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# The Limited Liability Company as a Security

Marc I. Steinberg\*  
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## I. INTRODUCTION

The limited liability company ("LLC") business form combines the advantages of a corporation's limited liability<sup>1</sup> with the benefits of a partnership's flow-through of income to its members.<sup>2</sup> Although Wyoming passed the first LLC Act in 1977,<sup>3</sup> relatively few other state legislatures thus far have adopted this concept as a possible alterna-

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1. COL. REV. STAT. ANN. § 7-80-107 (West Supp. 1991); FLA. STAT. ANN. § 608.436 (West Supp. 1992); KAN. STAT. ANN. § 17-7620 (Supp. 1991); NEVADA REV. STAT. § 86.371 (Michie 1991); TEX. REV. CIV. STAT. ANN. art. 1528n, 4.03 (Vernon Supp. 1992); UTAH CODE ANN. § 48-2b-109 (Supp. 1991); VA. CODE ANN. § 13.1-1019 (Michie Supp. 1991); WYO. STAT. § 17-15-113 (1977).

2. The Internal Revenue Service ("IRS") uses the following characteristics to determine whether to tax an unincorporated organization as a corporation or as another type of organization such as a partnership or a trust: (1) associates; (2) an objective to carry on business and divide gains; (3) continuity of life; (4) centralization of management; (5) limited liability; and (6) free transferability of interest. Treas. Reg. § 301.7701-2(a)(1) (as amended in 1983). If the organization has more corporate characteristics than noncorporate characteristics, not considering those common to both entities, the IRS will tax such unincorporated organization as a corporation. *Id.* at § 301.7701-2(a)(3) (as amended in 1983) (associates and objective to carry on business and divide gains not considered because they are common characteristics of both corporations and partnerships).

Under the Wyoming statute, the IRS classified the LLC interest as a partnership for federal income tax purposes because the LLC lacked a preponderance of the corporate characteristics not common to both. Rev. Rul. 88-76, 1988-2 C.B. 360 (LLC lacked continuity of life and free transferability of interests). Although the LLC state statutes differ in some significant respects, the overall provisions are relatively consistent, and, therefore, it may well be that in general the IRS will allow LLCs to enjoy the flow-through tax benefits of a partnership.

3. WYO. STAT. § 17-15-113 (1977).

tive for business.<sup>4</sup> Because the concept is fairly new, no federal or state court has analyzed whether LLC interests are securities under the Securities Act of 1933, the Securities Exchange Act of 1934, or any of the state blue sky securities law provisions.

While a few commentaries have addressed the LLC enterprise in general,<sup>5</sup> very few make mention of whether interests issued pursuant to this business form constitute securities.<sup>6</sup> This article generally responds to Professor Sargent's position that interests in a LLC are normally not securities.<sup>7</sup> We take the position that LLC interests usually satisfy the requirements for securities law status and, hence, such instruments normally are within the purview of the federal securities and the state blue sky laws.

First, this article analyzes an interest in a LLC as an "investment contract," utilizing the four-part test adopted by the United States Supreme Court in *SEC v. Howey*<sup>8</sup> as well as the Court's rationale in *Marine Bank v. Weaver*.<sup>9</sup> Second, we explore LLC interests under the same or similar circumstances test adhered to by the United States Supreme Court in *Landreth Timber Co. v. Landreth*,<sup>10</sup> focusing on whether LLC interests have the characteristics of stock. Finally, pursuant to the definition of a security under the federal securities acts, we examine a LLC interest as an "interest or instru-

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4. See, e.g., COL. REV. STAT. ANN. §§ 7-80-101 to -913 (West Supp. 1991); FLA. STAT. ANN. §§ 608.401-471 (West Supp. 1992); KAN. STAT. ANN. §§ 17-7601 to -7650 (Supp. 1991); NEVADA REV. STAT. §§ 86-011-571 (1991); TEX. REV. CIV. STAT. ANN. art. 1528n, 1.01-9.02 (Vernon Supp. 1992); UTAH CODE ANN. §§ 48-2b-101 to -156 (Supp. 1991); VA. CODE ANN. §§ 13.1-1000 to -1069 (Michie Supp. 1991); WYO. STAT. §§ 17-15-101 to -135 (1977). Note, however, that many other states are now considering whether to enact LLC legislation. See 55 Tax Notes 1019, 1021 (May 25, 1992).

5. For an overview and comparison of various state LLC statutes, see Brian Farmer & Louis A. Mezzullo, *The Virginia Limited Liability Company Act*, 25 U. RICH. L. REV. 789 (1991); Susan Pace Hamill, *The Limited Liability Company: A Possible Choice for Doing Business*, 41 FLA. L. REV. 721 (1989); Robert R. Keatinge, et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW. 375 (1992); John R. Maxfield, et al., *Colorado Enacts Limited Liability Company Legislation*, 19 COL. LAW. 1029 (1990); Curtis J. Braukmann, Comment, *Limited Liability Companies*, 39 U. KAN. L. REV. 967 (1991); Joseph P. Fonfara & 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).

6. Contrast Farmer & Mezzullo, *supra* note 5, at 828-29 (analogizing the LLC to a general or limited partnership and suggesting that the courts will find that an LLC interest is a security if it satisfies the definition of an "investment contract") with Mark A. Sargent, *Are Limited Liability Company Interests Securities?*, 19 PEPP. L. REV. 1069 (1992) (stating that a LLC interest normally does not satisfy the definition of a security).

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

8. 328 U.S. 293 (1946).

9. 455 U.S. 551 (1982).

10. 471 U.S. 681 (1985).

ment commonly known as a security"<sup>11</sup> to show that a common equity participant in an enterprise called a "company" (as in a Limited Liability Company) may reasonably expect the investment to have securities law coverage.

## II. LLC INTERESTS AS INVESTMENT CONTRACTS

In *SEC v. Howey*,<sup>12</sup> the United States Supreme Court set forth the standard test for determining whether an instrument is an investment contract, and, thus, satisfies the definition of a security.<sup>13</sup> *Howey* involved the sale of citrus grove units and optional service contracts to investors who received profits from the harvest. The Court found that this arrangement constituted an investment contract, stating, "[A]n investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is lead to expect profits solely from the efforts of the promoter or a third party."<sup>14</sup> The following discussion analyzes the four components of the *Howey* test in order to illustrate that, in general, an interest in a LLC satisfies each characteristic, focusing especially on the "solely from the efforts of others" element.

