 174–75 (emphasis added) (citations omitted). The Second Circuit has recently followed suit in setting up the framework for an analysis of whether an LLC interest is a security in *United States v. Leonard*, 529 F.3d 83 (2d Cir. 2008). Although this case rose on appeal as a challenge to criminal sentencing for violation of the federal securities laws, the Second Circuit utilized the same approach as in the cases above. The court began with the *Howey* investment contract analysis and used the *Williamson* partnership analysis as a guidepost in discussing the fourth prong of *Howey*. *See Leonard,* 529 F.3d at 87–91. While the court itself did not determine whether the LLC interests were securities, the court concluded "that the jury could have determined that, notwithstanding the organizational documents drafted to suggest active participation by members, the defendants sought and expected passive investors . . . and therefore the interests that they marketed constituted securities." *Id.* at 91.

172. *See* Coffee & Sale, *supra* note 18, at 309. ("Absent an authoritative appellate decision, division in the case law seems likely to persist on this issue."). Although two appellate decisions have been rendered, There still is no clear answer even with a judicial framework for analysis appearing to have been established in the case law. *See* discussion *supra* Part IV.B–C.

173. *See, e.g.*, Keith v. Black Diamond Advisors, Inc., 48 F. Supp. 2d 326, 334 (S.D.N.Y. 1999); Great Lakes Chem. Corp. v. Monsanto Co., 96 F. Supp. 2d 376, 384–85 (D. Del. 2000).

starting point;[174] third, so long as *Howey* is the doctrinal starting point, the final element of the investment contract analysis—whether profits are to be derived from the efforts of others—will usually be the element in dispute;[175] and, fourth, so long as the final element of *Howey* is in dispute, the *Willamson* general partnership analysis will likely serve as a useful guidepost for courts analyzing this final element.

These generalizations, reveal that the only clear answer to whether LLC interests are securities under federal securities laws is that there is none. The answer to this question is determined on a case-by-case basis. Since the limited liability company has become an increasingly popular form in which to do business over the last two decades,[176] particularly because of the flexibility it offers, an answer is needed.[177] Lawyers and businesspeople alike, using the LLC as a means to structure their business face substantial uncertainties and risks due to the unsettled question of whether LLC membership interests are securities. As a result, the following discussion introduces other potential solutions that have addressed this issue, including this note's proposal of a Reg. LLC.

V. EXISTING PROPOSALS FOR A SOLUTION

Commentators and scholars alike have posited many proposals to determine whether LLC membership interests are securities covered by the federal securities laws. Three such approaches include (1) a private ordering approach in which the parties decide for themselves by contract, (2) a legislative opt-out approach, and (3) a Congressional amendment to the definition of "security" in section 2(a)(1).[178] Each of these proposals is briefly outlined and evaluated below.

Professor Ribstein argues for a private-ordering approach, which would allow "the parties themselves [to] determine whether the securities laws apply."[179] The

174. While courts do recognize the similarities between LLCs, partnerships, and corporations, *Howey* is the doctrinal starting point for determining whether LLC interests are securities. *See, e.g.*, *Great Lakes Chem. Corp.*, 96 F. Supp. 2d 376 (refusing to apply the *Landreth* stock analysis to LLC interests, although the LLC interests bore the label "stock").

175. *See, e.g.*, *Robinson*, 349 F.3d 166; *Keith*, 48 F. Supp. 2d 326; Shirley v. JED Capital, LLC, 724 F. Supp. 2d 904 (N.D. Ill. 2010); *see also* Burke, supra note 95, at 758.

176. *See* David L. Cohen, *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, 448 (1998).

177. *See* 1 Ribstein & Keatinge, *supra* note 6, § 2:1 ("The inherent flexibility in most LLC statutes . . . enhances a firm's ability to adopt features that best serve its objectives.").

178. *See* Burke, *supra* note 95, at 767 ("If the theory of the intermediate-private-ordering approach is implemented using the legislative method of the opt-out approach, the result is a practical solution to the problems of LLC interests as securities.").

179. Ribstein, *supra* note 14, at 810, 812 ("LLC interests, like partnership interests, should be at least strongly presumed not to be 'securities.' This conclusion is based on an analysis of the extent to which courts should rely on investment form rather than substance . . . in defining a security."). Professor Ribstein further states, "The courts also could apply what might be called an 'intermediate private ordering' approach. Under this approach, the courts could hold that the securities laws do not apply when investors were led by the *form* of the transaction not to expect protection." *Id.* at 812.

rationale underpinning this approach stems from Professor Ribstein's contention that "contracting parties ordinarily are better suited than courts or regulators to determine the amount of disclosure that is appropriate in specific contexts."[180] In advancing this argument, Professor Ribstein reasons that "the form of the transaction reduces the costs of complying with and adjudicating disputes under the securities laws. . . . By facilitating contracting over disclosure rights, emphasizing the form of the transaction tends to produce an optimal amount of disclosure."[181]

