

Limited Liability Companies and the Federal Securities Laws: Congress Should Amend the Securities Laws to Avoid Coverage

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INTRODUCTION

The 1990s have witnessed a proliferation in the limited liability company ("LLC") as a popular option for business organization.¹ As the twenty-first century begins, all fifty states and the District of Columbia now have LLC statutes.² The rise in LLC popularity derives from the benefits—such as limited liability, pass-through tax treatment, relative freedom from management and governance requirements, and ease of creation—provided to organizers and investors when compared to traditional corporations and partnerships.³

While the management structure of LLCs can be quite varied, the general distinction is made between member-managed (members are vested with day-to-day operating power) and manager-managed (managers are vested with day-to-day operating power) LLCs.⁴ The type of management structure and the degree of centralized management can have a direct effect on the pass-through tax status of an LLC.⁵ However, the effect of different management arrangements on the status of

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1. See David L. Cohen, *Theories of the Corporation and the Limited Liability Company: How Should Courts and Legislatures Articulate Rules for Piercing the Veil, Fiduciary Responsibility and Securities Regulation for the Limited Liability Company?*, 51 OKLA. L. REV. 427, 447 (1998). For statistical data related to the growth of LLCs, see Susan Pace Harnill, *The Limited Liability Company: A Catalyst Exposing the Corporate Integration Question*, 95 MICH. L. REV. 393, 440-46 (1996).

2. See Martha M. Canan, *Check-the-Box Rules May Increase Disincorporations Given Fact That 50 States Now Have LLC Statutes in Place*, BNA CORP. COUNS. DAILY, Jan. 15, 1997, at D4.

3. Cohen, *supra* note 1, at 451-52; 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, 1229-33 (1994); Park McGinty, *The Limited Liability Company: Opportunity for Selective Securities Law Deregulation*, 64 U. CIN. L. REV. 369, 377 (1996).

4. McGinty, *supra* note 3, at 383. For a discussion of the varied management structures of LLCs, see Goforth, *supra* note 3, at 1237-38.

5. LLCs specifically confer limited liability on members. McGinty, *supra* note 3, at 378. Therefore, to avoid corporate taxation, an LLC "can ordinarily have no more than one of the remaining three corporate attributes: continuity of life, free transferability of interests, or centraliz[ed] . . . management." *Id.*; see Treas. Reg. § 301.7701-2(a)(3) (as amended in 1983).

LLCs under the federal securities laws remains an open question.

Despite the advantages of the LLC entity, organizers and investors still face uncertainty with respect to the coverage of the federal securities laws.⁶ In fact, one commentator has noted that “the proponents of LLCs generally have failed to predict that the LLC might be considered a security by the [Securities and Exchange Commission⁷] and be subject to [the federal securities laws].”⁸ This Note explores the issue of LLC interests as securities and concludes that congressional action is needed to definitively exclude LLC interests from federal securities law coverage.

Part I of this Note looks at the current judicial analysis of the issue. This Part begins with the traditional analysis under the securities laws and the Supreme Court’s test for an investment contract as stated in *SEC v. W.J. Howey Co.*⁹ The subsequent judicial interpretation of the *Howey* test is also explored (with emphasis on the fourth element). Next, the application of the investment-contract analysis to LLC interests in recent federal cases is discussed. Finally, Part I discusses the problems with the current judicial analysis and concludes that a more definitive approach is necessary.

Part II of this Note examines whether LLC interests should be considered securities and thus subject to the mandatory disclosure requirements and antifraud provisions of the federal securities laws. The discussion focuses on the purpose of the securities laws, the benefits of coverage to LLC investors, and the costs associated with finding that LLC interests are securities. This Part concludes that LLC interests should not be regarded as securities under the federal securities laws.

Part III examines alternative approaches to the issue of LLC interests as securities with emphasis on two proposed approaches: (1) Professor Larry E. Ribstein’s intermediate-private-ordering approach¹⁰ and (2) Professor Park McGinty’s legislative-opt-out approach.¹¹ By combining the strengths of each approach, Part III argues that Congress should amend the securities laws to include a definitive statement that LLC interests are not securities.