### A. Investment of Money

An investor must surrender some "tangible and definite consideration" in order to satisfy the investment of money element.<sup>15</sup> The Court has noted that in every decision in which it found a security to be present, the investor had received a separate financial interest for his or her relinquishment of the consideration.<sup>16</sup> This consideration usually takes the form of cash, but the Court noted that goods and services also may be sufficient consideration.<sup>17</sup>

Nonetheless, two LLC statutes exclude services as a valid form of

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11. Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C. § 78c(a)(10) (1988); Securities Act of 1933, § 2(1), 15 U.S.C. § 77b(1) (1988).

12. 328 U.S. 293 (1946).

13. *Id.* at 298-99.

14. *Id.* *Howey* and other Supreme Court decisions are addressed in MARC I. STEINBERG, SECURITIES REGULATION: LIABILITIES AND REMEDIES § 4A.01 *et. seq.* (1991).

15. *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 559 (1979).

16. *Id.* at 560 (stating that "the purchaser gave up some tangible and definable consideration in return for an interest that had substantially the characteristics of a security").

17. *Id.* at 560 n.12.

contribution to a LLC.<sup>18</sup> An investment in a LLC, however, normally satisfies the first element of the *Howey* test in spite of this limited exception, since interest holders usually contribute monetary amounts.<sup>19</sup>

### B. Common Enterprise

To date, the United States Supreme Court has declined to clarify the disagreement among the lower federal courts concerning the proper test to apply for the common enterprise analysis.<sup>20</sup> Irrespective of the standard employed, LLC interests normally will satisfy each circuit's requirements.<sup>21</sup> First, horizontal commonality, the shared common goal between investors,<sup>22</sup> satisfies the common enterprise element in all circuits.<sup>23</sup> Normally, interests in a LLC should meet the horizontal commonality test, since the contributors share a

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18. See FLA. STAT. ANN. § 608.4211 (West Supp. 1992); WYO. STAT. § 17-15-115 (1977).

19. Moreover, other investors may periodically contribute certain goods or supplies in return for an interest in the LLC. See COL. REV. STAT. ANN. § 7-80-501 (West Supp. 1991); KAN. STAT. ANN. § 17-7602(i) (Supp. 1991); NEVADA REV. STAT. § 86.041 (1991); TEX. REV. CIV. STAT. ANN. art. 1528n, 5.01 (Vernon Supp. 1992); UTAH CODE ANN. § 48-2b-124 (Supp. 1991); VA. CODE ANN. § 13.1-1002 (Michie Supp. 1991).

20. *Mordaunt v. Incomco*, 469 U.S. 1115, 1115-17 (1985) (White, J., dissenting from denial of petition for certiorari).

21. Some circuits remain undecided on which standard to adopt. For example, the United States appellate courts for the First, Second, Fourth, and Eighth Circuits have not made a final determination on which test applies. District courts within these circuits even disagree on the proper standard. In the Fourth Circuit, *compare* *Burton v. Heinold Commodities, Inc.*, 646 F. Supp. 360, 361-62 (E.D. Va. 1986) (horizontal commonality required) *with* *Shotto v. Laub*, 635 F. Supp. 835, 838 (D. Md. 1986) (vertical commonality alone suffices). Furthermore, even judges within the same district disagree on the proper standard. In the Second Circuit, *compare* *Savino v. E.F. Hutton & Co.*, 507 F. Supp. 1225, 1238 n.11 (S.D.N.Y. 1981) (vertical commonality alone suffices) *with* *Darrell v. Goodson*, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,349, at 97,325 (S.D.N.Y. 1980) (horizontal commonality required). Irrespective of the standard adopted, LLC interests normally satisfy the common enterprise component of the *Howey* test.

22. See MARC I. STEINBERG, UNDERSTANDING SECURITIES LAW 250 (1989):

Generally, horizontal commonality looks to the relationships which exist between an individual investor and the pool of other investors. A pooling of the interests of the investors is essential to finding the presence of horizontal commonality; all courts have held that horizontal commonality is sufficient to meet the common enterprise requirement of the *Howey* test.

23. All courts accept horizontal commonality as sufficient to support the common enterprise element. Some courts, however, still require a showing of horizontal commonality, and not vertical commonality alone, to satisfy the common enterprise test. See *Salcer v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 682 F.2d 459, 460 (3rd Cir. 1982); *Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 622 F.2d 216, 221-22 (6th Cir. 1980); *Minarik v. M-S Commodities, Inc.*, 457 F.2d 274, 276-77 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972); *see also* *Popham, Haik, Schnobrick, Kaufman & Doty, Ltd. v. Newcomb Secs. Co.*, 751 F.2d 1262, 1265 (D.C. Cir. 1985) (may be read as impliedly approving the horizontal commonality test adopted in *Meredith v. Conticommodity Servs., Inc.*, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,701, at 98,670-71 (D.D.C. 1980)).

common interest in the success and profitability of the LLC. An exception to this general principle exists if the enterprise only has one investor. Seven of the eight LLC statutes require two or more members to form a LLC.<sup>24</sup> If the two members are an investor and a promotor, however, the LLC may not satisfy the horizontal commonality test.<sup>25</sup> Such a situation would arise on a relatively infrequent basis.

Some circuits state that while horizontal commonality always satisfies the common enterprise element, vertical commonality, the interweaving of the promotor's and the investor's interests, also may satisfy the common enterprise definition.<sup>26</sup> In the typical business organization, the promoters and the investors will share a common goal in the LLC. Only in a rare instance would a promotor have a different goal from those of the investors in a LLC, which is organized for a specified business purpose.

### C. *Expectation of Profits*

Under the *Howey* standard, an investor's expectation of profits generally consists of either capital appreciation or an investor's participation in the earnings which result from the managerial use of

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24. See COL. REV. STAT. ANN. § 7-80-102(7) (West Supp. 1991); FLA. STAT. ANN. § 608.405 (West Supp. 1992); KAN. STAT. ANN. § 17-7605 (Supp. 1991); NEVADA REV. STAT. § 86.151 (1991); UTAH CODE ANN. § 48-2b-103 (Supp. 1991); VA. CODE ANN. § 13.1-1002 (Michie Supp. 1992); WYO. STAT. § 17-15-106 (1977). The Texas statute does not explicitly address the number of members needed to form an LLC. However, it appears that one person may hold an interest in an LLC, since any natural person can act as the organizer of an LLC, TEX. REV. CIV. STAT. ANN. art. 1528n, 3.01 (Vernon Supp. 1992), and the managers of the LLC may consist of one or more persons, *id.* at art. 1528n, 2.13.

25. In such a situation, there may not be present the requisite pooling of investor interests. See authorities cited *supra* notes 21-23.

