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Recommended Citation
Carol R. Goforth, Why Limited Liability Company Membership Interests Should Not be Treated as Securities and Possible Steps to Encourage this Result, 45 Hastings L.J. 1223 (1994).
Available at: https://repository.uchastings.edu/hastings_law_journal/vol45/iss5/2

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Why Limited Liability Company Membership Interests Should Not be Treated as Securities and Possible Steps to Encourage this Result

by

CAROL R. GOFORTH*

The limited liability company (LLC) is a new form of business entity in this country. An LLC is an entity that takes many of the most desirable attributes of the partnership and combines them with the most desirable features of the corporation. Like a partnership, the LLC has extreme organizational flexibility and tax benefits, such as the ability to make special allocations of income and loss and the lack of taxation at the entity level.¹ Like a corporation, the LLC features limited personal liability for all owners.²

Another way of looking at LLCs, which explains why they have gained such ready acceptance, is to compare the LLC with other business alternatives. The primary advantage that LLCs offer over partnerships is limited liability. Even limited partnerships cannot, by their very nature, offer limited liability to all equity participants.³ The most significant advantages LLCs have over C Corporations is that the LLC permits owners to avoid the double taxation currently burdening

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² The LLC has been summarized as a “non-corporate [form of] business that provides its members with limited liability and allows the members to participate actively in the entity’s management.” Robert R. Keatinge et al., The Limited Liability Company: A Study of the Emerging Entity, 47 Bus. Law. 375, 384, 387 (1992) (footnote omitted).

³ UNIF. LTD. PARTNERSHIP ACT § 9, 6 U.L.A. 586-87 (1916); REV. UNIF. LTD. PARTNERSHIP ACT § 403(b), 6 U.L.A. 465 (Supp. 1994).

[1223]
the corporate form, while simultaneously avoiding the often cumbersome corporate management structure dictated by statute.5

Even S Corporations cannot offer all the advantages of LLCs. For instance, shareholders in S Corporations are generally required to cede management authority to directors and to adhere to corporate formalities. In addition, the subchapter S rules of the Internal Revenue Code are highly restrictive, limiting the number and kind of shareholders, and essentially prohibiting special allocations among shareholders by limiting S Corporations to one class of stock.6

On the other hand, LLCs are not without drawbacks. While there are currently numerous potential disadvantages to LLCs, none is more troubling than the tremendous uncertainty surrounding this entity. Much of the uncertainty stems from the fact that not all jurisdictions have passed legislation recognizing LLCs as separate legal entities.7 Even in jurisdictions that have enabling legislation, the lack of

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5. "A corporation must be organized and managed by natural persons. Their qualifications, functions and procedures are often prescribed by a hierarchy of constitutions, statutes and administrative rules and regulations . . . ." HARRY G. HENN, HANDBOOK OF THE LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES § 180, at 343 (2d ed. 1970). Henn's description of corporate management extends for more than 150 pages of his one-volume treatise. Id. at 341-504.

6. S Corporations are governed by subchapter S of the Internal Revenue Code. I.R.C. §§ 1361-1379 (West 1989). Section 1361 restricts the availability of the beneficial subchapter S provisions. For example, subsection (b) provides an S corporation may have: only one class of stock, no more than 35 shareholders, and only individuals as shareholders. In addition, an S Corporation may not have a non-resident alien as a shareholder and may not be a member of an affiliated group. I.R.C. § 1361(b).

7. This particular problem may soon disappear. As of the end of 1993, only a handful of American states had failed to enact LLC legislation. The following information about introduction and enactment of LLC legislation was obtained from the BILLTRK database on WESTLAW. According to the bill tracking service on WESTLAW, the following states introduced LLC legislation in 1993 (citations are in WESTLAW search format): 1993 CA S.B. 469 (introduced Feb. 25, 1993); 1993 HI H.B. 863 (introduced Jan. 22, 1993); 1993 ME H.P. 1123 (introduced May 17, 1993); 1993 NY S.B. 27 (introduced Jan. 6, 1993); 1993 OH S.B. 74 (introduced Mar. 11, 1993); 1993 PA H.B. 1719 (introduced May 28, 1993); 1993 SC H.B. 4283 (introduced June 3, 1993); 1993 TN H.B. 952 (introduced Feb. 15, 1993); 1993 WA H.B. 1235 (introduced Jan. 20, 1993).

case law and legal commentary in the area gives rise to a number of troubling issues. Moreover, the inconsistencies among various LLC statutes also create many potential problems.

The first statute authorizing domestic LLCs was passed in Wyoming in 1977. Florida adopted similar legislation in 1982, but there were no further legislative developments until after 1988, when the Internal Revenue Service concluded that an LLC organized under the Wyoming statute was taxable as a partnership. The IRS ruling resulted in a trickle of new legislation that turned into a virtual flood of statutes authorizing the new form of business entity by the middle of 1993.

In fact, by July 1, 1994, a number of these states had enacted LLC legislation. The Mississippi LLC Act was signed into law by the Governor on March 15, 1994; LLC legislation was signed by the Governors of Ohio and Washington on April 1, 1994; the Kentucky LLC Act was signed by the Governor on April 11, 1994; the Governor of Maine signed LLC legislation on April 20; the Tennessee Governor did so on April 26; on June 8, 1994, the Governor of Alaska signed into law the Alaska LLC Act; and the Governor of South Carolina signed South Carolina LLC legislation on June 16, 1994.


10. As of February 22, 1988 there were only 26 Wyoming LLCs. 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, 531 (1988). Since the Wyoming statute had been in existence for more than a decade at that time, it is clear that the popularity of LLCs was quite limited until the IRS determined that they could be classified as partnerships.

11. Rev. Rul. 88-76, 1988-2 C.B. 360. This revenue ruling was issued only after a lengthy period of confusion about how the IRS would regard LLCs. The IRS had issued a private letter ruling in 1980 which concluded that a particular Wyoming LLC would be treated as a partnership for tax purposes, Priv. Ltr. Rul. 81-06-082 (Nov. 18, 1980), but had also issued a private letter ruling in 1982 finding that another Wyoming LLC would be taxed as a corporation, Priv. Ltr. Rul. 83-04-138 (Oct. 29, 1982).

In 1980 a proposed amendment to the partnership tax regulations was issued that would have provided that no organization offering the characteristic of limited liability to all of its members could qualify for tax treatment as a corporation. 45 Fed. Reg. 75,709 (1980) (to be codified at 26 C.F.R. pt. 301) (proposed Nov. 17, 1980). This amendment was withdrawn in 1983. 48 Fed. Reg. 14,389 (1983).

After this sequence of events, the IRS began a study project to determine how LLCs should be classified for tax purposes, focusing on how the limited liability attribute of this entity should affect the outcome. See Announcement 83-4, 1983-2 I.R.B. 30. In 1988 this study concluded that the limited liability aspect of LLCs should not, by itself, prevent an LLC from being classified as a partnership for tax purposes. See Turlington & Small, Tax Aspects of Limited Liability Companies (PLI Corp. Law & Practice Course Handbook Series, 805 PLI/Corp. 103 (Feb. 1, 1993)). The Wyoming Revenue Ruling discussed in the text was released after completion of this study project.
In 1990 both Colorado and Kansas enacted LLC legislation;\textsuperscript{12} Nevada, Texas, Utah, and Virginia followed suit in 1991.\textsuperscript{13} In 1992 Arizona, Delaware, Illinois, Iowa, Louisiana, Maryland, Minnesota, Oklahoma, Rhode Island, and West Virginia all passed statutes authorizing LLCs,\textsuperscript{14} and 18 states enacted LLC legislation in 1993.\textsuperscript{15} By March of 1994 every other American state was considering legislation authorizing LLCs. By July 1, 1994, eight more states had enacted statutes, leaving only a handful of states that do not have some form of LLC legislation enacted.\textsuperscript{16}

One of many open issues is the extent to which federal securities laws will apply to membership interests in LLCs. At the time this Article was written, there were two views on the proper classification

\textsuperscript{12} COLO. REV. STAT. ANN. §§ 7-80-101 to -913 (West Supp. 1993); KAN. STAT. ANN. §§ 17-7601 to -7651 (Supp. 1993).


\textsuperscript{16} \textit{See supra} note 7. As of July 1, 1994, the only states lacking LLC legislation were California, Hawaii, Massachusetts, Pennsylvania, New York, and Vermont.
of LLC membership interests for purposes of the federal securities laws. One of those views is that most LLC membership interests probably are not securities under either the federal or state law definition; the other view is that most LLC membership interests probably are securities. No commentator has analyzed in much detail whether LLC membership interests should be regulated as securities or, once that question is answered, suggested steps that might be taken to encourage courts to reach the better conclusion. This Article addresses the issues of whether the federal securities laws are likely to apply to LLC membership interests under existing legal doctrines; whether those laws ought to apply; and what steps can be taken to lead courts to reach the best result.

The first Section of the Article discusses the nature of the LLC and membership interests therein. The range of options available under state statutes with regard to the organization and operation of LLCs is analyzed, along with the practical requirements imposed by the necessity of creating an association that is recognized as a partnership for federal tax purposes. Because there are now so many articles that fill this descriptive function, this Section provides no more than an overview of the LLC as a new form of business entity.

The second Section of the Article is predictive. It examines the method by which courts will likely approach the question of whether, and under what circumstances, LLC membership interests will be treated as securities. A variety of possible approaches to the issue are discussed, including approaches suggested by other commentators in the area. Because this Article concludes that the most likely approach is for courts to analyze whether LLC membership interests qualify as investment contracts, a significant portion of this Section is devoted to

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18. Sargent, supra note 17, at 1102-03.
19. Steinberg & Conway, supra note 17, at 1122.
that analysis. This Section of the Article ultimately concludes that although most LLC membership interests should not be classified as securities under the existing rules, there is sufficient variation in the LLC form that some membership interests should be classified as securities under current jurisprudence.

The third Section of the Article is normative, dealing with the question of whether federal securities laws ought to apply to LLC membership interests. It includes a review of the purposes behind the federal securities laws and the consequences that follow the characterization of LLC membership interests as securities. This Section concludes that membership interests in LLCs should generally not be characterized as securities because the purposes of the federal securities laws will not be substantially advanced by such a characterization. Moreover, the costs of regulation as securities are likely to outweigh the benefits.

The final Section of the Article suggests measures that might encourage courts to conclude that most LLC membership interests are not securities. This Section includes suggested statutory provisions that will likely result in LLC membership interests that will not be classified as securities. Since state LLC statutes are so new, no model legislation has yet been promulgated in this area. However, there are two versions of model legislation in the drafting stage.\textsuperscript{21} Given the new and unsettled status of LLC legislation, it is not surprising that many states are undertaking review and amendment of their LLC statutes. This analysis is designed to offer some guidance to legislatures in amending LLC statutory provisions or in adopting such legislation for the few remaining states that may pass LLC statutes in the

\textsuperscript{21} Groups working under the auspices of both the National Conference of Commissioners on Uniform State Laws and the American Bar Association started work on model LLC legislation. The ABA's project was conducted under the auspices of a Working Group on the Prototype Limited Liability Company Act, Subcommittee on Limited Liability Companies, Committee on Partnerships and Unincorporated Business Organizations, Section of Business Law, a group that was never formally approved by the ABA or any of its standing sections or committees. It circulated a Draft Prototype LLC Act for comment in 1992. DRAFT PROTOTYPE LLC ACT (1992). This project has apparently been abandoned in favor of the work being conducted by the other group.

The National Conference group first circulated a discussion draft of a proposed Uniform LLC Act in 1993. Draft for Discussion Only, NCCUSL, UNIF. LLC ACT (1993 Draft). After undergoing substantial revisions, a draft was prepared for final submission to the National Conference of Commissioners of Uniform State Laws for consideration at their summer 1994 meeting. Draft for Approval, NCCUSL, UNIF. LLC ACT (1994 Draft). Because the draft for approval was finished after this Article was substantially complete, internal references to the draft Uniform LLC Act are to the earlier discussion draft and not the final draft for approval.
future. The last half of this Section makes suggestions about organizing LLCs under the various statutory regimes to increase the likelihood that courts will decline to apply the federal securities laws to particular LLC membership interests. Even if state legislatures do not adopt provisions to make it less likely that federal securities legislation will apply to LLC membership interests, planners in most jurisdictions have a wide range of options in drafting organizational and operating documents for LLCs. Therefore, the thrust of this Section is to provide persons wishing to avoid application of the securities laws with guidance in drafting organizational and operating documents for the LLC that make this result more likely.

I. What Are LLC Membership Interests?

The LLC is a statutorily created business form. As described briefly in the introduction, it is a business form that blends the most desirable attributes of partnerships and corporations. Like a partnership,22 it is extremely flexible and, if properly formed,23 avoids taxation at the entity level. As with a corporation, the owners are shielded from liability for debts created by the entity.24 Unlike the limited

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22. This statement is true only if the LLC is formed so as to qualify as a partnership for federal tax purposes. See infra notes 36-60 and accompanying text.


The other type of LLC statute, which has been selected by most of the states with LLC legislation, is flexible, allowing drafters to choose between characteristics. The result is that it is possible to form an LLC that will be classified as an association taxable as a corporation for federal tax purposes rather than as a partnership. See infra at notes 36-60 and accompanying text.

Because the tax benefits of classification as a partnership are likely to be a significant factor in choosing the LLC as a choice of business entity, it is presumed that most LLCs will be formed with the expectation of being classified as a partnership for federal tax purposes.

partnership, which also combines certain partnership and corporate attributes, there is no requirement that at least one owner be subjected to unlimited personal liability; nor is there any prohibition on members with limited liability participating in control.\textsuperscript{25} Unlike the S corporation—another hybrid of partnership and corporations—there are no limitations on who can invest in an LLC, and it is possible to achieve tax recognition of special allocations.\textsuperscript{26}

Aside from the benefits of avoiding double taxation while providing limited liability for investors, the biggest attraction of the LLC as a business form is the extreme flexibility offered by most state statutes.\textsuperscript{27} This treatment contrasts starkly with the detailed statutory re-

\textsuperscript{25} As is the case with limited partnerships. UNIF. LTD. PARTNERSHIP ACT § 9, 6 U.L.A. 586-87 (1969); REV. UNIF. LTD. PARTNERSHIP ACT § 403(b), 6 U.L.A. 465 (Supp. 1994).

\textsuperscript{26} I.R.C. § 1361 (West 1989).


A few states provide for manager-management as the default rule, but permit an LLC to elect member-management if that is desired. MINN. STAT. ANN. § 322B.606.1 (West Supp. 1994); OKLA. STAT. ANN. tit. 18, § 213 (West Supp. 1994); TEX. REV. CIV. STAT. ANN. art. 1528n, § 2.12 (West Supp. 1994). The effect of New Hampshire’s statute is unclear, since it provides that if managers are not specifically designated, management rights shall be vested in a member. N.H. REV. STAT. ANN. § 304-C:31(II) (Supp. 1993). It is not
requirements dealing with the lines of demarcation between shareholder and director authority in the corporate setting. The LLC is not prohibited from adopting an organizational structure that delegates management authority to others, who might then serve much as directors do in American corporations. However, this structure is certainly not required by most state statutes.

There are, of course, some basic characteristics common to all or most LLCs. All LLCs are formed upon the filing of an organizational document, most often called articles of organization. The owners are referred to as members, rather than shareholders or partners.


all but two jurisdictions, there must be at least two members in order to operate an LLC.\(^{32}\) The internal affairs of the LLC are managed in accordance with either the statutory default rules or with an operating agreement or internal regulations agreed upon by the members.\(^{33}\) Owners can contribute cash, property, and, in most cases, services to

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\(^{33}\) Some states also permit one person to form an LLC, but there must be two or more members after formation. See, e.g., Va. Code Ann. §§ 13.1-1010, 13.1-1002 (Michie 1993).

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the LLC in return for their membership interests.34 Absent agreement to the contrary, the owners have no personal liability for debts incurred by the LLC.35 Virtually all other attributes of LLCs vary depending on either the statute under which they are organized or the agreement between the members.

Given the flexibility of the LLC as a form of business entity, one may wonder whether it is possible to discuss LLCs generally or whether one must focus on the particular characteristics of a given LLC. In fact, while many state statutes do not place any substantial restrictions on LLC organization or management, there are limitations imposed by virtue of the fact that the LLC is a tax-driven entity.

If the Internal Revenue Service was unwilling to classify LLCs as partnerships for federal tax purposes, this discussion would be academic. In fact, until the IRS issued a revenue ruling in 1988 recognizing that Wyoming LLCs were taxable as partnerships,36 LLCs were

While some statutes affirmatively require the adoption of an operating agreement, in many jurisdictions the LLC statutes provide or imply that an operating agreement is not necessary if the parties wish to be bound by the statutory default rules.


35. See statutes cited supra note 24.

virtually unheard of in this country. The popularity of the LLC skyrocketed following this landmark revenue ruling. If the IRS ever revises its position so that LLCs are no longer eligible for this tax characterization, their popularity is likely to disappear, or at least substantially diminish.

This fact provides a meaningful limitation on the way in which LLCs are organized and operated because the IRS has declined to make partnership tax status automatic for LLCs. As with other unincorporated associations, the IRS applies a multi-factored analysis in determining whether partnership or corporate tax rules should apply.

The current Treasury regulations tax an unincorporated association as a corporation if the entity has more corporate characteristics than partnership characteristics. The six characteristics indicative of a corporation are: (1) an association of persons; (2) with the purpose of carrying on a business and dividing the gains; (3) having continuity of life; (4) centralization of management; (5) limited liability; and (6) free transferability of interests. Since the first two characteristics are also present in partnerships, they are generally not helpful in determining whether a particular association should be taxed as one or the

37. See supra notes 8-16 and accompanying text.
39. It is, of course, by no means certain that the IRS will revise its current position. At least one commentator has suggested that any such action would be politically unacceptable at this time. Kalinka, supra note 1, at 1146. However, commentators and the courts have criticized the current rules, providing some basis for believing that a change is at least conceivable. For a listing of some of the more recent criticism, see Kalinka, supra note 1, at 1145-46 n.328.
40. This is not at all surprising since the IRS has also declined to make partnership status automatic for associations organized as partnerships.
41. Treas. Reg. § 301.7701-2(a) (as amended in 1993). The mechanical approach of giving all characteristics equal weight and simply adding up the totals was adopted by the Tax Court in Larson v. Commissioner, 66 T.C. 159 (1976), acq. 1979-1 C.B. 1.

When an LLC splits the last four characteristics evenly, it will be treated as a partnership for tax purposes. See Rev. Rul. 93-5, 1993-1 C.B. 227 (Virginia LLC having centralized management and limited liability, but lacking continuity of life and free transferability is a partnership for tax purposes); Rev. Rul. 93-6, 1993-1 C.B. 229 (same for Colorado LLC); Rev. Rul. 93-30, 1993-1 C.B. 231 (same for Nevada LLC).
other. As a result, the four remaining characteristics are typically dispositive.

The objective of any entity seeking partnership status for tax purposes is to possess no more than two of the four dispositive characteristics. For an LLC, of course, the objective is even more restrictive. One of the four dispositive characteristics is limited liability. Although it is conceivable under some of the LLC statutes that an LLC could be formed that does not provide its members with limited liability, the chances of this being the case are remote. Thus, because an LLC will possess the "corporate" characteristic of limited liability, it must have no more than one of the three remaining characteristics. This means that in order to retain the tax benefits offered by the LLC choice of entity, planners must organize the LLC so that it does not have more than one of the following characteristics: (1) continuity of life; (2) centralization of management; and (3) free transferability of interests.