As an alternative, Professor McGinty advocates an opt-out approach and argues that "Congress could add [to the definition of security in the Securities Acts] the following phrase: 'interests in limited liability companies other than excluded LLC interests.'"[182] Under this approach, the definition of security would read as it presently does in section 2(a)(1), but simply with this additional language. According to McGinty, the term "excluded LLC interests" would allow LLCs who issue such interests, in a fashion similar to Professor Ribstein's private ordering approach, to choose "to exclude themselves from [securities law] coverage on the condition that they disclose [to prospective investors] that interests therein are not covered or protected by federal or state securities laws."[183] Professor McGinty argues that by allowing LLCs to opt-out from securities law coverage, business and transaction costs would be substantially reduced, making the formation of an LLC a more cost-effective venture.[184]

A third solution calls for Congress to amend the definition of "security" in both the 1933 Act and the 1934 Act to "definitively exclude LLC interests."[185] More specifically, this proposed solution would include in the definition of security a

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180. *Id.*

181. *Id.* at 824.

182. McGinty, *supra* note 95, at 437.

> LLCs should be able to opt in or out of the federal securities laws, provided that those that opt out clearly notify prospective investors (i) that no protections of federal securities laws cover such interests and (ii) what kind of disclosure they are making. Giving clear notice to investors, this regime would allow both LLCs and investors to reach a more voluntary equilibrium over how much disclosure and securities regulation they wanted.

Id.

183. *Id.*

184. *Id.* at 426, 437.

> Compliance with securities laws creates costs, some of which intuitively seem worthwhile and others of which seem to have few offsetting benefits. Prohibitions against fraud, which are the securities laws' most legitimate function, sometimes create legal risks that force firms into costly compliance with securities regulation, even when they eventually would be held not covered by the securities laws.

Id.

185. *See* Burke, *supra* note 95, at 767 ("If the theory of the intermediate-private-ordering approach is implemented using the legislative method of the opt-out approach, the result is a practical solution to the problems of LLC interests as securities.").

statement that "interests in limited liability companies are not securities within the definition of this act and are therefore not protected by the provision of this act."[186]

Collectively, these approaches do not allow for the possibility that in some instances LLC interests should be deemed securities and should therefore afford LLC members the protections of federal securities laws under their registration, disclosure, and anti-fraud provisions. It is not a choice that should be wholly subject to private-ordering because private ordering presumes equal footing in negotiations between the parties, which in some instances may leave the possibility for fraud in negotiations between entity managers and potential members of the LLC.[187] Furthermore, private ordering and the legislative opt-out have the potential to provide for different levels of protection of LLC membership interests within the same LLC, where some members may hold interests that are securities and are therefore subject to federal securities law and others holding a different class of interests do not.[188] Also, definitively excluding LLC interests from the definition of security provides an inadequate solution because, as the cases above indicate, some LLC interests do have the characteristics of a security and therefore should be subject to the federal securities laws. While excluding LLC interests from securities law coverage provides a definitive answer, it is over-inclusive because it expressly excludes all LLC membership interests, an approach contrary to the federal court analysis above. Accordingly, a categorical rule that the 1933 Act and 1934 Act will not protect investors in any LLC is inadequate because it does not afford the protections of the federal securities laws to LLC members that the securities laws were intended to protect.

VI. REGULATION LLC

The solution proposed here, Reg. LLC, is the promulgation of a regulatory safe harbor by the SEC. It is envisaged that Reg. LLC would afford LLC managers, who in good faith have structured an LLC, a safe harbor with an option not to register the membership interests. This would serve as the alternative to the current unpredictable jurisprudence that at times imposes liability for violations of the federal securities laws with respect to the purchase or sale of LLC membership interests.[189] As the cases indicate above, this note takes the position that it is difficult, if not impossible, to declare all LLC interests presumptively are or presumptively are not securities. This note principally argues that although *Howey's* investment contract analysis has guided courts faced with this question, the investment contract analysis has resulted in inconsistent results, leaving business managers and lawyers who have formed LLCs to the mercy of judicial interpretation. The inherent risk and

186. *Id.*

187. *See* Elaine A. Welle, *Freedom of Contract and the Federal Securities Laws: Opting Out of Securities Regulation by Private Agreement*, 56 Wash. & Lee L. Rev. 519, 540 (1999) ("If . . . the purpose of securities regulation is to serve a more publicly-directed purpose, such as increasing public confidence in capital markets, deterring fraud, or protecting investors, then the reform measures would be improvident.").

188. For additional criticism of Professor Ribstein and Professor McGinty's approaches, see *id.* at 528–32.

189. *See infra* note 19 and accompanying text.

uncertainty faced by businesspeople and lawyers can be simply addressed by the SEC developing Reg. LLC, a safe harbor for membership interests for this popular and fast-growing business form.

