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Are Limited Liability Company Interests Securities?

Mark A. Sargent*

I. INTRODUCTION

The limited liability company ("LLC") is one of the most interesting forms of business organization developed in recent years.[1] At first glance, the LLC may seem to be just another over-clever tax dodge doomed to a brief career. Upon closer inspection, however, the LLC actually seems to be worth taking seriously. This is so because the LLC attempts to achieve two of the most fundamental goals pursued by business planners.

First, the LLC permits the planner to choose between entity-level taxation and pass-through taxation,[2] allowing selection of the optimal tax status without sacrificing limited liability. By allowing the planner to choose entity-level taxation (by forming a corporation) or pass-through taxation (by forming an LLC) without submitting to the sub-

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1. For a comprehensive study of the limited liability company see Robert R. Keatinge et al., *The Limited Liability Company, A Study of the Emerging Entity*, 47 BUS. LAW. 378 (1992) [hereinafter Keatinge]. For a useful article, although dated by the recent spate of LLC statute enactments, see Wayne M. Gazur & Neil M. Goff, *Assessing the Limited Liability Company*, 41 CASE W. RES. L. REV. 387 (1991). For single state studies, see Jose M. Sariego, *The Florida Limited Liability Company Revisited: An Alternative Form of Business*, FLA. B. J., Nov. 1989, at 26; Alson R. Martin, *The Kansas Limited Liability Act - Business and Tax Considerations*, 59 J. KAN. B. ASS'N 17 (1990); S. Brian Farmer & Louis A. Mezzullo, *The Virginia Limited Liability Company Act*, 25 U. RICH. L. REV. 789 (1991); Joseph P. Fontana & Corey R. McCool, Comment, *The Wyoming Limited Liability Company: A Viable Alternative to the S Corporation and the Limited Partnership?*, 23 LAND & WATER L. REV. 523 (1988).

2. For a concise explanation of the difference between pass-through entities such as partnerships, which are not taxed at the entity level, and entities such as corporations, which are taxed at the entity level, see ROBERT W. HAMILTON, FUNDAMENTALS OF MODERN BUSINESS 294-96 (1989).

stantive limitations and intellectual gymnastics of an S corporation[3] or limited partnership status, the LLC promises to bring some rationality to a disordered situation.

Second, the LLC, much like a general partnership, permits the business planner great freedom to tailor governance and financial arrangements to the owners' needs, while maintaining limited liability for the owner. This much-desired flexibility unleashes the planner's ingenuity, allowing the limited liability-seeking owner to escape the straitjacket of the mandatory provisions of the corporation statutes and develop structures more suitable to life in a closely-held enterprise. The LLC statutes may thus meet much of the promise that special close corporation statutes of the 1960s and 1970s left unfulfilled.[4]

The promise of the LLC statutes, however, rests on tenuous foundations. In order for the Internal Revenue Service ("IRS") to treat an LLC as a pass-through entity for federal tax purposes, the LLC must classify itself as a partnership and not as an association taxable as a corporation.[5] Until recently, the IRS position with respect to the LLC seemed to be that it should *not* be classified as a partnership because no member of an LLC is liable for the entity's debts.[6] Between 1988 and 1990, however, the IRS issued a single revenue ruling and a short series of private letter rulings that apparently reversed this position and classified LLCs as partnerships.[7] These rulings, although highly specific and contingent, encouraged greater use of existing LLC statutes, and incited the enactment of similar statutes in other jurisdictions, as the states scrambled to create a pass-through vehicle that would enable entrepreneurs to exploit the post-1986 decline in

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3. An "S corporation" avoids taxation at the entity level by qualifying as a "small business corporation" and electing to be taxed under subchapter S of the Internal Revenue Code. *See* I.R.C. §§ 1361, 1366 (1982).

4. For a critical discussion of the fate of these statutes, see Dennis S. Karjala, *A Second Look at Special Close Corporation Legislation*, 58 TEX. L. REV. 1207 (1980); Dennis S. Karjala, *An Analysis of Close Corporation Legislation in the United States*, 21 ARIZ. ST. L.J. 663 (1989); David L. Dickson, *The Florida Close Corporation Act: An Experiment that Failed*, 21 U. MIAMI L. REV. 842 (1967); Ronald M. Shapiro, *The Statutory Close Corporation: A Critique and a Corporate Planning Alterative*, 36 MD. L. REV. 289 (1976) (critiquing Maryland's close corporation statute).

5. For more detailed discussion of this distinction and its relevance to the tax status of LLCs, see Susan Pace Hamill, *The Limited Liability Company: A Possible Choice for Doing Business?* 41 FLA. L. REV. 721, 724-39 (1989). *See also infra* notes 50-75 and accompanying text.

6. The IRS took this position in a set of proposed regulations, 45 Fed. Reg. 75,709 (1980) (to be codified at 26 C.F.R. pt. 301) (proposing amendments including Prop. Treas. Reg. §§ 301.7701-2(a)(2)-(4)), which were later withdrawn. I.R.S. Announcement 83-84, 1983-2 I.R.B. 31 (Dec. 16, 1982)).

7. Rev. Rul. 88-76, 1988-2 C.B. 360; Priv. Ltr. Rul. 89-37-010 (June 16, 1989); Priv. Ltr. Rul. 90-10-027 (Dec. 7, 1989); Priv. Ltr. Rul. 90-30-013 (April 25, 1990); Priv. Ltr. Rul. 90-29-019 (April 19, 1990); *see also* Priv. Ltr. Rul. 91-19-029 (May 10, 1991).

personal income tax rates.[8]

As of this writing, eight states have given effect to LLC statutes,[9] and LLC legislation is pending in approximately fifteen others.[10] The fate of all this law-making will depend upon the IRS' and Congress' continued willingness to treat LLCs as pass-through entities. The device's practical importance, furthermore, will depend upon the preservation of a corporate/personal income tax structure that favors the use of pass-through forms of business organization.

The LLC raises fascinating questions on several levels. It introduces new complications into the traditional choice of business form analysis. It poses tantalizing planning opportunities. It generates knotty tax issues of a technical nature and surfaces the policy question of whether a business organization's pass-through or non-pass-through status should depend on the arcane and largely irrelevant factors central to the IRS' partnership/association dichotomy.[11] This article, however, will not focus on these intriguing issues, many of which have been ably discussed elsewhere.[12] Instead, this article will consider whether the federal and state securities laws will treat limited liability interests as securities.[13]

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. It thus makes sense to think about whether interests in the new LLC entity will be treated as securities.

Part II of this article will set the stage for the definitional question by reviewing what LLCs are and how they are intended to operate.[14] Part III will provide the analytical context by describing how courts

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8. For a summary of the impact of the tax reforms of the 1980s on the rate structure, see HAMILTON, *supra* note 2, at 264-71. For an explanation of why the use of a pass-through entity is likely to be advantageous under the current, post-1986 rate structure, see *id.* at 319-22.

9. For citations to the LLC statutes in those states, see *infra* notes 17, 19 & 24-29.

10. *See* MARK A. SARGENT, THE LIMITED LIABILITY COMPANY HANDBOOK (forthcoming in 1992).

11. *See infra* notes 50-75 and accompanying text.

12. *See, e.g.*, Keatinge, *supra* note 1; Gazur & Goff, *supra* note 1; and Hamill, *supra* note 5.

13. This question has received little attention. For brief, although thoughtful discussions, see Keatinge, *supra* note 1, at 403-04; Farmer & Mezzullo, *supra* note 1, at 828-30.

14. *See infra* notes 17-75 and accompanying text.

have applied the key tests for the existence of a security to general partnerships and limited partnerships, which are forms of business organization somewhat analogous to LLCs.[15] Finally, Part IV will apply those tests to the LLC and demonstrate how this entity raises subtle definitional questions.[16]

II. THE LIMITED LIABILITY COMPANY: A PRÉCIS

A. *Origins and Proliferation*

The Wyoming legislature enacted the first limited liability company legislation in 1977,[17] with the usual hope of attracting businesses, or at least business franchises, to the state.[18] Florida followed suit in 1982, adopting a statute[19] modeled largely after the Wyoming statute. The uncertainty surrounding the federal tax status of LLCs,[20] however, led to minimal use of the Wyoming[21] and Florida[22] devices, and forestalled adoption of similar statutes in other jurisdictions.

The IRS broke this deadlock in 1988 with Revenue Ruling 88-76,[23] which classified a Wyoming LLC as a partnership for federal tax purposes. The ruling caused Colorado[24] and Kansas[25] to adopt their own LLC statutes, soon followed by Nevada,[26], Texas,[27] Utah[28] and Virginia.[29] As stated above,[30] this pattern of enactments can be expected to continue so long as the IRS maintains its position on the partnership status of LLCs.

While there are numerous technical and substantive differences among the several LLC statutes,[31] they show a tendency toward rela-

15. *See infra* notes 76-171 and accompanying text.

16. *See infra* notes 172-202 and accompanying text.

17. WYO. STAT. §§ 17-15-101 to -136 (1977). For discussion of the little-known "limited partnership association" as a precursor to the LLC, see Keatinge, *supra* note 1, at 381-84.

18. Gazur & Goff, *supra* note 1, at 389.

19. FLA. STAT. ANN. §§ 608.401-.471 (West Supp. 1991).

20. *See supra* notes 6-11 and accompanying text; *see also infra* notes 50-75 and accompanying text.

21. Only 26 Wyoming LLCs had been established as of February 22, 1988. Fontana & McCool, *supra* note 1, at 523, 531.

22. Apparently, only two LLCs were formed in Florida in the year following adoption of the LLC statute. Comment, *The Limited Liability Company Act*, 11 FLA. ST. U. L. REV. 387, 388 (1983). For discussion of this phenomenon, see Sariego, *supra* note 1, at 26.

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

24. COLO. REV. STAT. §§ 7-80-101 to -913 (Supp. 1990).

25. KAN. STAT. ANN. §§ 17-7601 to -7651 (Supp. 1991).

26. NEV. REV. STAT. ANN. §§ 86.276-.332 (Michie Supp. 1991).

27. 1991 TEX. SESS. LAW SERV. 901 (Vernon) (referring to H.B. 278, § 46).

28. UTAH CODE ANN. §§ 48-2b-101 to -156 (Supp. 1991).

29. VA. CODE ANN. §§ 13.1-1000 to -1069 (Michie Supp. 1991).

30. *See supra* notes 5-8 and accompanying text.

31. For a detailed survey of the differences among the Wyoming, Florida and Col-

tive uniformity, if only because departures from the dominant format might raise questions about the tax status of entities organized under the individual state statutes. The tendency toward uniformity should be reinforced by the American Bar Association's Section of Business Law, which has a subcommittee drafting a prototype LLC statute,[32] and by the National Conference of Commissioners on Uniform State Laws (NCCUSL), which has formed a drafting committee charged with producing a uniform LLC act.[33]

B. Fundamental Characteristics

The leading commentators on LLCs have summarized the LLC as "a non-corporate business [form] that provides its members with limited liability and allows the members to participate actively in the entity's management."[34] This succinct definition reveals the entity's basic characteristics.

As a non-corporate form of business, the LLC has been designed to avoid double taxation and to permit pass-through of income and losses for tax purposes. It also avoids the application of the mandatory provisions of corporation statutes that require boards of directors and officers, and the attendant paraphernalia relating to meetings and voting rights. As a non-corporation, the LLC also can duck application of the corporation statutes' various legal capital[35] provisions governing the corporate financial structure. This provides a degree of flexibility in management and financial planning heretofore found principally in general partnerships.

Unlike general partners, however, the members of an LLC have shareholder-type limited liability. The LLC thus has a hybrid character. Like a general partnership, it is highly flexible and "tailorable," and it is not (so far) taxable at the entity level. Like a corporation, it provides limited liability to its owners. Partnership/corporation hybrids, of course, are nothing new. The limited partner-

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orado statutes, see Gazur & Goff, *supra* note 1, at 472-501. For a comprehensive comparison of eight statutes, see Keatinge, *supra* note 1, at 409-23.