The characteristic of continuity of life exists when the entity continues to exist after the death, retirement, resignation, incapacity, bankruptcy, or insolvency of one or more of its members. Corporations possess this characteristic because they continue to exist until formally dissolved, regardless of what happens to any of the shareholders. Partnerships generally lack this characteristic, since the partners' status determines the continued existence of the partnership.

Unfortunately, there is no one statement about continuity of life that will adequately address all LLCs. Some state statutes are worded such that LLCs formed in those jurisdictions will probably lack continuity of life. These statutes generally require that the LLC dissolve upon withdrawal of any member, whether by death, retirement, resignation, incapacitation, bankruptcy, or insolvency. Because such stat-
utes correspond so closely to partnership statutes in requiring dissolution in the event of withdrawal by any member, LLCs formed in accordance with such provisions will generally lack the characteristic of continuity of life.

Other state statutes permit members to agree in advance in the organizational documents that the LLC will continue in existence regardless of the status of individual members. 48 LLCs formed in these jurisdictions will probably possess the characteristic of continuity of life if the members elect in advance to have the LLC continue in existence. Conversely, if the members do not elect in advance to continue the LLC after an event of withdrawal, the LLC will probably lack the characteristic of continuity of life. In these jurisdictions, therefore, the only way to tell if an LLC has this corporate characteristic is to conduct a case-by-case analysis.

Centralization of management—also clearly present in the case of corporations and absent in the case of partnerships—may or may not be present in LLCs. Centralization of management requires “concentration of continuing exclusive authority” to manage the entity without the approval of other members. 49 The powers and authority of a corporate board of directors satisfy this requirement, while a general partnership typically lacks this characteristic since each partner has the power to bind the partnership. 50 Even if the general partners delegate their authority to a managing partner or committee, they still


50. Treas. Reg. § 301.7701-2(c)(4) (as amended in 1993). In addition, limited partnerships typically lack this characteristic as long as the general partner owns a "meaningful proprietary interest" in the partnership. Larson, 66 T.C. at 177 (citing Zuckerman v. United States, 524 F.2d 729 (Cl. Ct. 1975)). If the limited partners own more than 94.3% of the total interest in the partnership, they own substantially all of the partnership interest and the corporate characteristic of centralized management will be present. Treas. Reg. § 301.7701-3(b)(2) (example (1)) (as amended in 1993). Moreover, if the limited partners' interests exceed 80% of the total partnership interests, the IRS will not issue a ruling that a limited partnership lacks the characteristic of centralized management. Rev. Proc. 89-12, 1989-1 C.B. 798.

There is one other requirement that limited partnerships must meet in order to avoid possessing the characteristic of centralized management: the limited partners must not have an unrestricted right to remove the general partner. See, e.g., Zuckerman, 524 F.2d at 737-39; Larson, 66 T.C. at 176-79. Apparently, the theory is that if the limited partners have an unrestricted right to remove the general partner, the general partner is under their control and, therefore, acting as a central manager.
have apparent authority to bind the partnership, which is enough to avoid the characteristic of centralized management.51

Most LLC statutes provide that members will manage the LLC unless they agree otherwise.52 At least one, however, provides that managers must control the LLC.53 The Minnesota, Oklahoma, and Texas statutes take an intermediate position, specifying that LLCs must be managed by managers unless the members agree otherwise.54 To the extent that the relevant statute provides that members may manage the LLC—subject to their right to delegate that authority to one or more managers—a strong analogy can be drawn between LLCs and partnerships. LLCs that provide members with apparent authority to bind the enterprise also look very much like partnerships, even if actual authority is delegated to selected managers.

The Uniform Partnership Act contemplates a wide degree of flexibility in management options. The partners can either exercise control themselves or delegate their authority to others. This does not change the fact that it is the partners who have the ultimate control.55 The same analysis can be applied to members in LLCs. As long as the statutes give them the initial authority, the fact that they might choose

52. See statutes cited supra note 27.
53. One state mandates the manager-management model. This is the only state that unequivocally mandates one management model in preference to others. COLO. REV. STAT. ANN. § 7-80-401 (West Supp. 1993). The North Dakota statute can also be interpreted as mandating the election of a board of governors, but since the statute also says that if the members desire to act by unanimous consent or vote, they do not need to have governors, this is not entirely certain. N.D. CENT. CODE § 10-32-69.1 (1994).
54. MINN. STAT. ANN. § 322B.606 (West Supp. 1994) (management authority is vested in a board of governors, unless the members agree to take the authority for themselves); OKLA. STAT. ANN. tit. 18, §§ 2014-2015 (West Supp. 1994); TEX. REV. CIV. STAT. ANN. art. 1528n, § 2.12 (West Supp. 1994).

Under this analysis, not even delegation of authority by general partners to a managing partner or committee will change the result. See, e.g., Sloan, 394 F. Supp. at 1314 ("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.” (citation omitted)).
to delegate it might not be enough to change the fact that they have
the ultimate control. The critical issue is whether, and to what extent,
delegation of authority to managers divests each member of apparent
authority.\textsuperscript{56}

The preceding discussion should suffice to indicate that an LLC
can have a wide range of management alternatives and at least pre-
serve the argument that it does not possess centralized management.
This characteristic, while important for a number of reasons,\textsuperscript{57}
does not do much towards assuring uniformity.

The final corporate characteristic, free transferability of interests,
can also pose problems for LLCs desiring to be characterized as part-
nerships for tax purposes. Free transferability of interests requires
that substantially all owners have the power to transfer all attributes
of ownership, including the right to participate in management, with-
out obtaining consent from any other owner.\textsuperscript{58} Corporations possess
this characteristic because state corporate statutes expressly allow
stockholders to convey all of their interest in corporate stock, unless
the shareholders have imposed advance restrictions on its transferabil-
ity. On the other hand, partnership statutes provide that an attempted
conveyance of a partnership interest results in no more than an assign-
ment of the right to receive distributions, unless all other partners
consent to the assignee becoming a substitute partner.

In the case of LLCs, the state statutes vary widely. Several state
statutes provide that a transferee of an LLC membership interest ac-
quires no rights to participate in the management of the LLC unless
and until all other members consent.\textsuperscript{59} Other statutes require less
than unanimous approval of transfers or permit the members to agree
to reduce the restrictions on transferability in the operating docu-
ments.\textsuperscript{60} The majority rule appears to require unanimous approval for

\begin{footnotes}
\item[56.] For an extended discussion of this issue, see \textit{infra} notes 149-166 and accompanying
text.
\item[57.] \textit{See supra} notes 36-45 and accompanying text.
\item[58.] Treas. Reg. § 301.7701-2(e)(1)(as amended in 1993). Free transferability will not
exist if the member has the right to transfer only the right to participate in distributions
\end{footnotes}
the admission of new members unless the operating documents of the LLC provide differently.

To retain the desirable classification as a partnership for tax purposes, an LLC must possess certain specified characteristics regardless of the flexibility in the state legislation. Unfortunately, the limitations imposed by IRS regulations are not sufficient to support any single, comprehensive description of all LLCs.

The fact that LLCs will vary between jurisdictions, and between LLCs within the same jurisdiction, must be recognized and accepted. This Article does not attempt to treat all LLCs as being equivalent. Thus, a range of options as to each significant attribute of LLCs is examined.

II. What Analysis Will Courts Likely Employ to Determine if LLC Membership Interests Are Securities?

The two principal pieces of federal securities legislation—the Securities Act of 1933 (the '33 Act) and the Securities Exchange Act of 1934 (the '34 Act)—both contain lengthy definitions of the word “security.”61 The statutory definition of security is the obvious starting point.


One statute adopts the default rule requiring unanimous acceptance of a new member, but also provides that the parties cannot agree to new members by less than a majority vote. UTAH CODE ANN. § 48-26-122 (1994). One statute requires only a majority vote of remaining members, and even this is permissive. Connecticut Limited Liability Company Act, 1993 Conn. Pub. Acts 93-267, § 38(a).

61. The '33 Act contains the following definition of “security,” which follows the phrase, “unless the context otherwise requires”:

The term 'security' means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any inter-
point for an analysis of whether LLC membership interests will be classified as securities.

Both Acts contain lists of specific interests that are "securities," but neither purports to include a substantive definition applicable to all such interests. Some of the listed interests have relatively well-defined contours; others are relatively elastic and appear designed to cover a broad spectrum of interests. Not surprisingly, LLC membership interests, having been authorized for the first time in this country more than four decades after Congress crafted the statutory definition of "security" in the '33 and '34 Acts, are not included in the list of interests covered by the legislation. There are, however, a number of possible approaches that may be applied when examining the question of how to classify LLC interests under the securities laws.

A. The Landreth Test—Ordinary Attributes of Stock

One possible approach, which has been urged by one commentator, is for the courts to equate LLC membership interests with stock. In Landreth Timber Co. v. Landreth, the Supreme Court considered the circumstances under which a stock instrument would be treated as a security under the federal securities laws. The Court determined that an instrument bearing the "stock" label should be classified as a security whenever it has the following ordinary attributes of stock: (1)
the right to receive profits based on the proportion of the owner’s interest in the entity; (2) the ability to vote in proportion to the interest owned; (3) negotiability of the interest; (4) ability to pledge the interest; and (5) the possibility that the interest will appreciate in value.64

The argument in favor of applying the ordinary attributes of stock test to LLC membership interests is based on the similarities between LLCs and corporations and between membership interests and stock. This approach has some appeal since LLCs possess a number of characteristics normally associated with corporations. LLCs are formed by filing articles of organization,65 a process which is analogous to the requirement that a corporate charter be filed for corporations. In addition, the word “company,” which has traditionally been associated with corporations, must be included in the title of LLCs.66


In fact, not all states require the word “company” or any abbreviation thereof to appear in the name of a domestic LLC. See TEX. REV. CIV. STAT. ANN. art. 1528n, § 203.01 (West Supp. 1994) (the name must include “Limited,” “Ltd.”, or “LLC”); and WYO. STAT. § 17-15-105 (1989 & Supp. 1994) (the name must include “Limited,” “Ltd.”, or
At first glance, LLC membership interests do have many of the ordinary attributes of stock. The default rules of most LLC statutes provide that, if the articles of organization or operating agreement do not provide for different allocations, members will share proportionately in profits of the entity. Absent agreement to the contrary, management rights in most jurisdictions are also allocated proportionately. LLC statutes generally do allow assignment of each member's right to receive distributions, which might satisfy the requirement that an interest must be capable of being negotiated and pledged in order to qualify as stock. Finally, there is no doubt that the typical LLC interest can appreciate in value. However, a more careful analysis of these attributes indicates that LLC membership interests are really no more akin to stock than are partnership interests, which have not been found to possess the ordinary attributes of stock.

With regard to the first element of the Landreth test, the question is whether membership interests really convey the right to receive a proportionate amount of profits in a manner akin to stock. It is true that the default rules of most LLC statutes provide that, absent agreement to the contrary, each member will be allocated profits and losses in proportion to the value of their contribution to the LLC.
rate distributions are not allocated in quite this way. In the case of ordinary stock, the right to receive distributions is not apportioned on the basis of the value of the contribution, but on the number of shares of stock acquired. For example, if investor A buys one share of X corporation common stock for $1.00, and investor B buys one share of the same stock but pays $10.00, B will not receive ten times the amount distributed to A. Rather, A and B will receive equal distributions, since they own an equal number of shares.

Moreover, although the default rules for partnerships provide that, absent agreement to the contrary, partners share equally in profits and losses (after a return of initial contributions), many partnerships in fact allocate profits and losses in proportion to the value of contributions, exactly as the default rules for most LLCs provide. In addition, since both partnerships and LLCs must maintain detailed capital accounts for all partners or members in order to comply with the Internal Revenue Code, the manner in which profit and loss allocations in LLCs will be structured will be the same as for partnerships. This is not required for corporate distributions.

As to the second element of the Landreth test—the requirement that voting be allocated proportionately—on close examination, LLC membership interests are also quite distinct from corporate stock. Shareholders have the right to vote on limited issues, such as the election of directors and certain fundamental structural changes. Moreover, their voting rights are based on the number of voting shares held, with each share in a class having the same number of votes. Even if the corporation issues multiple classes of stock—each having different voting rights—the presumption in each state is that, absent a provision to the contrary in the articles of incorporation, each share of


71. See Henn & Alexander, supra note 28, § 188. "In a strict sense, management of the business and affairs of a corporation is under the direction of its board of directors, and shareholders have no functions of management as such." Id. at 490-91.

72. "Each share is usually entitled to one vote . . . ." Id. at 493.
stock will have one vote, and in no case will shares of stock of the same class have different voting rights.\textsuperscript{73}

Participatory rights of members in LLCs, although they may be “proportionate” in some sense, are not really equivalent to this type of voting right. First, the types of issues upon which LLC members are entitled to render decisions are very different from the types of issues considered by corporate shareholders. In most states, absent a contrary provision in the articles of organization or an operating agreement, LLC members have the right to make all the day-to-day management decisions.\textsuperscript{74} Even in those states where the default rule provides that management authority will be vested in designated managers—with the exception of Colorado and, possibly, North Dakota—individual LLCs can still elect to opt out of this management model and have direct member-management. This model gives members far greater control than shareholders can aspire to, at least in their capacities as shareholders.\textsuperscript{75}

Although LLC members have control over a far greater range of decisions, in many states this power need not be exercised by “voting”

\textsuperscript{73} Actually, this last statement is no longer completely accurate. One of the more inventive anti-takeover defenses of recent years has been the issuance of stock having variable voting rights. Such stock contains equal voting rights, unless and until a particular stockholder acquires more than a minimum threshold of the outstanding shares. In that event, shares held by such shareholder cease to have voting rights, with the result that not all shares of the same class have equal voting rights. See Baker v. Providence & Worcester Co., 378 A.2d 121 (Del. 1977).

The SEC attempted to prevent companies from taking steps to nullify, restrict, or disparately reduce the per share votes of existing shareholders by adopting Rule 19c-4 under the '34 Act. Voting Rights Listing Standards — Disenfranchisement Rule, Exchange Act Release No. 34-25891, 53 Fed. Reg. 26,376 (July 12, 1988). The Business Roundtable challenged the SEC’s authority to promulgate this rule, and in Business Roundtable v. SEC, Fed. Sec. L. Rep. ¶ 95,291 (June 12, 1990), the court invalidated it. The NYSE and NASDAQ, however, voluntarily adopted the essence of Rule 19c-4, and the AMEX also took action to limit disenfranchisement of existing shareholders. None of these actions, however, precludes the sale of new classes of shares with such restrictions.

In fact, in a few jurisdictions, this result is imposed by statute. \textit{E.g.,} IND. CODE § 23-1-42-9 (Supp. 1994); 15 PA. CONS. STAT. §§ 2561-2568 (1993). Under these provisions, any time a shareholder acquires “control shares,” such shares lose any voting rights. For example, under the Indiana statute, control shares are defined as shares that, for the operation of the Act, would bring the acquirer’s voting control to or above any of three thresholds: 20\%, 33 1/3\%, or 50\%. IND. CODE § 23-1-42-4(a) (Supp. 1994).

Even in this situation, however, all shares of stock in the class must be subject to the same restriction, so that if any shareholder exceeds the threshold, the same loss of voting power is triggered.

\textsuperscript{74} See statutes cited supra note 27.

\textsuperscript{75} Shareholders can, of course, be elected to serve as directors. In this case, however, their voting power derives not from their status as shareholders, but from the fact that they have been elected to serve as directors.
in any formal sense. Several LLC statutes provide that decisions by
members can be reached by voting, approval, or consent to a particu-
lar course of action.\textsuperscript{76} Other statutes suggest that a vote will not be
necessary in other ways.\textsuperscript{77} Still other LLC statutes fail to mention or
discuss voting by members at all.\textsuperscript{78}

Finally, even assuming that the power to make decisions or the
right to approve them is the same as “voting” power, and assuming
that the difference in the type of issues considered is not significant,
there is yet another distinction between the participatory rights of
members in an LLC and the rights of shareholders in a corporation.
As mentioned earlier, corporate shareholders derive voting power
from the number of shares owned. The consideration paid for stock is
totally irrelevant in calculating the voting power of those shares.

In the case of LLC membership interests, the “voting” or man-
agement power of a particular interest may depend on a number of
things. Although virtually all of the state LLC statutes permit the
parties to apportion voting power in any way they choose, the statutes
provide a default rule for allocating power. Some statutes have a de-
fault rule apportioning participatory rights on the basis of the value of
property contributed;\textsuperscript{79} other statutes give members equal voting


\textsuperscript{77} For example, Delaware specifies that the operating agreement can provide that
no vote is needed and also offers suggested issues that might be included in an operating
agreement if an LLC desires to require member votes. \textit{Del. Code Ann. tit. 6, § 18-302}
(1993). Florida does not specify that any voting is required but does say that any mecha-
nism for deciding issues can be included in the LLC’s regulations (the same as an operating
provides that all decisions by members shall “be made by concurrence.” No formal vote is

ners without discussing any requirement for voting).

\textsuperscript{79} In fact, most state LLC statutes provide that, in the absence of contrary agree-
ment, members in an LLC will have voting rights proportionate to their investment in the
LLC. The way in which the relative value of their investment is calculated varies from
state to state, with some states considering book value or agreed value of contributions and
others looking at the relative rights to share in profits. The following states have a default
(Smith-Hurd Supp. 1994); \textit{Ind. Code} § 23-18-4-3 (Supp. 1994); \textit{Iowa Code Ann.}
power.\textsuperscript{80} This, of course, is subject to a contrary provision in the articles of organization or an operating agreement. In some jurisdictions, the participatory rights of LLC membership interests are totally dependent upon the agreement of the parties.\textsuperscript{81} By contrast to stock rights, there is no single way in which voting rights are apportioned. Moreover, all of the default rules discussed above differ substantially from the allocation of stockholders' voting rights.

The voting rights of LLC members are more akin to partnership voting rights than to those of shareholders in a corporation. In some states, the default rule is exactly like the default rule provided for partnerships—all owners have equal management rights.\textsuperscript{82} Even in those states where voting rights are allocated based on the value of capital contributions, this allocation of power is very common in partnerships and is quite distinct from the calculation of shareholder voting power.\textsuperscript{83}

In LLCs where the members have delegated management authority to one or more managers, the residual authority retained by members is closer to the limited scope of authority granted to corporate shareholders. However, participatory rights of LLC members are still different from the rights of stockholders in that most LLC statutes

\begin{itemize}
\item \textsuperscript{81} This is the case, for example, in Texas. \textsc{Tex. Rev. Civ. Stat. Ann.} art. 1568n, § 4.02 (West Supp. 1994).
\item \textsuperscript{82} \textit{See} statutes cited supra note 27.
\item \textsuperscript{83} This is not to say, of course, that no LLC will ever elect to allocate voting rights in a manner which is essentially the same as for corporate stockholders. For example, if an LLC was to adopt an operating agreement providing that membership interests would be sold in units at a price to be set by either the existing members or managers and that each unit of membership interest would have one vote, this would look exactly like stock in respect to how the votes per member are to be calculated.
\end{itemize}
do not give members the right to demand a formal vote, and the way in which such rights are apportioned is also different.