26. *McGill v. American Land & Exploration Co.*, 776 F.2d 923, 925-26 (10th Cir. 1985); *Villeneuve v. Advance Business Concepts Corp.*, 698 F.2d 1121, 1124 (11th Cir. 1983); *SEC v. Continental Commodities Corp.*, 497 F.2d 516, 522 (5th Cir. 1974); *SEC v. Glenn W. Turner Enters., Inc.*, 474 F.2d 476, 482 n.8 (9th Cir.), *cert. denied*, 441 U.S. 821 (1973). Some courts and commentators distinguish the vertical commonality test even further by contrasting a narrow view, requiring a commonality of interest between the promotor and the success of the investment, with a liberal interpretation, requiring the investor to rely on the promotor for the success of the investment. See *Mordaunt v. Incomco*, 469 U.S. 1115, 1115-17 (1985) (White, J., dissenting from denial of petition for certiorari); II LOUIS LOSS AND JOEL SELIGMAN, *SECURITIES REGULATION* 927-935 (3d ed. 1989); James D. Gordon III, *Common Enterprise and Multiple Investors: A Contractual Theory for Defining Investment Contracts and Notes*, 1988 COLUM. BUS. L. REV. 635; Sargent, *supra* note 7, at 1082 n. 84; Nathan W. Drage, Comment, *Are Limited Partnership Interests Securities? A Different Conclusion Under the California Limited Partnership Act*, 18 PAC. L.J. 125 (1986).

the investor's funds.<sup>27</sup> Moreover, a number of courts suggest that an investor can satisfy the expectation of profits element even if the investor's principal purpose is to obtain tax benefits.<sup>28</sup> In most instances, an investor will contribute his or her money with the expectation of some sort of profitable return in the LLC.

#### D. *Solely from the Efforts of Others*

On several occasions, the Supreme Court has asserted that, in defining the term "security," "form should be disregarded for substance and the emphasis should be on economic reality."<sup>29</sup> Consistent with this principle, the lower federal courts have not literally construed the phrase that profits be derived *solely* from the efforts of others.<sup>30</sup> Rather, even though there is input from the investors, this requirement is deemed satisfied if the efforts made by others "are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."<sup>31</sup> Although the Supreme Court has yet to embrace the foregoing standard, it has restated the *Howey* test in a more flexible manner.<sup>32</sup>

Applying the economic reality test, the lower federal courts generally have held limited partnership interests to be securities.<sup>33</sup> This

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27. *United Hous. Found. v. Forman*, 321 U.S. 837, 852 (1975).

28. *See, e.g., Long v. Shultz Cattle Co.*, 881 F.2d 129, (5th Cir. 1989) (implying that obtaining tax benefits without receiving profits may satisfy the expectation of profits definition); *Kolibash v. Sagittarius Recording Co.*, 626 F. Supp. 1173, 1179 (S.D. Ohio 1986); *Stowell v. Ted S. Finkel Inv. Servs., Inc.*, 489 F. Supp. 1209, 1221 (S.D. Fla.), *aff'd on other grounds*, 641 F.2d 323 (5th Cir. 1980); *Investors Credit Corp. v. Extended Warranties, Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) 94,343 at 92,258 (M.D. Tenn. Jan. 28, 1989); *but see United Hous. Found. v. Forman*, 321 U.S. 837, 852 (1975) (implying that tax benefits alone are not sufficient, but arguably stating the rationale for such failure is because they do not result from the managerial efforts of others, not because they do not necessarily constitute profits); *Gurdy v. Bank of La Place*, No. 90-3428, 1992 WL 20083 (5th Cir. Feb. 25, 1992) (implying that tax benefits alone may not satisfy the expectation of profit element because the term "carries with it a connotation of potential appreciation or depreciation in the value of the investment contract").

29. *See, e.g., Reves v. Ernst & Young*, 110 S.Ct. 945, 949 (1990); *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 848 (1975); *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967).

30. *See United Hous. Found. v. Forman*, 421 U.S. at 852 n.16.

31. *See, e.g., 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 Prod. 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. McCullough 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); *SEC v. Glenn W. Turner Enters., Inc.*, 474 F.2d 476, 483 (9th Cir.), *cert. denied*, 441 U.S. 821 (1973).

32. *United Hous. Found. v. Forman*, 421 U.S. at 852 ("The touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.").

33. As the Fifth Circuit has stated: "There is no disagreement . . . that, generally,

conclusion largely has been supported by such factors as the limited partners' inability to dissolve the partnership, their lack of power to bind other partners, and their lack of authority to take an active role in the partnership's management.<sup>34</sup> In those situations, however, where limited partners exert meaningful control over the partnership, courts have held that such interests are not securities.<sup>35</sup>

On the other hand, general partnership interests usually are not securities due to the fact that the individual participants exercise a meaningful level of managerial control.<sup>36</sup> A number of primarily older cases opine that general partners have ultimate control and hence are not dependent upon the efforts of others, even if such authority is not actually exercised or is delegated to a managerial committee.<sup>37</sup> This approach neglects economic reality and is not the prevailing view.<sup>38</sup> Admittedly, under this view, LLC interests normally would not be securities since most of the state statutes vest management power in the LLC members.<sup>39</sup> This ability to control the direction of the entity looks similar to the general partnership structure. Utilizing the foregoing approach, the power vested to LLC participants by statute normally should defeat claims that such participants did not have the power to control their investments.

In *Williamson v. Tucker*,<sup>40</sup> however, the Fifth Circuit, applying

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investment contracts include limited partnership interests." *L&B Hospital Ventures, Inc. v. Healthcare Int'l, Inc.*, 894 F.2d 150, 151 (5th Cir.), *cert. denied*, 111 S.Ct. 55 (1990). *See* *Sibel v. Scott*, 725 F.2d 995, 998 (5th Cir. 1984); *Mayer v. Oil Field Systems Corp.*, 721 F.2d 59, 65 (2d Cir. 1983); *SEC v. Murphy*, 626 F.2d 633, 640-41 (9th Cir. 1980); *Goodman v. Epstein*, 582 F.2d 388, 406-08 (7th Cir. 1978), *cert. denied*, 440 U.S. 939 (1979).

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

35. *See, e.g.*, *Gordon v. Terry*, 684 F.2d 736 (11th Cir. 1982); *Bank of American National Trust v. Hotel Rittenhouse*, 595 F. Supp. 800 (E.D. Pa. 1984); *Darrah v. Garrett*, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,472 (W.D. Ohio 1984). *See generally* *Loss and Seligman, supra* note 26, at 961-63; *Sargent, supra* note 7, at 1084-87.

36. *See, e.g.*, *Youmans v. Simon*, 791 F.2d 346-47.