32. Marshall B. Paul & Stuart Levine, *Choosing a State of Organization for a Limited Liability Company*, 62 PRENTICE HALL L. & BUS. BULL., Nov. 26, 1991, at ¶ 24.1.

33. For a discussion of the background to that decision, *see* Keatinge, *supra* note 1, at 456-57; Farmer & Mezzullo, *supra* note 1, at 791.

34. Keatinge, *supra* note 1, at 384 (footnote omitted).

35. The last word on par value, stated capital and other corporate legal capital concepts can be found in BAYLESS MANNING & JAMES J. HANKS, JR., LEGAL CAPITAL (3d ed. 1990).

ship has been around for a long time.[36] The great advantage of the LLC, however, is that its members, unlike limited partners,[37] have no restrictions on their right to participate in control of the business. In addition, there is no need to have a member or other participant that would have unlimited liability similar to that of a general partner of a limited partnership.[38]

The flexibility allowed to LLCs deserves particular emphasis. The LLC statutes contain no rules governing the issuance of ownership interests, the creation of classes or series of interests, or the allocation of equity contributions to stated capital or capital surplus accounts. There are also no statutory rules concerning differential treatment of holders of the same class or series of interest as there are under the corporation statutes.[39] This hands-off approach leaves virtually all of the essential elements of the capital structure to be determined by the parties, with results reflected in an "operating agreement"[40] that is roughly analogous to a general partnership agreement.

Similarly, the LLC statutes abandon the corporation statutes' mandatory hierarchy of shareholders, directors and officers. The statutes thus eliminate the numerous distinctions over who has the authority to amend the articles or bylaws, elect or remove the managers of the organization, or authorize distribution of earnings. Whole bodies of corporate law doctrine, such as the rule invalidating

36. For a discussion of the nineteenth century origins of limited partnerships in the United States, see the Official Comment to section 1 of the Uniform Limited Partnership Act of 1916 ("ULPA"), UNIFIED LIMITED PARTNERSHIP ACT § 1, 6 U.L.A. 562-63 (1969) (act revised in 1976 and amended in 1985).

37. Compare the strict rule contained in section 7 of the ULPA, 6 U.L.A. 582 (1969), stating, "A limited partner shall not become liable as a general partner unless, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business," *Id.* (applied in Holzman v. DeEscamilla, 86 Cal. App. 2d 858, 195 P.2d 833 (Cal. Dist. Ct. App. 1948)) with the safe harbor rule of section 303 of the Revised Uniform Limited Partnership Act of 1976 ("RULPA"), 6 U.L.A. 325-26 (Supp. 1991), which permits a substantially greater level of limited partner control. For an application of the RULPA approach, see Mount Vernon Savings & Loan Ass'n v. Partridge Assoc., 679 F. Supp. 522 (D. Md. 1987). Note also that the National Conference of Commissioners on Uniform State Laws has approved amendments to RULPA, which include some modifications of section 303. RULPA § 303, 6 U.L.A. 325-26, 415 (Supp. 1991). For critique of the control concept under the limited partnership statutes, see Joseph J. Basile, Jr., *Limited Liability for Limited Partners: An Argument for Abolition of the Control Rule*, 38 VAND. L. REV. 1199 (1985). RULPA and the 1985 amendments thereto have reduced the risk that a limited partner might lose limited liability status by participating in control, but the LLC has apparently eliminated that risk for its members.

38. *See* ULPA § 9(1), 6 U.L.A. 132 (1969); RULPA § 403(b), 6 U.L.A. 345 (Supp. 1991).

39. Keatinge, *supra* note 1 at 386.

40. For examples of such operating agreements, see MARK A. SARGENT, THE LIMITED LIABILITY COMPANY HANDBOOK (forthcoming in 1992).

board-sterilizing agreements, are also rendered irrelevant.[41] The statutes also allow the owners of the business to use the operating agreement to set up the management of the entity in a manner far less restrictive than would be permitted by the special close corporation statutes, which generally share the same goal of circumventing the mandatory provisions of the general corporation statute to facilitate managerial flexibility.[42]

The depth of this flexibility with respect to management of the LLC is profound. In essence, the LLC statutes permit business owners to avoid mandatory intermediary management structures (such as boards of directors)[43] and to run the business directly on any organi-

41. This rule prohibits agreements that would "sterilize" the board by binding the directors' votes with respect to matters within their authority (such as election of officers). Such agreements are distinguishable from shareholders' agreements, since shareholders are permitted to bind their votes with respect to matters within their purview (such as election of directors). The rationale for this distinction is that directors should somehow remain "independent"—a faintly absurd concept in the context of close corporations. To trace the waffling development of this rule, see Somers v. AAA Temporary Servs., Inc., 284 N.E.2d 462 (Ill. 1972) (holding that two sole shareholders of close corporation did not have power to amend bylaws in order to reduce number of directors from three to two where such power was not reserved in articles of incorporation); Galler v. Galler, 203 N.E.2d 577 (Ill. 1964) (holding that shareholder-director restrictions are to be upheld in closely held corporation absent public injury, complaining minority interest, or apparent injury to creditors); Long Park, Inc. v. Trenton-New Brunswick Theatres Co., 77 N.E.2d 633 (N.Y. 1948) (sterilizing restrictions deprive directors of all powers to select and supervise managment); McQuade v. Stoneham, 189 N.E. 234 (N.Y. 1934) (invalidating shareholder agreement on grounds that board must be left free to exercise its own business judgment); Manson v. Curtis, 119 N.E. 559 (N.Y. 1918) (holding that agreements among stockholders who constitute minority in number, but who represent majority of shares, are valid and binding if they do not contravene express charter or statutes).

One of the goals of some of the special close corporation statutes was to circumvent the board sterilization problem by allowing elimination of the board of directors, ERNEST L. FOLK, III, THE GENERAL CORPORATION § 351 (1972), or by authorizing unanimous stockholders' agreements that could "regulate any aspect of the affairs of the corporation," including matters traditionally relegated to the board. *See, e.g.*, MD. CORP. & ASS'NS CODE ANN. § 4-401 (1985 and Supp. 1991).

42. Special close corporation statutes that permit elimination of the board, *see* DEL. CODE ANN. tit. 8, § 251 (1983 and Supp. 1991), direct management through shareholders agreements, *see* MD. CORP. & ASS'NS CODE ANN. § 4-401 (1985 & Supp. 1991), or operation of the entity as a partnership, *see* DEL. CODE ANN. tit. 8, § 354 (1983), obviously share this goal. The usefulness of these statutes, however, is undercut by stringent eligibility criteria and excessive unanimity requirements. *See* DEL. CODE ANN. tit. 8, § 342 (1983 and Supp. 1991) (setting out eligibility criteria under close corporation statute). For analysis of the eligibility issue, see Zion v. Kurtz, 405 N.E.2d 681 (N.Y. 1980). For a critique of the various unanimity requirements under the Maryland close corporation statute, see Shapiro, *supra* note 4, at 292-96.

43. Note that all of the LLC statutes except Colorado's provide that the firm will be managed by LLC members unless the LLC's articles of organization provide otherwise. FLA. STAT. ANN. § 608.422 (West Supp. 1992); KAN. STAT. ANN. § 17-7612 (Supp.

zational basis they wish. The members have the choice, however, of providing in their articles of organization for delegation of their authority to a group of managers.[44] In other words, the LLC members can choose to manage the LLC directly themselves or indirectly through managers. As shown below, this distinction may be important for securities law purposes.

Despite all of this flexibility, LLCs are not purely informal vehicles. The statutes all require a filing for an LLC to be formed,[45] and some of the statutes require the filings to make fairly substantial disclosures with respect to the entity's financing.[46] Some statutes limit the LLC's duration to thirty years.[47] LLCs in some states are required to maintain specified records.[48] In addition, the LLC statutes contain default provisions, such as a provision requiring the LLC to distribute income to LLC members in proportion to their contributions, unless the articles or operating agreement provide otherwise.[49]

The most substantive limitations on the flexibility of LLCs derive from preconditions essential to the preservation of their tax status as pass-through entities. In particular, the statutes must ensure that the LLC lacks certain basic corporate characteristics. The need to meet these federal tax preconditions imposes at least a modest constraint

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1991); NEV. REV. STAT. ANN. § 86.312 (Michie Supp. 1991); 1991 Tex. Sess. Law Serv. 901 (Vernon) (referring to H.B. 278, § 46, art. 2.12); UTAH CODE ANN. § 48-2b-125 (Supp. 1991); VA. CODE ANN. § 13.1-1022 (Michie Supp. 1991); WYO. STAT. § 17-15-116 (1977).

44. *See, e.g.*, FLA. ST. ANN. § 608.422 (West 1992); KAN. STAT. ANN. § 17-7612 (Supp. 1991); NEV. REV. STAT. ANN. § 86.312 (Michie Supp. 1991); 1991 Tex. Sess. Law Serv. 901 (Vernon) (referring to H.B. 278, § 48, art. 2.12); UTAH CODE ANN. § 43-26-125 (Supp. 1991); VA. CODE ANN. § 13.1-1022 (Michie Supp. 1991); WYO. STAT. § 17-15-116 (1977). The Colorado statute, in contrast, states that the LLC must be managed by managers. COLO. REV. STAT. § 7-80-401 (Supp. 1991). The Texas LLC statute takes an intermediate position, providing that the LLC will be managed by managers unless the members elect to exercise that authority themselves. 1991 Tex. Sess. Law Serv. 901 (Vernon) (referring to H.B. 278, § 46, art. 2.12).

45. COLO. REV. STAT. § 7-80-207(1)(a) (Supp. 1991); FLA. STAT. ANN. § 608.409(1) (West Supp. 1992); KAN. STAT. ANN. § 17-7609 (Supp. 1991); NEV. REV. STAT. ANN. § 86.293 (Michie Supp. 1991); 1991 Tex. Sess. Law Serv. 901 (Vernon) (referring to H.B. 278, § 46, art. 3.03) (Vernon); UTAH CODE ANN. § 48-2b-118(1) (Supp. 1991); VA. CODE ANN. § 13.1-1052 (Michie Supp. 1991); WYO. STAT. § 17-15-109 (1977).

46. *See, e.g.*, FLA. STAT. ANN. § 608.407 (West Supp. 1991); WYO. STAT. 817-15-107 (1977).

47. COLO. REV. STAT. § 7-80-204(1)(b) (West Supp. 1991); FLA. STAT. ANN. § 608-407(1)(b) (West Supp. 1991); NEV. REV. STAT. ANN. § 86.290(b) (Michie Supp. 1991); 1991 Tex. Sess. Law Serv. 901 (Vernon) (referring to H.B. 278, § 46, art. 3.02(2)); WYO. STAT. § 17-15-107(a)(ii) (1977). It is likely, however, that newer statutes will abandon the uniform 30-year limit in favor of a limit to be fixed in each LLC's articles of organization.

48. *See, e.g.*, COLO. REV. STAT. § 7-80-411 (West Supp. 1991); NEV. REV. STAT. ANN. § 86.297 (Michie Supp. 1991).

49. *See, e.g.*, COLO. REV. STAT. § 7-80-503 (West Supp. 1991); VA. CODE ANN. § 13.1-1029 (Michie Supp. 1991); WYO. STAT. § 17-15-119 (1977).

on the ability to plan for problems of duration and termination of the relations among the LLC and its members.