With regard to the third element of Landreth—negotiability and the right to pledge the interests—it is probably not accurate to conclude that LLC membership interests are completely negotiable. Negotiability implies the right to transfer all attributes of ownership, not merely the right to share in distributions. Absent agreement to the contrary, a stockholder can transfer his or her shares and convey to the transferee all of the transferor's rights in the corporation without any additional act or agreement by the other stockholders. This contrasts starkly with the transferability restrictions imposed under both partnership law and LLC statutes. Similar to partnership interests, LLC interests can be assigned. However, under the LLC statutes the transferee does not thereby acquire the right to participate in management of the entity. Rather, the transferee's interest is limited to the right to receive allocations and distributions. This is analogous to the rules governing transferability of partnership interests, which are not examined under the securities laws under the same approach used for evaluating stock.

A similar limitation applies with regard to the fourth element of Landreth—the right to pledge the interest. LLC interests, in exactly the same manner as partnership interests, may be pledged to the extent of any right to receive distributions. Unlike stock, however, the pledgee acquires no rights to become a substitute owner with rights to participate in control of the entity upon default of the pledgor. Again, this characteristic is like that of partnership interests rather than stock.

In certain respects, this detailed analysis of whether the similarity between LLC interests and stock justifies the imposition of the Landreth test obscures what is perhaps the fundamental difference between LLC membership interests and stock. The Landreth Court specified that the test it enunciated applied to interests that were labeled “stock.” LLC membership interests are not called stock in any of the statutes. While it is conceivable that an LLC might issue a document bearing such a label to members to document their membership interests, there is no reason for this to happen, and well-advised LLCs will almost certainly not do so. Most membership interests are likely to be called just that—membership interests—and, as such,

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84. See discussion supra notes 59-60 and accompanying text.
85. The pledgee obtains no greater rights than any other assignee.
there is no real reason why courts ought to ignore this essential element of the Landreth test.\textsuperscript{86} After all, Landreth is based to a large extent on the notion that "stock" is expressly included in the laundry list of items that are to be treated as securities. That statutory language ought to be respected so that anything which is called stock—and really is stock—is covered by the legislation. There is nothing in the language of either the '33 or '34 Acts to indicate that LLC membership interests should be treated as stock and subjected to the broad analysis of the Landreth test.

B. Partnership Analysis

Another possibility is that LLC membership interests could be analogized to partnership interests and, therefore, treated as securities under the same circumstances as are partnership interests. As discussed, many LLCs have more characteristics in common with partnerships than with corporations. LLCs are formed when two or more persons associate with one another to act as co-owners of a business for the purpose of sharing profits.\textsuperscript{87} Although this is the classic definition of a partnership, generally speaking these are also characteristics of corporations. Thus, the fact that an LLC would fit within the classic definition of partnership is not particularly helpful in determining whether LLC membership interests should be analogized to partnership interests rather than to stock, or if some other analysis should be employed.

Most legal authority on the issue is found in the area of federal taxation. Because the tax classification of LLCs has been of such im-

\textsuperscript{86} Even if an LLC membership interest is evidenced by a certificate mistakenly labelled "stock," the analysis employed in this Section suggests that, in fact, the interest is not "stock" and should not be treated as such under the securities laws.

\textsuperscript{87} In fact, absent enabling legislation that recognizes LLCs as a separate legal entity, there is an extremely good argument that LLCs would in fact be partnerships.

Under the Uniform Partnership Act (U.P.A.), "[a] partnership is an association of two or more persons to carry on as co-owners a business for profit." 6 U.L.A. 22 (1969). An LLC would appear to fit within this definition. Moreover, U.P.A. § 7(4) provides that, with certain exceptions not likely to be relevant in the case of most LLCs, the receipt of a share of profits is prima facie evidence that the recipient is a partner. 6 U.L.A. 39 (1969). Since members in LLCs are almost certain to expect a share of profits, there is likely to be prima facie evidence of a partnership.

The one exception to this analysis would be single-member LLCs, which are apparently authorized in both Arkansas, Ark. Code Ann § 4-32-201 (Michie Supp. 1993), and Texas, Tex. Rev. Civ. Stat. Ann. art. 1528n, § 2.09 (West. Supp. 1994). Single member LLCs will not be addressed in any detail in this Article since they are authorized in only two states, are unlikely to be particularly popular, and are not likely to give rise to any securities issues.
portance, there is a relatively well-established approach for determining whether LLCs should be considered to be more like partnerships or corporations. Under the current Treasury regulations, in order to be classified as a partnership for federal tax purposes, LLCs must avoid at least two of these three corporate characteristics: (1) continuity of life apart from their members; (2) centralized management; and/or (3) free transferability of the membership interests. It is possible for an LLC to avoid all three of these attributes, making an LLC much more akin to a partnership than to a corporation, at least for tax purposes. As long as LLCs have no more than one of these "corporate characteristics," they are classified as partnerships for purposes of federal taxation. There would be a certain symmetry to treating them as partnerships under the federal securities laws as well.

Conceding that LLCs, in many respects, are like partnerships, and assuming that membership interests should be treated as securities under the same circumstances as are partnership interests, raises the question of when partnership interests should be treated as securities. Although the Supreme Court has not addressed the question of when partnership interests are to be classified as securities under the '33 and '34 Act, a number of federal courts and commentators have. The earlier cases draw a distinction between general partnership interests and limited partnership interests. The former were generally held not to be securities, while the latter were generally characterized as securities subject to the provisions of the '33 and '34 Act. More recent cases, including the opinion of the Fifth Circuit in *Williamson v.*

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88. See discussion supra notes 36-60 and accompanying text.

89. The cases cited supra note 55 also stand for the proposition that because general partners do not depend solely on others for their profits, general partnership interests are generally not securities. While this is the general rule, there are certainly exceptions to this, and some general partnership interests will be securities. See infra notes 90-93 and accompanying text.

Similarly, limited partners do depend solely on the efforts of others for their share of profits, so limited partnership interests have generally been characterized as securities. 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 (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 730 (2d Cir. 1977).

This is also not without exception. Some limited partnership interests have been found not to be securities by virtue of special factors showing involvement of limited partners in management. See *Bank of America Nat'l Trust & Sav. Ass'n v. Hotel Rittenhouse Assocs.*, 595 F. Supp. 800, 805-07 (E.D. Pa. 1984); *Frazier v. Manson*, 484 F. Supp. 449, 450-53 (N.D. Tex. 1980), aff'd, 651 F.2d 1078 (5th Cir. 1981).
Tucker,90 have included analysis that is more sophisticated than merely distinguishing between general and limited partnerships.

In Williamson, the Fifth Circuit held that while general partnership interests typically will not be securities, a general partner might prevail in a securities action upon a showing that he was so dependent on the promoter or a third party that he was, in fact, unable to exercise meaningful partnership powers.91 The court offered three examples in which a general partnership interest might properly be classified as a security:

(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.92

Cases that apply this analysis, however, generally conclude that the general partnership interests under consideration are not properly characterized as securities.93 Only in very unusual circumstances will a general partner be able to overcome the presumption that a general partnership interest is not a security.94

The difference between treatment of general and limited partnership interests highlights one of the most significant attributes of LLC membership interests—that they may or may not include management rights. General partners, by statute, have the right to participate in

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91. 645 F.2d at 422.

92. Id.


94. See, e.g., Stone v. Kirk, 8 F.3d 1079 (6th Cir. 1993); SEC v. Professional Assoc., 731 F.2d 349 (6th Cir. 1984).
the management and control of their partnership.\textsuperscript{95} Even if they choose to delegate most of that authority to a managing partner or committee, they have the \textit{power} to manage. Further, even if they delegate actual authority, they retain apparent authority to bind the partnership in the ordinary course of partnership operations.\textsuperscript{96} On the other hand, limited partners are statutorily precluded from exercising excessive control over their partnerships\textsuperscript{97} and face the possibility of losing the protection of limited liability if they exercise substantial control.\textsuperscript{98} Generally speaking, it is this distinction that has resulted in limited partnership interests typically being classified as securities while general partnership interests typically are not. In this regard, LLC membership interests are not precisely like general partnership interests or limited partnership interests, although in some respects they will look more like one than the other.

In most states, the LLC statutes create a presumption, absent contrary agreement by the parties, that members will participate in the management of the LLC. There is certainly no statutory penalty attached to their participation in management, as is the case with limited partners who exercise control. This is not to say, of course, that members might not by agreement cede so much of their authority that in a given case the members in the LLC look more like limited partners insofar as their management rights are concerned. To some extent this is also possible in general partnerships.

On the other hand, there is also a significant distinction between the authority of general partners and the authority of members in an LLC. Generally, under the UPA, general partners \textit{cannot} divest themselves of apparent authority by agreement.\textsuperscript{99} By contrast LLC members in most states can cede both actual and apparent authority by


\textsuperscript{96} See Treas. Reg. § 301.7701-2(c)(4) (as amended in 1993) (describing authority to make management decisions).

\textsuperscript{97} In actuality, limited partners did have the right to inspect records and to seek an accounting even under the U.L.P.A. section 7. 6 U.L.A. 582 (1969). Moreover, under the R.U.L.P.A., limited partners have extensive participatory rights, including the right to act as an officer, director, or shareholder of a corporate general partner. \textit{Rev. Unif. Ltd. Partnership Act} § 303(b), 6 U.L.A. 442-43 (Supp. 1994).

\textsuperscript{98} \textit{Unif. Ltd. Partnership Act} § 7, 6 U.L.A. 582 (1969) (providing that limited partners who assume excessive control will have unlimited personal liability thereafter); \textit{Rev. Unif. Ltd. Partnership Act} § 303, 6 U.L.A. 442-43 (Supp. 1994) (providing that limited partners who assume excessive control will have unlimited personal liability as to persons who deal with the limited partnership believing the limited partner to be a general partner).

agreeing in their articles of organization or operating agreement to allow managers to exercise day-to-day control.\textsuperscript{100}

Though hard to classify, the management structure of LLCs is best divided into three categories: member-managed LLCs, manager-managed LLCs, and LLCs with hybrid management. For member-managed LLCs, the closest parallel is clearly the general partnership where management duties are shared by the partners.\textsuperscript{101} Manager-managed LLCs are likely to be more akin to the limited partnership, although it is certainly possible to conceive of a manager-managed LLC that operates more like a general partnership,\textsuperscript{102} and there are differences between manager-managed LLCs and limited partnerships.\textsuperscript{103} The hybrid management model would permit delegation of actual authority to managers while allowing members to retain apparent authority to bind the LLC to ordinary business acts.\textsuperscript{104} Because it is difficult to determine whether some LLCs are more like general or limited partnerships, the application of the \textit{Williamson} test in the context of LLCs is complicated.

Under \textit{Williamson}\textsuperscript{105} and its progeny, general partnership interests will be classified as securities only after a presumption to the contrary has been overcome by showing that the arrangement is really like a limited partnership despite its nomenclature.\textsuperscript{106} In order to apply this test to LLCs, a preliminary determination must be made as to

\begin{itemize}
\item \textsuperscript{100} See \textit{supra} note 27; see also discussion \textit{infra} notes 150-166 and accompanying text.
\item \textsuperscript{101} This seems to be quite clear. Member-managed LLCs are analogous to general partnerships in that all owners have both actual and apparent authority. In no other form of business entity is this the case.
\item \textsuperscript{102} For example, an LLC can be formed as a manager-managed operation, but with the affirmative requirement that all members be elected to serve as the managers. While this seems unduly cumbersome, it is entirely possible that this structure will be utilized, particularly in jurisdictions like Colorado, which requires management of the LLC to be vested in one or more managers. \textsc{colo. rev. stat. ann.} \textsection{} 7-80-401 (West Supp. 1993). In such jurisdictions, the only hope of avoiding the corporate characteristic of centralized management would be to adopt a scheme whereby all members become managers automatically by virtue of their status as members. This may not be possible in Colorado since the statute also seems to require election of the managers. \textsc{colo. rev. stat. ann.} \textsection{} 7-80-402 (West Supp. 1993).
\item \textsuperscript{103} The biggest difference is that members in LLCs do not face any statutory penalty for participating in management and control, but there is also the possibility that the apparent authority of members will be far different from that of limited partners.
\item \textsuperscript{104} See \textit{infra} notes 150-166 and accompanying text.
\item \textsuperscript{105} Williamson v. Tucker, 645 F.2d 404 (5th Cir.), \textit{cert. denied}, 454 U.S. 897 (1981).
\item \textsuperscript{106} This is the first of the three examples offered by the court in \textit{Williamson}. Any time the agreement "leaves so little power in the hands of the partner . . . that the arrangement in fact distributes power as would a limited partnership" the interest should be classified as a security. \textit{Id.} at 424.
\end{itemize}
whether the LLC in question is more akin to a general partnership or to a limited partnership. In the case of LLCs more akin to general partnerships, the presumption that membership interests are not securities would be triggered, but could be overcome by any of the three approaches outlined in Williamson. LLCs that are more akin to limited partnerships would probably be treated as securities.

Application of the partnership analysis to LLC membership interests is complicated by the fact that LLCs are not required to be like either general or limited partnerships, and may, in fact, be more like a combination of the two entities. Although the partnership analysis can be stretched to apply to LLCs, under state law, LLCs are neither general nor limited partnerships. They are a new form of entity which represent a blending of the characteristics of general partnerships, limited partnerships, and corporations.

While treating LLC membership interests like general partnership interests would probably not offend anyone's sensibilities, there are other alternatives that do not require stretching the Williamson test beyond its intended boundaries. LLC interests may be examined in order to see whether they qualify as “investment contracts”—a catch-all category that was intended to prevent promoters from avoiding application of the securities laws by creating novel and creative interests.

Before turning to an analysis of whether LLC membership interests qualify as investment contracts, however, there is one other possible approach that deserves consideration.

C. The Family Resemblance Test

One of the specific categories of interests covered by the '33 and '34 Acts, albeit to a slightly different extent, is promissory notes. Although included in the list of “securities,” there is virtually univer-

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107. The fact that they may be taxed as partnerships under either a state or federal taxation scheme is no more than a recognition that all unincorporated associations are taxed as either corporations or partnerships, not that no other business form exists.

108. Some of the cases and commentators who address the proper classification of partnership interests under the federal securities laws have indicated that the proper resolution of this issue requires no more than an analysis of the investment contract test. See, e.g., Dennis S. Kajala, Federalism, Full Disclosure, and the National Markets in the Interpretation of Federal Securities Law, 80 Nw. U. L. Rev. 1473, 1511 n.156 (1986) (noting that Williamson has been used by many courts as a basis for finding “no investment contract as a matter of law . . .”). However, the Williamson test seems to have a different focus from the Howey investment contract analysis; thus, I have examined these rules separately in this Article.
sal agreement that not all notes should be considered securities, rendering the literal approach that has prevailed in interpreting the meaning of the word “stock” inappropriate. After years of heated debate among the federal circuits, the Supreme Court finally adopted the “family resemblance” test to determine whether a note should be classified as a security.

While it should be clear that an LLC membership interest has far more in common with a general partnership interest than with any promissory note, at least one commentator has suggested that the family resemblance test encompasses “the determination whether LLC interests are securities.” Thus, before considering the investment contract analysis, which was originally intended to be broad-based, one must examine the family resemblance test to determine its applicability to LLC membership interests.

The Supreme Court relied on the family resemblance test to determine the proper classification of promissory notes under the federal securities laws in *Reves v. Ernst & Young*. In *Reves*, the Court held that promissory notes are presumptively securities, unless the note in question bears a strong family resemblance to other notes that are recognized as being something other than securities. To deter-

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109. Quite reasonably, courts and commentators generally have been unwilling to find that notes arising out of home mortgages, consumer installment sales, and ordinary commercial financing are to be classified as securities subject to the registration requirements of the federal securities laws. As one court explained: “If it had been intended, in legislation entitled the ‘Securities Exchange Act,’ to extend federal jurisdiction to transactions of this type, Congress most certainly would have given a real indication of such intent.” Lino v. City Investing Co., 487 F.2d 689, 695 (3d Cir. 1973).


111. Steinberg & Conway, supra note 17, at 1121.


113. By way of example, Judge Friendly listed the following types of notes that would not be classified as securities: “the note delivered in consumer financing, the note secured by a mortgage on a home, the short-term note secured by a lien on a small business or some of its assets, the note evidencing a ‘character’ loan to a bank customer, short-term notes secured by an assignment of accounts receivable, or a note which simply formalizes an open-account debt incurred in the ordinary course of business . . . .” Exchange Nat'l Bank of Chicago v. Touche Ross & Co., 544 F.2d 1126, 1137-38 (2d Cir. 1976), cert. denied, 469 U.S. 884 (1984).
mine when a note bears such a family resemblance, the Court set out a
four-part test. The test requires courts to examine: (1) the motivations
of a reasonable buyer and seller of such notes; (2) the plan of distri-
bution of the instrument; (3) the reasonable expectations of the public;
and (4) whether some other factor, such as the existence of another
regulatory scheme, sufficiently protects investors.\footnote{114}

It seems relatively easy to apply the first factor to LLCs. As to
the motives of the buyer and seller, the Supreme Court in \textit{Reves}
indicated that "[i]f the seller's purpose is to raise money for the general
use of a business enterprise . . . the instrument is likely to be a secur-
ity."\footnote{115} Most LLC members are likely to make monetary contribu-
tions toward the LLC's general operations. Only in limited situations
would an LLC issue membership interests in order to finance particu-
lar transactions rather than general operations. Non-monetary contrib-
butions might be made in a number of situations, but the most
common investment in LLCs is likely to be a cash contribution. Thus,
as to this element, most LLC membership interests will likely look
like securities.

As to the other elements of the \textit{Reves} test, however, it is unclear
how LLC membership interests should be analyzed. The second ele-
ment of the family resemblance test requires that in order to be classi-
fied as a security, the interest should be expected to be traded for
speculation or investment.\footnote{116} Since LLC membership interests typi-
cally will be structured to avoid free transferability, this element
would appear to be lacking. However, in \textit{Reves} itself, the demand
notes, which were found to satisfy this criteria, could not be traded.\footnote{117} According to the Court, it was enough that they were "offered and
sold to a broad segment of the public."\footnote{118} Applying this analysis to
LLC membership interests, they may be found to satisfy the second
element even though they are not freely tradeable since there is noth-
ing in the LLC statutes to prevent the LLC from issuing interests to a

\footnotetext{114}{\textit{Reves}, 494 U.S. at 66-67.}
\footnotetext{115}{\textit{Id.} at 66.}
\footnotetext{116}{\textit{Id.} (citing SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943)).}
\footnotetext{117}{\textit{Id.} at 68.}
\footnotetext{118}{\textit{Id.} It has been pointed out that this interpretation is inherently self-contradictory
because the family resemblance test excludes such interests as residential mortgage loans
and consumer finance loans, both of which are, in fact, the subject of significant speculative
trading. See Gary B. Gorton \& Joseph G. Haubrich, \textit{The Loan Sales Market}, in \textit{2 Re-
search in Financial Services} 89 (G. Kaufman ed., 1990).}
"broad segment of the public" upon the agreement of existing members.  

The distinction between the demand notes in Reves and LLC membership interests is that there is no statute restricting free transferability of notes. The LLC statutes do limit transferability of LLC membership interests absent a less restrictive provision in an operating agreement and generally require unanimous consent of all members to the transfer of membership interests. Thus, it is hard to say whether LLC membership interests would satisfy the requirement of common trading which is the second element of the Reves test.

Similarly, as to the third element—the reasonable expectation of the purchasers—it is hard to say what investors in LLCs will expect. It has been argued, principally on the basis of the fact that LLCs must have the word “company” in their name, that members are likely to regard their LLC membership interests as being the equivalent of stock, thus making them subject to the protection of the federal securities laws. On the other hand, it has also been suggested that LLCs have been viewed and organized principally as a replacement for general partnerships. If viewed in this light, investors might not expect the securities laws to apply to their purchases, since general partnership interests are generally not classified as securities.