37. *See, e.g.*, *Goodwin v. Elkins & Co.*, 730 F.2d 99, 102-03 (3d Cir. 1984) (Garth J., separate opinion); *Hirsch v. duPont*, 396 F. Supp. 1214, 1220 (S.D.N.Y. 1975), *aff'd*, 553 F.2d 750 (2d Cir. 1977); *Romney v. Richard Prows, Inc.*, 289 F. Supp. 313, 314-15 (N.D. Utah 1968).

38. *See infra* notes 40-45 and accompanying text.

39. COL. REV. STAT. ANN. § 7-8-401 (West Supp. 1991); FLA. STAT. ANN. § 608.422 (West Supp. 1992); KAN. STAT. ANN. § 17-7612 (Supp. 1991); NEVADA REV. STAT. § 86.291 (1991); UTAH CODE ANN. § 48-2b-125 (Supp. 1991); VA. CODE ANN. § 13.1-1002(A) (Michie Supp. 1991); WYO. STAT. § 17-15-166 (1977). Note that the LLC operating documents, like a limited or general partnership agreement, may allocate power so that only the promoters exert significant managerial efforts.

40. 645 F.2d 404 (5th Cir. 1981).



the economic reality test,<sup>41</sup> recognized that in certain circumstances general partnership interests may be considered securities.<sup>42</sup> The *Williamson* court described the following three situations where a general partnership interest can be designated a security: First, where the partnership agreement allocates so little power in the hands of the subject partner that the arrangement distributes power similar to that of a limited partnership; second, where a partner's inexperience or lack of knowledge renders such partner incapable of exercising his or her partnership powers in a meaningful way; and third, where a partner depends on the manager's unique entrepreneurial or managerial abilities to such a degree that replacing such person is not a feasible alternative.<sup>43</sup> Nonetheless, as *Williamson* made clear, a general partner who seeks securities law coverage bears a heavy burden of proof.<sup>44</sup>

*Williamson's* economic reality approach to general partnership interests represents the emerging and apparent majority view.<sup>45</sup> Provided that investors purchasing LLC interests can prove that one of the *Williamson* factors applies to their situation, they may sustain their claims that the investments come within the securities laws. Because the LLC business form is relatively new, it is still unsettled how much management power each member will possess in the entity. This is important because, due to the provisions contained in the LLC operating documents (such as the written agreement among the members) or the expertise required to actually operate the business, investors may rely heavily on the promotor's skills. Such lack of control may deem the investor incapable or inexperienced to meaningfully exercise his or her partnership powers in the enterprise, thus satisfying the *Williamson* test. Such a determination, however, must be made on an ad hoc basis, looking to the provisions of the pertinent LLC documents as well as balancing the knowledge and experience of the individual investor against the power and control of the LLC management framework.

The Texas LLC statute makes the opposite presumption from the

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41. *Id.* at 418. See cases cited *supra* note 29.

42. 645 F.2d at 420 (“[T]he mere fact that an investment takes the form of a general partnership or joint venture does not inevitably insulate it from the reach of the federal securities laws.”).

43. *Id.* at 422. In an accompanying footnote the court pointed out that by listing the three factors, “this is not to say that other factors could not also give rise to such a dependence on the promoter or manager that the exercise of partnership powers would be effectively precluded.” *Id.* at 422 n.15.

44. *Id.* at 424. See *Youmans v. Simon*, 791 F.2d 341, 346 (5th Cir. 1986).

45. See *Koch v. Hankins*, 928 F.2d 1471, 1476-81 (9th Cir. 1991); *Banghart v. Hollywood Gen. Partnership*, 902 F.2d 805, 807-08 (10th Cir. 1990); *Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.*, 840 F.2d 236, 241 (4th Cir. 1988); *Odom v. Slavik*, 703 F.2d 212, 215 (6th Cir. 1983); *Gordon v. Terry*, 684 F.2d 736, 840 (11th Cir. 1982).

other LLC statutes, stating that the powers of the LLC are vested in the managers of the entity, and that the managers need not participate as LLC members.<sup>46</sup> This structure closely resembles a limited partnership, which generally constitutes a security because limited partners normally rely on the general partners to control the entity's activities.<sup>47</sup> Nonetheless, as in a limited partnership, a determination must be made on an ad hoc basis whether the members in a particular Texas LLC had managerial control over the investment which would preclude them from invoking *Howey's* "solely from the efforts of others" element.<sup>48</sup>

#### *E. Effect of Marine Bank v. Weaver*

In *Marine Bank v. Weaver*,<sup>49</sup> the Supreme Court held that a profit-sharing agreement entered into by two parties was not an investment contract.<sup>50</sup> Without applying the *Howey* test, the Court pointed to such factors as the unique nature of the agreement, that it was privately negotiated one-on-one, that no prospectus had been disseminated to prospective investors, and that the agreement was not capable of being mass marketed.<sup>51</sup> *Marine Bank* leaves open the distinct possibility that certain LLC interests may satisfy the *Howey* test, yet not be investment contracts due to their uniquely private nature. Indeed, a few lower courts have applied *Marine Bank's* rationale in other novel contexts to preclude securities law coverage.<sup>52</sup>

The fact of the matter, however, is that relatively few LLCs will be

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46. TEX. REV. CIV. STAT. ANN. art. 1528n, 2.12 (Vernon 1992).

47. See discussion *supra* notes 33-35 and accompanying text.

48. Cf. *L & B Hosp. Ventures, Inc. v. Healthcare Int'l, Inc.*, 894 F.2d 150, 152 (5th Cir.), *cert. denied*, 111 S. Ct. 55 (1990); discussion *supra* notes 29-35 and accompanying text.

By analogy, the Fifth Circuit in *Youmans v. Simon*, 791 F.2d 341 (5th Cir. 1986), compared a limited partner's position to that of a stockholder in a corporation. The court pointed out that limited partners cannot dissolve the partnership, bind other partners, or actively participate in the managerial functions of the partnership. Moreover, their liability is of a limited nature. Thus, the court held that the limited partnership constituted a security. Similarly, in *Siebel v. Scott*, 725 F.2d 995 (5th Cir. 1984), the court noted that limited partners represent the type of investors that the securities laws should protect. The court recognized that most limited partners simply invest their money and rely on the skills and knowledge of the general partners to generate profits.

49. 455 U.S. 551 (1982).

50. *Id.* at 559-60.