C. The Tax Tightrope

The IRS classifies unincorporated organizations as either partnerships or as associations taxable as corporations on the basis of whether the organization possesses characteristics specified in the applicable regulations.[50] The IRS will tax an unincorporated organization as a corporation if, under all the circumstances, the entity has more corporate characteristics than partnership characteristics.[51] The characteristics indicative of corporate status are: (1) associates; (2) an objective to carry on business and divide the gains; (3) continuity of life; (4) centralization of management; (5) limited liability; and (6) free transferability of interests.[52]

The first two characteristics are of no importance analytically because the IRS does not take into account characteristics such as the presence of "associates" or an "objective to carry on business and divide the gains,"[53] which are shared by both corporations and partnerships. That leaves four corporate characteristics to be considered. An organization will be treated as a partnership if it lacks two of the four remaining corporate characteristics.[54]

With respect to the four remaining corporate characteristics, there is little question that members of a LLC will be held to have limited liability[55] since that is one of the basic elements of this form of business organization. There is also little uncertainty about the corporate characteristic of centralized management. If the LLC is member-managed, it will be found to lack centralized management, much like a general partnership.[56] On the other hand, if the members choose to have the LLC operated by a group of managers that includes less than all the members, or if the LLC is organized under a statute that requires delegation of authority to managers,[57] then the LLC proba-

50. Treas. Reg. § 301.7701-1(c) (1983).

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

52. *Id.*

53. Treas. Reg. § 301.7701-2(a)(3) (1983).

54. *Id.*

55. *See* Rev. Rul. 88-76, 1988-2 C.B. 360, 361 (finding limited liability regarding a Wyoming LLC).

56. Treas. Reg. § 301.7701-2(c)(4) (1983). The test is whether any person or group that does not include all of the owners has the exclusive authority to manage the business. Treas. Reg. § 301-7701-2(c)(1) (1983).

57. *See, e.g.*, COLO. REV. STAT. § 7-80-401 (West Supp. 1991).

bly will run a greater risk of being found to possess the corporate characteristic of central management.[58] The principal analytical (and practical) difficulties involve the remaining two corporate characteristics: continuity of life and free transferability of interests.

Continuity of life exists when the organization does not dissolve because one of its owners dies, retires, resigns, or suffers insanity, bankruptcy or expulsion.[59] Corporations obviously possess this characteristic because a corporation will survive until formal dissolution, regardless of what may happen to its shareholders. General partnerships and limited partnerships, in contrast, are usually thought to lack continuity of life.[60] Unfortunately, no such definitive statement can be made with respect to LLCs. Much depends on the terms of the particular state statute under which the LLC is organized.

LLCs organized under the Wyoming, Colorado, Virginia and Nevada statutes probably will be found to lack continuity of life. Under the dissolution provisions of these statutes,[61] an LLC dissolves upon the death, retirement, resignation, bankruptcy or any other event terminating membership unless, after the event, *all* remaining members agree to continue the business under a right to do so established in the articles of organization.[62] In the absence of such unanimous agreement, the LLC will dissolve, regardless of any contrary provisions in the articles or operating agreement providing for continuation of the entity by the non-dissolving members.[63] Under Revenue Ruling 88-76, this should be enough to establish a lack of continuity of life.[64]

Under the Florida and Kansas statutes, however, unanimous consent to continue the business after an event of dissolution is *not* necessary if the articles provide the non-dissolving members with a right to continue the business.[65] Florida and Kansas LLCs with articles creating such a right incur a risk of being defined as possessing continuity of life.[66] The same can be said about Texas LLCs since the Texas statute permits the articles or regulations to either empower less than all (indeed, less than a majority) of the members to con-

58. *See supra* note 52 (finding characteristic of central management in a Wyoming LLC with designated managers).

59. Treas. Reg. § 301.7701-2(b)(1) (1983).

60. Treas. Reg. § 301.7701-2(b)(3) (1983).

61. *See, e.g.*, COLO. REV. STAT. § 7-80-801 (West Supp. 1991); NEV. REV. STAT. ANN. § 86.320 (Michie Supp. 1991); VA. CODE ANN. § 13.1-1046(3) (Michie Supp. 1991); WYO. STAT. ANN. § 17-15-123 (1977).

62. *See, e.g.*, WYO. STAT. ANN. § 17-15-123 (1977).

63. *Id.*

64. Rev. Rul. 88-76, 1988-2 C.B. 360, 361 (noting that Wyoming LLC lacked continuity of life).

65. FLA. STAT. ANN. § 608.441(c) (West Supp. 1991); KAN. STAT. ANN. § 17-7622 (Supp. 1991).

66. *See* Keatinge, *supra* note 1, at 425-26.

tinue the business after an event of dissolution, or eliminate the consent requirement entirely.[67] LLCs organized under the Utah statute incur a similar risk in that Utah's statutory dissolution provisions require only a majority of members entitled to receive a majority of the capital to agree to continue the business after an event of dissolution.[68]

From a planning perspective, all of these statutes pose problems. Apparently, the Wyoming, Colorado, Virginia and Nevada statutes were drafted to ensure that their LLCs would be found to lack continuity of existence. The cost of that assurance is the planners' inability to draft continuity agreements prior to an event of dissolution; the survival of the entity thus will depend upon the parties' ability to achieve a unanimous agreement *after* such an event. The Florida, Kansas, Texas and Utah statutes obviously attempt to give the planner more flexibility, either by making prospective continuity agreements enforceable or by permitting less than all of the members to agree to continue post-dissolution. The cost, however, is the greater risk of tax characterization as a corporation.

Similar problems exist with respect to the final corporate characteristic, free transferability of interests. Free transferability exists when substantially all of the owners have the power to transfer, without any other owner's consent, all attributes of ownership to a person not a member of the organization.[69] A right to assign the member's interest in profits, but not the member's right to participate in management, does not constitute free transferability.[70] A general partnership, therefore, does not possess free transferability since a partner can convey only his interest in the profits, not management rights, without the consent of all the partners.[71] The Wyoming statute fits this paradigm nicely by providing that the transferee of an LLC's member's interest shall not have a right to participate in management or otherwise become a member unless all members consent.[72] The transferability provisions of the Florida, Kansas, Colorado, Virginia and Nevada statutes are similar.[73]

The Utah and Texas statutes, however, depart from this norm, and

67. 1991 Tex. Sess. Law Serv. 901 (Vernon) (referring to H.B. 278, § 46, art. 6.01(4)).
68. UTAH CODE ANN. § 48-2b-137 (Supp. 1991).
69. Treas. Reg. § 301.7701-2(e) (1983).
70. *Id.*
71. UNIF. PARTNERSHIP ACT § 18(g), 6 U.L.A. 213 (1969).
72. WYO. STAT. § 17-15-122 (1977).
73. COLO. REV. STAT. § 7-80-702 (Supp. 1990); FLA. STAT. ANN. § 608.432 (West

their LLCs thus may be found to possess the corporate characteristic of free transferability of interests. The Utah statute requires only a majority of members to approve a transfer of interest.[74] The Texas statute seems to require unanimous consent, yet allows the members considerable flexibility to reduce the unanimity requirement.[75]

LLCs organized under the Utah and Texas statutes may have some difficulty establishing that they do not possess free transferability of interests. The drafters' attempt to provide organizers of Utah and Texas LLCs greater flexibility thus may come to naught. The lack of flexibility with respect to this issue, however, may not be of great importance because free transferability of interest in closely held enterprises is seldom either desirable or, as a practical matter, possible.

III. Are LLC Interests Securities? The Analytical Context

The foregoing discussion has provided some sense of what LLCs are and how they work. It also will help answer the question of whether interests in LLCs are securities. This part sets forth an analytical context that establishes the basic tests for the existence of a security and shows how those tests have been applied to similar forms of business organization.

A. *Laundry Lists and Investment Contracts*

Providing the proper analytical context is no simple matter. There is no consensus about the definition of "security."[76] The task of defining a security has bedeviled courts for decades. Well-intentioned academic commentators have not been able to dispel the confusion by creating ingenious, highly sophisticated redefinitions of "security," because those redefinitions have been mostly ignored by the courts and the legislatures.[77] The Supreme Court, furthermore, generates new controversies every time it addresses the issue, with each deci-

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Supp. 1991); KAN. STAT. ANN. § 17-7618 (Supp. 1991); NEV. REV. STAT. ANN. § 318(1) (Michie Supp. 1991); VA. CODE ANN. § 13.1-1039, -1040 (Michie Supp. 1991).

74. UTAH CODE. ANN. § 48-2b-131 (Supp. 1991).

75. 1991 Tex. Sess. Law Serv. 901 (Vernon) (referring to H.B. 278, § 46, art. 4.07(B)).

76. *See* William J. Carney & Barbara G. Fraser, *Defining a "Security": Georgia's Struggle with the "Risk Capital" Test*, 30 EMORY L.J. 73, 73 (1981). "One of the notable intellectual failures of American corporate law has been its inability to deal successfully with the problem of defining a security". *Id.*

77. *See, e.g.*, Ronald J. Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?*, 18 W. RESERVE L. REV. 367 (1967); Scott T. Fitzgibbon, *What Is a Security?—A Redefinition Based on Eligibility to Participate in the Financial Markets*, 64 MINN. L. REV. 893 (1980); William J. Carney, *Defining a Security: The Addition of a Market-Oriented Contextual Approach to Investment Contract Analysis*, 33 EMORY L.J. 311 (1984). For suggestions that these proponents of radical redefinitions may have had more influence than is suggested in the text, see *infra* notes 143 and 157 and accompanying text.

sion on the topic adding more levels of uncertainty rather than less.[78]

Part of the problem is structural. The Securities Act of 1933 (the 1933 Act),[79] the Securities Exchange Act of 1934 (the 1934 Act),[80] and the Uniform Securities Act (the Uniform Act)[81] do not contain substantive definitions of "security." They contain lists of specific interests that are considered securities under the acts.[82] By eschewing a universal definition of security in favor of these "laundry lists," the drafters of these acts managed to avoid the conceptual and practical difficulties of laying down just what a security really is, but they did so by shifting the definitional burden entirely onto the courts. The laundry list approach further complicated matters by allowing the development of separate and often inconsistent patterns of analysis with respect to key listed items such as notes, stocks, and investment contracts.

The laundry list approach may be the wisest, since any attempt at universal definition may prove either over- or under-inclusive and insufficiently responsive to the great variety of market circumstances where it may be appropriate to recognize the presence of a security. In addition, the courts have used the term "investment contract" as a relatively elastic means of establishing the parameters of the "security" concept, although they have stopped short of using it to create a universal definition of security.[83] The concept of investment contract

78. An example in point is the Court's recent decision in Reves v. Ernst & Young, 494 U.S. 56 (1990), involving the question of whether notes are securities. One commentator was so disturbed by the Court's analysis, which he described as a "stunning series of non-sequiturs", that he felt compelled to provide an alien's-eye view of the intellectual chaos within the Court over the definition of security. James D. Gordon, III, *Interplanetary Intelligence About Promissory Notes as Securities*, 69 TEX. L. REV. 383, 402 (1990).

79. 15 U.S.C. §§ 77e-77z (1988).

80. 15 U.S.C. §§ 78a-78u (1988).

81. UNIF. SEC. ACT, 7B U.L.A. 509-688 (1985). Thirty-five states have securities acts modeled on this act. UNIF. SEC. ACT, 7B U.L.A. 124 (Supp. 1991). Five states have adopted acts based on a 1985 revision of the Uniform Securities Act. UNIF. SEC. ACT, 7B U.L.A. 57-123 (Supp. 1991) (also known as the "Revised Uniform Securities Act," revised 1985).

82. *See* 15 U.S.C. § 77b(1) (1988); 15 U.S.C. § 78c(a)(10) (1988); UNIF. SEC. ACT § 401(1), 7B U.L.A. 580-81 (1985); UNIF. SEC. ACT § 101(16), 7B U.L.A. 62-63 (Supp. 1991).