I. THE CURRENT JUDICIAL ANALYSIS OF LLC INTERESTS AS SECURITIES

The Securities Act of 1933¹² (“Securities Act”) defines a “security” as follows:

[A]ny note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-

LLCs that are managed by members should normally lack centralized management, whereas LLCs managed by managers would appear normally to have centralized management. McGinty, *supra* note 3, at 383-84.

6. See *infra* Part I.B-C (discussing the current uncertainty regarding judicial determination of LLC interests as securities).

7. The Securities and Exchange Commission will be referred to hereafter as the “SEC” or the “Commission.”

8. Cohen, *supra* note 1, at 464.

9. 328 U.S. 293 (1946).

10. See Larry E. Ribstein, *Form and Substance in the Definition of a “Security”: The Case of Limited Liability Companies*, 51 WASH. & LEE L. REV. 807 (1994).

11. See McGinty, *supra* note 3.

12. 15 U.S.C. §§ 77a-77aa (1994 & Supp. IV 1998).

trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.¹³

The Supreme Court has stated that the definition of "security" in the Securities Exchange Act of 1934¹⁴ ("Exchange Act") is "virtually identical" to the definition in the Securities Act.¹⁵ Because of the general nature of some parts of the definition of a "security" contained in the securities laws, the Supreme Court has articulated three tests for analyzing securities:¹⁶ (1) the *Howey* test for investment contracts,¹⁷ (2) the *Landreth Timber* test for stock,¹⁸ and (3) the *Reves* test for notes.¹⁹

Certainly, all three tests are available for judicial analysis in determining whether an LLC interest is a security.²⁰ Finding the most appropriate test requires a comparison of the LLC to other business forms. An LLC is governed internally by either an operating agreement decided upon by the members or the statutory default rules of the state of organization.²¹ By allowing the members of an LLC to alter the default rules by an operating agreement between members, the LLC offers a flexible management structure. An LLC is unlike a corporation because it is free from the double taxation (if structured properly)²² and restrictive governance requirements of a corporation.²³ As a business entity, the LLC is a hybrid combining aspects of both limited and general partnerships. The LLC offers the limited liability and pass-through tax status of a limited partnership without requiring the centralized management of a limited partnership.²⁴ The LLC offers the option of member control

13. *Id.* § 77b(1).

14. 15 U.S.C. §§ 78a-78mm (1994 & Supp. IV 1998).

15. *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967) (using cases construing the meaning of "security" under the Securities Act to aid in determining the meaning of "security" under the Exchange Act). There are a few minor differences between the Securities Act definition of a "security" and the Exchange Act definition, but courts generally treat them as the same. Goforth, *supra* note 3, at 1239-40 n.61.

16. McGinty, *supra* note 3, at 385.

17. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946).

18. *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 687, 690 (1985).

19. *Reves v. Ernst & Young*, 494 U.S. 56, 67 (1990).

20. For a detailed discussion of the application of the different tests for LLC interests, see Goforth, *supra* note 3, at 1240-78 (analyzing LLC interests under the *Landreth Timber* test for stock, the *Reves* test for notes, and the *Howey* test for investment contracts).

21. *Id.* at 1232. Most states' default rules designate management of the LLC by members. McGinty, *supra* note 3, at 383.

22. *See infra* note 24.

23. McGinty, *supra* note 3, at 369.

24. The LLC offers flexible management options that include both member-managed and manager-managed LLCs. *See supra* note 4 and accompanying text. However, "[t]ax rules

of management, making it resemble a general partnership (with limited liability for members).

Thus, the relevant test for LLCs appears to be the *Howey* test for investment contracts as it is applied to the business entities the LLC bids to replace: the limited partnership and the general partnership.²⁵ In fact, most commentators, state courts, and the SEC agree that the *Howey* test for limited and general partnerships will likely serve as a touchstone for courts examining LLC interests.²⁶ The remainder of this Part will examine the *Howey* test for investment contracts, its subsequent judicial interpretation, its application in recent LLC cases, and the problems associated with using this judicial test.