Because LLCs are so new, it is impossible to say definitively how LLC membership interests are presently regarded, or how they will be regarded in the future. This makes it extremely difficult to apply the third element of the Reves test to LLC membership interests.

The final element of the Reves test asks if there is some other reason, such as the existence of an alternative regulatory scheme, which reduces the risk of the investment. While it is not clear that

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119. Of course, if membership interests in an LLC become publicly traded, this may result in the LLC being classified as an association taxable as a corporation under the Internal Revenue Code. See I.R.C. § 7704(a) (1989) (stating that a publicly traded partnership will be taxed as a corporation unless 90% or more of its income is passive).

120. See statutes cited supra note 59. In the unlikely event that LLC members agree to free transferability, this analysis would be much simpler. However since such an election is unlikely given the tax consequences of free transferability, the determination of whether a particular LLC possesses this characteristic must be done on a case-by-case basis. For a discussion of the tax consequences of free transferability, see supra notes 58-60 and accompanying text.

121. See statutes cited supra note 66.

122. Steinberg & Conway, supra note 17, at 1116, 1122.


124. See supra notes 87-108 and accompanying text.
such an alternative regulatory scheme exists, it is at least possible that existing legislation and regulations may\textsuperscript{125} provide investors in LLCs with a measure of protection. There are two possible regulatory schemes that may provide such protection. First, the various LLC statutes offer investors substantial protection. Second, the Internal Revenue Code imposes certain requirements that may protect investors.

Given the variety in state LLC statutes, it is difficult to talk in generalities. However, every state LLC statute provides some measure of protection to investors,\textsuperscript{126} although the protection vary considerably from state to state. One of the most significant protection offered by a number of state statutes is the right to inspect records. In many states, members are entitled to inspect and copy a wide variety of records, ranging from membership lists, operating agreements, and tax returns to all relevant business information.\textsuperscript{127} These statutory

\textsuperscript{125} The word "may" is used because of the substantial uncertainty that surrounds existing tax regulations governing classification of LLCs as partnerships and because of the extreme diversity of state legislation governing formation and operation of LLCs. For a discussion concerning the uncertainty surrounding existing tax regulations, see supra notes 36-60 and accompanying text.

\textsuperscript{126} It can be argued that there is no more protection offered to LLC members by virtue of the LLC statutes than to corporate shareholders by virtue of corporate statutes. This argument, while quite valid, is nonetheless not relevant to analyzing how the Reves test would apply to LLC membership interests. Stock is not considered to be a security because it meets the four-part Reves test, including the lack of an alternate scheme of regulation that makes application of the securities laws unimportant. Rather, stock is treated as a security because it is included in the laundry list of items in both the '33 and '34 Acts. Under Landreth, if an instrument called "stock" actually possesses the attributes of stock, it will be a security regardless of whether there is really any need for the securities laws to apply. 471 U.S. at 693-97. In fact, in Landreth, the Supreme Court rejected the "sale of business" doctrine that lower courts had developed primarily as a way of avoiding application of the securities laws to transactions in which the participants should not have needed the protection of the securities laws. \textit{Id}.


Kansas imposes a requirement that every LLC file an annual report containing detailed information. Although it does not have to be kept by the LLC, this report would,
rights to inspect and copy relevant records offer significant protection, especially since the main focus of the federal securities laws is to guarantee access to information. 128

Another protection included in a number of statutes is the presumption that members will have management or agency authority unless the articles of organization or an operating agreement provide for delegation to managers. 129 The presumption of management authority for all members is a very significant power and protective device for potential members. 130 Some of the LLC statutes also provide that when authority is delegated to managers, the managers will have certain specified duties and responsibilities. 131 The statutory requirement that managers exercise their powers in good faith and for the benefit of the company offers a measure of protection to potential investors.

There are a variety of other protective provisions that appear in some LLC statutes. For example, some of the statutes give members a right to petition for involuntary dissolution in the event of fraud or abuse of power. 132 However, most statutes limit this right to instances where it is no longer practicable to carry on the business in accord-


128. See infra notes 222-229 and accompanying text.

129. See statutes cited supra note 27.

130. If the LLC is member-managed, members have the actual authority to make business decisions for the LLC. This provides a significant degree of protection for members because it effectively prevents them from being cut off from information about the day-to-day activities of the LLC unless they do not wish to review such data. Even if the LLC has designated managers, as long as members retain apparent authority to manage the LLC, this protects members from being shut out of the decision-making loop because it would be foolhardy to preclude a member with power to bind the LLC from having access to material information.


ance with the operating agreement. Most state statutes provide for automatic dissolution in the event that any member resigns from the LLC unless there is unanimous or at least majority agreement to continue the business, although some states would apparently allow the members to agree in advance to continue the LLC. All statutes require the filing of articles of organization containing certain information about the LLC, which then become a matter of public record available for inspection by potential members.

In fact, LLCs are a statutory creation that would not exist without express authorization. While investor protection varies tremendously under the statutes, it seems clear that the statutes in question provide a degree of protection that is normally missing in the context of ordinary promissory notes.

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136. See statutes cited supra note 30. Admittedly, the information required to be included in articles of organization in many jurisdictions is quite sparse.

137. By no means should the preceding discussion be taken as an exclusive listing of the protective features in various state statutes. A number of state schemes have atypical provisions that would act to protect members in those jurisdictions. For example, in Texas, the statute provides that, absent agreement to the contrary in the LLC's internal regulations, authority over day-to-day decisions will be vested in managers. However, since members are given exclusive authority to amend the regulations at any time, the managers...
In addition to the state regulatory structure, which is virtually impossible to discuss in detail without an involved examination of individual statutory provisions, the Internal Revenue Code offers another source of potential regulation that may inure to the benefit of LLC members. As discussed earlier, LLCs derive much of their potential attractiveness as an alternative form of business organization from the fact that they can be classified as partnerships for tax purposes. Because this classification is not automatic, the need to comply with regulatory requirements imposes certain limitations on LLCs. As discussed, current Treasury regulations permit an LLC to be classified as a partnership for tax purposes only if the LLC has no more than one of the following three characteristics: (1) continuity of life; (2) centralization of management; and (3) free transferability of interests. If any LLC has two of these three characteristics, it will be deemed to be more like a corporation than a partnership, and it will lose its partnership tax status. In order to preserve this classification, no LLC is likely to have both continuity of life and centralized management. Either of these alternatives provides some protection for potential investors.

Because the analysis of what is required to avoid the corporate characteristic of centralized management is more straightforward, and it is more obvious how this characteristic can protect investors, it will be dealt with first. According to the regulations, centralized management refers to a “concentration of continuing exclusive authority” to manage the entity without the approval of other members. The powers and authority of a corporate board of directors, for example, are enough to satisfy this requirement. A general partnership, on the other hand, typically lacks this characteristic since each partner has the power to bind the partnership. In addition, a limited partnership typically lacks this characteristic so long as the general partner


138. See discussion supra notes 36-39 and accompanying text.

139. See supra notes 41-60 and accompanying text.

140. Treas. Reg. § 301.7701-2(a) (as amended in 1993). Actually, the regulations specify that an unincorporated association will be classified as an association taxable as a corporation whenever it possesses a majority of the following four characteristics: (1) continuity of life; (2) centralization of management; (3) limited liability; and (4) free transferability of interests. See Rev. Rul. 79-106, 1979-1 C.B. 448.

141. See supra note 45 and accompanying text.


owes a “meaningful proprietary interest” in the partnership. Corporations, therefore, possess the characteristic of centralized management because management authority is divorced from ownership, while general partnerships lack this characteristic, and limited partnerships can be structured so as to avoid centralized management.

LLCs are not so easily classified. The state LLC statutes contain significant variations, and LLCs formed within a given state are likely to have variations as great. The majority of LLC statutes provide that members will manage the LLC, unless the members agree otherwise. Some statutes provide that the LLC will be controlled by managers unless the members agree otherwise, or even that the LLC must be controlled by managers. Member-managed LLCs will certainly lack the corporate characteristic of centralized management, and this fact will likely mean that there is no reason for the securities laws to be applied. As to manager-managed LLCs, it is difficult to say whether members will be protected by virtue of the requirements of the Internal Revenue Code, even if the LLC is structured so as to avoid centralized management.

In order to have a manager-managed LLC that will lack centralized management, one of two things must happen. Either the LLC must be akin to a general partnership with one or more managing partners or a limited partnership that is structured so as to lack cen-

144. Larson v. Commissioner, 66 T.C. 159, 176-79 (1976), acq. 1979-1 C.B. 1. It is clear that if the limited partners own more than 94.3% of the total interest in the partnership, they own substantially all of the partnership interest and the corporate characteristic of centralized management would be present. Treas. Reg. § 301.7701-3(b)(2) (as amended in 1993) (example (1)). Moreover, if the limited partners’ interests exceed 80% of the total partnership interests, the IRS will not issue a ruling that a limited partnership lacks the characteristic of centralized management. Rev. Proc. 89-12, 1989-1 C.B. 798-801.

Additionally, in order to insure that the general partner has a substantial interest in the partnership, the limited partners cannot have an unrestricted right to remove the general partner. See, e.g., Zuckerman v. United States, 524 F.2d 729, 735 (Ct. Cl. 1975); Larson, 66 T.C. at 176-79.


146. COLO. REV. STAT. ANN. § 7-80-401 (West Supp. 1993). The members may be managers; however, this is no different from corporate directors, who may also be shareholders. The North Dakota statute can also be interpreted as mandating the election of a board of governors. However, this is not entirely certain since the statute also says that if the members desire to act by unanimous consent or vote they do not need to have governors. N.D. CENT. CODE. § 10-32-69.1 (1994).

147. A member with management authority has both actual and apparent authority to bind the company to transactions entered into in the ordinary course of business. This authority obviates the need for the special protection of the securities laws, which are designed primarily to protect passive investors by providing access to information.
entralized management. In general partnerships, the appointment of one or more managing partners will not result in centralization of management since there is no way for the other partners to effectively divest themselves of apparent authority.\footnote{\textsuperscript{148}} A manager-managed LLC would, therefore, be equivalent to a general partnership with one or more managing partners if the LLC members retained apparent authority to bind the entity to certain transactions. This management model is actually a hybrid between member-management and manager-management and, to avoid confusion, will generally be referred to as hybrid-management in this Article. Determining which management model exists may be quite difficult in a number of situations.

First, most state statutes appear to bifurcate the apparent authority of members, providing that members in member-managed LLCs have all management authority, while in manager-managed LLCs, such authority is vested in managers.\footnote{\textsuperscript{149}} Some state statutes simply provide that management will be vested exclusively in the members unless the members have placed managers in control.\footnote{\textsuperscript{150}} Many state statutes do not expressly address the apparent authority of LLC mem-

\footnote{\textsuperscript{148}} Because of the mutual agency relationship between members of a general partnership subject to a statute corresponding to the Uniform Partnership Act, such a general partnership cannot achieve effective concentration of management powers . . . . [E]ven if the partners agree among themselves that the powers of management shall be exclusively in a selected few, this agreement will be ineffective as against an outsider who had no notice of it. Treas. Reg. § 301.7701-2(c)(4)(as amended in 1993).

\footnote{\textsuperscript{149}} For a list of statutory provisions adopting either member-management or manager-management as the default model, see statutes cited supra note 27.

\footnote{\textsuperscript{150}} For example, the Arizona statute provides that management is vested in the members unless the articles of organization provide otherwise. However, this is somehow subject to the operating agreement as well. ARIZ. REV. STAT. ANN. § 29-681. A (Supp. 1993). The Delaware statute specifies that management is in members except as otherwise provided by agreement, in which case management is in managers to the extent so vested. DEL. CODE ANN. tit. 6, § 18-402 (1993). The Iowa LLC Act says that management is in the members unless the articles or the operating agreement provide otherwise. IOWA CODE ANN. § 490A.702 (West Supp. 1994). See also KAN. STAT. ANN. § 17-7612 (Supp. 1993) (stating that management is in the members except if the articles or the operating agreement so provides; if it so provides, then management may be vested in managers); UTAH CODE ANN. § 48-2b-125 (Supp. 1994) (stating that management is in members unless managers are designated in the articles; this provision addresses apparent authority as well); VA. CODE ANN. § 13.1-1022 (Michie 1993) (stating that management is in members, except as provided in articles or operating agreement).

The opposite rule appears in some states with manager-management as the default rule. MINN. STAT. ANN. § 322B.606 (West Supp. 1994) (stating that management is in the board of governors except that members may choose to act on unanimous vote); OKLA. STAT. ANN. tit. 18, § 2013 (West Supp. 1994) (stating that management is vested in managers except as provided in articles or operating agreement).
bers, and it is not clear whether these state legislators intended that members be allowed to delegate actual authority to managers while retaining apparent authority to bind the LLC, or only that members be allowed to delegate all authority (both actual and apparent) to managers.

Some of these states require that managers be named in the articles or the operating agreement, some require designation of managers in the articles, and some apparently require both a designation of managers in one or the other of such documents and an express transfer of as much authority as is desired. In such states, a designation of managers might be sufficient to convey actual authority to one or more managers and to divest the members of apparent authority. Since the language addressing management rights and apparent authority of members varies tremendously from state to state, and is not spelled out with any degree of clarity, the courts will have to decide under what circumstances LLC members in such jurisdictions will have the apparent authority to bind the LLC to acts within the ordinary business of the company. To date, no such decisions have been rendered.


152. Iowa Code Ann. § 490A.702 (West Supp. 1994) (stating that management is in members unless articles or operating agreement provide otherwise); Okla. Stat. Ann. tit. 18, § 2012 (West Supp. 1994) (stating that management is in managers except as provided in articles or operating agreement); Va. Code Ann. § 13.1-1022 (Michie 1993) (stating that management is in members, except as provided in articles or operating agreement).

153. Ariz. Rev. Stat. Ann. § 29-681.A (Supp. 1993) (stating that management is in members unless the articles of organization provide otherwise, but this is somehow subject to the operating agreement as well); Utah Code Ann. § 48-2b-125 (1994) (stating that management is in members unless in managers as designated in the articles; this provision addresses apparent authority as well).

154. Del. Code Ann. tit. 6, § 18-402 (1993) (stating that management is in members except as provided in agreement, and then management is in managers to the extent so vested); Kan. Stat. Ann. § 17-7612 (Supp. 1993) (stating that management is in members, except if the articles or the operating agreement so provides, management may be vested in managers).
In other states, the statutes purport to address the issue of authority by adding a provision which specifies that in member-managed LLCs only members can enter into binding contracts on behalf of the LLC and in manager-managed LLCs, only managers will have that authority. The statutes differ as to what is required for designation of managers and leave open the question of what happens when managers are chosen in a different way, or when the articles or operating agreement purport to leave some power in the hands of members. Thus, even in these statutes, where the drafters apparently wanted to be more careful with regard to apparent authority of members, there are a number of open questions about member authority that will have to be resolved in the context of particular LLCs.

155. FLA. STAT. ANN. § 608.424 (West 1993 & Supp. 1994) (stating that except as provided in the articles, no debts or liabilities shall be incurred except by managers in the case of manager-managed LLCs and members in the case of member-managed LLCs); NEV. REV. STAT. ANN. § 86.301 (Michie 1994) (stating that no debts or liabilities shall be incurred except by managers in the case of manager-managed LLCs and members in the case of member-managed LLCs where the articles so provide); TEX. REV. CIV. STAT. ANN. art. 1528n, § 2.10 (West Supp. 1994) (stating that except as provided in the articles or regulations, no debts or liabilities shall be incurred except by managers in the case of manager-managed LLCs, members in the case of member-managed LLCs, and any agent with apparent authority); W. VA. CODE § 31-1A-21 (Supp. 1994) (stating that no debts or liabilities shall be incurred except by managers in the case of manager-managed LLCs and members in the case of member-managed LLCs); WYO. STAT. § 17-15-117 (1989 & Supp. 1994) (no debts or liabilities shall be incurred except by one or more managers in the case of manager-managed LLCs and one or more members in the case of member-managed LLCs).

Colorado is different in that it is the only state which clearly provides that its LLCs must be manager-managed. Nonetheless, Colorado complicates the issue of actual and apparent authority by including a provision on contracting debts and liabilities that is analogous to the statutes listed above. The Colorado statute says that, except as provided in the articles or operating agreement, only managers will be able to bind the LLC. COLO. REV. STAT. ANN. § 7-80-407 (West Supp. 1993). Presumably, this means that the members of a Colorado LLC could elect in either the articles or an operating agreement to give members actual and/or apparent authority. The North Dakota statute can also be interpreted as mandating the election of a board of governors, but this is not entirely certain since the statute says that if the members desire to act by unanimous consent or vote, they do not need to have governors. N.D. CENT. CODE. § 10-32-69.1 (1994).

156. FLA. STAT. ANN. § 608.422 (West 1993 & Supp. 1994) (stating that managers must be designated in the articles); NEV. REV. STAT. ANN. § 86.291 (Michie 1994) (stating that managers must be designated in the articles); TEX. REV. CIV. STAT. ANN. art. 1528n, § 2.10 (West Supp. 1994) (management is presumed to be in the hands of managers, unless the regulations reserve such power to the members); W. VA. CODE § 31-1A-18 (Supp. 1994) (stating that the articles or operating agreement can designate managers); WYO. STAT. § 17-15-117 (1989 & Supp. 1994) (stating that managers must be designated in the articles).
Finally, some states expressly address the mutual agency of members, but do not clarify the issue to any substantial extent. The Arkansas statute, which provides a good example, contains two provisions relevant to the issue of apparent authority. The first provides that, absent agreement to the contrary in the articles of organization, members in an Arkansas LLC will have mutual agency as to each other and that if there is a specific delegation of authority to managers in the articles of organization, the members will be stripped of their ability to bind the LLC solely by reason of being a member. The second statutory provision appears to say that the members can also delegate their management authority via terms in the operating agreement. While a fair reading of the statutory language indicates that the Arkansas Legislature was probably attempting to allow members the option of designating managers without stripping themselves of apparent authority, the language is anything but clear. The actual provision dealing with the effect of delegating authority in an operating agreement states:

If the articles of organization indicate that management of the limited liability company is vested in a manager or managers, or unless an operating agreement vests management of the limited liability company in one or more managers, then the manager or managers shall have exclusive power to manage the business and affairs of the limited liability company except to the extent otherwise provided in an operating agreement.

The real problem stems from the use of the word “power” when the legislature refers to rights of managers. Under ordinary agency principles, “power” generally refers to both actual and apparent authority. If “power” is read in this way, however, there is absolutely no

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162. Ark. Code Ann. § 4-32-401 (Michie Supp. 1993) (unless provided by either the articles of organization or by written operating agreement, management is to be vested in the members).
164. According to the Second Restatement of Agency, “[a]uthority is the power of the agent to affect the legal relations of the principal by acts done in accordance with the principal's manifestations of consent to him.” Restatement (Second) of Agency § 7 (1958). Apparent authority is also defined in terms of the agent's “power” to act. “Apparent authority is the power to affect the legal relations of another person by transactions with third persons, professedly as agent for the other, arising from and in accordance with
need for distinguishing between the effect of including a delegation of authority in the articles of organization and an operating agreement.