83. The Supreme Court made clear that its test for the existence of an investment contract under SEC v. W.J. Howey Co., 328 U.S. 293 (1946), is not a universal test for the definition of security in Landreth Timber Co. v. Landreth, 471 U.S. 681 (1985), when it stated that "the Howey economic reality test was designed to determine whether a particular instrument is an 'investment contract,' not whether it fits within *any* of the examples listed in the statutory definition of 'security.'" *Id.* at 691 (emphasis added).

has served as a means, albeit a partial and imprecise one, of getting to the essence of a security.

The definition of "investment contract" must be explored in order to decide whether LLC interests are securities. The outlines of the definition derived from the Supreme Court's 1946 decision in *SEC v. W. J. Howey Co.*[84] are familiar. An investment contract "means a transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of a promoter or third party."[85] Each of the elements in this definition, however, has posed severe analytical and policy problems.

For example, must there be an investment of cash in order to meet the investment of "money" criterion?[86] Is a "common enterprise" present when a relationship exists only between the promoter and a single investor (vertical commonality), or must there be more than one investor whose investments are somehow pooled (horizontal commonality)?[87] What exactly is meant by "profits"?[88] All of these questions have occupied the courts and commentators for decades.[89] The most vexed question, however, and the one most determinative

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84. 328 U.S. 293 (1946).

85. *Id.* at 298-99.

86. In International Brotherhood of Teamsters v. Daniel, 439 U.S. 551 (1979), the Supreme Court rejected the argument "that a person's 'investment,' in order to meet the definition of an investment contract, must take the form of cash only, rather than of goods and services." *Id.* at 560 n.12. The Court required only that "the purchaser gave up some tangible and definable consideration in return for an interest that had substantially the characteristics of a security." *Id.* at 560.

87. The United States Courts of Appeal for the Third, Sixth and Seventh Circuits require a showing of horizontal commonality through a pooling of investments. Salcer v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 682 F.2d 459, 460 (3d Cir. 1982); Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 622 F.2d 216, 221-25 (6th Cir. 1980), *aff'd on other grounds*, 456 U.S. 353 (1982); Milnarik v. M-S Commodities, Inc., 457 F.2d 274, 276-77 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972). In contrast, the Fifth and Eleventh Circuits are satisfied with respect to the common enterprise requirement if a single investor is dependent upon the expertise of a single promoter. Villeneuve v. Advanced Business Concepts Corp., 698 F.2d 1121, 1124 (11th Cir. 1983); *aff'd en banc*, 730 F.2d 1403 (11th Cir. 1984); SEC v. Continental Commodities Corp., 497 F.2d 516, 520-23 (5th Cir. 1974). The Ninth Circuit has created a hybrid approach that does not require a pooling of investments, but requires the promoter to do more than furnish counsel to another for a commission. El Khadem v. Equity Sec. Corp., 494 F.2d 1224, 1229 (9th Cir. 1974), *cert. denied*, 419 U.S. 900 (1974); Brodt v. Bache & Co., 595 F.2d 459, 461 (9th Cir. 1978). For critical discussion of this issue, see II LOUIS LOSS AND JOEL SELIGMAN, SECURITIES REGULATION 927-935 (3d ed. 1989) (hereinafter Loss & Seligman); James D. Gordon, III, *Common Enterprise and Multiple Investors: A Contractual Theory for Defining Investment Contracts and Notes*, 1988 COLUM. BUS. L. REV. 635.

88. For example, is there an "expectation of profits" when the investment is promoted as providing tax benefits derived from initial losses? Some courts have said yes. Goodman v. Epstein, 582 F.2d 388, 407-08 (7th Cir. 1978), *cert. denied*, 440 U.S. 939 (1979); SEC v. Aqua-Sonic Prod. Corp., 687 F.2d 577, 583 (2d Cir. 1982), *cert. denied sub nom.*, Hecht v. SEC, 459 U.S. 1086 (1982); SEC v. Goldfield Deep Mines Co. of Nev., 758 F.2d 459, 463-64 (9th Cir. 1985).

89. For citations to the relevant authorities, see Loss & Seligman, *supra* note 87, at 920-86.

of whether LLC interests are securities, is generated by *Howey*'s apparent requirement that the investor's expectation of profits be dependent "solely" on the efforts of others.

The term "solely" has created difficulties because its literal application would mean that only purchasers who have remained entirely passive would be considered to have purchased securities. This would exclude many situations in which the "economic realities"[90] of the transaction require even an engaged investor to rely on the entrepreneurial or managerial skills of the promoter.

It was in one such situation, involving multi-level distributorship and pyramid schemes, that the Ninth Circuit Court of Appeals formulated a more flexible test. In its 1973 decision in *SEC v. Glenn W. Turner Enterprises, Inc.*,[91] the Ninth Circuit stated that the test should be "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."[92] Eight other circuits have since adopted this formulation of the "efforts of others" requirement.[93] While the Supreme Court has not yet provided an unequivocal endorsement of the formulation,[94] it is generally regarded as "[t]he better view."[95]

The "efforts of others" criterion, however formulated, has proved to be the key to the question of whether interests in general partnerships and limited partnerships, the forms of business organization most similar to LLCs,[96] should be considered securities. Analysis of

90. United Housing Found., Inc. v. Forman, 421 U.S. 837, 851-52 (1975). The Court must consider "the substance—the economic realities of the transaction—rather than the names that may have been employed by the parties." *Id.*

91. 474 F.2d 476 (9th Cir. 1973), *cert. denied*, 414 U.S. 821 (1973).

92. *Id.* at 482.

93. *See* SEC v. Professional Assocs., 731 F.2d 349, 357 (6th Cir. 1984); Goodwin v. Elkins & Co., 730 F.2d 99, 103 (3d Cir.), *cert. denied*, 469 U.S. 831 (1984); SEC v. Aqua-Sonic Prods. Corp., 687 F.2d 577, 582 (2d Cir.), *cert. denied*, 459 U.S. 1086 (1982); Kim v. Cochenour, 687 F.2d 210, 213 n.7 (7th Cir. 1982); Baurer v. Planning Group Inc., 669 F.2d 770, 779 (D.C. Cir. 1981); Aldrich v. McCulloch Properties, Inc., 627 F.2d 1036, 1040 n.3 (10th Cir. 1980); Fargo Partners v. Dain Corp., 540 F.2d 912, 914-15 (8th Cir. 1976); SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 483 (5th Cir. 1974).

94. In United Hous. Found., Inc. v. Forman, 421 U.S. 837, 852 (1975), the Supreme Court referred to a "reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others," and omitted the use of the word "solely" altogether. The Court expressly declined to say, however, whether it was adopting the *Glenn W. Turner* formulation. *Id.* at 852 n.16.

95. Loss & Seligman, *supra* note 87, at 941.

96. This is not to say, of course, that the LLC bears little resemblance to a corporation. It is only to emphasize that consideration of whether stock in a corporation is a security does not ordinarily require investment contract analysis, since "stock" is one

this question will set the stage for consideration of whether LLCs are securities.

1. Are General Partnership Interests Securities? *Williamson v. Tucker* and Its Progeny

As Professors Loss and Seligman have pointed out, the "pivotal criterion for distinguishing partnership or joint venture interests that are securities from those that are not will be the profits 'solely [or substantially] from the efforts of others' element in the *Howey* test."[97] A strong line of authority holds that general partners are not dependent (solely or substantially) on the efforts of others because they have the ultimate power under the partnership statute to control the business.[98] Under this analysis, it does not matter whether a partner has actually exercised managerial power or delegated her authority to others, such as a management or executive committee. The possession of latent or ultimate control of the partnership is sufficient. This type of control is thought to be possessed by each partner because each general partner is an agent of the partnership. Notice to one partner is notice to all, and every partner can veto actions that contravene the partnership agreement.[99]

The Fifth Circuit Court of Appeals offered an important qualification to this reasoning, however, when it emphasized in *Williamson v. Tucker*[100] that "the mere fact that an investment takes the form of a

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of the listed items within the statutory definition of security. For citations to those definitions, see *supra* note 82. The key test with respect to stock is whether it possesses "all of the characteristics . . . traditionally associated with common stock." Landreth Timber Co. v. Landreth, 471 U.S. 681, 687 (1985). If the stock in question bears those characteristics, it is a security. If it does not, then investment contract analysis is appropriate. *See* Loss & Seligman, *supra* note 87, at 872-73.

97. Loss & Seligman, *supra* note 87, at 961 (citations omitted). Note that "joint ventures" are analyzed in the same terms as partnerships. *See, e.g.*, McGill v. American Land & Exploration Co., 776 F.2d 923, 925 (10th Cir. 1985).

98. *See, e.g.*, Goodwin v. Elkins & Co., 730 F.2d 99, 107 (3d Cir.), *cert. denied*, 469 U.S. 831 (1984); Odom v. Slavik, 703 F.2d 212, 215-16 (6th Cir. 1983); Frazier v. Manson, 651 F.2d 1078, 1081 (5th Cir. 1981); Slevin v. Pedersen Assocs., 540 F. Supp. 437, 441 (S.D.N.Y. 1982); Elson v. Geiger, 506 F. Supp. 238, 243 (E.D. Mich. 1980), *aff'd*, 701 F.2d 176 (6th Cir. 1982); Hirsch v. DuPont, 396 F. Supp. 1214, 1220-22 (S.D.N.Y. 1975), *aff'd*, 553 F.2d 750 (2d Cir. 1977); New York Stock Exch., Inc. v. Sloan, 394 F. Supp. 1303, 1314 (S.D.N.Y. 1975); Oxford Fin. Cos. v. Harvey, 385 F. Supp. 431, 433-34 (E.D. Pa. 1974).

99. *See, e.g.*, *Sloan*, 394 F. Supp. at 1314, stating:

> The fact that a partner may choose to delegate his day-to-day managerial responsibilities to a committee does not diminish in the least his legal right to a voice in partnership matters, nor his responsibility under state law for acts of the partnership . . . . These factors critically distinguish the status of a general partner from that of the purchaser of an investment contract who in law as well as in fact is a "passive" investor.

Id.

100. 645 F.2d 404 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981). For additional discussion of *Williamson v. Tucker*, see Marc H. Morgenstern, *Real Estate Joint Venture In-*

general partnership or joint venture does not inevitably insulate it from the reach of the federal securities laws."[101] Even though all general partners would seem to possess an ultimate power of control by statute, it still must be determined, as a matter of fact,[102] whether the partner is "dependent on the promoter or manager for the effective exercise of his partnership powers."[103]

The court conceded that a partner "who claims his general partnership interest . . . is an investment contract has a difficult burden to overcome."[104] The partner must overcome the fact that he possesses substantial power under the statute by showing that "he was so dependent on the promoter or on a third party that he was in fact unable to exercise meaningful partnership powers."[105] The court then offered three examples of how a partner could establish such dependence:

> (1) an agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership; or (2) the partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or (3) the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers.[106]

The court ultimately found that the plaintiffs had failed to establish the requisite degree of dependence on others, but it had set new pa-

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terests as Securities: The Implications of Williamson v. Tucker, 59 WASH. U. L.Q. 1231 (1982); Leslie J. Levinson, *General Partnership Interests and the Securities Act of 1933: Recent Judicial Developments*, 10 OHIO N.U. L. REV. 463 (1983); Comment, *General Partnership Interests as Securities Under the Federal Securities Laws: Substance Over Form*, 54 FORDHAM L. REVIEW 303 (1985).

101. *Williamson*, 645 F.2d at 422.

102. *See* Dennis S. Karjala, *Federalism, Full Disclosure, and the National Markets in the Interpretation of Federal Securities Law*, 80 NW. U. L. REV. 1473, 1510-12 (1986) ("the Fifth Circuit concluded that dependence on the efforts of others was a question of fact").