A. The *Howey* Test for an Investment Contract

The Supreme Court explicitly defined the term “investment contract” as used in the Securities Act in *Howey* as follows:

[A] contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise.²⁷

The *Howey* test can be divided into four elements: (1) investment of money, (2) in a common enterprise, (3) expectation of profits, and (4) profits solely from the efforts of others.²⁸

ensure that LLC members generally will not delegate control to managers.” Ribstein, *supra* note 10, at 820. In order to maintain pass-through tax status, an LLC must not have more than three of the following traits: continuity of life, limited liability, centralized management, or free transferability of interests. See Treas. Reg. § 301.7701-2(a) (as amended in 1993). Because all LLCs have limited liability, a centrally managed LLC would have to be sure that it lacks both continuity of life and free transferability in order to be assured of pass-through status. Ribstein, *supra* note 10, at 821. Ribstein states that “most firms that want to combine centralized management with limited liability and partnership tax treatment should organize as limited partnerships . . .” *Id.* He concludes by stating that “firms that choose the LLC form probably are doing so precisely because of the differences between LLCs and limited partnerships regarding member participation in control.” *Id.*

25. McGinty, *supra* note 3, at 389.

26. *Id.* Regarding the *Landreth Timber* test for stock, Professor Carol R. Goforth explains that “[t]he *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.” Goforth, *supra* note 3, at 1247. She concludes that “[t]here 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.” *Id.* at 1248. Regarding the *Reves* test for notes, Goforth concludes that “since there is [the *Howey* test] 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.” *Id.* at 1270.

27. SEC v. W.J. Howey Co., 328 U.S. 293, 299 (1946).

28. *Id.*; Goforth, *supra* note 3, at 1274-76; McGinty, *supra* note 3, at 388-89.

The first element of the *Howey* test requires an investment of money.²⁹ In *International Brotherhood of Teamsters v. Daniel*,³⁰ the Supreme Court found that this element is met if “the purchaser gave up some tangible and definable consideration in return for an interest that had substantially the characteristics of a security.”³¹ Given the likelihood that a membership interest in an LLC will provide a member with some management control of the entity,³² it is extremely likely that an LLC membership interest will only be exchanged for valuable consideration (either cash or some other tangible consideration such as property). Therefore, LLC interests will likely meet this element of the *Howey* test.³³

The second element of the *Howey* test requires a common enterprise.³⁴ There are two competing interpretations of the commonality element: (1) vertical commonality and (2) horizontal commonality.³⁵ Vertical commonality requires a common interest between the investor and manager of the firm.³⁶ Horizontal commonality is more restrictive and requires a pooling of interests by members of the firm, meaning that the members’ interests must rise or fall together.³⁷ Under vertical commonality, an LLC would almost certainly pass this prong of the *Howey* test because both the management and the members (whether manager-managed or member-managed) have a common interest in the success of the enterprise.³⁸ In the majority of LLCs, even the more restrictive horizontal commonality requirement will be satisfied since there are likely to be more than two or three members in most LLCs whose contributions to the venture will be combined and whose fortunes will rise or fall together.³⁹

The third element of the *Howey* test is the requirement of an expectation of profit.⁴⁰ Most LLC investors are likely to be seeking profits.⁴¹ In addition, even such benefits as tax advantages may satisfy this element.⁴² An investor is unlikely to invest in an

29. *Howey*, 328 U.S. at 299.

30. 439 U.S. 551 (1979).

31. *Id.* at 560.

32. *See supra* note 24.

33. Goforth, *supra* note 3, at 1274. Goforth states that LLC interests are likely to be acquired for valuable consideration regardless of how the LLC is organized or operated. *Id.*

34. *Howey*, 328 U.S. at 299.