51. *Id.*

52. See, e.g., *Mace Neufeld Productions, Inc. v. Orion Pictures Corp.*, 860 F.2d 944, 946-47 (9th Cir. 1988); *Bank of America Nat'l Trust and Savings Assoc. v. Hotel Rittenhouse Assoc.*, 595 F. Supp. 800, 805 (E.D. Pa. 1984).

subject to the *Marine Bank* analysis. For the most part, LLC interests are not such unique investments so as to prevent them from being offered on a mass scale. In other words, even if interests in a particular LLC are in fact privately negotiated, the key criterion is whether such interests are capable of mass distribution or public trading.<sup>53</sup> In this respect, LLC interests are quite similar to limited partnership interests which normally are classified as investment contracts.<sup>54</sup> Hence, while LLC interests may be of a relatively recent vintage, they generally are not of the unique nature required to come within the *Marine Bank* analysis. Therefore, unless the particular LLC interests possess unique characteristics that are especially tailored to the participants involved,<sup>55</sup> thereby rendering such interests incapable of being mass marketed, *Howey*, rather than *Marine Bank*, should control.<sup>56</sup>

#### F. Summation

It appears that the LLC agreement (as well as other pertinent operating documents) frequently will be crucial. Based on the general

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53. Cf. *Reves v. Ernst & Young*, 110 S.Ct. 945, 951-52 (1990); *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946); *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 644 (1943).

Interpreting *Howey* in view of *Marine Bank*, one court opined that an investment contract "means a contract, transaction or scheme whereby a person (1) invests his money (2) in a common enterprise and (3) is led to expect profits (4) solely from the efforts of the promoter or a third party, and (5) risks loss." *Dooner v. NMI Limited*, 725 F. Supp. 153, 158 (S.D.N.Y. 1989), citing, *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 756 F.2d 230, 239 (2d Cir. 1985). On the other hand, this author has concluded that

an instrument will not be deemed an investment contract, irrespective of the *Howey* test, if: (1) the transaction involves a novel or unique instrument (2) which is not capable of mass distribution or public trading (3) where no prospectus has been distributed and (4) the transaction is negotiated privately involving few individuals.

STEINBERG, *supra* note 14, § 4A.04[2] (emphasis in original). Under the foregoing interpretation,

all of the conditions enumerated must exist for the transaction to be declared outside the scope of the federal securities laws under *Weaver*. If any condition is not present, then the proper analysis for determining the existence of an investment contract normally is the *Howey* test. Even where the *Howey* test is met, however, if there exists an alternative regulatory scheme that significantly reduces the instrument's risk of loss, a court may well hold that the instrument is not a security. See *Reves v. Ernst & Young*, 100 S.Ct. 945 (1990).

*Id.* at 4A-51 n.37 (emphasis in original). Note that LLC interests are not subject to an alternative regulatory framework that significantly reduces the investor's risk of loss. See *infra* notes 105-07 and accompanying text.

54. See discussion *supra* notes 33-35 and accompanying text.

55. For example, in *Marine Bank*, there were a number of novel provisions, including that the lender was entitled to use the borrower's barn and pasture. 455 U.S. at 553. In the LLC context, the alleged uniqueness of the arrangement may be evidenced by the applicable operating documents.

56. See Marc I. Steinberg & 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, 518-25 (1987).

partnership analogy, a court's determination whether a LLC interest will be characterized as an investment contract often may depend on the LLC agreement (and other applicable operating documents). If the LLC agreement retains real power in the LLC members, then LLC interests generally are not investment contracts. This outcome may be reached regardless of the control actually exercised by the LLC participants, so long as such participants are capable of meaningfully exercising their powers.<sup>57</sup> Hence, where the LLC agreement allocates specifically clear powers to the members to provide them with access to relevant information and with the means to protect their investments, the presumption arises that such LLC interests are not investment contracts unless such presumption is overcome by evidence that the LLC members "were rendered passive investors because they were somehow precluded from exercising their powers of control and supervision."<sup>58</sup> On the other hand, when the LLC operating documents allocate power similar to that structured in a limited partnership, then the presumption arises that the subject LLC members may invoke the securities laws. Applying the economic reality test, this presumption may be rebutted by a showing that such LLC participants, through their actions outside of such documents, exercised essential managerial efforts.<sup>59</sup>

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57. *Cf. Banghart v. Hollywood General Partnership*, 902 F.2d 805, 808 (10th Cir. 1990).

58. *Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.*, 840 F.2d 236, 239-42 (4th Cir. 1988) (ascertaining whether general partnership interest is a security).

59. *Cf. L & B Hospital Ventures, Inc. v. Healthcare International, Inc.* 894 F.2d 150, 152-53 (5th Cir.), *cert. denied*, 111 S. Ct. 55 (1990).

Note that a number of states employ the risk capital test to determine whether an instrument is an investment contract. As Professor Sargent points out, there is no single risk capital test. *See Sargent, supra* note 7, at 1092-95. For various formulations, *see, e.g., Silver Hills Country Club v. Sobieski*, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961); *State Commissioner of Securities v. Hawaii Market Center, Inc.*, 52 Haw. 642, 485 P.2d 105 (1971); Ga. Code Ann. § 10-5-2(16) (1981); Okla. Stat. tit. 71, § 2(20)(P) (1981) (containing an expensive risk capital test, defined as 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"). By eliminating the horizontal commonality requirement (if not the common enterprise requirement altogether), greatly relaxing the "efforts of others" criterion, and not imposing a common trading capability requirement, it is possible that certain LLC interests, while not within the scope of the federal securities laws, may be investment contracts under the applicable state blue sky laws. *See generally William J. Carney & Barbara G. Fraser, Defining a "Security": Georgia's Struggle with the "Risk Capital" Test*, 30 EMORY L. J. 73, 111-13 (1981).

## II. SAME OR SIMILAR CHARACTERISTICS TEST

In *Landreth Timber Co. v. Landreth*,<sup>60</sup> the United States Supreme Court adhered to what may be coined as the same or similar characteristics test in analyzing whether an instrument had the qualities of stock and, therefore, should qualify as a security.<sup>61</sup> The Court noted that the instrument's label does not conclusively render it a security.<sup>62</sup> Rather, if the instrument bears the label "stock" and has the characteristics normally associated with stock, then the securities laws will apply.<sup>63</sup> The Court looked to the following attributes of common stock to determine whether a security existed: (1) right to receive profits based on the apportionment of one's interest in the entity; (2) ability to vote in proportion to the interest owned; (3) negotiability of the investment; (4) ability to pledge the interest; and (5) ability for the interest to appreciate in value.<sup>64</sup>

It should be recognized that in *Landreth*, as in other Supreme Court decisions,<sup>65</sup> the interest in question was labeled stock whereas no such term is given to LLC interests. Nonetheless, because LLC interests are issued by an entity called a "Company" and the typical issuance of an equity interest by a commercial enterprise calling itself a company or corporation is stock, substance should prevail over form, thereby mandating that LLC interests be analyzed pursuant to the ordinary attributes of stock standard. The satisfaction of this standard in the LLC setting comports with the Supreme Court's acknowledgment in such contexts that individuals, "both trained and untrained in business matters [are] likely [to] have a high expectation that their activities are governed by the [Securities] Acts."<sup>66</sup> Hence, if LLC interests satisfy the five-factor analysis set forth above,<sup>67</sup> then such interests should be deemed securities.<sup>68</sup>

Applying the first factor of the attributes of stock test, the LLC statutes generally provide for the distribution of profits to the mem-

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60. 471 U.S. 681 (1985). See *Gould v. Rufenacht*, 471 U.S. 701 (1985).