Specifically, this note proposes that the choice of whether an LLC interest is a security should be made by the LLC's managers at the outset of the LLC's formation, so that it can be part of the calculus of what business form the entity takes and what registration and disclosure obligations the entity wishes to take on. However, this choice should be grounded in a regulatory safe harbor that sets forth certain conditions relating to the characteristics of the given LLC interest that, if met, would not bring the LLC interest within the definition of a security. This would allow businesspeople and lawyers both flexibility and predictability as they decide how to establish the capital and governance structures of their businesses and whether the LLC is the right business form for their purposes. Accordingly, this note proposes a regulatory safe harbor, Reg. LLC, as a pragmatic solution because the safe harbor would include conditions that, if satisfied, would mean a particular LLC interest is *not* a security under section 2(a)(1) and not subject to registration and disclosure under the 1933 and 1934 Acts.

In structuring Reg. LLC, it is important to consider two perhaps competing interests: first, the underlying policy of the federal securities laws, namely, investor protection through disclosure and anti-fraud measures,[190] and second, the flexibility offered by the LLC business form.[191] Reg. LLC strikes this balance by preserving the choice and flexibility offered prospective business managers by the LLC statutes, while at the same time affording investor protection. Additionally, the proposed framework for the conditions of Reg. LLC draws on the case law previously discussed and incorporates the factors that courts found dispositive on the issue of whether LLC membership interests constitute securities.

In analyzing the relevant federal case law, this note has extracted four general principles from the decisions of federal courts that have attempted to answer whether LLC interests are securities: (1) a case-by-case determination is necessary as the courts use a fact specific analysis; (2) if the *Howey* test is satisfied, LLC interests will be deemed securities; (3) the fourth prong of *Howey*, the expectation of profits to be derived from the efforts of others, will typically in dispute; and (4) when the fourth prong of *Howey* is in dispute, the Fifth Circuit's *Williamson* general partnership analysis will likely serve as a guidepost for courts' interpretations. Specifically, the second, third, and fourth principles should serve as the basis for the Reg. LLC safe harbor setting forth the conditions under which an LLC membership interest would not be deemed a security allowing, as the Supreme Court in *Howey* articulated, "a flexible rather than a static principle."[192] It would logically follow that this can be used to form the foundation of a regulatory safe harbor for the LLC as well.

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190. *See* United Hous. Found., Inc. v. Forman, 421 U.S. 837 (1975).

191. *See* 1 Ribstein & Keatinge, *supra* note 6, § 2:1 ("The inherent flexibility in most LLC statutes . . . enhances a firm's ability to adopt features that best serve its objectives.").

192. 328 U.S. 293, 299 (1946).

As can be observed from the discussion of the relevant case law, the underlying principles of *Howey* are essentially dispositive to the analysis. Simply, if an LLC membership interest is offered for sale and is made within a "common enterprise," i.e., satisfies "horizontal commonality," with an expectation of profit to be derived *principally* through the efforts of others, the interests will then in all likelihood be considered a security under the federal securities laws. This appears to be the case in most manager-managed LLCs because the member-investor is in most instances solely relying on the manager(s) of the LLC to turn a profit of his investment.

However, the close case is that of a member-managed LLC, where the member either does not exercise the level of control that he is expected to exercise or that the LLC Operating Agreement provides that he exercise. This is the most important factor that will contribute to forming Reg. LLC, the fourth prong of *Howey*, and an analysis into the expectation of control of the LLC member-investor-manager. This expectation can be determined by review of the disclosure materials provided the member-investor-manager, the LLC Operating Agreement, and discussions surrounding the role the LLC member is expected to take because as the cases indicate, the level of control actually exercised or even the level of control expected to be exercised, will in all likelihood determine whether an LLC membership interest is a security. By reviewing these materials at the time of formation, the expectations of a member's involvement and level of control in the profitability of the LLC, lawyers and businesspeople will be able to decipher whether an LLC membership interest is a security.

Thus, under Reg. LLC, an LLC membership would not be deemed a security if certain conditions were satisfied—principally, a level of managerial control given to each member through the Operating Agreement and adequate disclosures provided to members about the role each member was to take and the level of managerial control, if any, each member was to assume.

VII. CONCLUSION

While this note has taken the position that the specific facts and circumstances of any particular LLC interest should dictate whether it is a security, the answer to this question should not be left to the unpredictability of the judicial process, which can open up the LLC, its managers, and its members to potential securities law liability in connection with the purchase or sale of LLC membership interests. In the alternative, using the federal courts' application of *Howey* and *Williamson* to LLC membership interests as a basis for development, Reg. LLC would provide businesspeople and lawyers alike flexibility and predictability as they decide how to establish the capital and governance structures of their businesses and determine whether the LLC is the right business form for their purposes. This will allow promoters and managers the option to choose another corporate form to better meet their needs. However, if an LLC is the best form of entity for the respective business, the LLC promoters and managers may still opt to create LLC membership interests that, not satisfying the conditions of the safe harbor, are securities pursuant to Reg. LLC and therefore subject to registration and disclosure under the 1933 and 1934 Acts.