35. Goforth, *supra* note 3, at 1274.

36. *Id.* Often a distinction is made between broad vertical commonality and strict vertical commonality. Strict vertical commonality requires that the manager and the investors share the risk of the venture, while broad vertical commonality simply requires a connection between the efforts of the manager and the collective success (or loss) of the investors. *See* Theresa A. Gabaldon, *A Sense of a Security: An Empirical Study*, 25 J. Corp. L. 307, 338 (2000).

37. Goforth, *supra* note 3, at 1274.

38. A manager-managed LLC in which the manager is not a member and is compensated independent of the success of the enterprise is theoretically possible. *Id.* However, this scenario is unlikely because members are not likely to concede management control without some incentive for a successful venture.

39. *Id.* at 1274-75.

40. SEC v. W.J. Howey Co., 328 U.S. 293, 299 (1946).

41. Goforth, *supra* note 3, at 1275.

42. *Id.* at 1273; *see* SEC v. Goldfield Deep Mines Co., 758 F.2d 459, 464 (9th Cir. 1985) (“[T]he prospect of tax benefits resulting from initial losses does not necessarily detract from an expectation of profits.”); SEC v. Aqua-Somic Prods. Corp., 687 F.2d 577, 583 (2d Cir.

LLC without either an expectation of profit or the expectation of tax benefits from the venture. Therefore, most, if not all, LLCs will meet the third element of *Howey*.

The fourth element of the *Howey* test—that the profits be “solely from the efforts of the promoter or a third party”⁴³—is the most controversial element of the test.⁴⁴ Analysis of the fourth element of *Howey* represents the point of decision regarding limited partnership interests and general partnership interests as securities. Likewise, the fourth element is likely to be the deciding factor of whether an LLC interest is considered a security under *Howey*. Because limited partnerships require centralized management, interests in them are generally regarded as securities (because they satisfy the elements of *Howey*, including the fourth element).⁴⁵ In contrast, general partnership interests are often presumed not to be securities because the fourth element of *Howey* is not met.⁴⁶ Thus, if LLC interests are analogized to limited partnership interests, then they will likely be found to be securities; if LLC interests are analogized to general partnership interests, then they are less likely to be found securities.⁴⁷

Even if LLC interests are analogized to general partnership interests, the determination is not always clear. If the term “solely” is interpreted literally, then most LLC interests (and also general partnership interests) would probably fail to meet this element and be found not to be securities. As Goforth states:

A literal interpretation [of “solely”] 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.⁴⁸

However, the Ninth Circuit in *SEC v. Glenn W. Turner Enterprises, Inc.*⁴⁹ held that the proper interpretation of this element of *Howey* 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.”⁵⁰ A majority of other circuits have adopted this approach.⁵¹ In addition, the Supreme

1982) (finding that the expectation-of-profit requirement was met even though the investment was promoted primarily for tax benefits), *cert. denied sub nom. Hecht v. SEC*, 459 U.S. 1086 (1982); *Goodman v. Epstein*, 582 F.2d 388, 407-08 (7th Cir. 1978) (finding that the possibility of tax losses does not compel a conclusion that investors did not have expectation of profits), *cert. denied*, 440 U.S. 939 (1979).

43. *Howey*, 328 U.S. at 299.

44. See Goforth, *supra* note 3, at 1273; McGinty, *supra* note 3, at 389; see also *Williamson v. Tucker*, 645 F.2d 404, 418 (5th Cir. 1981) (stating that the fourth factor is most litigated).

45. McGinty, *supra* note 3, at 390.

46. *Id.* at 391.

47. *Id.* at 389.

48. Goforth, *supra* note 3, at 1273. Even in manager-managed LLCs, the members, if they do not already manage the LLC, may take over management duties at any time if they so choose. McGinty, *supra* note 3, at 390.

49. 474 F.2d 476 (9th Cir. 1973).

50. *Id.* at 482.