The end result of this analysis is that it is not always easy to determine whether a manager-managed LLC should be viewed in the same way as a general partnership with managing partners (i.e., as having hybrid-management). To the extent that LLC members do retain apparent authority, there is some justification for assuming that the members are not completely helpless, passive investors requiring the protection of the securities laws, even if the entity is manager-managed.

As noted, the second possibility is that the LLCs might attempt to avoid the corporate characteristic of centralized management by seeking to look like a limited partnership. Under current Treasury regulations, a limited partnership will lack centralized management unless the limited partners own substantially all of the partnership interests. In other words, if the general partner in the limited partnership has a substantial interest in the partnership, then the limited partnership will lack centralized management. In a manager-managed LLC, this would require that the managers be members with a substantial interest in the company. This would provide substantial protection to those members with management authority and might provide protection to members with minority interests who presumably would have the right to vote on continuation of the managers. However, the viability of this alternative under the federal income tax code is questionable. The Internal Revenue Service has indicated that it will not consider the percentage of membership interests actually held by members in manager-managed LLCs, ruling in one case that a manager-managed LLC possessed centralized management even where all members were in fact serving as managers.


166. The letter rulings that the IRS has released on LLCs focus on whether management rights proceed from membership status or must be conferred independent of that status. All eight of the rulings published as of the date of this writing that have evaluated manager-managed LLCs have found the corporate characteristic of centralized management to be present. See Rev. Proc. 93-53, 1993-26 I.R.B. 7; Rev. Proc. 93-50, 1993-25 I.R.B. 13; Rev. Proc. 93-49, 1993-25 I.R.B. 11; Rev. Rul. 93-38, 1993-1 C.B. 233; Rev. Rul. 93-30, 1993-1 C.B. 231; Rev. Rul. 93-6, 1993-1 C.B. 229; Rev. Rul. 93-5, 1993-1 C.B. 227; Rev. Rul. 88-76, 1988-2 C.B. 360. This was true even of an LLC in which all members were in fact managers because their managerial status came about as a result of their having been elected. Rev. Rul. 93-6, 1993-1 C.B. 229.
Of course, it is possible that an LLC can be structured to possess the characteristic of centralized management, so long as the LLC does not also possess the corporate characteristic of continuity of life. The question would then become whether the requirement that the LLC in question must lack continuity of life would provide any meaningful protection to investors.

Under the regulations, continuity of life is lacking if the death, retirement, resignation, incapacity, bankruptcy, or insolvency of any partner triggers a dissolution of the organization. By unanimous vote of the remaining partners, or even upon a majority vote in the case of a limited partnership, the business of the partnership may be continued without resulting in the entity possessing the characteristic of continuity of life. Also, the IRS recently ruled that a limited partnership will not possess the corporate characteristic of continuity of life as long as it requires a unanimous vote of the general partners or a majority vote of the limited partners to continue the business.

If, as this language implies, any LLC member can dissolve the organization by resigning, and such dissolution can only be overcome by a vote of all or at least a majority of the remaining members, this places investors in a powerful position. Even the requirement that at

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170. Critics of this argument might suggest that this fact renders the right of dissatisfied members to trigger dissolution insignificant. If a promoter sells an interest in an LLC to an investor and retains at least a majority of the remaining interests, the promoter could thwart any attempt to dissolve the LLC by casting the promoter's majority vote for continuance.

The IRS has, however, been willing to look at whether corporate characteristics are present in fact or merely in appearance. For example, in evaluating whether a German unincorporated association should be classified as a corporation or partnership for tax purposes, the IRS looked beyond the form of the operating documents in Rev. Rul. 93-4, 1993-1 C.B. 2255. In that case, the German business entity argued that it lacked the corporate characteristic of free transferability of interests because the operating documents required unanimous approval of other owners before any ownership interests could be transferred. The Service found that, in reality, because all owners of the entity were wholly owned subsidiaries of the same parent company, any time either wanted to transfer an interest, the other would surely consent. Thus, in reality, there was no restriction on transferability of the interests in question.

Similarly, if a majority interest in an LLC is retained by a promoter, the Service might decide that majority consent to continue the LLC in operation would be no more than a sham, resulting in the LLC possessing the characteristic of continuity of life, possibly costing the LLC its partnership tax classification.
least a majority of members elect to continue the business of the LLC would give members a high degree of protection. If they are cheated or defrauded, members need not rely on state fraud laws since they can trigger dissolution of the LLC by resigning.

The foregoing analysis is not completely settled. In fact, there is a degree of uncertainty surrounding the tax classification of LLCs. In April 1993, the Acting Commissioner of the Internal Revenue Service promulgated new final Treasury regulations relating to the characteristic of continuity of life of limited partnerships.171 When the amendments were first proposed in July 1992, commentators suggested that the regulations be clarified to specifically include LLCs.172 The IRS expressly declined to adopt this suggestion on the grounds that the notice of proposed rule making had set forth a very limited approach that should not be abandoned to address the issue of LLCs.173

Commentators also requested that the IRS clarify whether an entity lacks the corporate characteristic of continuity of life if only one event of withdrawal, such as bankruptcy, triggered dissolution.174 Other commentators requested a clarification to “indicate that an organization will lack continuity of life if a dissolution occurs upon an event of withdrawal of any member and that ‘any’ does not mean ‘each.’”175 The IRS also declined to adopt these suggestions, stating that while the concerns had merit, they had either been addressed in other published guidance or would be considered in future publications.176

In support of this contention, the IRS cited four revenue rulings, all of which specifically relate to LLCs,177 and one revenue procedure.178 Three of the revenue rulings involved domestic LLCs seeking a ruling on their tax classification.179 Each of these three rulings in-

172. Id.
173. Id.
174. Id. 175. Id.
176. Id.
178. Rev. Proc. 92-35, 1992-1 C.B. 790 (dealing with limited partnerships that provide for dissolution of the partnership upon the bankruptcy or removal of a general partner).
volved LLCs that would dissolve upon the death, resignation, or expulsion of any member, and in each case the IRS concluded that the LLC in question should be classified as a partnership. None of these rulings provides guidance on whether an LLC will be held to possess the characteristic of continuity of life if only one of the events of withdrawal listed in the regulations triggers dissolution. Nor does any of them answer the question of how to analyze an LLC that would dissolve upon an event of withdrawal by some but not all members (e.g., an LLC that would dissolve upon the resignation of the managing-member, but not upon the resignation of any of the other members).

The cited revenue procedure does suggest a possible answer to the former question, but only in the context of limited partnerships. In the revenue procedure, the IRS stated that it would not take the position that a limited partnership lacked the characteristic of continuity of life if the bankruptcy or removal of a general partner triggered dissolution of the limited partnership. This leaves the question of what would happen to an LLC that dissolves on the bankruptcy of a member but not on that member’s voluntary resignation.

In several jurisdictions, this question may be academic because the authorizing legislation appears to mandate that dissolution be triggered upon the happening of any event of withdrawal. In many

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180. In each case, this result was compelled by state statute. The Wyoming LLC statute provides that a Wyoming LLC shall be dissolved upon the death, retirement, resignation, expulsion, bankruptcy, dissolution of a member or occurrence of any other event which terminates the continued membership of a member in the limited liability company, unless the business of the limited liability company is continued by the consent of all the remaining members under a right to do so stated in the articles of organization of the limited liability company.


181. Rev. Proc. 92-35, 1992-1 C.B. 790 deals with limited partnerships that provide for dissolution of the partnership upon the bankruptcy or removal of a general partner.

182. Id.

states, however, while this is the default rule, the members are apparently free to agree to alternate arrangements.\textsuperscript{184} It is, therefore, possible that an LLC could be formed in such a way that no member would have the right to voluntarily dissolve it. In this case, the argument that the Internal Revenue Code provides an alternative system of regulation that acts to protect investors would be significantly weakened. Nonetheless, the Code certainly provides a degree of regulation that is completely missing in the case of promissory notes.

The analysis presented in this Section demonstrates how poorly the \textit{Reves} analysis applies to LLC membership interests. \textit{Reves} adopted a presumption that promissory notes are securities unless the family resemblance test is met. It did not purport to adopt a test applicable to other types of interests. Certainly if there were no alternative approaches available, one might stretch, with some degree of difficulty, the \textit{Reves} test to apply to LLC membership interests, despite the obvious complexities and problems such an approach would entail. However, since there is an alternate approach available which was designed to apply to interests that do not fit a well-established pattern, it seems preferable to follow that approach when attempting to analyze whether LLC membership interests will be securities.

\textsuperscript{184} The following state statutes also provide that, in the absence of an agreement to the contrary, the LLC will dissolve upon the dissociation of any member. However, these statutes apparently permit the members of an LLC to agree in advance that dissociation will not trigger dissolution. \textsc{Ark. Code Ann.} § 4-32-901(c) (Michie Supp. 1993); \textsc{Ga. Code Ann.} § 14-11-602(4) (Harrison Supp. 1994); \textsc{Idaho Code} § 53-642(3)(b) (1994); \textsc{Ili. Ann. Stat.} ch. 805, para. 180/35-1(3) (Smith-Hurd Supp. 1994); \textsc{Md. Code Ann., Corps. \\& Ass'ns} § 4A-902(3) (1993); \textsc{Minn. Stat. Ann.} § 322B.80 (West Supp. 1994); \textsc{N.H. Rev. Stat. Ann.} § 304-C:50(IV)(b) (Supp. 1993); \textsc{R.I. Gen. Laws} § 7-16-39(d) (1992); \textsc{Tex. Rev. Civ. Stat. Ann.} art. 1528n, § 6.01(B) (West Supp. 1994); \textsc{Utah Code Ann.} § 48-2b-137(3) (1994).

A number of statutes contain wording that makes it difficult to tell if the members will be able to eliminate one or more events of dissociation as a trigger for dissolution. The most common wording in these statutes is to the effect that dissociation of any member triggers dissolution unless the LLC is continued by unanimous agreement or as otherwise provided in an operating agreement. This raises the question of whether the drafters intend to allow the operating agreement only to provide a different procedure for exercising continuation rights after the fact or also to allow the members to remove events of dissociation as triggers for dissolution prior to the event in question. \textsc{Ala. Code} § 10-12-37(3)(9b) (Supp. 1993); \textit{Connecticut Limited Liability Act, 1993 Conn. Pub. Acts} 93-267, § 41; \textsc{Ind. Code} § 23-18-9-1(3) (Supp. 1994); \textsc{La. Rev. Stat. Ann.} § 12:1334(3) (West Supp. 1994); \textsc{Mich. Comp. Laws Ann.} § 450.4801(d) (West Supp. 1994); \textsc{Mont. Code Ann.} § 35-8-901(3) (1993).
D. LLC Membership Interests as Investment Contracts

In many respects, applying any of the previously discussed tests would be a little like trying to force the stepsister’s foot into Cinderella’s shoe. Each of those tests was developed in the context of a specific type of interest that, in most cases, is distinct from an LLC membership interest. An LLC membership interest is not corporate stock, even though LLCs share certain characteristics with corporations. Nor is an LLC membership interest exactly analogous to a partnership interest, although LLCs will typically have a number of characteristics in common with partnerships—either general or limited—depending on the management structure of the particular LLC. Finally, an LLC membership interest is not a promissory note. As demonstrated, tests that were developed in the context of these other types of interests are not easily applied to LLCs. However, there is another approach that seems well suited to analyzing LLC membership interests, and a number of commentators have assumed in passing that it will be applied to LLC membership interests.\(^{185}\) This test is the investment contract analysis originally adopted by the Supreme Court in \textit{SEC v. W. J. Howey Co.}\(^ {186}\)

Most courts seeking to determine applicability of the federal securities laws to LLC membership interests will probably attempt to determine whether such interests fit within the definition of an investment contract. The investment contract has long been recognized as one of the broad, catch-all terms in the laundry list of interests that qualify as securities.\(^ {187}\) Examining whether a particular interest is an investment contract is, therefore, an appropriate approach for analyzing interests that do not fit well into other categories.

Neither the '33 nor '34 Act defines investment contract, although the term appears in both statutes. The general definition of an invest-


\(^{186}\) 328 U.S. 293 (1946).

\(^{187}\) See supra note 61 and accompanying text.
ment contract is derived from Howey—-a case that raised at least as many questions as it answered. In Howey, the Supreme Court stated that investment contract "means a contact, 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." Unfortunately, this deceptively simple statement left many issues unanswered.

Does the Howey test really require an investment of money, or will the commitment of property or even services suffice? What is necessary to support a finding of a "common enterprise"? Does commonality require only common interests between the investor and the promoter (vertical commonality), or must multiple investors share in the same interests (horizontal commonality)? What is meant by the expectation of profits? Perhaps most importantly, what does it mean that such profits must be expected "solely" from the efforts of a third party? Finally, if these prongs are all met, does that automatically mean that the interest will be a security?

There have been attempts to answer all of these questions in one way or another by various courts. Some of the answers are relatively definite; other questions remain open. For example, the Supreme Court has held that an investment need not be in cash to satisfy the first prong of the test. Six circuits have addressed the commonality issue. Some courts require horizontal commonality; others accept a showing of vertical commonality; and a compromise position

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188. 328 U.S. 293.
189. Id. at 298-99.
190. This last question is not obvious from a reading of the Howey decision. In recent years, however, there have been indications that the Howey four-part test may not be sufficient to determine definitively whether an interest should be classified as a security. See Marine Bank v. Weaver, 455 U.S. 551, 559-60 (1982) (holding that because of the unique nature of one-on-one negotiations in a slaughterhouse, investment scheme was not a security).
191. In International Bhd. of Teamsters v. Daniel, 439 U.S. 551 (1979), the Supreme Court found that this element was met if "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.
192. The Courts of Appeals for the Third, Fifth, Sixth, Seventh, Ninth, and Eleventh Circuits have all addressed the issue of commonality. See infra notes 193-196.
194. See 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, 521-23 (5th Cir. 1974).
has been employed by yet another circuit.\textsuperscript{195} Regarding the determination of profits, some courts have adopted a liberal interpretation, finding that even the expectation of tax benefits will satisfy this element.\textsuperscript{196} However, the Supreme Court had apparently employed a more restrictive approach in an earlier decision.\textsuperscript{197}

The aspect of the Supreme Court’s definition of investment contract that has generated the most controversy is the requirement that investors must expect profits “solely” from the efforts of others. The term “solely,” if interpreted literally, would rob the term “investment contract” of much of its usefulness as a general category of interests that are to be classified as securities. Only totally passive investors would be protected by the securities laws under this approach. A literal interpretation would exclude interests in which the form of the transaction offered a minute degree of theoretical involvement to investors, even if the economic and practical realities of the situation were such that the investors had no meaningful control over their investment and were forced to rely on the expertise of others.

The likely solution to this problem was provided by the Ninth Circuit in \textit{SEC v. Glenn W. Turner Enterprises, Inc.}\textsuperscript{198} The Ninth Circuit held that the appropriate interpretation of the third element of the \textit{Howey} test was to require proof that efforts by someone other than the investor “are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.”\textsuperscript{199} A majority of the other federal circuits have also adopted this approach.\textsuperscript{200} Moreover, the Supreme Court, in \textit{United Housing

\textsuperscript{195} The Ninth Circuit has not accepted either the horizontal commonality or the vertical commonality approach. Horizontal commonality, in the sense that multiple investors must pool their resources, is clearly not required. On the other hand, the Ninth Circuit requires more than that the promoter has a common interest with the investor by virtue of earning commissions in exchange for advice. Brodt v. Bache & Co., 595 F.2d 459, 461 (9th Cir. 1978); El Khadem v. Equity Sec. Corp., 494 F.2d 1224, 1229 (9th Cir.), \textit{cert. denied}, 419 U.S. 900 (1974).


\textsuperscript{197} \textit{United Hous. Found., Inc. v. Forman}, 421 U.S. 837 (1975). Justice Powell, writing for the majority, seemed to limit the definition of profits to capital appreciation or participation in earnings. \textit{Id.} at 852.

\textsuperscript{198} 474 F.2d 476 (9th Cir.), \textit{cert. denied}, 414 U.S. 821 (1973).

\textsuperscript{199} \textit{Id.} at 482.

\textsuperscript{200} \textit{See SEC v. Professional Assocs.}, 731 F.2d 349, 357 (6th Cir. 1984); Goodwin v. Elkins & Co., 730 F.2d 99, 103 (3d Cir.), \textit{cert. denied}, 469 U.S. 831 (1984); \textit{Aqua-Sonic Prods. Corp.}, 687 F.2d at 582; Kim v. Cochenour, 687 F.2d 210, 213 n.7 (7th Cir. 1982); Baurer v. Planning Group, Inc., 669 F.2d 770, 778-79 (D.C. Cir. 1981); Aldrich v. McCul-
Foundation v. Foreman, referred to a "reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others," omitting the word "solely" from the rephrased Howey formulation. However, because the Court expressly declined to state whether it was adopting the Ninth Circuit view, there is still some room for doubt as to the proper interpretation of this aspect of the Howey test.

It is important to focus on this particular element in the definition of an investment contract since proper classification of LLC membership interests under this test is likely to depend on the extent to which members in the LLC are dependent on the efforts of others for a return on their contributions. All of the other elements of the Howey test are likely to be met in the vast majority of instances, regardless of the language employed in the state LLC statute or any advance planning by members or their attorneys.

The first element of the Howey test, as currently interpreted, requires that the purchaser give up some tangible and definable consideration in return for the interest. Most LLC membership interests will undoubtedly be acquired in a way that meets this criterion, regardless of how the LLC is organized or operated. In fact, one commentator has asserted that most are likely to be acquired in exchange for money. It is unrealistic to expect that any degree of planning will enable members to avoid this element, either upon the initial issuance of such interests or their subsequent transfer.

The second part of the Howey test requires commonality. As mentioned earlier, there are two competing interpretations of the requirements under this element. In some jurisdictions, vertical commonality—common interests between the investor and manager of the enterprise—suffices to meet this test. Very few LLCs are likely to fail this test, although a manager-managed LLC in which the manager is not a member and will receive compensation independent of the success of the venture is at least conceivable. Other jurisdictions require horizontal commonality—a pooling of interests by members. In the majority of situations, even this more restrictive test will be satisfied since there are likely to be more than two or three members in most

loch 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).
202. Id. at 852.
203. Id. at 852 n.16.
204. Sargent, supra note 17, at 1096.
LLCs whose contributions to the venture will be combined and whose fortunes will rise or fall together.205

The requirement of expectation of profits is also likely to be satisfied in the majority of cases. Investors in LLCs are likely to be seeking profits,206 although tax benefits may also play a significant role in attracting investors. While sophisticated planning might be successful in attracting investors via unconventional benefits rather than profits, this is not likely to be the case. Moreover, it is possible that an expectation of receiving even the more exotic benefits might satisfy this test.207

The final requirement, that the expectation of profits be based on the entrepreneurial efforts of others, is the one element that is likely to be determinative in most instances when an investment contract analysis is applied. Commentators who have focused on the issue of the proper characterization of LLC membership interests treat this as the critical factor,208 as do commentators who address the securities classification of LLC membership interests more briefly.209

Each of the LLC management alternatives discussed previously (member management, manager management, and hybrid management) has different ramifications when it comes to applying this element of the Howey investment contract analysis. In the member-managed LLC, members would only in very unusual circumstances be able to argue that they must rely on the entrepreneurial efforts of others rather than on their own management skills. In this model, members have ultimate power over the LLC. Although statutes vary as to how the management authority will be divided among the members, and this is subject to further agreement of the parties, the general framework is essentially antithetical to the notion of member passivity.