61. 471 U.S. at 686.

62. *Id.*

63. *Id. Accord*, *Gould v. Rufenacht*, 471 U.S. 701, 704 (1985). Compare *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 851 (1975).

64. 471 U.S. at 686, *relying on* *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 851 (1975). In an accompanying footnote, the *Landreth* Court pointed out: "[W]e wish to make clear that these characteristics are those usually associated with common stock, the kind of stock often at issue in cases involving the sale of a business. Various types of preferred stock may have different characteristics and still be covered by the Acts." 471 U.S. at 686 n.2.

65. See *Gould v. Rufenacht*, 471 U.S. 701 (1985); *United Hous. Found., Inc. v. Forman*, 421 U.S. 837 (1975).

66. *Landreth*, 471 U.S. at 693.

67. See *supra* note 64 and accompanying text.

68. Furthermore, the fulfillment of these attributes lends support to the view that an interest in a LLC is "commonly known as a security." See *infra* notes 87-107 and accompanying text.

bers of the enterprise based on their contribution of capital. Generally, some statutes state that, absent provision in the operating agreement, a LLC should divide profits or gains according to an investor's contribution to the capital or operating value of the enterprise.<sup>69</sup> Other statutes simply provide that the operating agreement will govern the distribution of profits, but allow any investor to demand cash in return for his or her contribution to the capital of the company.<sup>70</sup>

Second, most LLC statutes do not explicitly outline the voting rights of those participating in the enterprise. Most, however, set forth that, unless the LLC operating documents provide otherwise, the management of the LLC is vested in the members of the company, and that managerial rights are determined in proportion to the members' contribution of capital.<sup>71</sup> Implicit in this framework is the notion that a member's ability to exercise managerial input for the LLC depends significantly on the amount of capital invested in the enterprise, much like in the corporate setting. The Colorado statute explicitly states that the right to vote is divided on a per capita basis.<sup>72</sup> The Texas statute allows for the formulation of voting rights in any manner consistent with the regulations.<sup>73</sup> Only the Kansas statute states that each member of the LLC has only one vote.<sup>74</sup>

Third, the LLC statutes allow all members to transfer or assign their interests in the LLC. The statutes limit the free transferability of such interests, however, by requiring either a unanimous written consent of all members,<sup>75</sup> a unanimous consent with no writing

69. KAN. STAT. ANN. § 17-7615 (Supp. 1991); TEX. REV. CIV. STAT. ANN. art. 1528n, 5.03 (Vernon Supp. 1992); UTAH CODE ANN. § 48-2b-130 (Supp. 1991); VA. CODE ANN. § 13.1-1029 (Michie Supp. 1991). The Nevada and Colorado statutes specifically define membership interest as "a member's share of the profits and losses of a limited liability company and the right to receive distributions of [the] company's assets." COL. REV. STAT. ANN. § 7-80-102(10) (West Supp. 1991); NEVADA REV. STAT. § 86.091 (1991).

70. FLA. STAT. ANN. §§ 608.426, 608.427(3) (West Supp. 1992); WYO. STAT. §§ 17-15-119, 17-15-120(c) (1977).

71. FLA. STAT. ANN. § 608.422 (West Supp. 1992); NEVADA REV. STAT. § 86-3.291 (1991); UTAH CODE ANN. § 48-2b-125(1) (Supp. 1991); VA. CODE ANN. § 13.1-1022(B) (Michie Supp. 1991); WYO. STAT. § 17-15-116 (1977).

72. COL. REV. STAT. ANN. § 7-80-706(1) (West Supp. 1991).

73. TEX. REV. CIV. STAT. ANN. art. 1568n, 4.02 (Vernon Supp. 1992).

74. KAN. STAT. ANN. § 17-7612 (Supp. 1991).

75. COL. REV. STAT. ANN. § 7-80-702(1) (West Supp. 1992); FLA. STAT. ANN. § 608.432 (West Supp. 1992); KAN. STAT. ANN. § 17-7618 (Supp. 1991); NEVADA REV. STAT. § 86.351(1) (1991); TEX. REV. CIV. STAT. art. 1528n, arts. 4.01(B)(1), 4.05(1)-(2) (Vernon Supp. 1992); WYO. STAT. § 17-15-122 (1977).

requirement,<sup>76</sup> or a majority consent<sup>77</sup> of all nontransferring members before allowing the assignee to participate as a member of the LLC. This limitation on the transferability of LLC interests should not present a block to defining such interests as securities, however, when analogized to the close corporation context.

In corporations composed of few shareholders, those who own the business frequently desire significant income from employment with or dividends declared by the entity.<sup>78</sup> The nature of the relationships between the various stockholders may give rise to heightened fiduciary duties, thereby likening a close corporation to an incorporated partnership.<sup>79</sup> The importance of *delectus personae* to the individual participants frequently results in the execution of stock transfer restrictions, including right of first refusal, first option, and buy-sell provisions.<sup>80</sup> Any such provision generally will be upheld if it is not perceived as an unreasonable restraint on alienation.<sup>81</sup> Similarly, stock transfer restrictions are authorized by close corporation statutes enacted by several states.<sup>82</sup> A number of these statutes adhere to the principle that stock issued by such entities is not freely transferable and only allow such transfer pursuant to specified exceptions.<sup>83</sup> Moreover, certain close corporation statutes allow shareholders to transfer their interests to third parties, but restrict the right of any such transferee to participate in the management or administration of the close corporation during the term of the shareholder agreement unless the shareholders agree otherwise.<sup>84</sup> Hence, even though limitations frequently exist on an investor's ability to

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76. VA. CODE ANN. §§ 13.1-1039, 13.1-1040(A) (Michie Supp. 1991).