103. *Williamson*, 645 F.2d at 422. The court pointed out that some of the cases using the concept of latent partnership control to avoid characterization of general partnership interests as securities presumed that the partner in question was not in fact dependent on someone else for the exercise of his partnership powers. *Id.*

A few pre-*Williamson* cases had used a similar analysis to conclude that the general partnership interests in question were not securities, although not with the clarity and force found in the *Williamson* opinion. *See, e.g.*, Nor-Tex Agencies, Inc. v. Jones, 482 F.2d 1093, 1098-99 (5th Cir. 1973), *cert. denied*, 415 U.S. 477 (1974); Pawgan v. Silverstein, 265 F. Supp. 898, 900 (S.D.N.Y. 1967). For a pioneer pre-*Williamson* discussion of the general partnership question, see Joseph C. Long, *Partnership, Limited Partnership, and Joint Venture Interests as Securities*, 37 MO. L. REV. 581, 612-15 (1972).

104. *Williamson*, 645 F.2d at 422.

105. *Id.*

106. *Id.* The court emphasized that this was a non-exclusive list. *Id.* at 424 n.15.

rameters for analysis of the question of the securities status of general partnership interests.[107] *Williamson* also spawned several decisions finding general partnership interests to be securities.[108]

Most cases applying *Williamson*'s analytical framework, however, have held that the general partnership interests in question should not be considered securities.[109] This line of cases gives rise to the suspicion, if not conclusion, that general partnership interests will be found to be securities only under unusual conditions. The Fourth Circuit's 1988 decision in *Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.*,[110] is an example of the stringent way in which the courts are analyzing the *Williamson* exception to the basic presumption about the securities status of general partnership interests.

The *Rivanna Trawlers* court began its analysis by warning "that only under limited circumstances can an investor's general partnership interest be characterized as an investment contract" and thus a security.[111] The court, in effect, started with a presumption that a general partnership interest is a security. It then directed examination of both "the partnership agreement and circumstances of [the] particular partnership to determine the reality of the contractual

107. *Id.* at 425.

108. *See* SEC v. Professional Assocs., 731 F.2d 349, 356-57 (6th Cir. 1984); Westlake v. Abrams, 565 F. Supp. 1330, 1342-43 (N.D. Ga. 1983); Fund of Funds, Ltd. v. Arthur Anderson & Co., 545 F. Supp. 1314, 1348-49 (S.D.N.Y. 1982); *see also* Koch v. Hankins, 928 F.2d 1471, 1480 (9th Cir. 1991) (fact question whether partners in 35 affiliated general partnerships could exercise control); Youmans v. Simon, 791 F.2d 341, 347 (5th Cir. 1986) (similar fact question as to ability to exercise control of joint venture).

109. *See, e.g.*, Reeves v. Teuscher, 881 F.2d 1495, 1499-1500 (9th Cir. 1989); Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc. Borchardt, 840 F.2d 236 (4th Cir. 1988); Goodwin v. Elkins & Co., 730 F.2d 99, 107 (3d Cir.), *cert. denied*, 469 U.S. 831 (1984); Odom v. Slavik, 703 F.2d 212, 215 (6th Cir. 1983); Casablanca Prod., Inc. v. Pace Int'l Research, Inc., 697 F. Supp. 1563, 1567 (D. Or. 1988); Power Petroleums v. P & G Mining Co., 682 F. Supp. 492, 494 (D. Colo. 1988). Note, however, that in Matek v. Murat, 862 F.2d 720 (9th Cir. 1988), the Ninth Circuit criticized *Williamson* on fundamental grounds, describing the second and third factor defined by the *Williamson* court in the language quoted above (see text accompanying note 103) as creating "uncertainty in the area of business investing." *Id.* at 729. The court thus declined to apply those factors and ruled that the focus should be exclusively on how the partnership agreement allocated authority, rather than on "how in fact the entity functioned in carrying out its business affairs" and whether the partners actually participated in control. *Id.* at 730-31. The Court found authority for that approach in the two pre-*Williamson* cases of Fargo Partners v. Dain Corp. 540 F.2d 912, 914-15 (8th Cir. 1976), and Schultz v. Dain Corp., 568 F.2d 612, 615-16 (8th Cir. 1978). A more recent Ninth Circuit decision, however, seriously undercut the significance of *Matek* by deciding to apply all three *Williamson* factors, and ruled that " '[t]he question of an investor's control over his investment is decided in terms of practical as well as legal ability to control.' " Koch v. Hankins, 928 F.2d 1471, 1478 (9th Cir. 1991) (citing Hocking v. Dubois, 885 F.2d 1449, 1460 (9th Cir. 1989)). *Matek* thus represents a failed attempt to circumscribe *Williamson*'s conversion of the control issue into a highly fact-based analysis of both the agreement and the partners' actual behavior. For discussion of *Matek*, *see* Note, *Matek v. Murat: Back to "Terms of Agreement,"* 26 SAN DIEGO L. REV. 701 (1989).

110. 840 F.2d 236 (4th Cir. 1988).

111. *Id.* at 241.

rights of the general partners."[112] If, on the basis of that examination, the court could conclude that the powers allocated to the general partners

> are specific and unambiguous, and . . . [are] sufficient to allow the general partners to exercise ultimate control, as a majority, over the partnership and its business, then the presumption that the general partnership is not a security can only be rebutted by evidence that it is *not possible* for the partners to exercise those powers.[113]

The message here seems fairly clear. So long as the partnership agreement (with a sufficient degree of specificity) leaves at least a majority of the partners with "ultimate control," then the general partnership interests will not be considered securities, unless it can be shown that it was "not possible" for the partners to exercise their powers.[114] In this case, the court found that the partnership agreement gave the partners "the authority to manage their investments,"[115] and that they were capable of and did in fact exercise that authority.[116]

The conclusion that can be drawn from *Rivanna Trawlers* and, more generally, *Williamson* and its progeny, is that analysis of the efforts of others criterion requires consideration of the general partners' statutory control rights, contractual rights and actual behavior. Even if a partner does not participate in management, the retention of ultimate control, particularly under a specific general partnership agreement, will preclude the finding of a security, unless a very clear legal or practical inability to exercise that control can be shown. In short, general partnership interests will be treated as securities only in anomalous situations. This conclusion—and this pattern of analysis—should be kept in mind when examining LLCs.

2. Are Limited Partnership Interests Securities? Public Offerings and Half-Interests in Hamburger Stands

As seen above, general partnership interests usually are not considered investment contracts because general partners ordinarily retain

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112. *Id.* Interestingly, the court emphasized the importance of the partners' contractual rights rather than statutory rights to participate in control, probably because the statutory rights can be modified by contract. UNIF. PARTNERSHIP ACT § 18(e), 6 U.L.A. 213 (1969) (providing that "[a]ll partners have equal rights in the management and conduct of the partnership business," subject to any agreement between them).

113. *Rivanna Trawlers*, 840 F.2d at 241 (emphasis added).

114. *Id.*

115. *Id.* at 242.

116. *Id.* This analysis is consistent with that applied by the Ninth Circuit in Koch v. Hankins, 928 F.2d 1471 (9th Cir. 1991). *See also supra* note 109.

ultimate control. General partnership interests may become investment contracts only when the partners are incapable of exercising that control. These premises allow substantial delegation of general partners' managerial authority without causing them to be regarded as depending on the efforts of others under *Howey*.

Limited partnership interests, in contrast, are considered investment contracts because a limited partner who exercises too much control loses limited liability for the obligations of the limited partnership.[117] A limited partner, by virtue of this basic premise of limited partnership law, must be dependent on the efforts of others to generate profits from the enterprise. As a result, limited partnership interests are ordinarily considered securities,[118] despite the fact that limited partners have some participatory rights under the Uniform Limited Partnership Act[119] and extensive participatory rights under the Revised Uniform Limited Partnership Act.[120]

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117. ULPA § 7, 6 U.L.A. 582 (1969); RULPA § 303, 6 U.L.A. 325-26 (Supp. 1991).

118. *See* Mayer v. Oil Field Sys. Corp., 721 F.2d 59 (2d Cir. 1983); SEC v. Holschuh, 694 F.2d 130, 137 (7th Cir. 1982); SEC v. Murphy, 626 F.2d 633, 640-41 (9th Cir. 1980); Goodman v. Epstein, 582 F.2d 388, 408-09 (7th Cir. 1978), *cert. denied*, 440 U.S. 939 (1979); Hirsch v. DuPont, 396 F. Supp. 1214, 1227-28 (S.D.N.Y. 1975) *aff'd*, 553 F.2d 750 (2d Cir. 1977).

119. ULPA § 7, 6 U.L.A. 582 (1969), provides no express safe harbor defining the limited partners' participatory rights, but ULPA §§ 10(a)-(b), 6 U.L.A. 590 (1969), gives the limited partners an inspection right and a right to demand an accounting. Some courts, furthermore, have been sympathetic to limited partners who have reserved rights of participation in control, but have not exercised them. *See* Plasteel Prod. Corp. v. Helman, 271 F.2d 354 (1st Cir. 1959); Rathke v. Griffith, 218 P.2d 757 (Wash. 1950). Other courts have permitted limited partners, in effect, to participate in control of the limited partnership by controlling the partnership's corporate general partner as a shareholder officer or director. *See, e.g.*, Frigidaire Sales Corp. v. Union Properties, Inc., 544 P.2d 781 (Wash. Ct. App. 1976), *aff'd*, 562 P.2d 244 (Wash. 1977) (no liability under state version of section 7); *but see* Delaney v. Fidelity Lease Ltd., 526 S.W.2d 543 (Tex. 1973) (court reached opposite conclusion in similar situation).

120. RULPA § 303(b), 6 U.L.A. 325-26 (Supp. 1991), provides considerably more leeway by listing a series of activities with the preface that a "limited partner does not participate in control of the business . . . solely by doing one or more of the following." This non-exclusive list of activities includes "being an officer, director or shareholder of a general partner that is a corporation," bringing a derivative action on behalf of the limited partnership, and voting on a broad variety of matters. Furthermore, the 1985 amendments to section 303, provide in RULPA § 303(a), 6 U.L.A. 325 (Supp. 1991), that a limited partner who participates in control of the business "is liable only to persons who transact business with the limited partnership reasonably believing, based upon the limited partner's conduct, that the limited partner is a general partner."

This increase under RULPA in the ability of the limited partners to participate in control seems to suggest that the usual presumption that limited partnership interests are securities should be reversed. So far this does not seem to have occurred, probably because there is still a residual risk under section 303 that a limited partner who goes too far in exercising control will lose limited liability status. *See*, Loss & Seligman, *supra* note 87, at 961-63 n.211. Note, however, that the Georgia Revised Uniform Limited Partnership Act goes further than RULPA by stating unequivocally that a "limited partner is not liable for the obligations of a limited partnership by reason of being a limited partner and does not become so by participating in the management or control of the business." GA. CODE ANN. § 14-9-303 (19[]). Can Georgia limited partner-

There are a few cases, however, that pose a narrow and somewhat ill-defined qualification to this line of reasoning. These cases suggest that a limited partnership interest may not be an investment contract if: (1) the limited partners in fact exercise substantial control over the limited partnership; and (2) there are only a small number of limited partners. The reason for the significance of these factors requires some explanation.

The significance of the exercise of control should be obvious since it undercuts the presumption that limited partners cannot exercise control. In *Darrah v. Garrett*,[121] for example, the court found that the limited partners exercised control of the limited partnership by virtue of their control over an affiliated corporation, which used the limited partnership as "a mere mechanism or conduit for transferring corporate profits."[122] In *Bank of America National Trust & Savings Association v. Hotel Rittenhouse Associates*,[123] the court emphasized that the limited partnership agreement gave the limited partners the right to approve the disposal or encumbrance of partnership property, the appointment or removal of a manager, and the admission of additional general partners.[124] The court in *Bamco 18 v. Reeves*[125] contented itself with finding that the limited partner "had a say . . . in the operation"[126] of a partnership asset and "some control over the subject of its investment."[127]

Unfortunately, the opinions in these cases do not clearly illustrate much control is too much from the *Howey* perspective. In particular, they do not establish how great the departure from the level of control permitted to limited partners under state partnership law must be before the basic presumption about a limited partner's inherent dependence on the efforts of others will be overcome.