In the hybrid management situation, involving delegation of actual authority to managers but retention of apparent authority, a very strong analogy can be drawn between the LLC and a general partner-


206. See Sargent, supra note 17, at 1096.


208. Sargent, supra note 17, at 1083; Steinberg & Conway, supra note 17, at 1109-13.

209. E.g., Geu, Understanding the LLC, Part Two, supra note 1, at 510-18.
ship with one or more managers. General partners, while free to delegate actual authority to others, cannot divest themselves of apparent authority, which they possess by statute. This apparent authority may sufficiently show that general partners are not relying solely on the entrepreneurial efforts of their appointed managers. Current cases treat general partners as relying on the entrepreneurial efforts of others only when the general partner “was so dependent on the promoter or a third party that he was in fact unable to exercise meaningful partnership powers.”

Similarly, in an LLC where members retain apparent authority to bind their company, a strong argument can be made that they retain traditional “partnership” power. This is especially true in instances when according to statute, articles of organization, or operating agreement, the members retain a significant degree of control over the managers.

In manager-managed LLCs in which members have divested themselves of apparent as well as actual authority, it is likely that the members will rely solely on the efforts of others. If a member is elected to serve as a manager or becomes a manager of a manager-managed LLC in some other fashion, the member will probably not

210. Williamson v. Tucker, 645 F.2d 404, 424 (5th Cir. 1981). The Fifth Circuit in Williamson offered three examples of when a general partnership interest might properly be classified as a security:

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.

Id.

211. This cumbersome structure may result because of the interaction between particular state LLC statutes and the Tax Code. The Colorado LLC legislation provides that “management of the limited liability company’s business and affairs shall be vested in a manager or managers.” COLO. REV. STAT. ANN. § 7-80-401 (West Supp. 1993). It is permissible to provide that the members shall be the managers.

The reason why LLCs are most likely to adopt such a provision is that they may be attempting to avoid the corporate characteristic of centralized management. As discussed earlier, LLCs are likely to attempt to avoid this in order to insure that they are classified as partnerships for tax purposes. See discussion supra notes 36-45. The rulings that the IRS has released on LLCs focus on whether management rights proceed from membership status or must be conferred independent of that status. All eight of the rulings published as of the date of this writing that have evaluated manager-managed LLCs have found the corporate characteristic of centralized management to be present. Rev. Rul. 93-53, 1993-26 I.R.B. 7 (Fla.); Rev. Rul. 93-50, 1993-25 I.R.B. 13 (W. Va.); Rev. Rul. 93-49, 1993-25 I.R.B.
be relying on the efforts of others. However, in most cases, members of manager-managed LLCs, who are not also managers, completely lack authority, either actual or apparent. Such members would appear to be relying on the efforts of others, thus satisfying the fourth prong of the Howey test. The exceptional situation exists in which the powers of members as set out in the operating agreement were so extensive that it would be inaccurate to depict the non-managing member as a passive investor.

If the discussion ended here, it would appear that some LLC membership interests should be classified as securities under the Howey investment contract analysis. It would also appear that one could draw a general demarcation line between manager-managed LLCs (which typically should be securities) and member-managed LLCs (which should not be). In addition, it would be unlikely that membership interests in LLCs with a hybrid management model would be classified as securities.

There is, however, an additional complication that needs to be addressed. There have been some recent indications that the Howey test should include a consideration of whether the interest at issue involves a privately negotiated transaction or a sale to the public. This factor suggests that not all membership interests in manager-managed LLCs should be classified as securities.

In Marine Bank v. Weaver, the Supreme Court was asked to determine whether a certificate of deposit and a profit-sharing agreement were securities. Both the certificate of deposit and the profit sharing arrangement were entered into after substantial, one-on-one negotiations between the interested parties. In its brief discussion of the certificate of deposit, the Court ignored Howey and found that the instruments were amply protected by the existence of comprehen-

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11 (Ill.); Rev. Rul. 93-38, 1993-1 C.B. 223 (Del.); Rev. Rul. 93-30, 1993-1 C.B. 231 (Nev.); Rev. Rul. 93-6, 1993-1 C.B. 227 (Colo.); Rev. Rul. 93-5, 1993-3 I.R.B. 6 (Va.); Rev. Rul. 88-76, 1988-2 C.B. 360 (Wyo.). This was true even of the LLC in which all members were in fact managers because their managerial status came about as a result of their having been elected. Rev. Rul. 93-6, 1993-1 C.B. 227. It might be possible to avoid this result even in a manager-managed LLC if the articles of organization or operating agreement provides that all members will automatically become members by virtue of their status as members, without any additional act by any party. This is by no means certain, however.

212. See Marine Bank v. Weaver, 455 U.S. 551, 559-60 (1982).
213. Id.
214. Id. at 553, 560.
sive federal banking regulations, and thus did not need the protection of the federal securities laws.\footnote{215} With regard to the profit-sharing agreement, the Court was also reluctant to employ the \textit{Howey} test. Instead, the Court focused on the nature of the transaction and the bargaining between the parties. Although the profit sharing arrangement would presumably have satisfied the \textit{Howey} test, the Court concluded that this was "not sufficient to make that agreement a security."\footnote{216} Because the agreement had been privately negotiated and was essentially unique, the Court declined to treat it as a security.\footnote{217}

At least one commentator has concluded that \textit{Weaver} is a clear indication that the Supreme Court now views \textit{Howey} as a necessary but not sufficient condition for finding an investment contract.\footnote{218} Under this approach, even if LLC membership interests satisfied the \textit{Howey} test, they would only be considered to be securities if sufficient other factors were also present.

The other factor that was clearly missing in \textit{Weaver} was the absence of any impersonal market.\footnote{219} The profit-sharing agreement in \textit{Weaver} was negotiated one-on-one and did not implicate any established market. While LLC membership interests will not always be negotiated on a one-on-one basis, they will certainly not implicate any established securities markets. Thus, the almost certain absence of any wide trading in such interests provides yet another reason for suspecting that, under the investment contract analysis, LLC membership interests will generally not qualify as securities.\footnote{220}

\section*{III. Should the Federal Securities Law Apply to LLC Membership Interests?}

As discussed, under current rules governing the characterization of interests as securities, there is a good chance that LLC membership interests will generally not be classified as securities. This conclusion

\footnotesize{\begin{itemize}
\item 215. \textit{Id.} at 558-59. The Court found that the federal banking regulations offered sufficient protection even though the certificate of deposit in question was in excess of the insurance provided by the Federal Deposit Insurance Corporation. \textit{Id.} at 553 n.1.
\item 216. \textit{Id.} at 560.
\item 217. \textit{Id.}
\item 219. 455 U.S. at 560.
\item 220. For a detailed discussion of why LLCs are not likely to be traded on any established markets and the significance of this fact, see \textit{infra} notes 237-238 and accompanying text.
\end{itemize}}
raises the question of whether that result is desirable. If the securities 
laws ought to be applied to LLC membership interests, either a new 
legislative formulation should be developed, or the courts should con-
sider applying a different test in order to evaluate LLC membership 
interests.\textsuperscript{221} To determine whether securities laws ought to apply to 
LLC membership interests, the logical starting point is to assess the 
consequences of applying the federal securities laws.

The most prominent feature of both the '33 Act\textsuperscript{222} and the '34 
Act\textsuperscript{223} is the extent to which they require disclosure of information. 
The statutes and the regulations promulgated thereunder by the SEC 
contain detailed disclosure requirements and anti-fraud provisions to 
ensure that the disclosures are both complete and accurate.\textsuperscript{224} In very 
general terms, the '33 Act protects potential investors\textsuperscript{225} in newly 
isued securities by ensuring that they are provided with enough infor-

\textsuperscript{221}. Of course, even if they do apply a different test, there is no guarantee that a 
different result will be obtained. For a discussion of how other tests might be applied to 
LLC membership interests, see \textit{supra} Section II.A-C.


\textsuperscript{224}. The informational requirements of the '33 Act require the issuer of a security to 
file a registration statement and to deliver prospectuses in connection with any distribution, 
unless an exemption can be found. Securities Act of 1933, §§ 1-26, scheds. A-B, 15 

The Securities Exchange Act of 1934 contains ongoing reporting requirements, such as 
anti-fraud provision of the '34 Act is undoubtedly § 10(b). 15 U.S.C. § 78j(b) (1988 & 

However, disclosure and anti-fraud requirements are not the sole focus of the Securities 
Acts. For example, another potential consequence of treating LLC membership interests 
as securities is that they must be sold only through the efforts of licensed broker-

\textsuperscript{225}. This straightforward phrase assumes a degree of complexity when the literature 
debating the purpose of the federal securities acts is examined. One school of thought 
views legislation as the product of competing interest groups seeking essentially to protect 
or create monopoly power. \textit{E.g.,} ROBERT CHATOV, CORPORATE FINANCIAL REPORTING: 
PUBLIC OR PRIVATE CONTROL? 186-89 (1975); JAMES S. MOFSKY, BLUE SKY RESTRICTIONS 
ON NEW BUSINESS PROMOTIONS 12 (1971); SUSAN M. PHILLIPS & J. RICHARD 
AND THE REGULATION OF CORPORATE SECURITIES 23 (Henry G. Manne ed., 1969); Henry 
G. MANNE, ECONOMIC ASPECTS OF REQUIRED DISCLOSURE UNDER THE FEDERAL SECURITIES LAWS, IN 
WALL STREET IN TRANSITION 23, 25 (Henry G. Manne & Ezra Solomon eds., 1974). The 
other, and apparently prevailing view, assumes or concludes that the securities laws were 
enacted in a good faith attempt to protect the public. \textit{See, e.g.,} HOMER KRIPKE, THE SEC 
AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE 32-37 (1979); 
Frank H. Easterbrook & Daniel R. Fischel, MANDATORY DISCLOSURE AND THE PROTECTION OF 
INVESTORS, 70 VA. L. REV. 669, 680-87 (1984); Larry E. Ribstein, PRIVATE ORDERING AND THE
formation from the issuer to make a rational investment decision, while the '34 Act focuses on the ongoing disclosure obligations of publicly held companies. Both Acts also incorporate specific anti-fraud provisions designed to ensure that all disclosures are accurate and free of fraud.

The potential benefits from application of the mandatory disclosure rules to LLC membership interests include: (1) guaranteeing that minimally adequate information is available to investors, offering a standardized format for information thereby facilitating comparisons between potential investments; (2) reducing the incentive for "over investment" in securities research by investors; and (3) providing a basis for national litigation to resolve common factual and legal issues in the event of a dispute.


The Supreme Court has never expressly acknowledged this debate and appears to have accepted the good faith of Congress in this regard without question. This Article also assumes that the purpose of the securities laws was and is to protect the public, principally by requiring full and accurate disclosure of material information.


228. By way of example, the language of § 10(b) of the '34 Act makes it unlawful for any person to "use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. § 78j(b) (1988 & Supp. III 1991).

229. This listing of potential benefits from the current scheme of federal securities regulation is neither original nor comprehensive. Numerous other commentators have discussed the potential benefits of securities regulations and have commented on these as justification for mandatory disclosure and/or federal anti-fraud provisions. See, e.g., John C. Coffee, Jr., Market Failure and the Economic Case for a Mandatory Disclosure System, 70 Va. L. Rev. 717 (1984); Easterbrook & Fischel, supra note 225; Ribstein, supra note 225; David J. Schulte, The Debatable Case for Securities Disclosure Regulation, 13 J. Corp. L. 535 (1988).

As to potential benefits that have been left off of this list, the one that has been mentioned most frequently is the promotion of public confidence in the securities markets. "The justification most commonly offered for mandatory disclosure regulation is that it is necessary to preserve public confidence in the capital markets." Schulte, supra at 539.
In the case of LLC membership interests, the first purpose is not likely to be particularly important. The need for an independent requirement that minimal information be provided is most important in the case of investment securities marketed nationally to a large pool of small, passive investors. When the interest in question involves a limited number of investors or targets participants who are likely to have an active role in management responsibilities, the risk of inadequate information is minimized. When the transaction is negotiated privately, the potential participant will normally have sufficient bargaining power to insist on being provided with sufficient information. Similarly, participants who will have management rights are less likely to need the protection of mandatory disclosure since they are likely to be sophisticated enough to ask the right questions, and are in a position to acquire sufficient information independent of federally mandated disclosures. Moreover, if investors have management authority, including the power to bind the entity to acts apparently carried on in the usual course of business of that entity, it will clearly not be in the best interests of other participants to withhold any material information from such investors.

There are good reasons for believing that LLCs will involve either privately negotiated transactions involving management responsibilities or marketing to a relatively small number of investors. However, this justification is utterly and obviously inapplicable to interests that will not be traded on an established market.

The benefits listed in this Article include the justifications that have been most frequently discussed and have at least some possibility of applying to mandatory disclosures for LLCs.


231. Where the transaction is unique, "central disclosure by the firm is rarely necessary to overcome problems of under- and over-production of securities research." Ribstein, supra note 225, at 23. Not only have commentators reached this conclusion, but there is some indication that the courts agree. For example, in Marine Bank v. Weaver, 455 U.S. 551 (1982), the Court concluded that the securities laws did not apply to a one-on-one arrangement even though it would have qualified as an investment contract under the Howey four-part analysis. See infra notes 259-276 and accompanying text.

232. "Investors in closely held firms usually depend on their own managerial and monitoring skills, and therefore have relatively little need for information bearing on returns that may be expected from the 'efforts of others.'" Ribstein, supra note 225, at 22-23.

233. This is, of course, the classic scope of apparent authority of partners in a partnership. A number of LLC statutes also adopt this as the agency power of members in member-managed LLCs. See supra notes 149-166 and accompanying text.

234. There may be a number of situations in which transactions involving LLC membership interests are both negotiated privately, so that they can be structured according to the interests of the particular participants, and are marketed only to those who will participate in management. However, it is also possible to conceive of transactions involving only one of these two characteristics.
In situations involving potential investment in member-managed LLCs, any new members by definition will participate in management.\textsuperscript{235} It is unlikely that such interests will be marketed broadly. Even if they are, the very fact that investors will be asked to participate in management reduces the need for mandatory disclosures. Existing participants will probably not seek an unsophisticated, uninformed member who will be given the power to bind the enterprise. Furthermore, an investor sufficiently sophisticated to be attractive as a potential member with management authority is not likely to invest without adequate information, regardless of whether the federal securities laws apply to the transaction.

In situations involving manager-managed LLCs, potential investors will probably be much more passive, but it is still unlikely that a broad, national marketing of interests will occur. For one thing, most commentators agree that the restrictions on transfer and/or management responsibilities\textsuperscript{236} that are inherent in LLCs make it unlikely that LLC membership interests will be marketed to broad segments of the public.\textsuperscript{237} Aside from such considerations, however, if the LLC membership interests become publicly traded, the tax advantages offered by this choice of business entity are likely to disappear\textsuperscript{238} since under the existing tax code, a publicly traded partnership is taxed as a corporation.\textsuperscript{239} Similar to partnerships, an LLC would be considered to be publicly traded if its membership interests were either traded on an established securities exchange or were readily tradeable on a secondary market or its equivalent.\textsuperscript{240} The House Conference report on the bill that adopted the rules on publicly traded partnerships indicated that a secondary market would exist if investors are readily able to buy, sell, or exchange their interests in a matter economically com-

\textsuperscript{235} Member-management, by definition, means that all members will have some say in management. Under the default rules in states that permit member-management, this would mean either that all members would have an equal say in the management of the LLC or that each would have a proportionate say based on the value of each member's contribution. See statutes cited supra note 27.

\textsuperscript{236} Recall that in order to preserve the benefits of classification as a partnership for tax purposes, no LLC may possess both free transferability and centralized management. See supra notes 36-40 and accompanying text.


\textsuperscript{238} I.R.C. § 7704(a) (1989) (publicly traded partnership will be taxed as a corporation unless 90% or more of its income is passive).


\textsuperscript{240} Id.
parable to trading on an established market.\textsuperscript{241} The restrictions on transferability of LLC membership interests included in the LLC statutes would not prevent this situation from developing as long as the economic interest (the right to receive income) could be freely transferred.\textsuperscript{242} These restrictions, therefore, provide a second reason why LLC membership interests are unlikely to be widely marketed and are also unlikely to require federally mandated disclosures to ensure that investors have access to minimum information.\textsuperscript{243}

As to the second potential benefit—offering a standardized format for information and thereby facilitating comparisons between potential investments—this need is obviated since most deals will likely involve private negotiations between the company and a limited number of potential participants or will involve participants who will assume management rights and responsibilities. Even if basic information is provided in the same format, the unique ordering of each transaction necessitated by individual negotiation and unique management abilities and responsibilities is likely to prevent easy comparisons between LLCs. It is only where units are mass-marketed, and there are equivalent competing investments available, that the need for a standardized format in order to facilitate comparisons is essential.\textsuperscript{244}

The third potential benefit—reducing the incentive for over-investment in securities research by investors—only applies to the extent that the research by investors is excessive. It is economically undesirable for investors to engage in securities research if multiple investors would be engaging in essentially duplicative research, or if the cost of amassing the required data would be reduced by having the issuer of the securities conduct the research. To the extent that LLC membership interests are offered only to a small number of investors, the risk of duplicative research is reduced. Moreover, if each investor's interest would be unique, because of differing management roles or the likelihood of individual negotiation, the research would presumably not duplicate that undertaken by others. In addition, most material information of a general nature will be readily available from

242. \textit{Id.}
243. There is, of course, the argument that it is still easy to conceive of a marketing scheme directed toward a few, unsophisticated investors who do not know enough to ask for the information that would, in fact, be readily available to them. In reality, the likelihood that any such investor would actually read and/or comprehend the disclosures in the form required by the federal securities laws is diminishingly small.
244. \textit{See} Ribstein, \textit{supra} note 225, at 17-18, 22-24.}
the LLC without the need for additional federal regulation because the LLC must maintain detailed financial records under the federal tax rules, and because most state LLC statutes require that members be provided with access to substantial data.\footnote{245}

The final distinct benefit—providing a basis for national litigation to resolve common factual and legal issues—is also minimized where a small number of investors are involved or where the investors have different roles. If each LLC involves a limited number of investors, or if each investment is unique, the necessity for a single forum to resolve common factual or legal issues is substantially reduced.

With regard to the anti-fraud provisions of the federal securities laws, the only real potential benefit is that these rules provide a basis for national litigation.\footnote{246} In the case of securities that are mass-marketed, traded widely, and held by a widely dispersed group of investors, and where investors are likely to have similar interests in the event of any dispute about the accuracy of disclosures, the need for a mechanism to resolve claims expeditiously is obvious. Since LLC membership interests are likely to be sold on a much more limited basis and there is virtually no possibility that the interests will be marketed widely enough for even a strong secondary market to develop, the need for a federal forum in which to resolve claims is less important. In addition, many LLC investors are likely to have unique


\footnote{246}{ None of the other potential benefits discussed in this Article would have any application to anti-fraud provisions since they all relate to the benefits of providing optimal levels of information and since every state has anti-fraud laws which should be sufficient to insure that any disclosures made are accurate.}
claims, predicated on specific information provided to them in the course of negotiations about management rights and responsibilities. This factor also reduces the potential benefits of a national forum for litigation, since different investors would need to present different factual and legal claims, preventing federal litigation from being any more efficient.

Nothing in the foregoing discussion completely eliminates the potential benefits of applying federal securities laws to LLC membership interests, and some investors would undoubtedly benefit from mandated disclosure and the anti-fraud rules. The real problem is that the cost of federal regulation can be tremendous. Thus, the question becomes whether these potential benefits outweigh the likely cost of regulation.