77. UTAH CODE ANN. 48-2b-131(1) (Supp. 1991).

78. See F. HODGE O'NEAL AND ROBERT B. THOMPSON, O'NEAL'S CLOSE CORPORATIONS § 1.02 (3d ed. 1987).

79. See, e.g., *Wilkes v. Springside Nursing Home, Inc.*, 370 Mass. 842, 353 N.E.2d 657 (1976); *Matter of Kemp & Beatley, Inc.*, 64 N.Y.2d 63, 484 N.Y.J.2d 799, 473 N.E.2d 1173 (1984); *Exadaktilos v. Cinnaminson Realty Co.*, 167 N.J. Super. 141, 400 A.2d 554, *aff'd*, 173 N.J. Super. 559, 414 A.2d 994 (1979).

80. See ROBERT CHARLES CLARK, CORPORATE LAW § 18.2 (1986).

81. See, e.g., *Allen v. Biltmore Tissue Corp.*, 2 N.Y.2d 534, 161 N.Y.S.2d 418, 141 N.E.2d 812 (1957); LEWIS D. SOLOMON, DONALD E. SCHWARTZ, AND JEFFREY D. BAUMAN, CORPORATIONS: LAW AND POLICY 396 (2d ed. 1988) ("The general American rule has been that unreasonable restraints on the alienation of personal property are void.").

82. See, e.g., CAL. CORP. CODE § 418 (1990); DEL. GEN. CORP. L. § 342(a)(2) (1974); KAN. STAT. ANN. § 17-72022 (1988); MD. CLOSE CORP. L. §§ 4-401(a)(2), 4-503(b) (1985); NEV. REV. STAT. § 78A.050 (1991); N.J. REV. STAT. § 14A:7-12 (19 —); WISC. STAT. § 180.1805(3) (1992); WYO. STAT. § 17-17-111 (1989); discussion in O'NEAL & THOMPSON *supra* note 78, at § 7.07.

83. See authorities cited *supra* note 82.

84. See TEX. BUS. CORP. ACT ANN. arts. 12.32(A)(4) 12.36(B), 12.37(D) (Vernon Supp. 1992) (depending on the agreement, shareholders may modify the transferability restriction by majority vote of all outstanding shares, consent of all shareholders, or written consent of all shareholders). See also MD. CLOSE CORP. L. §§ 4-401(a)(1), (4), 4-504(a) (1985).

transfer stock in a closely-held corporation, these instruments generally come within the purview of the securities laws. Similarly, although the LLC structure places certain restrictions on transferability of interests, such restrictions normally should not bar LLC interests from satisfying this element.

Fourth, an individual's interest in the LLC is his or her personal property.<sup>85</sup> Such personal property may be pledged by the individual in order to obtain loans, financing, or to conduct further business transactions. Finally, LLC interests may increase in value by, for example, the applicable LLC earning profits and the reinvesting of such profits, resulting in the LLC's capital appreciation.<sup>86</sup>

In sum, an investor's interest in a LLC ordinarily possesses characteristics similar to those associated with stock. Accordingly, courts normally should apply the securities laws to the transaction in reliance on the foregoing five-factor analysis. It must be remembered, however, that the operating agreements or articles of organization allow the LLC members to adjust the statutory requirements to fit the specific needs of the enterprise. Thus, when evaluating LLC interests, one should look to such documents to help determine whether the five-factor analysis is satisfied.

### III. LLC INTERESTS UNDER THE DEFINITION OF A SECURITY

Both the 1933 and 1934 Acts provide definitions for the term "security."<sup>87</sup> The United States Supreme Court has consistently recog-

85. See COL. REV. STAT. ANN. §§ 7-80-702 (West Supp. 1991); FLA. STAT. ANN. §§ 608.431 (West Supp. 1992); KAN. STAT. ANN. §§ 17-7617 (Supp. 1991); NEVADA REV. STAT. §§ 86.351 (1991); TEX. REV. CIV. STAT. ANN. art. 1528n, 4.04 (Vernon Supp. 1992); UTAH CODE ANN. §§ 48-2b-103 (Supp. 1991); VA. CODE ANN. §§ 13.1-1038 (Michie Supp. 1991); WYO. STAT. §§ 17-15-122 (1977).

86. See COL. REV. STAT. ANN. § 7-80-104(g) (West Supp. 1991); FLA. STAT. ANN. § 608.404(6) (West Supp. 1992); KAN. STAT. ANN. § 17-7604(f) (Supp. 1991); NEVADA REV. STAT. 86.281(7) (1991); UTAH CODE ANN. § 48-2b-105(g) (Supp. 1991); VA. CODE ANN. § 12.1-1009(6) (Michie Supp. 1991); WYO. STAT. § 17-15-104(vii) (1977).

For lower court decisions analyzing the five-factor analysis, see, e.g., *Seger v. Federal Intermediate Credit Bank of Omaha*, 850 F.2d 468 (8th Cir. 1988) (applying criteria, lender's Class B "stock" did not have characteristics normally associated with such an instrument and, hence, was not a security); *One-O-One Enterprises, Inc. v. Caruso*, 848 F.2d 1283 (D.C. Cir. 1988) (option to purchase stock deemed a security relying on *Landreth*); *McVay v. Western Plains Service Corporation*, 823 F.2d 1395 (10th Cir. 1987) (interpreting *Forman* and *Landreth*, loan participation certificates held not to be "stock" within scope of the securities laws because such certificates "lack[ed] any of the basic attributes of true stock").

87. Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C. § 78c(a)(10) (1988); Securities Act of 1933, § 2(1), 15 U.S.C. § 77b(1) (1988).



nized the parallel characteristics of the two definitions and analyzed them as similar in their opinions.<sup>88</sup> Instead of providing a broad definition or explanation of the term “security,” both statutes list various interests, such as notes, stocks, bonds, and investment contracts, among numerous other categories, as securities. The definition of a security is not limited to the laundry list provided in the statutes. In addition, “any interest or instrument commonly known as a security” falls within the purview of the security definition.<sup>89</sup>

In *United Housing Foundation, Inc. v. Forman*,<sup>90</sup> as well as subsequent decisions,<sup>91</sup> the Supreme Court recognized that an investor’s perception of his or her interest provides some guidance as to whether the particular instrument falls within the statutory definition.<sup>92</sup> In this regard, the *Forman* Court realized that the name attached to the instrument has some relevance to whether such instrument is deemed a security, if it induced the investor to engage in the purchase.<sup>93</sup> While the Court focused on the terms stocks and bonds as traditional names identified with a security, it also acknowledged that if an instrument contains significant characteristics typically associated with a security, this can also support the view that the interest is commonly known as a security.<sup>94</sup> Applied to the LLC context, an investor’s justifiable perception when purchasing equity interests in an enterprise called a “company” is that such interests are covered by the securities laws. This common understanding, especially when combined with the realization that LLC interests possess characteristics which are typically associated with stock, should result in classifying this instrument as a security.