51. Goforth, *supra* note 3, at 1273; see also *SEC v. Prof'l Assocs.*, 731 F.2d 349, 357 (6th

Court in *United Housing Foundation Inc. v. Forman*⁵² omitted the word “solely” from its rephrasing of the *Howey* test.⁵³

In *Williamson v. Tucker*,⁵⁴ the Fifth Circuit developed an expanded interpretation of the fourth element of the *Howey* test as applied to general partnerships. The court stated that “the mere fact that an investment takes the form of a general partnership or joint venture does not inevitably insulate it from the reach of the federal securities laws.”⁵⁵ The court continued by enumerating three situations in which a general partnership’s interests may meet the fourth element of *Howey* and be deemed a security:

A general partnership or joint venture interest can be designated a security if the investor can establish, for example, that (1) an agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership; or (2) the partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or (3) the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers.⁵⁶

As a result of subsequent judicial interpretation, the meaning of the fourth element of *Howey*, as applied to both LLC interests and general partnership interests, has become much less certain than originally stated.

Because the first three elements of *Howey* are likely to be satisfied in the majority of LLC interest cases, the focus of the judicial inquiry into whether LLC interests are securities will most often be the fourth element of *Howey*—whether the profits are from the efforts of others—and the subsequent judicial analysis interpreting the fourth element.⁵⁷ The judicial determination of whether LLC interests are securities “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.”⁵⁸ Thus, under current judicial analysis, the degree of management control left to the members of the LLC by the operating agreement or the default statutes of the state becomes the central issue in determining the security status of LLC interests.

Cir. 1984); *Goodwin v. Elkins & Co.*, 730 F.2d 99, 103 (3d Cir. 1984); *SEC v. Aqua-Sonic Prods. Corp.*, 687 F.2d 577, 582 (2d Cir. 1982), *cert. denied sub nom. Hecht v. SEC*, 459 U.S. 1086 (1982); *Kim v. Cochenour*, 687 F.2d 210, 213 n.7 (7th Cir. 1982); *Baurer v. Planning Group, Inc.*, 669 F.2d 770, 778-79 (D.C. Cir. 1981); *Aldrich v. McCulloch Props., Inc.*, 627 F.2d 1036, 1040 n.3 (10th Cir. 1980); *Fargo Partners v. Dain Corp.*, 540 F.2d 912, 914-15 (8th Cir. 1976); *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 483 (5th Cir. 1974).

52. 421 U.S. 837 (1975).

53. *Id.* at 852. However, the Court expressly declined to state whether it adopted the Ninth Circuit interpretation. *Id.* at 852 n.16.

54. 645 F.2d 404 (5th Cir. 1981).

55. *Id.* at 422.

56. *Id.* at 424.

57. Goforth, *supra* note 3, at 1274 (“[T]he [first three] 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.”).

58. *Id.*

B. Recent Caselaw Applying Howey to LLC Interests

In *SEC v. Parkersburg Wireless LLC*,⁵⁹ the court was required to determine whether the LLC interests sold by the defendants were securities under the federal securities laws. The court applied the *Howey* test to the LLC interests and held that the interests were securities.⁶⁰ The first three factors of an investment contract were easily satisfied in the case.⁶¹ The focus of the controversy in the case was the fourth element—whether the profits were from the efforts of others.⁶²

In this case, the defendant contended that the fourth element of the test was not met because the members held the ultimate power in the LLC.⁶³ However, the court rejected this argument and found that the fourth element of *Howey* was met because “the investors had little, if any, true input into the company.”⁶⁴ The court engaged in a fact-specific analysis of the LLC transaction to determine that the interests met the definition of an investment contract and were therefore securities.

Another recent case involving the issue of LLC interests as securities under the federal securities laws is *SEC v. Shreveport Wireless Cable Television Partnership*.⁶⁵ Although this case involved two partnership interests and one LLC interest, the court treated the partnership and LLC interests as identical in its analysis.⁶⁶ The court applied the *Howey* investment-contract test and found the only issue in controversy to be whether the fourth element was met.⁶⁷

In *Shreveport Wireless*, the court adopted the expansive *Williamson* interpretation

59. 991 F. Supp. 6 (D.D.C. 1997).