In fact, a number of commentators have argued that such cost exceeds any benefits of mandatory disclosure, even for interests that are widely traded on public markets to large numbers of essentially passive investors. Mandatory disclosure includes direct costs such as the expense of compiling and disseminating the required information together with the indirect costs of all those associated with the disclosure process and the opportunity costs that would occur when the formidable obstacle of mandatory disclosure leads to the abandonment of potentially profitable ventures. All of these costs would apply to LLCs, despite the fact that the range of potential benefits is severely restricted, given the nature of most LLC membership interests. Moreover, the limited nature of LLC membership interests does not mean that the cost of compliance will be similarly reduced. It has been noted that "many of the costs of disclosure are the same, regardless of the size of the firm or the offering."

In addition to the cost of complying with the disclosure requirements of the securities laws themselves, there are other potential con-

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248. Easterbrook & Fischel, supra note 225, at 671.
sequences associated with the treatment of LLC interests as securities. One particularly negative consequence, especially for professional service enterprises that elect the LLC form, is the risk of being prohibited from electing the cash method of accounting.\textsuperscript{249} Virtually all professional service enterprises use the cash method of accounting in order to take into consideration the fact that services are often performed long before fees are received.\textsuperscript{250} Congress, recognizing both the legitimate tax advantages gained by permitting taxable income to be reported on the cash method and the potential for abuse, has imposed a general requirement that certain enterprises be precluded from using the cash method of accounting.\textsuperscript{251} Among the kinds of enterprises prohibited from relying on the cash method of accounting are those that qualify as a "tax shelter."\textsuperscript{252}

For purposes of this rule, "tax shelter" is defined to include "any enterprise (other than a C corporation) if at any time interests in such enterprise have been offered for sale in any offering required to be registered with any Federal or State agency having the authority to regulate the offering of securities . . . ."\textsuperscript{253} With nothing more, this section would mean that if an offering of LLC membership interests is made in a manner that requires registration,\textsuperscript{254} regardless of whether the securities laws are actually complied with, that LLC would lose any ability to rely on the cash method of accounting—a result that is potentially disastrous for professional service LLCs. In reality, however, the definition of "tax shelter" has been expanded far beyond this.

In addition to defining tax shelters in the terms discussed above, the current temporary regulations define the requirement of registration to include situations in which "under the applicable federal or state law, failure to file a notice of exemption from registration would result in a violation of the applicable federal or state law (regardless

\textsuperscript{249} The cash method of accounting generally permits taxable income to be reported on the basis of cash receipts and disbursements rather than when claims accrue. See I.R.C. § 446 (1989).

\textsuperscript{250} See Shop Talk, 79 J. Tax’n 63 (Sheldon I. Bannoff et al. eds., 1993) (explaining that professionals report on the cash method because of lagging collectibles and the traditional nature of professional service organizations in which charging interest on late payments is viewed as uncomfortable for both the firm and its clients).

\textsuperscript{251} I.R.C. § 448 (1989).


\textsuperscript{254} Recall that the securities laws generally require any sale of a security to be registered unless an exemption is available. Securities Act of 1933 § 5, 15 U.S.C. § 77e (1988).
of whether the notice is in fact filed).\textsuperscript{255} This is critical to LLCs wishing to use the cash method of accounting because most exemptions from the federal registration requirement, and/or the regulations that have been adopted to clarify such exemptions, require the filing of a notice.\textsuperscript{256}

In essence, this means that if an LLC has membership interests that are classified as securities, the cash method of accounting may be unavailable.\textsuperscript{257} In turn, this may mean that the LLC may be unavailable as a practical matter to a number of enterprises, or at least not available to the extent intended by state legislatures.

The foregoing discussion clearly points toward the conclusion that the federal securities laws should generally not be applied to LLC membership interests because the potential benefits are so restricted


\textsuperscript{256} For example, Regulation A (Rules 251-263) requires the filing of an offering statement. Regulation D (Rules 501-508) requires filing of Form D as to sales solely to accredited investors under § 4(b).

The interstate offering exemption does not require the filing of any notice with the SEC, but state Blue Sky laws may well require a notice of exemption even for small offerings. Even the Internal Revenue Code recognizes that state laws may often require the filing of a notice in order to preserve an exemption. In fact, in the provision restricting availability of the cash method of accounting, the definition of "tax shelter" is modified to exclude S corporations "required to file a notice of exemption from registration with a State agency . . . if there is a requirement applicable to all corporations offering securities for sale in the State that to be exempt from such registration the corporation must file such a notice." I.R.C. § 448(d)(3) (1989). However, this exclusion does not apply to LLCs.

Note that there are similar problems with regard to state registration requirements; however, this topic is beyond the scope of this Article.

\textsuperscript{257} As of the end of June 1994, there were a total of eight private letter rulings from the IRS dealing with the issue of whether an LLC would be legally entitled to use the cash method of accounting. In most of these rulings, the Service relied on a representation from the party requesting the ruling that it would never be required to register interests in itself (as that term is defined in the regulations) in determining that the cash method of accounting would not be unavailable. See Priv. Ltr. Rul. 94-22-034 (Mar. 3, 1994), Priv. Ltr. Rul. 94-21-025 (Feb. 24, 1994), Priv. Ltr. Rul. 94-15-005 (Jan. 1, 1994), Priv. Ltr. Rul. 94-12-030 (Dec. 22, 1993), Priv. Ltr. Rul. 93-50-013 (Sept. 15, 1993) and Priv. Ltr. Rul. 93-28-005 (Dec. 21, 1992). One Private Letter Ruling did not address the issue of whether the LLC in question would be precluded from utilizing the cash method of accounting because it might be required to "register" interests in itself prior to sale. See Priv. Ltr. Rul. 94-07-030 (Nov. 24, 1993). In another, the Service found that the LLC could rely on the cash method of accounting based in part upon a representation that it will not offer any interests in itself for sale (and thus would not have to worry about either registering or finding an exemption). See Priv. Ltr. Rul. 93-28-005 (Dec. 21, 1992).

In none of these letter rulings did the Service discuss whether the membership interests were, in fact, to be classified as securities. However, the recited facts in most of these letter rulings indicate that the LLCs in question would offer substantial management rights to all owners. There is a strong possibility, therefore, that the interests would not have been classified by the courts as securities in the first place.
and the costs are likely to be high. This conclusion is actually quite consistent with the views of a number of other commentators who, while not addressing the proper classification of LLC membership interests, have considered the proper scope of the securities laws.\textsuperscript{258}

For example, in 1967, Professor Ronald Coffey advanced the idea that the securities laws ought to apply to transactions in which there is "a need for the special fraud procedures, protection, and remedies provided by the securities laws."\textsuperscript{259} This has probably been the most influential article on the issue.\textsuperscript{260} In Professor Coffey's view, the federal securities laws should apply when a buyer invests funds that are "subject to the perils of enterprise failure" if the buyer is not familiar with the enterprise or not exercising management control.\textsuperscript{261} If the buyer is familiar with the business and in a position to participate in its control, he "is hardly in a position to claim that he was induced to furnish value by means of misstatement or half-truths about the character of the venture."\textsuperscript{262} If this approach is applied to LLCs, typical LLC membership interests should not be covered. Many buyers will be in a position to participate in control,\textsuperscript{263} and even when the buyer is not expected to exercise management power, there is a good chance that any investor will be relatively familiar with the business prior to making an investment decision.\textsuperscript{264}

\textsuperscript{258} See, e.g., Carney, supra note 218 (also arguing in favor of a market-oriented approach); Eric Chiappinelli, Reinventing a Security: Arguments for a Public Interest Definition, 49 WASH. & LEE L. REV. 957 (1992) (suggesting that the securities laws should only apply where public regulatory benefits would be clear); Ronald Coffey, The Economic Realities of a "Security": Is There a More Meaningful Formula?, 18 CASE W. RES. L. REV. 367 (1967) (suggesting that the securities laws should only apply where they are specifically needed); FitzGibbon, supra note 226 (suggesting that securities laws should only apply to interests eligible to participate in public markets); Ribstein, supra note 225 (suggesting that parties wishing federal securities law protection should have to "opt in" by structuring their transaction in specific, enumerated ways).

\textsuperscript{259} Coffey, supra note 258, at 373.

\textsuperscript{260} Professor Coffey's article has been cited by the Supreme Court and many lower federal courts. See, e.g., United Hous. Found., Inc. v. Forman, 421 U.S. 837, 857 n.24 (1975); Rucenacht v. O'Halloran, 737 F.2d 320, 321 n.2 (3d Cir. 1984); United Cal. Bank v. Financial Corp., 557 F.2d 1351, 1358 n.9 (9th Cir. 1977); SEC v. Koscot Interplanetary, 497 F.2d 473, 483 (5th Cir. 1974). In addition, according to Shepard's Citator, more than fifty law review articles have made reference to this particular article.

\textsuperscript{261} Coffey, supra note 258, at 396.

\textsuperscript{262} Id.

\textsuperscript{263} This will be required in member-managed LLCs.

\textsuperscript{264} Unless the LLC is manager-managed, a potential investor will probably have apparent authority to bind the LLC, making it unlikely that other owners will accept an investor who is completely ignorant of the entity's business and affairs. Alternatively, if the LLC is manager-managed, in order to be classified as a partnership for federal tax purposes, the member's interests cannot be freely transferable. Few investors, even those
Other commentators have suggested that the scope of the federal securities laws should be determined with reference to the financial markets. Under this approach, the term "security" would be limited to "financial instrument[s] eligible to participate in a public market." The justification offered for this approach is that it would pay proper "respect [to] the intention of the framers to focus the securities law on the financial markets," while avoiding the uncertainty inherent in the various approaches currently employed by the courts. Application of this approach to LLC membership interests is even easier. Since LLC membership interests would not be traded on established financial markets, there would be no reason for any LLC membership interest to be covered by the securities laws under this approach.

Another approach that has been recommended is to ask directly whether the particular instrument involves a transaction that needs who are relatively unsophisticated, are likely to accept an investment in an entity with which they have no familiarity when they will be unable to sell their interests without the consent of other members.

Moreover, as a practical matter, the very nature of the LLC lends itself particularly well to smaller businesses. Accord James W. Lovely, Agency Costs, Liquidity, and the Limited Liability Company as an Alternative to the Close Corporation, 21 STETSON L. REV. 377 (1992); Sylvester J. Orsi, Comment, The Limited Liability Company: An Organizational Alternative for Small Business, 70 NEB. L. REV. 150 (1991); Diane Solov, Ohio Law Allows New Business Structure, THE PLAIN DEALER, Apr. 9, 1994, at 1C (reporting that "[l]awyers and accountants say businesses most likely to find limited liability companies appealing are closely held firms, family-owned companies and joint ventures."). Investors in small businesses generally know enough to be cautious about the investment, and often the deals which induce such investments are carefully negotiated.

All of this supports the conclusion that odds favor an investor in an LLC being reasonably well informed.

265. See, e.g., Carney, supra note 218; Chiappinelli, supra note 258; FitzGibbon, supra note 226.

266. FitzGibbon, supra note 226, at 919 (emphasis in original). Accord Chiappinelli, supra note 258, at 974 ("A new instrument should be subject to the securities laws when doing so would achieve such regulatory benefits as uniformity or market consolidation, market integrity, or market participant oversight." (footnotes omitted)).

267. FitzGibbon, supra note 226, at 918.

268. Professor Carney makes the argument that, in actuality, several courts have recognized a market-oriented approach, at least implicitly. Among the examples cited by Professor Carney are SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943), in which the Supreme Court placed significant emphasis on the market context of the offering, and Marine Bank v. Weaver, 455 U.S. 551 (1982), in which the Court excluded a unique arrangement from the scope of the securities laws because the transaction was negotiated one-on-one, rather than in an impersonal market. Carney, supra note 218, at 334.

269. The reason for this statement is that the LLC would likely lose its tax classification as a partnership if this happened. See supra notes 36-40 and accompanying text.
the protection of the securities laws. To reconcile this approach with existing securities jurisprudence, Professor Chang advocates the creation of a two-tiered approach to the definition of a security. First, one would have to determine whether a particular device was an instrument, such as a stock certificate, a bond, or even an investment contract, which by reference to existing expectations could reasonably be considered a security. The second step would be to determine if the transaction is one that justifies application of the securities laws. LLC membership interests might easily be excluded under either tier of this approach. LLC membership interests are not necessarily represented by any instrument since there is generally no requirement in the LLC statutes that any "certificate" of membership be issued. Even if an LLC membership interest is found to be an instrument, all of the reasons presented earlier as to why the potential benefits of securities regulation are unlikely to apply to LLC membership interests apply to this analysis.

Yet another approach to the proper definition of "security" is to adopt a private-ordering paradigm. Professor Ribstein has suggested that the federal courts explicitly allow parties to opt out of the disclosure and anti-fraud provisions of the federal securities laws by structuring their transaction to fit a particular form. The particular form of transaction that Professor Ribstein suggested for the opt-out

271. Id. at 405-406.
272. "If the transaction involving an instrument does not justify the application of the acts, then, as to this particular class of transactions, the instrument is excluded from regulation." Id. at 459.
273. Lest the reader be concerned that my interpretation of the word "instrument" is too narrow, a review of the statutory language defining a "security" might provide the best response. For example, the term "security" is defined in the '33 Act to include "evidence of indebtedness," a "certificate of interest of participation in any profit sharing agreement," or "voting trust certificate." 15 U.S.C. § 77(b)(1) (1988)(emphasis added). The indebtedness or interest in the profit sharing agreement or voting trust by itself is not the security; the certificate is.
274. Ribstein, supra note 225, at 26-36.
275. The lack of predictability offered by the current approaches seems to be one of the most prominent justifications for allowing parties to opt out. In fact, Professor Ribstein quoted the following Supreme Court decisions to emphasize the fact that others have also condemned the lack of predictability: "[W]e find more daunting . . . the prospect that parties to a transaction may never know whether they are covered by the Acts until they engage in extended discovery and litigation . . . . [T]he parties' inability to determine at the time of the transaction whether the Acts apply neither serves the Acts' protective purpose nor permits the purchaser to compensate for the added risk of no protection when negotiating the transaction." Id. at 58 (quoting Landreth Timber Co. v. Landreth, 471 U.S. 681, 696-97 (1985) (referring to the "sale of business" doctrine that would have excluded stock
option was the general partnership, but an equally compelling argument can be made for the LLC or at least the member-managed LLC. As with general partnerships, most potential investors in LLCs will not benefit tremendously from application of the securities laws.\textsuperscript{276} The specific attributes of the general partnership to which Professor Ribstein pointed—the management and informational rights and the ability to trigger dissolution—also apply to LLCs, particularly those that are member-managed. Adopting a rule that LLC membership interests in member-managed LLCs are per se not securities would permit recognition of all the benefits of private ordering and predictability discussed by Professor Ribstein.

Even if these alternative approaches to the definition of a security remain no more than interesting speculation and commentary, none of these suggestions would cut against determining that LLC membership interests are generally not securities. With this in mind, two questions remain. First, for state legislators wishing to make the LLC as attractive as possible for new business ventures in their jurisdiction, what statutory provisions are most likely to lead courts to the conclusion that LLC membership interests are not securities? Second, regardless of the provisions of the state statute, what provisions can be included in an LLC's articles of organization or operating agreement as a matter of individual planning to make it more likely that the courts will decline to apply the securities laws to membership interests in a given LLC?

**IV. Influencing Judicial Decisions**

Although this Article concludes that, under existing legal guidelines, courts ought to decide that LLC membership interests are not securities in most instances, there are certainly a number of choices that can be made to make this result more likely. Some choices would have to be made by legislators responsible for adopting and amending the legislation that authorizes the creation of LLCs. Other choices can be made by practitioners or others who are forming an LLC and do not wish the membership interests therein to be subject to the federal securities laws. The first half of this Section addresses the legislative options that might make it more likely for the courts to decline to treat LLC membership interests as securities. The latter half of this

\textsuperscript{276} See supra notes 229-246 and accompanying text.
Section examines options available to those planning for a particular LLC under any of the various legislative schemes.

A. Legislative Choices

Before actually addressing the statutory provisions that might make it easier for courts to decide that LLC membership interests are not securities, it is worth considering whether there is any meaningful possibility of influencing state legislation. Prior to 1990, only two states had statutes authorizing the formation of LLCs. In slightly more than two and one-half years, more than thirty additional states have adopted similar legislation, with more states likely to follow in the future. Because LLC statutes are so new, no model legislation has yet been promulgated in this regard, although there are two versions of model legislation in the drafting stage.

Because of the lack of model legislation, the speed with which these statutes have been passed, and differing philosophies concerning the appropriate goals of LLC legislation, LLC statutes vary tremendously from state to state. Some statutes are very detailed and were obviously drafted with great care. Other statutes are relatively short and appear to leave numerous issues open. Since LLC

278. See supra notes 12-16 and accompanying text.
279. See discussion of the two draft model statutes supra note 21.
280. For example, two competing goals are certainty and flexibility. One type of LLC statute emphasizes the benefits of creating an entity that will be taxed as a partnership. These statutes are basically fool proof in that any LLC created under the auspices of such legislation will satisfy the current IRS regulations concerning what it takes for an unincorporated association to qualify as a partnership for federal tax purposes. E.g., Wyo. Stat. §§ 17-15-101 to -136 (1989 & Supp. 1994). The other type of statute emphasizes the flexibility of the LLC form. LLCs formed under such legislation can be organized so as to satisfy the current partnership tax regulations, but careless drafting or planning might well result in an LLC that is classified by the IRS as an association taxable as a corporation. E.g., Del. Code. Ann. tit. 6, §§ 18-101 to -1106 (1993).
283. Many states, for example, do not address the issue of whether LLCs can be used by professional groups such as physicians, accountants, or attorneys. E.g., Okla. Stat. Ann. tit. 18, §§ 2000-2060 (West Supp. 1994). Other states have language about the apparent authority of members and managers, which is confusing at best. See supra notes 151-166 and accompanying text. Other statutes omit any discussion of various potential rights of members, such as the right to petition for dissolution, the right to request information
legislation is so new and unsettled, it is inevitable that many states will be undertaking review of, and amendment to, their LLC statutes.\textsuperscript{284} One potential consideration for state legislators might be to adopt a statutory form that makes application of the federal securities laws less likely—particularly if the LLC form is seen as a vehicle for attracting in-state investment.\textsuperscript{285} If this is a goal, as this Article suggests, a number of provisions might be considered.

The most obvious suggestion is to create a default rule that provides for member management of the LLC. Since member-managed LLCs are so analogous to general partnerships in terms of the participatory rights of equity owners, the strongest case for avoiding application of the federal securities laws can be made in the case of such LLCs. Therefore, a state that provides this as the default rule may make it more likely that LLCs formed under its statute will avoid application of federal securities laws to their LLC membership interests.\textsuperscript{286}

Currently, there is quite a range of default rules relating to management of LLCs. While most states specify that members will have management rights (unless the articles of organization and/or the operating agreement delegates such authority to managers)\textsuperscript{287} some statutes provide that the LLC will be controlled by managers unless the members agree otherwise,\textsuperscript{288} or even that the LLC \textit{must} be controlled from the LLC, or the right to demand distributions upon withdrawal, leaving open the question of whether members of LLCs in such jurisdictions will have such rights.

\textsuperscript{284} As of September 15, 1993, more than a dozen states were contemplating amendments to their LLC statutes, or amendment to other statutes necessitated by the hasty adoption of LLC legislation.