This uncertainty about the control factor suggests that the second factor may be more important. In *Bamco 18* the court supported its characterization of the limited partnership interests by emphasizing that "there was no public offering of limited partnership interests

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ship interests no longer be presumed to be securities? Is a case-by-case determination required?

121. Fed. Sec. L. Rep. (CCH) ¶ 91,472 (N.D. Ohio 1984).

122. *Id.* at ¶ 98,364.

123. 595 F. Supp. 800 (E.D. Pa. 1984).

124. *Id.* at 806.

125. 675 F. Supp. 826 (S.D.N.Y. 1987).

126. *Id.* at 830.

127. *Id.*

and that the sale of the interest was the result of negotiations."[128] Similarly, in *Hotel Rittenhouse*, the court found that "the transaction in question [was] distinguishable from . . . large-scale investment schemes."[129] In both cases, the courts distinguished the cases at hand, in each of which there was only one limited partner,[130] from *Mayer v. Oil Field Systems Corp.*,[131] a leading case holding limited partnership interests to be securities. In *Mayer*, Judge Friendly of the Second Circuit justified his characterization of limited partnership interests as securities not only by reference to the limited partners' lack of a "managerial role,"[132] but by virtue of the "considerable number of limited partners"[133] in the partnership at hand. Both the *Bamco 18* and the *Hotel Rittenhouse* courts, furthermore, relied on language from Professor Loss, who defined the problem as one of being able "to distinguish between the public offering of securities parading as 'limited partnership interests' and 'an offering of a half interest in a hamburger stand.' "[134]

These arguments tap into a line of reasoning of increasing importance in the way the Supreme Court thinks about the definition of a security. While the *Bamco 18* and *Hotel Rittenhouse* courts do not cite the Supreme Court's 1982 decision in *Marine Bank v. Weaver*[135] in support of their emphasis on the small number of limited partners, they very well could have found some support in that case.

In *Marine Bank*, a lender had agreed to receive fifty percent of a borrower company's profits until the loan was repaid. The agreement also gave the lender the power to veto any future borrowing by the company.[136] In deciding that this agreement was not an investment contract, the Court emphasized, *inter alia*, that the investment contracts found in its earlier decisions had market characteristics different from the instant agreement's characteristics.

> The unusual instruments found to constitute securities in prior cases involved offers to a number of potential investors, not a private transaction as in this case. In *Howey*, for example, 42 persons purchased interests in a citrus grove during a 4-month period . . . . In *C.M. Joiner Leasing*, offers to sell oil leases were sent to over 1,000 prospects . . . . In *C.M. Joiner Leasing*, we noted that a

128. *Id.* at 831.

129. *Hotel Rittenhouse*, 595 F. Supp. at 807.

130. *Bamco 18*, 675 F. Supp. at 830; *Hotel Rittenhouse*, 595 F. Supp. at 807.

131. 721 F.2d 59 (2d Cir. 1983).

132. *Id.* at 65.

133. *Id.*

134. LOUIS LOSS, FUNDAMENTALS OF SECURITIES REGULATION 198-99 (1983) (cited in *Bamco 18* 675 F. Supp. at 830, and *Hotel Rittenhouse*, 595 F. Supp. at 806). The full quotation is as follows: "The problem, as Judge Frank put it when he was Chairman of the SEC, is to distinguish between the public offering of securities parading as 'limited partnership interests' and 'an offering of a half interest in a hamburger stand.' " *Id.* *See also* Loss & Seligman, *supra* note 87, at 960 (same language).

135. 455 U.S. 551 (1982).

136. *Id.* at 553.

> security is an instrument in which there is "common trading". . . . The instruments involved in *C.M. Joiner Leasing* and *Howey* had equivalent values to most persons and could have been traded publicly.[137]

There is much confusion about this set of assumptions, since it is somewhat at odds with the Court's own statement, earlier in the same opinion, that "the coverage of the antifraud provisions of the securities laws is not limited to instruments traded at securities exchanges and over-the-counter markets, but extends to uncommon and irregular instruments."[138] In addition, its apparent characterization of private transactions as non-securities transactions would seem to render nugatory the non-public offering exemption under the 1933 Act.[139] It is also not clear whether the Court was merely trying to apply the horizontal commonality version of the common enterprise test, or whether it was trying to do something more. In any event, the thrust of the Court's reasoning in *Marine Bank* seems consistent with that of the courts in *Bamco 18* and *Hotel Rittenhouse*.

A more recent Supreme Court decision suggests that the Court continues to regard the presence of some kind of public distribution or the potential for "common trading" to be essential to the existence of a security. In *Reves v. Ernst & Young*,[140] the Court found the fact that certain notes were "offered and sold to a broad segment of the public,"[141] to be one of the key factors in determining that the notes were securities. The theoretical basis and relative importance of this factor are by no means clear,[142] and the Court has not begun to draw the dividing line between public and private for purposes of the definition of security.[143] It does seem, however, that the Court is maintaining a distinction that may allow some limited partnership

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137. *Id.* at 559-60.

138. *Id.* at 556.

139. 15 U.S.C. § 77d(2) (1988). For critical discussion of *Marine Bank*, see Marc I. Steinberg and William E. Kaulbach, *The Supreme Court and the Definition of "Security": The "Context" Clause, "Investment Contract" Analysis, and Their Ramifications*, 40 VAND. L. REV. 489 (1987). For a more positive evaluation, see Karjala, *supra* note 102, at 1510.

140. 494 U.S. 56 (1990).

141. *Id.* at 68.

142. For a critical discussion of the Court's basic conceptual confusion with respect to this factor, see Gordon, *supra* note 78, at 392-93, 395, 397. For a thorough analysis of the pose-*Reves* confusion in the lower courts over these concepts, see Janet Kerr and Karen Eisenhauer, *Reves Revisited*, 19 PEPP. L. REV. 1123 (1992).

143. For more sophisticated attempts to tie the definition of "security" to market characteristics and the proper allocation of federal and state regulatory responsibilities, see Karjala, *supra* note 102, at 1508-15; *see also* Fitzgibbon, *supra* note 77. The *Marine Bank* and *Reves* decisions suggest that these proponents of market-based definitions of securities may yet have their day.

interests to avoid securities status.[144] This distinction also may have a bearing on the securities status of LLC interests.

B. *The Risk Capital Alternative*

Before applying the *Howey* analysis to limited liability company interests, it is useful to spend some time considering an alternative form of analysis—the so-called "risk capital" test. Despite little acceptance in the federal courts,[145] a lack of uniformity in its formulation, and some basic uncertainties in its meaning,[146] the risk capital test is applied in several states (most notably California) as a means of determining the existence of a security.[147] A persistent conceptual incoherence may mean that risk capital is "more of a label than a test,"[148] but its importance at the state level justifies at least a brief summary of this approach to the definition of security.

The first point to note about the risk capital test is that there is no single risk capital test. There are different versions in different states. Some take the form of statutory definitions,[149] others were established in case law,[150] and others are largely the creation of administrative decisions.[151] In some jurisdictions the risk capital test is used as a means of defining "investment contract" as an alternative to *Howey*;[152] in others it is an independent means of defining

144. It would seem, however, that the limited partners will also have to control the partnership to some degree; the mere lack of potential for common trading may not be enough to reverse the usual presumption.

145. *See, e.g.*, SEC v. Glenn W. Turner Enter., 474 F.2d 476, 483 n.10 (9th Cir. 1973), *cert. denied*, 414 U.S. 821 (1973) (refusing to apply risk capital analysis).

146. *See infra* notes 160-67 and accompanying text. For additional critical discussion, see Carney & Fraser, *supra* note 76, at 96-118.

147. For a survey of state applications of the risk capital concept, see 1 JOSEPH C. LONG, BLUE SKY LAW § 2.04[3] (1990) [hereinafter LONG].

148. JAMES D. COX, ROBERT W. HILLMAN AND DONALD C. LANGEVOORT, SECURITIES REGULATION 155 (1991) [hereinafter Cox, Hillman & Langevoort].

149. *See, e.g.*, OKLA. STAT. ANN. tit. 71, § 2(r)(16) (West Supp. 1992), (defining a security as including an "investment of money or money's worth including goods furnished and/or services performed in the risk capital of a venture with the expectation of some benefit to the investor where the investor has no direct control over the investment or policy decisions of the venture").

150. *See, e.g.*, People v. Figueroa, 715 P.2d 680, (Cal. 1986); Silver Hills Country Club v. Sobieski, 361 P.2d 906, (Cal. 1961); State ex rel. Healy v. Consumer Business Systems, Inc., 482 P.2d 549 (Or. Ct. App. 1971).

151. *See, e.g.*, Op. Cal. Att'y Gen. No. 66-284 (June 2, 1967), [1961-71 Transfer Binder] Blue Sky L. Rep. (CCH) ¶ 70,747 (applying a risk capital analysis and holding that sale of a franchise could be sale of a security); Okla. Sec. Comm'n Interpretive Op., 2 Blue Sky L. Rep. (CCH) ¶ 46,641 (July 3, 1980) (applying Op. Cal. Att'y Gen. No. 66-284 and a risk capital analysis). California securities regulators also apply a type of risk capital analysis to the question of whether real estate timesharing interests are securities. *See* Cal. Corp. Comm'r Interpretive Op. 78-30 (Apr. 24, 1978).

152. This seems to be the approach in California. *See* People v. Figueroa, 715 P.2d 680 (Cal. 1986).

security.[153]

Perhaps the most coherent version of the risk capital test was articulated by the Hawaii Supreme Court in 1971 in *State v. Hawaii Market Center, Inc.*[154] This version of the test has also been applied by courts in several other jurisdictions[155] and adopted by statute in six others.[156] The *Hawaii Market Center* test, which was based on an original formulation by Professor Coffey,[157] provides that:

> [A]n investment contract is created whenever:
> (1) An offeree furnishes initial value to an offeror, and
> (2) [A] portion of this initial value is subjected to the risks of the enterprise, and
> (3) [T]he furnishing of the initial value is induced by the offeror's promises or representations which give rise to a reasonable understanding that a valuable benefit of some kind, over and above the initial value, will accrue to the offeree as a result of the operation of the enterprise, and
> (4) [T]he offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise.[158]

Much of this approach is similar to the the *Howey* test. The first criterion is generally regarded as equivalent to the *Howey* investment of money requirement.[159] The fourth criterion is similar to the liberalized *Glenn W. Turner* version of the *Howey* efforts of others requirement.[160] Other components, in contrast, are more novel.

The third criterion of a promise or representation of benefit, for example, reflects the risk capital test's origin in cases involving clubs[161] or founder-membership schemes[162] in which the investors

153. *See, e.g.*, OKLA. STAT. ANN. tit. 71, § 2(r)(11), (16) (West Supp. 1992) (which lists "investment contract" and items which satisfy the risk capital definition quoted in *supra* note 146 as separate types of securities.).

154. 485 P.2d 105 (Haw. 1971).

155. *See, e.g.*, Securities Admin. v. College Assistance Plan, Inc., 533 F. Supp. 118 (D. Guam 1981), *aff'd*, 700 F.2d 548 (9th Cir. 1983); Casali v. Schultz, 732 S.W.2d 836 (Ark. 1987); State v. George, 362 N.E.2d 1223 (Ohio Ct. App. 1975).

156. ALASKA STAT. § 45.55.130(12) (1980); GA. CODE ANN. § 10-5-2(16) (Michie 1981); MICH. COMP. LAWS § 451.80(1) (1979); N.D. CENT. CODE § 10-04-02(12) (1985); OKLA. STAT. tit. 71, § 2(20)(P) (1981); WASH. REV. CODE § 21.02.005(12) (1988).