60. *Id.* at 8-9.

61. *Id.* at 8. The court found that an investment of money had occurred and that there was an expectation of profit. *Id.* The court also found both vertical and horizontal commonality and therefore did not specifically address the issue of which type of commonality is sufficient to find an investment contract. *Id.*

62. *See id.* at 8-9.

63. *Id.* at 9 n.3.

64. *Id.* at 8. In reaching this conclusion, the court adopted the expansive interpretation of an investment contract as stated in *Williamson v. Tucker*, 645 F.2d 404, 418 (5th Cir. 1981), and *SEC v. Glenn W. Turner Enterprises*, 474 F.2d 476, 482 (9th Cir. 1973). *Parkersburg Wireless*, 991 F. Supp. at 9 n.3. The court noted:

Regardless of the general treatment of LLCs under the applicable state law, the “ultimate power” over [the LLC] rested not with the geographically dispersed, inexperienced, predominantly retired . . . investors, but with [management]. While the investors theoretically may have possessed a right to manage the affairs [of the LLC] under the terms of the Operating Agreement, the inexperience and geographic diversity of the 700-odd investors essentially precluded this from ever coming to pass.

Id. For a discussion of *Williamson* and *Glenn Turner*, see *supra* Part I.A.

65. No. CIV.A.94-1781, 1998 WL 892948 (D.D.C. Oct. 20, 1998).

66. *Id.* at *5 n.3 (“The Court will treat the [partnership and LLC interests] at issue as the same kind of interest because the powers granted to the investors . . . are the same.”).

67. *Id.* at *4 (“The parties thus agree that whether the general partnership and limited liability company interests in this case constitute ‘investment contracts’ . . . turns on whether the investors expected to earn profits from the efforts of others.”).

of the fourth element of an investment contract.⁶⁸ The court stated, “If . . . the investor’s profits after the time of sale are primarily dependant [sic] upon the promoter’s efforts, the investor should have the protection of the federal securities laws.”⁶⁹ The court concluded that “there exists a genuine issue of material fact as to what extent and as of what date the partners controlled the enterprise.”⁷⁰

A final case involving LLC interests as securities under the federal securities laws is *Keith v. Black Diamond Advisors, Inc.*⁷¹ As in the two previously discussed cases, the court applied the *Howey* test for an investment contract to determine if the LLC interest at issue was a security.⁷² The court determined that the first three elements of an investment contract were easily met and found that “[t]he critical inquiry here involves the fourth prong of *Howey*—whether [the investors] invested in [the LLC] with the intention of deriving profit from the managerial or entrepreneurial efforts of others.”⁷³

The court also accepted the *Williamson* interpretation of the fourth element of *Howey*.⁷⁴ However, the court concluded that the investor was not passive and that therefore the LLC interests in question were not securities.⁷⁵ As in the two previously discussed cases, the court’s determination required an analysis of the specific facts in the case.

C. The Problems with the Current Judicial Analysis of LLC Interests as Securities

As discussed above, the current judicial analysis of LLC interests as securities involves application of the *Howey* test for investment contracts and the subsequent

68. *Id.* at *5. The court stated:

A general partnership will be considered a security if the SEC is able to “demonstrate that, in spite of the partnership form which the investment took, [the investors were] so dependent on the promoter or on a third party that [they were] in fact unable to exercise meaningful partnership powers.”

Id. (alterations in original) (quoting *Williamson*, 645 F.2d at 424).

69. *Id.* at *7.

70. *Id.*

71. 48 F. Supp. 2d 326 (S.D.N.Y. 1999).

72. *Id.* at 332.

73. *Id.*

74. *Id.* at 333 (“In *Williamson v. Tucker*, 645 F.2d 404 (5th Cir. 1981), the court recognized that although general partnership interests, in contrast to limited partnership interests, are ordinarily not securities because of the level of managerial control exercised by a general partner, in some limited circumstances a general partnership interest may be a ‘security.’”).