\textsuperscript{285} For example, this was apparently one of the motivations that led Florida to adopt its LLC statute. \textit{See} Richard Johnson, Comment, \textit{The Limited Liability Company Act}, 11 \textit{Fla. St. U. L. Rev.} 387, 387 (1983).

\textsuperscript{286} In addition, this would add to uniformity among state laws. Since the majority of state statutes already adopt the member-management model as a default rule for LLCs, this would be a logical suggestion even if the only advantage were a greater degree of consistency in LLC legislation. \textit{Accord} \textit{Unif. LLC Act} (1993 Draft), \textit{supra} note 21, at § 301.


by managers. Of these three options, the statutes which provide the most support for the proposition that LLC membership interests generally should not be securities are those which specify that management will be vested in the members unless the articles of organization specify that managers will have such authority.

In addition to member management, statutes could also be drafted to make it clear that members could elect to retain apparent authority even after designating managers. A few states have apparently attempted to accomplish this. Some states address the

289. COLO. REV. STAT. ANN. § 7-80-401 (West Supp. 1993). The members may in fact be the managers, but this would have to be by election, not by virtue of their status as members. See also N.D. CENT. CODE § 10-32-69.1 (1994).

290. In addition to the three models discussed above, one statute does not directly address the management of the LLC. MD. CODE ANN., CORPS. & ASS'NS § 4A-401(a) (1993). The Maryland Code does, however, provide that every member is an agent of the LLC, with authority to bind the entity unless the articles of organization contain a limitation of the members' authority. Id. This is basically consistent with the member-management model; thus, Maryland has been characterized in this Article as adopting member-management as a default model.

291. The 1993 discussion draft of the Uniform LLC Act adopts the default rule of member-management. UNIF. LLC ACT (1993 Draft), supra note 21, at § 301(a). The ABA project would also have adopted the member-management model as a default rule. DRAFT PROTOTYPE LLC ACT (1992), supra note 21, at §§ 301, 401.

292. Apparent authority is derived from basic agency principles and refers to the power to bind a principal even absent actual authority. RESTATEMENT (SECOND) OF AGENCY § 8 (1958). "Apparent authority is the power to affect the legal relations of another person by transactions with third persons, professedly as agent for the other, arising from and in accordance with the other's manifestations to such third persons." Id.

293. This is referred to throughout as a hybrid-management model. See discussion supra notes 149-166 and accompanying text.

294. ARIZ. REV. STAT. ANN. §§ 29-654(A)(1-2), (B)(2-3) (Supp. 1993) (detailing the agency powers of members in both the member- and manager-managed models); ARK. CODE ANN. §§ 4-32-301, 4-32-401 (Michie Supp. 1993) (detailing the agency powers of members in both the member- and manager-managed models); MD. CODE ANN., CORPS. & ASS'NS § 4A-401(a) (1993) (providing that every member is an agent of the LLC unless the articles provide to the contrary); OKLA. STAT. ANN. tit. 18, § 2019 (West Supp. 1994) (addressing the agency powers of managers only); R.I. GEN. LAWS § 7-16-20 (1992) (addressing the agency powers of managers only); UTAH CODE ANN. §§ 48-2b-125(1)-(2) (1994) (detailing the agency powers of members in both the member- and manager-managed models).

The model legislation that is currently being considered by the Commissioners on Uniform State Laws also addresses the issue of authority of members and managers. UNIF. LLC ACT (1993 Draft), supra note 21, at § 301. The Draft Prototype LLC Act also addressed the agency powers of members and managers. DRAFT PROTOTYPE LLC ACT (1992), supra note 21, at §§ 301, 401. Although the Prototype legislation has apparently been abandoned by the ABA, this section is particularly important since it apparently served as the model for the LLC legislation in several states.
agency authority of both members and managers,\textsuperscript{295} while others address only one side of the issue.\textsuperscript{296} The majority of states, however, specify that the members will have exclusive power to manage the LLC unless the articles and/or operating agreement contain an express delegation of such authority to managers, in which case managers will have the exclusive power.\textsuperscript{297}

The reason that some states address the issue of member and manager authority to bind the LLC is probably derived from the current tax regulations concerning centralized management.\textsuperscript{298} The current regulations, while less than perfectly clear, seem to indicate that an organization will possess centralized management if any person or persons other than all of the members have the exclusive authority to make management decisions that bind the business.\textsuperscript{299} In the context of general partnerships, this test is met even if the partners delegate exclusive actual authority to one or more managers because “even if the partners agree among themselves that the powers of management shall be exclusively in a selected few, this agreement will be ineffective as against an outsider who had no notice of it.”\textsuperscript{300} Because persons wishing to form an LLC may wish to avoid the corporate characteristic of centralized management, some statutes have apparently been drafted with the intent of allowing an LLC to elect a manager-man-


Although it does not mention agency authority or the right to bind the entity explicitly, the effect of a provision giving either members or managers the exclusive power to manage is almost certain that in member-managed LLCs, the members have both actual and apparent authority to bind the LLC. Further, in manager-managed LLCs, managers are in the same position. There is no possibility of designating actual authority to managers while one or more of the members retain the apparent authority to bind the LLC simply by virtue of their status as members.

\textsuperscript{298} See supra notes 36-45 and accompanying text.

\textsuperscript{299} Treas. Reg. § 301.7701-2(c)(1) (as amended in 1993).

\textsuperscript{300} Id. at § 301.7701-2(c)(4).
agement model, while leaving enough authority in the hands of mem-
bers so that centralized management is lacking.\textsuperscript{301}

This analysis is also relevant to the securities classification of LLC
membership interests. A membership interest that includes the right
to bind the LLC is not likely to be issued to an uninformed, passive
investor who needs the protection of the securities laws.\textsuperscript{302}

The problem is that most statutes fall short of accomplishing this
with any degree of clarity. Those states that ignore the issue alto-
gether apparently do not permit the LLC to choose a management
structure that delegates actual authority to managers while retaining
significant management rights for the members.\textsuperscript{303} Those statutes that
deal only with the apparent authority of managers also fail to provide
maximum flexibility to LLCs in regard to establishing a structure in
which membership interests are least likely to be treated as
securities.\textsuperscript{304}

Of the remaining statutory models, the Utah statute provides that
members in a member-managed LLC will have the authority to bind
the LLC, unless the articles of organization provide otherwise.\textsuperscript{305} This
statute does not provide for retention of apparent authority by mem-
bers when a manager-managed LLC is organized. In one section, the
Arkansas statute provides that all members have apparent authority
to bind the LLC unless the articles of organization delegate such au-
thority to managers,\textsuperscript{306} which by implication should mean that a pur-
ported delegation of authority in an operating agreement would be
sufficient to strip members of actual but not apparent authority. Un-
fortunately, the next section of the Arkansas statute provides that if

\textsuperscript{301} Certain comments to the 1993 Draft of the Uniform Limited Liability Company
Act seem to confirm this reasoning by explicitly referring to the centralized management
test set forth in Treas. Reg. § 301.7701-2(c) “which implicitly recognizes a dichotomy be-
tween ‘exclusive authority to make management decisions’ and ‘the agency power to bind
the entity.’” UNIF. LLC ACT (1993 Draft), supra note 21, § 301 cmt.

\textsuperscript{302} It would clearly not be in the best interests of the LLC to keep investors who have
the authority to bind the LLC in the dark as to material developments. Thus, the presence
of this characteristic is likely to indicate an interest to which there is no need to apply the
securities laws. Since giving members the right to bind the LLC is tantamount to saying
that they are not expected to rely on the entrepreneurial efforts of others, this would mean
that the LLC membership interests would fail the Howey test and would not be considered
to be securities.

\textsuperscript{303} Those rights would be inherent in any model where a member in a manager-man-
aged LLC retained apparent authority to bind the entity.

\textsuperscript{304} Oklahoma and Rhode Island fit this pattern. OKLA. STAT. ANN. tit. 18, § 2019

\textsuperscript{305} UTAH CODE ANN. § 48-2b-125 (1994).

\textsuperscript{306} ARK. CODE ANN. § 4-32-301 (Michie Supp. 1993).
managers are designated in an operating agreement, they will have exclusive power to manage the LLC. The question of what these two provisions mean when read together is debatable.

The Arizona legislation is not subject to any of these criticisms. The agency powers of members and managers are addressed in a separate provision which explains first that unless the articles vest management in one or more managers, all members have actual and apparent authority to carry on the LLC's usual business. The second subsection of this provision says that if the articles do vest the management rights in manager(s), members lose their agency status except to the extent that the manager delegates authority to them or as provided in the operating agreement. There is nothing inconsistent with this scheme in the second statutory provision dealing with management rights which provides that management authority is vested in the members unless the articles provide for managers, “subject to any provision in an operating agreement restricting or enlarging the management rights or responsibilities of one or more members or classes of members.”

The Arizona statutory language, therefore, offers the best choice of flexible provisions that permit LLCs to be organized with the broadest range of management options, including those that are less likely to result in membership interests that should be treated as securities.

In addition to statutory rules that provide for a member-managed LLC as a default model and permit delegation of actual authority to managers while retaining significant management rights for members, state LLC statutes could include a number of protective provisions. The inclusion of such provisions should strengthen the argument that states have chosen to regulate LLCs in a manner that adequately protects potential investors. For example, statutes could provide detailed informational rights to members.

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307. Ark. Code Ann. § 4-32-401 (Michie Supp. 1993). This ambiguity can be traced to the fact that the Arkansas Legislature chose to rely on the draft of the Prototype LLC Act, which was then being worked upon by a working group of an ABA subcommittee. See Draft Prototype LLC Act, supra note 21, §§ 301, 401. This draft has apparently been abandoned by the ABA in favor of the project currently underway by the Commissioners on Uniform State Laws.


Although a number of state statutes do not explicitly address the informational rights of LLC members, other states currently have provisions requiring the LLC to maintain detailed records and to provide some or all of that information to members upon a proper request. Of those statutes, some require the LLC to provide members with any of the listed records or even other material information any time the member can show a reasonable purpose. However, other statutes permit the LLC to specify circumstances under which such information will be made available and it is apparently possible under some of these statutes that the LLC might eliminate this statutory right altogether.

To make the strongest argument that the state LLC statutes generally provide sufficient protection for investors so that there is no need for application of the federal securities laws, strong informational rights are very desirable. The ideal statutory model would be one that requires any LLC to provide all members with material information upon the showing of a reasonable purpose.

The draft of the Uniform LLC Act does require that an LLC provide its members with access to its books and records upon the showing of a proper purpose. This draft, however, does not provide any


313. See statutes cited supra note 127.


316. Both Arkansas and Louisiana have LLC legislation that provides that members have the right to inspect the LLC records, except as otherwise provided in the articles or an operating agreement. ARK. CODE ANN. § 4-32-405 (Michie Supp. 1993); LA. REV. STAT. ANN. § 12:1319 (West Supp. 1994). The Louisiana statute, however, complicates the situation by adding the following sentence at the end of the section on records: "Rights under this Section shall not be affected by any actual or constructive notice . . . to the contrary." The effect of this sentence, which seems to contradict the preceding language, is unclear.

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guidance on what books and records must be kept. The justification for this is that many small businesses might not keep formal books and records in any given format and it should be sufficient to require that an LLC provide its members with whatever records it actually possesses.318

While there apparently is good reason to expect small businesses to operate more informally, a list of certain items that would have to be included is certainly a good idea in order to provide a reasonable level of protection for investors. Items that could be required without imposing an undue burden on the smaller businesses organized as LLCs include a list of members and their addresses; the articles of organization and any amendments; all written operating agreements and any amendments; federal, state, and local tax returns for the last three years; and copies of any financial statements. Several states have such a list in their LLC statutes.319

Another example of a possible protective provision would be for statutes to spell out the right of members to withdraw and receive the fair value of their membership interest. Such a right would strengthen the argument that the state legislation includes sufficient protection so that LLC membership interests would not need to be classified as securities.

A number of state statutes do not specifically address what happens when a member withdraws, except to say that this is an event of disassociation, which in turn triggers dissolution of the LLC unless the remaining members elect to continue the LLC in existence.320 Some of the LLC statutes provide that, subject to contrary agreement of the parties in the articles or an operating agreement, a member has the right to receive the fair market value of his or her LLC membership

318. Id. at § 410 cmt. This language generally follows §§ 403(a) and (b) of the Revised Uniform Partnership Act, which was approved by the National Conference of Commissioners on Uniform State Laws in 1992. 6 U.L.A. 465 (Supp. 1994).


interest upon withdrawing from the LLC. Only one state requires that an LLC pay a withdrawing member the fair value of his or her membership interest, without providing that this requirement is subject to a contrary agreement expressed in either the articles or an operating agreement. The current draft of the Uniform LLC Act would also give a withdrawing member the absolute right to be paid the fair value of the membership interest. The language of the draft Uniform LLC Act is quite clear, and adequately protects the remaining members in the case of a wrongfully dissociating member by specifying that this right to be bought out does not affect any liability that the wrongfully dissociating member may have for damages.

Yet another protection that could be incorporated into state LLC legislation would give members the right to petition for judicial dissolution. As with the preceding suggestions, this would support the notion that LLC membership interests do not need to be subject to the federal securities laws because the state statutes assure sufficient protection for investors.

A number of state statutes already have provisions governing judicial dissolution. However, the most common formulation permits judicial dissolution only upon a showing that it is no longer reasonably practical to carry on the business of the LLC in accordance with the operating agreement. A few statutes do, however, permit judicial dissolution upon proof of abuse of authority, fraudulent behavior, or the like. The right to force judicial dissolution in the event of fraud-

323. Unif. LLC Act (1993 Draft), supra note 21, §§ 602, 701 (providing for mandatory purchase of a dissociated member's interest).
324. See supra notes 126-136 and accompanying text.
ulent or oppressive behavior would provide a significant protection to investors, adding support to the position that there is no need for LLC membership interests to be classified as securities.

B. Drafting and Planning Strategies

In addition to the foregoing legislative options, a number of drafting or planning strategies can be employed in the formation and operation of LLCs to make it less likely that the federal securities laws will apply to any transfer of membership interests. As with legislative possibilities, the most obvious possibility relates to member-management.

Currently, only one jurisdiction has chosen a legislative scheme that mandates manager-management, although one other state comes close to that position.\(^{327}\) In every other state, either the default rule provides for member-management\(^{328}\) or the statute permits the LLC to elect the member-management model.\(^{329}\) In states where member-management is allowed, selection of this option is the best technique for avoidance of the securities laws.\(^{330}\) Even in Colorado and North Dakota, which appear not to permit member-management, if the LLC has a written operating agreement which specifies that all members must be selected or automatically serve as managers, one can argue that this is essentially equivalent to a general partnership and that the federal securities laws should not apply.

The problem is that many LLCs may desire or need a more centralized management model. One could possibly accomplish this by giving all members general management authority while delegating actual authority over most decisions to an executive committee, or the like. Certainly the adoption of this model in the context of general partnerships does not result in general partnership interests being

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\(^{327}\) **Colo. Rev. Stat. Ann.** § 7-80-401 (West Supp. 1993). The North Dakota statute can also be interpreted as mandating the election of a board of governors; however, since the statute also says that if the members desire to act by unanimous consent or vote, they do not need to have governors, this is not entirely certain. **N.D. Cent. Code** § 10-32-69.1 (1994).


\(^{330}\) *See supra* notes 149-150 and accompanying text.
classified as securities, unless the designation is so complete that the non-managing general partners retain no powers greater than a limited partner would ordinarily have. From a practical perspective, the down side to this suggestion is that all members would presumably retain statutory management authority, which might encompass apparent authority to bind the LLC.

In instances where the LLC needs a more centralized management model than pure member-management, and it is not practicable or desirable to permit members to retain apparent authority to bind the enterprise, other steps will have to be taken to avoid application of the securities laws. While it would certainly not hurt to adopt articles of organization or an operating agreement providing members with all the protective provisions discussed in the preceding section, such provisions would not have the same weight as if they were included in a statute. Unlike inclusion of such provisions in a state statute, mere inclusion of such provisions in the organizational and operating documents of individual LLCs does not support the notion that functions of federal securities laws are adequately fulfilled.

Probably the best advice with regard to the federal securities laws for LLCs that decline to adopt the member-management model is that all transactions involving the transfer of membership interest should be structured with some exemption in mind, at least until the courts have provided sufficient assurance that the securities laws will generally not be applied to such transactions.

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331. See *supra* notes 105-106.

332. In a few states, this attribute is explicit. For example, in Utah, the LLC statute provides that members in a member-managed LLC will have the authority to bind the LLC unless the articles of organization provide otherwise. *Utah Code Ann.* § 48-2b-125 (Supp. 1994). The Arkansas statute provides in one section that all members have apparent authority to bind the LLC unless the articles of organization delegate such authority to managers. *Ark. Code Ann.* § 4-32-301 (Michie Supp. 1993). The Arizona statute says that unless the articles vest management in one or more managers, all members have actual and apparent authority to carry on the LLC’s usual business. *Ariz. Rev. Stat. Ann.* § 29-654.A. (Supp. 1993).

333. These would include the right of each member to obtain information from the LLC upon a reasonable request; the right to withdraw and receive the fair value of the membership interest being surrendered; the right to cause dissolution in the event of fraud, duress, oppression, or otherwise. See *supra* notes 126-136 and accompanying text.

334. A discussion of the available securities exemptions is far beyond the scope of this Article.
V. Conclusion

The question of whether and when the federal securities laws will and should apply to membership interests is not easy to answer, especially given the extreme diversity among and flexibility of the state LLC statutes. While it seems clear that membership interests in member-managed LLCs or LLCs with hybrid-management should generally not be securities, and good arguments can be made that most membership interests in manager-managed LLCs should not be securities, there is no certainty that courts will agree with this analysis.

Policy arguments generally support the conclusion that membership interests in LLCs need not be subjected to the burdens of the federal securities laws. If state legislators are willing to amend their statutes to give members a greater range of authority and to enhance protective provisions, an even stronger case could be made that LLC membership interests should not be classified as securities. If not, in order to avoid the potentially devastating civil penalties for the unregistered sale of securities, LLCs that decline to adopt the member-management model should structure transactions involving the transfer of membership interests so as to comply with one or more exemptions from registration.

It is always possible that unscrupulous con artists will seize on the LLC as a new vehicle for defrauding the unsuspecting members of the public and, in fact, there is some indication that this may have already occurred in isolated instances.335 However, the solution of protecting investors by requiring registration or exemption for all or even most LLC membership interests seems akin to using a high-powered rifle to kill the cockroach. The costs imposed by requiring LLCs to treat the sale of membership interests as securities may well substantially diminish the usefulness of the form of entity. Although the expenses of registration might be avoided if a sale of LLC membership interests is structured in such a way that it is intended to comply with an exemption, the additional costs of complying with the exemption and the risks if the exemption is ultimately found to have been unavailable make this a generally undesirable approach for a business entity uniquely suited for smaller and start-up businesses.

335. See, e.g., Vicki Cabot, State Lawmakers Moving to Reform Limited Liability, ARIZONA BUS. GAZETTE, Feb. 10, 1994, (Leisure), at 22 (“Limited liability structure . . . has been called the perfect vehicle for fraud. That’s why state lawmakers are moving to tighten reporting requirements for the new business structure.”).
The best argument for applying the federal securities laws can be made in the case of an LLC organized so that investors are forced into uninformed passivity, and in which the membership interests are widely marketed. In the typical LLC, however, this is not likely to be the case, and a presumption against application of the federal securities laws seems justified if the LLC is truly to be a boon to the small business.