157. Coffey, *supra* note 77, at 377. Professor Coffey's formulation has been the most successful of the academic attempts at redefinition in terms of acceptance by the courts and state legislatures.

158. *Hawaii Mkt Center*, 485 P.2d at 109.

159. *See* LONG, *supra* note 147, at § 2.04[4] (stating that "[i]tem 1 of this test is nothing more than the investment concept of the Howey test").

160. *See supra* note 91-95 and accompanying text.

161. *See* Silver Hills Country Club v. Sobieski, 361 P.2d 906, (Cal. 1961) (memberships in country clubs); 1973 Op. Ga. Att'y Gen. 38, [1971-1978 Transfer Binder] Blue Sky L. Rep. (CCH) ¶ 71,213 (March 5, 1973) (memberships in campsite).

162. These schemes allow "founders" to get in on the ground floor of a "distributorship" program, and then earn commissions by recruiting additional members. Most of

received benefits (such as the use of club facilities) that could not be strictly defined as profits in *Howey* terms. The second criterion is even more idiosyncratic and perhaps most expressive of the essence of the overall test—the requirement that the investors have contributed capital "subjected to the risks of the enterprise," or risk capital.[163]

This second criterion is not only novel, but somewhat mysterious. The first and fourth criteria really raise no new issues distinctive from those raised by *Howey*'s efforts of others and investment of money requirements. The benefits/profits distinction reflects a departure from *Howey*, but its meaning is not all that elusive, and it is of importance only in those exceptional cases in which profits in the narrow sense are not expected. The meaning of "risk capital" under the second part of the *Hawaii Market Center* test and other versions of the risk capital test, in contrast, is quite elusive.[164]

For example, risk capital is sometimes thought to mean capital that is subject to a high or an excessive degree of risk.[165] Some courts have held that the lack of such "riskiness" precludes the finding of a security.[166] Alternatively, risk capital is sometimes regarded to mean the initial capitalization of the issuers is distinct from additional capital sought by an operating company that has already gone through one or more rounds of financing. The second criterion of the *Hawaii Market Center* test, for example, speaks in terms of "initial value", causing some courts to use the term risk capital exclusively in the sense of initial capitalization.[167] Others, however, have expressly re-

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these programs are essentially pyramid schemes in which the contributions of subsequent participants are used to provide a return to the initial investors. The pyramid collapses when there are no longer enough new participants to pay those who have already bought in to the scheme. For an example, see State v. Hawaii Mkt. Ctr., Inc., 485 P.2d 105 (Haw. 1971).

163. Professor Long has offered a simplified version of this test that retains most of the basic elements just outlined in the text: "(1) an investment, (2) in the risk capital of an enterprise, and (3) the expectation of a benefit." LONG, *supra* note 147, at § 2.04[3]. It is unclear whether Professor Long would include an "efforts of others" element. Without such an element, this would be a far broader definition of risk capital than under the *Hawaii Market Center* test.

164. *See* LONG, *supra* note 147, at § 2.04[3].

165. For a discussion of this interpretation, see LONG, *supra* note 147, at § 2.04[3]; COX, HILLMAN & LANGEVOORT, *supra* note 148, at 151.

166. *See, e.g.*, Moreland v. Department of Corp., 239 Cal. Rptr. 558 (Cal. Ct. App. 1987) (a transaction satisfying either *Howey* or the risk capital test is classified as a security); Hamilton Jewelers v. Department of Corp., 112 Cal. Rptr. 387 (Cal. Ct. App. 1974); *cf.* People v. Wind River Mining Project, 269 Cal. Rptr. 106 (Cal. Ct. App. 1990) (greater quantum of risk means that purchasers are investing risk capital).

167. *See, e.g.*, State *ex rel.* Healy v. Consumer Business Sys., Inc., 482 P.2d 549, 555 (Or. Ct. App. 1971) (expressing concern about "whether the franchiser is dependent upon the franchisees' capital to initiate his operations, not just [to] manufacture his product."); *In re* Jet Set Travel Club, [1971-78 Transfer Binder] Blue Sky L. Rep. (CCH) ¶ 71,175, at 67,649 (Or. Corp. Comm'n 1974), *rev'd on other grounds*, 535 P.2d 109 (Or. Ct. App. 1975) (no risk capital when the firm had already begun operations).

jected this limitation on the term.[168]

The exact meaning of the central term "risk capital" thus remains unclear, which is probably the reason why the test has had only very limited acceptance. It does, however, pose an interesting alternative to *Howey*, despite some similarities between the tests. First, it is in one sense a liberalized version of *Howey*, because it employs the more flexible version of the efforts of others requirement and it does not require horizontal commonality.[169] There also seems to be no trace of the public distribution or potential for common trading requirement that has emerged under *Marine Bank* and *Reves*.[170] Second, and more importantly, it allows (albeit in a confused way) consideration of the degree of risk incurred by the purchaser as an element of the definition of security.[171] These distinctions should be taken into account when considering whether LLC interests are securities under the risk capital test.

IV. LIMITED LIABILITY COMPANY INTERESTS (PROBABLY) ARE NOT SECURITIES

For purposes of the federal securities laws, the narrow question is whether LLC interests are investment contracts. While LLCs possess certain corporate-like characteristics,[172] they are not corporations. They thus do not issue stock, which is one of the instruments listed in the statutory definition of a security.[173] If they did, the

168. *See, e.g.*, State *ex rel.* Park v. Glenn Turner Enter., Inc., [1971-78 Transfer Binder] Blue Sky L. Rep. (CCH) ¶ 71,023, at 67,201 (D. Idaho 1972) (commenting that "[t]he unwary and gullible investor can be fleeced much more readily by the older more affluent company which has been long in business").

169. Some commentators have gone so far as to say that the risk capital test even eliminates the need for vertical commonality, requiring only a transfer of value from the investor to the promoter, and no linking of destinies. *See* Carney & Fraser, *supra* note 76, at 111-13.

170. *See supra* notes 128-144 and accompanying text.

171. Note that there is a subtext in the Supreme Court investment contract decisions with respect to the matter of risk. In United Hous. Found. v. Forman, 421 U.S. 837 (1975), the Court noted that purchasers of stock in a nonprofit housing cooperative corporation "take no risk in any significant sense." *Id.* at 857 n.24. In International Brotherhood of Teamsters v. Daniel, 439 U.S. 551 (1979), the Court distinguished between the risk of investing in a pension plan and the risk of investing in securities. *Id.* at 562. The association of the element of risk with the definition of investment contracts under *Howey* has been very tentative, and no coherent analysis along these lines has yet emerged. For a critical discussion of this issue, see Carney & Fraser, *supra* note 76, at 106-08 (noting that the Court's "analysis of the source of the risk . . . is irrelevant to questions of whether the investment is at risk").

172. *See supra* notes 42-49 and accompanying text.

173. *See supra* note 82 for citations to the statutory definitions of "security."

question would be whether their "stock" possessed the common characteristics of stock, and not whether it constituted an investment contract.[174] Because LLCs do not issue stock, or any of the other instruments included on the statutory laundry list, interests in them (like those in general partnerships and limited partnerships) must be investment contracts in order to be securities. This Part will begin with an analysis of whether LLC interests are investment contracts under the *Howey* test. It will then conclude with a separate analysis of these interests' securities status under the risk capital concept.

A. LLC Interests Under Howey: Control and Common Trading

LLC interests would ordinarily meet most aspects of the *Howey* test without posing substantial difficulties. LLC members typically invest money in exchange for their interests, and thus do not produce the kinds of uncertainties associated with more unorthodox forms of investment.[175] They also usually invest in a common enterprise in which the participants' pooled funds are subject to a common fate. This pooling probably meets the more rigorous horizontal commonality version of the common enterprise requirement. LLCs typically would not be structured in the form of a vertical promoter/single investor relationship; they are likely to be structured around the joint contributions of two or more members in a "horizontal" partnership-like relation.[176] Furthermore, LLC members ordinarily will be expecting profits, and not some unconventional form of benefit.[177]

As with general partnerships and limited partnerships, the central question is whether LLC members rely on the efforts of others. With respect to general and limited partnerships, Part II showed basically two opposing presumptions. First, general partnership interests are virtually presumed not to be securities because general partners retain ultimate control over the enterprise by means of their statutory authority as general partners. This presumption seems to operate even if the partners have delegated substantial managerial authority or have otherwise not participated in control of the enterprise. The principal, if not the only, way to overcome this presumption is to show that the partners had no legal or practical

174. *See supra* note 83.

175. *See supra* notes 157-163 and accompanying text.

176. *See supra* notes 85-87 and accompanying text.

177. Since an LLC is a pass-through vehicle, LLC members may sometimes be hoping to take advantage of the pass-through of losses for tax purposes. The expectation of tax losses, however, has been held to satisfy the expectation of profits requirement in other contexts. SEC v. Aqua-Sonic Prod. Corp., 687 F.2d 577, 583 (2d Cir.) (licensing to sell product), *cert. denied sub nom.*, Hecht v. SEC, 459 U.S. 1086 (1982); Kolibash v. Sagittarius Recording Co., 626 F. Supp. 1173, 1178 (S.D. Ohio 1986) (a "recording lease program.")

ability to exercise their rights of control.[178]

On the other hand, limited partnership interests are presumed to be securities because state limited partnership law precludes limited partners from exercising control. Limited partners are thus presumed to be dependent on the efforts of others.[179] This presumption is very strong. The authorization of much greater limited partner participation under RULPA has not disturbed this view.[180] Only a very few cases have found the extraordinary degree of limited partner control, combined with a lack of potential for common trading, that would overcome the presumption.[181]

Where do LLCs interests fall between these polarities? To what extent is either presumption applicable to LLCs?

LLCs are probably least analogous to limited partnerships for purposes of these questions. One of the structural advantages of LLCs over limited partnerships is that LLC members can achieve the tax benefits of the entity's pass-through status without risking their limited liability by participating in control.[182] The lack of a state law prohibition (or at least restriction) on participation in control of the LLC means that there can be no limited partnership-like presumption that LLC members are dependent on the efforts of others. LLC interests hence are not presumptively investment contracts for the reason that limited partnership interests are.[183]

The analogy to general partnerships is much closer. In order to avoid characterizing their LLCs as possessing centralized management for tax purposes, most LLC statutes provide that the members will manage the LLCs, unless the articles of organization provide otherwise.[184] The Uniform Partnership Act provides similarly.[185] Furthermore, the tax risk associated with delegating authority to

178. *See supra* notes 100-116 and accompanying text.

179. *See supra* notes 117-120 and accompanying text.

180. *See supra* note 120.

181. *See supra* notes 121-144 and accompanying text.

182. *See supra* note 34 and accompanying text.

183. *See supra* notes 117-120 and accompanying text.

184. FLA. STAT. ANN. § 608.422 (West Supp. 1991) (management "in proportion to . . . contributions to the capital"); KAN. STAT. ANN. § 17-7612 (Supp. 1991); NEV. REV. STAT. ANN. § 86.312 (Michie Supp. 1991); UTAH CODE ANN. § 48-2b-125 (Supp. 1991) (management "in proportion to . . . interests in the profits"); VA. CODE ANN. § 13.1-1022 (Michie Supp. 1991) (allowing for delegation of managerial authority in the operating agreement); WYO. STAT. § 17-15-116 (1977). In contrast, the Colorado statute requires the LLC to be controlled by managers. COLO. REV. STAT. § 7-80-401 (Supp. 1990). The members, however, may also be the managers. *See* Comment, *Limited Liability Companies*, 39 KAN. L. REV. 967, 978-80 (1991). The Texas statute takes an intermediate position by providing that the LLC will be managed by managers unless the

managers creates an incentive for member-management. LLC members also have the authority to elect and remove managers in manager-managed LLCs.[186] If there are no managers, LLC members have the authority to bind the partnership.[187] LLCs and general partnerships both seem to be entities in which member/partner participation in control seems to be the essence of the relationship.