75. *Id.* at 334. The court stated:

[I]f at the time of his investment in [the LLC], [the investor] did not intend to be a passive investor, as he clearly did not, the [LLC] interests could not be securities. Furthermore, although the degree of control he actually exercised was less than he expected to exercise, that fact does not convert his interests into securities.

Id.

judicial interpretation of the definition of an investment contract.⁷⁶ However, there are two problems related to this method of analyzing whether LLC interests are securities.

The first problem with the current judicial analysis is the inherent difficulty of applying the fourth element of the *Howey* test to LLC interests.⁷⁷ Ribstein divides the difficulties into two types: (1) the determination of the degree of investor involvement in management and (2) the determination of “the expected impact of the investors’ efforts on the success of the enterprise.”⁷⁸

In order to determine the degree of investor involvement in management, the court must evaluate, among other things, “the [investors’] explicit voting or management rights, their ‘background’ right to participate in management under the [LLC] statute to the extent that it is not specifically negated by the agreement, and their effective veto power implicit in their ability to dissolve the firm at will.”⁷⁹ Ribstein concludes that these determinations are likely to vary from case to case because LLCs are highly customized arrangements.⁸⁰ The recent cases discussed in Part I are evidence that Ribstein’s conclusion is accurate.⁸¹

A court’s evaluation of the expected impact of investors’ efforts on the success of the enterprise is equally difficult. Ribstein points out that in an LLC, “each owner may have little power to cause the firm to take a particular action, but nevertheless has the power to block actions” by the firm.⁸² The effect of such a veto power on the firm’s success may not be clear.⁸³ In addition, “even when the members actively participate in a management decision, it often will not be clear how much each member’s participation contributed to the firm’s success.”⁸⁴

The inherent difficulty of applying the *Howey* analysis to LLC interests creates uncertainty in regards to whether LLC interests are securities.⁸⁵ This uncertainty gives

76. See *supra* Part I.A-B. Specifically, the current judicial analysis usually involves the application of the fourth element of an investment contract—that the profits be from the efforts of others—and its subsequent judicial analysis. See *supra* Part I.B.

77. Ribstein, *supra* note 10, at 829.

78. *Id.*

79. *Id.* (citations omitted).

80. *Id.*

81. See *supra* Part I.B.

82. Ribstein, *supra* note 10, at 829.

83. *Id.*

84. *Id.* Ribstein offers a comparison to franchise transactions to demonstrate the difficulty of such an inquiry. *Id.* at 829 n.74 (“The difficulty in determining each member’s contribution to the firm’s success is similar to the issue in the franchise context in which the enterprise’s success turns on both the franchisee-investor’s management of the outlet and the franchisor-promoter’s management of the overall enterprise.”); see, e.g., *Mr. Steak, Inc. v. River City Steak, Inc.*, 324 F. Supp. 640, 646 (D. Colo. 1970) (concluding that the franchise interest at issue in the case was not a security).

85. The discussion in Part I.B demonstrates that the judicial outcome in LLC interests cases can be varied. Of the three cases discussed in that section, one found that the LLC interest was a security, *SEC v. Parkersburg Wireless LLC*, 991 F. Supp. 6, 8 (D.D.C. 1997), one found that the LLC interests was not a security, *Keith v. Black Diamond Advisors, Inc.*, 48 F. Supp. 2d 326, 332-34 (S.D.N.Y. 1999), and one found that there existed a material issue of fact and denied a motion for summary judgment, *SEC v. Shreveport Wireless Cable Television P’ship*,

rise to the second major problem with the current judicial analysis of LLC interests as securities—the problem of increased litigation and compliance costs.