The Supreme Court’s “family resemblance” test enunciated in

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88. See, e.g., *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 847 n.12 (1975) (“The definition[s] [are] virtually identical and for present purposes, the coverage of the two Acts may be considered the same.”); *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967).

89. Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C. § 78c(a)(10) (1988); Securities Act of 1933, § 2(1), 15 U.S.C. § 77b(1) (1988). Note that the definition of security is prefaced by the language “unless the content otherwise requires.” The United States Supreme Court addressed this phrase in *Marine Bank v. Weaver*, 455 U.S. 551 (1982), discussed in Steinberg & Kaulbach, *supra* note 56, at 498-519.

In *SEC v. C.M. Joiner Leasing Corp*, 320 U.S. 344 (1943), the United States Supreme Court supported a liberal construction of the “security” definition, stating “uncommon . . . devices . . . are also reached if it be proved as a matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as . . . ‘any interest or instrument commonly known as a ‘security.’” *Id.* at 351.

90. 421 U.S. 837 (1975).

91. *Gould v. Rufenacht*, 471 U.S. 701 (1985); *Lamberth Timber Company v. Landreth*, 471 U.S. 681 (1985).

92. See *Landreth*, 471 U.S. at 693; *Forman*, 421 U.S. at 848-50.

93. 421 U.S. at 848-50.

94. *Id.* at 851.

*Reves v. Ernest & Young*<sup>95</sup> provides guidance in this area. In *Reves*, the Court analyzed whether a note constitutes a security by listing four factors that comprise the family resemblance test.<sup>96</sup> Significantly, the *Reves* Court opined that these four factors are the ones that it has looked to "in deciding whether a transaction involves a 'security'."<sup>97</sup> Hence, the family resemblance test apparently has widespread application, encompassing the determination whether LLC interests are securities.<sup>98</sup>

Applying the family resemblance test, one first examines the motivations that would prompt a reasonable buyer and seller to engage in the transaction. If the seller is interested in raising funds for the general use of the business or to finance expansion and the purchaser is primarily interested in the profits expected to be generated, it is likely that such instruments are securities.<sup>99</sup> Ordinarily, these motivations exist in the LLC context.<sup>100</sup>

Second, one must assess the plan of distribution to determine whether the instruments may be commonly traded. So long as the LLC interests are capable of mass distribution or public trading, this factor should be deemed satisfied, even if there were in fact few offerees or purchasers.<sup>101</sup> This interpretation of *Reves* comports with the Court's prior statements on this issue.<sup>102</sup> The third factor analyzes the reasonable expectations of the investing public. According to *Reves*, "[t]he Court will consider instruments to be 'securities' on the basis of such public expectations, even where an economic analysis of the circumstances of the particular transaction might suggest

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95. 110 S. Ct. 945 (1990).

96. *Id.* at 951-52.

97. *Id.* at 951.

98. See Marc I. Steinberg, *Notes as Securities: Reves and Its Implications*, 51 OHIO ST. L.J. 675, 679 (1990) ("[I]f any applicable standard has widespread application in the definition of 'security' setting, it is the 'family resemblance' test.").

99. See 110 S. Ct. at 951-52.

100. From the investor's point of view, such a result is due to the prospect of capital appreciation, participation in earnings, and tax benefits.

101. See *supra* notes 53-56 and accompanying text.

102. Hence, the Court's language in *Reves* that there be common trading so that the instruments are "offered and sold to a broad segment of the public" (110 S. Ct. at 952) should be read in light of the Court's previous decisions. See, e.g., *Landreth*, 471 U.S. at 687, 693 (1985) (stock of closely held corporation not traded on any exchange held to be a "security"); *Tcherepnin v. Knight*, 389 U.S. 332, 337 (1967) (nonnegotiable but transferable "withdrawable capital shares" in savings and loan association held to be a "security"); *Howey*, 328 U.S. 293, 295 (1946) (units of citrus grove and maintenance contract held to be "securities" although not traded on exchange). Even though the Court did not refer to the "capability" of mass distribution, the cases relied on by the Court support this proposition.

that the instruments are not 'securities' as used in that transaction."<sup>103</sup> As discussed above, both sophisticated and uninitiated investors may justifiably view the term "company" when purchasing LLC interests as giving rise to securities law coverage.<sup>104</sup>

The last factor of the family resemblance text is whether there exists another regulatory framework that significantly lessens the investment's risk, thereby rendering application of the securities laws unnecessary.<sup>105</sup> Other than the federal and state securities laws,<sup>106</sup> there is no regulatory framework that greatly reduces such risk. This is especially relevant since the LLC is a new and relatively uninterpreted business structure, which needs sufficient safeguards in order to encourage investors to utilize this form. Hence, given that LLC interests generally satisfy the family resemblance test and are justifiably perceived as securities, these interests should be deemed to be within the purview of the securities laws.<sup>107</sup>

#### IV. CONCLUSION

While each LLC interest must be analyzed by looking at the applicable statutes as well as the specific provisions contained in the member agreement and other operating documents, this article takes the position that LLC interests normally are securities. Three different methods of analysis lead to this result. First, one may look at the traditional "investment contract" test and find that LLC interests satisfy the *Howey* test, especially in light of the *Williamson* rationale. Second, LLC interests meet the attributes of stock test as set forth by the Supreme Court. Finally, one can classify an interest in a LLC as "any interest commonly known as a security."

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103. 110 S. Ct. at 952.

104. See *supra* notes 63-68 and accompanying text.

105. 110 S. Ct. at 952. Although subject to criticism, the functional regulation factor set forth in *Reves* is consistent with the *Marine Bank* analysis. See *Marine Bank*, 455 U.S. at 559; *Daniel*, 439 U.S. at 569-70 (dicta). For criticism of the functional regulation analysis, see Steinberg & Kaulbach, *supra* note 56, at 504-18.

106. Of course, the state blue sky statutes and actions for common law fraud are designed to supplement, not usurp, the federal securities laws.

107. See Steinberg, *supra* note 98, at 678-81. For additional commentary on *Reves* and its implications, see James D. Gordon III, *Interplanetary Intelligence About Promissory Notes as Securities*, 69 TEX. L. REV. 383 (1990); Janet E. Kerr and Karen M. Eisenhauer, *Reves Revisited*, 19 PEPP. L. REV. 1123 (1992).