This is not to say, however, that control rights may not be allocated in many different ways in both settings. An LLC operating agreement, much like a general partnership agreement, can delegate substantial authority to managers. It can take a middle position and divide day-to-day management responsibilities and residual powers of approval, election, or removal between members and managers. Alternatively, it can simply implement straight-out member management. The LLC statutes, much like the Uniform Partnership Act, thus contemplate (and purposefully permit) a wide spectrum of degrees of participation in control by LLC members. Since these variations in degree of participation by general partners do not ordinarily overcome the presumption that they are relying on their own efforts to generate a profit,[188] a similar presumption should arise with respect to LLC interests. This presumption should be overcome only when a *Williamson*-type analysis shows that a member is so unsophisticated, inexperienced, inexpert, uninformed, or dominated by the managers that he is incapable of exercising his authority and is wholly dependent on the manager. Further, the presumption might be overcome by showing that the deferral of authority to the manager in the operating agreement is so massive that the members have essentially no control rights (including residual rights to remove the manager or amend the articles of organization).[189]

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regulations provide otherwise. 1991 Tex. Sess. Law Serv. 901 (Vernon) (referring to H.B. 278, § 46, art. 2.12).

185. UNIF. PARTNERSHIP ACT § 18(e), 6 U.L.A. 213 (1969).

186. *See, e.g.*, WYO. STAT. § 17-15-116 (1977) (providing for annual election of managers); COLO. REV. STAT. § 7-80-405 (Supp. 1990) (providing for removal of managers with or without cause).

187. *See, e.g.*, UTAH CODE ANN. § 48-2b-125 (Supp. 1991). The implicit limitation on the members' authority when the LLC is operated by managers is not all that different from the limitation on the authority of general partners who have delegated their authority to an executive or management committee, except that general partners are arguably surrounded by a larger penumbra of apparent authority. *See* UNIF. PARTNERSHIP ACT § 9(1)-(2), 6 U.L.A. 132 (1969).

188. *See supra* notes 97-99 and accompanying text.

189. These conclusions probably would apply to Colorado LLCs as well, even though those entities are required to have managers. LLC members retain certain powers under the statute, such as the right to vote annually on the election of managers, the right to unanimously approve transfers of other members' interests, and, if granted in the articles, the right to unanimously consent to the continuation of the LLC upon dissolution. COLO. REV. STAT. §§ 7-80-204(1), -401(1), -402(2), -702(1), -801(c) (Supp. 1990). The operating agreement may also give the members additional voting rights. For further discussion, see John R. Maxfield, et al., *Colorado Enacts Limited*

This conclusion can be supported by the line of reasoning in *Marine Bank*, *Reves*, and some of the limited partnership cases regarding whether the interests in question have been publicly distributed or are subject to common trading.[190] As previously noted,[191] the rationale used in these cases is still somewhat incoherent, but it demonstrates a tendency not to find securities in transactions that have been privately negotiated and those involving interests for which there is little if any secondary market. That tendency should reinforce the characterization of LLC interests as non-securities, at least so long as the interests are not marketed publicly.

In the absence of extreme circumstances, the presumption that LLC interests are not investment contracts should stand. It should stand even if one takes the position that a manager-managed LLC, with a governing group somewhat like a board of directors, several classes of ownership interests, articles of organization filed in a state office (*i.e.*, virtual "incorporation"), a high degree of continuity of life, and only residual authority in the members, has the "look and feel" of a close corporation. All that seems to be missing from this picture is stock. The argument thus could be made that such LLC interests are closely analogous to stock in a close corporation and, hence should be treated as securities since stock in a close corporation is universally regarded as a security.

This argument starts off with the wrong assumptions. Stock in a close corporation is a security, technically, because stock is listed as such within the statutory definitions of "security." The inclusion of stock within these statutory laundry lists does not mean, however, that it makes sense to treat that form of ownership interest in a closely-held enterprise as a security subject to the coverage of the securities laws. The law tends to treat all stock (or at least stock bearing the common characteristics of stock) as a security, largely because it would be wasteful to try to determine on a case-by-case basis whether stock is a security, as the Supreme Court recognized

Liability Corporation Legislation, 19 COL. LAW. 1029, 1030-31 (1990). Furthermore, as mentioned in the text, nothing prevents the members from being the managers and thereby rendering the member/manager distinction largely trivial. In short, Colorado LLC members possess substantial residual authority under the statute and may possess even greater authority under the operating agreement or because the managers and members are identical. Hence, the presumption that LLC members are not relying on the efforts of others may not apply with as much force to Colorado LLC interests, but the ultimate outcome of the *Howey* analysis is likely to be the same.

190. *See supra* notes 135-144 and accompanying text.

191. *See supra* notes 142-144 and accompanying text.

when it rejected the sale of business doctrine.[192] Such case-by-case determinations would probably be too upsetting to the commonsense expectation that this very familiar form of instrument should always be treated as a security, and would probably inject too much uncertainty into routine transactions.

Only such powerful considerations should be permitted to overcome what *should* be the basic presumption—that ownership interests in closely-held enterprises (whatever their form of organization) should not be treated as securities.[193] The private, informal and relatively equal relations among owners of these entities (whether called partners, shareholders or members), which take place outside the context of public securities markets, should be governed by the common law of fraud, fiduciary duty, and contract. We thus should not assume that LLC interests will be considered securities because they are analogous to stock in a close corporation. We should recognize, instead, that the status of close corporation stock as a security is an anomaly that can be justified, if at all, only by profound considerations of convenience and historical expectations. The analogy of LLC interests to corporate stock hence should not enhance the risk of securitization of LLC interests, but rather should call into question the theoretical underpinnings of the traditional assumption that stock in a close corporation is a security.

The fact that LLC members, unlike general partners, possess limited liability is not inconsistent with this conclusion. It has been argued that the "critical difference between LLCs and general partnerships is that partners' personal liability necessarily provides incentives to be highly informed about the business. At the same time, personal liability discourages involvement by unsophisticated investors. It follows that LLCs may have greater securities law

192. The Supreme Court rejected this doctrine in Landreth Timber Co. v. Landreth, 471 U.S. 681 (1985). The sale of business doctrine expressed the sentiment that application of the federal securities law to private, arms-length transactions that happened to involve the sale of stock (as distinct from the sale of assets) did not make sense. The Court refused to take this consideration into account when determining whether interests that possess the common characteristics of stock should always be treated as a security, largely because of the concerns about predictability and the historical expectations described above. *Id.* at 695-97. In Justice Stevens' forceful dissent, he stated that he

> would hold that the antifraud provisions of the federal securities laws are inapplicable unless the transaction involves (i) the sale of a security that is traded in a public market; or (ii) an investor who is not in a position to negotiate appropriate contractual warranties and to insist on access to inside information before consummating the transaction.

Id. at 699 (Stevens, J., dissenting).

193. For a very recent discussion that reaches a similar conclusion, see Larry E. Ribstein, *Private Ordering and the Securities Laws*, 42 CASE W. RES. L. REV. 1, 22-24 (1992).

exposure than partnerships."[194] This is a highly formalistic distinction between the incentives of investors in general partnerships and investors in limited liability vehicles such as corporations and LLCs, particularly when those investors are all investing in closely-held enterprises. As a practical matter, investors in such enterprises—whatever the form of business organization—all have substantial incentives to be highly informed about the business, because their investment is likely to represent a large percentage of their personal wealth, their position is illiquid because there is no real secondary market for their interests, and because they have often personally guaranteed the business' obligations. It is also by no means clear that the general partnership's lack of limited liability either encourages or discourages "unsophisticated investors." Many unsophisticated investors are attracted to the general partnership form because of its relative simplicity. This purported distinction between the incentives of general partners and LLC members thus has little bearing on the question of whether LLC members are more or less dependent on the efforts of others and does not undermine the basic conclusion: LLC interests are not ordinarily investment contracts under the *Howey* test.

B. *The Risk Capital Test: Control and Risk*

The first basic question that arises under the risk capital analysis with respect to LLCs is the same question that arises under the *Howey* test: are LLC members dependent upon the efforts of others? An equivalent of the liberalized version of the *Howey* efforts of others requirement is built into the fourth element of the *Hawaii Market Center* definition,[195] as well as into its several statutory incarnations[196] and other statutory risk capital definitions.[197] To the extent that a risk capital test requires an investor to rely on the efforts of others, the analysis of the allocation of control in LLCs outlined above[198] will apply. The liberalized version of this criterion under *Hawaii Market Center* and its progeny might effect the outcome of that analysis marginally, but the issues are the same. Furthermore, there would be no need to answer the question of whether the LLC members have invested "risk capital," if it were found that they were

194. Keatinge, *supra* note 1, at 403-04.
195. *See supra* notes 154-160 and accompanying text.
196. *See supra* note 153.
197. *See supra* note 146.
198. *See supra* notes 178-192 and accompanying text.

relying on their own efforts to generate profits, and not those of others. That finding would end the inquiry.

If, on the other hand, it were found that the members are relying on the efforts of others, then the nature of their investment would have to be determined. Has there been an investment of "risk capital" as that term is understood in the governing jurisdiction? If the operative definition associates risk capital with "riskiness,"[199] then an LLC interest might be found to be risk capital since this form of equity investment is not likely to be collateralized or otherwise attached to a security interest.[200] Investment in an operating enterprise without any fixed rate of return, promoter's guarantee, or priority against creditors would also contribute to the impression of riskiness. Predicting the requisite degree of riskiness, however, is itself fairly risky, causing substantial uncertainty to surround this means of defining risk capital.

Investment in LLC interests will also take the form of a contribution of initial capital if the investment is made at the time the LLC is formed. This may make a difference in some jurisdictions.[201] More broadly, it may simply be found that the LLC investment is subject to the risks of the enterprise; such risk may be enough to characterize it as risk capital under the term's most expansive definitions.[202]

Whether risk capital is defined more or less expansively, there is a good chance that investment in an LLC interest would be characterized as "risk capital." This would nevertheless not compel the conclusion that the LLC interest is a security, unless it were also found that the LLC members are dependent on efforts of others under the fourth element of the *Hawaii Market Center* test or its equivalent. In light of the primacy of this issue under the *Howey* test, there is probably not a greater chance that LLCs interests will be found to be securities in risk capital jurisdictions than under *Howey*.

V. CONCLUSION

The conclusion that LLC interests are not securities under most circumstances should come as good news to business planners. If these interests are not securities, then their offer and sale will not generate the transactional costs of determining the availability of an exemption from federal and state securities registration and performing the due diligence needed to establish such exemptions. In addition, issuers that forgot about securities law compliance before they

199. *See supra* notes 165-66 and accompanying text.
200. *Cf. supra* note 166.
201. *See supra* note 168.
202. This seems to be Professor Long's view of the concept. *See* LONG, *supra* note 147, at 2-136 to -137.

sold the interests will not need to worry about having given the investors an option to rescind their investment if the deal goes sour. Questions of fraud, furthermore, will be fought out under the common law in the state courts, where they belong, rather than in the federal courts.

The non-securities status of LLC interests presents a planning advantage that may not be as critical as the LLC's pass-through status for tax purposes, but is still very important. It is also very simple. If the owners of a closely-held enterprise incorporate a business, the corporation will issue stock. Stock is a security. Securities law compliance will be necessary, and the risks of litigation and liability under the securities law will be unavoidable. If those owners want to avoid all that, they should form an LLC. The LLC, except under unusual circumstances, will meet the long-standing need for a limited liability vehicle, well-adapted to closely-held enterprises, whose owners will not own securities.