“The difficulty of applying the [*Howey*] test [to LLC interests] can make litigation costly by multiplying the legal and factual issues that must be determined at trial. Moreover, this difficulty can [also] increase the likelihood of litigation.”⁸⁶ In addition, “[b]ecause the outcome of the case may be difficult to predict at the time of litigation, . . . the probability of settling the suit prior to litigation” decreases.⁸⁷

The uncertainty of the judicial analysis of LLC interests as securities also creates significant compliance costs. McGinty states that the risks of securities law violations often “force firms into costly compliance with securities regulation, even when they eventually would be held not covered by the securities laws.”⁸⁸ McGinty concludes “LLCs that take defensive securities law measures will have incurred significant costs.”⁸⁹ In light of the uncertainty surrounding current judicial determinations of LLC interests as securities, this Note will next consider whether LLC interests should be considered securities under federal securities laws and whether there are alternative approaches to the issue that would eliminate the uncertainty and its associated costs.

II. THE ARGUMENT AGAINST LLC INTERESTS AS SECURITIES

Several commentators have addressed the question of whether LLC interests should be considered securities. Professor Elaine A. Welle has argued that LLC interests should be considered securities based on traditional analysis and public policy.⁹⁰ On the other hand, commentators such as Goforth, McGinty, and Ribstein have presented arguments supporting the conclusion that LLC interests should not be considered securities.⁹¹ The debate involves two primary issues: (1) the purpose of the federal securities laws and the benefits of securities law coverage and (2) the costs associated with securities law coverage for LLC interests.

A. The Purpose of the Federal Securities Laws and the Benefits of Securities Law Coverage for LLC Interests

In order to regulate the securities market, Congress has adopted several laws of which the most important for the present discussion are the Securities Act and the

No. CIV.A.94-1781, 1998 WL 892948, at *6 (D.D.C. Oct. 20, 1998).

86. Ribstein, *supra* note 10, at 829-30; *see also* McGinty, *supra* note 3, at 436 (discussing the “extra litigation costs” associated with the current judicial analysis of LLC interests as securities).

87. Ribstein, *supra* note 10, at 830; *see also* Isaac Ehrlich & Richard A. Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEGAL STUD. 257, 265 (1974).

88. McGinty, *supra* note 3, at 426.

89. *Id.* at 436.

90. Elaine A. Welle, *Freedom of Contract and the Securities Laws: Opting Out of Securities Regulation by Private Agreement*, 56 WASH. & LEE L. REV. 519, 532-86 (1999).

91. Goforth, *supra* note 3, at 1278-91; McGinty, *supra* note 3, at 423-36; Ribstein, *supra* note 10, at 824-32.

Exchange Act. Both the Securities Act and the Exchange Act focus on mandatory disclosure as the means of regulating the securities market.⁹² In addition, each act incorporates “specific anti-fraud provisions designed to ensure that all disclosures are accurate and free of fraud.”⁹³

In *SEC v. Capital Gains Research Bureau, Inc.*,⁹⁴ the Supreme Court stated that a fundamental purpose of the securities laws is “to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry.”⁹⁵ However, the purpose of the securities laws is not simply mandatory disclosure for disclosure’s sake. The ultimate purpose of mandatory disclosure (and the Securities Act and the Exchange Act) is the protection of investors.⁹⁶ Therefore, the answer to whether LLC interests as securities serves the purpose of the securities laws must focus on whether mandatory disclosure concerning LLC interests would promote the protection of investors.

Generally, LLCs are “either privately negotiated transactions involving management responsibilities or [are marketed] to a relatively small number of investors.”⁹⁷ In the case of member-managed LLCs, a new member will have the power to participate in management of the entity.⁹⁸ The management power of the new member greatly reduces the need for mandatory disclosure.⁹⁹ Any new investor that is sophisticated enough to be attractive as a potential member-manager is unlikely to invest without adequate disclosure, regardless of the scope of the federal securities laws.¹⁰⁰ Thus, for member-managed LLCs, protection of the investor through the federal securities laws appears unnecessary.

In the case of manager-managed LLCs, investors are more likely to be passive.¹⁰¹ However, a broad, national marketing of LLC interests is not likely to occur because

92. Welle, *supra* note 90, at 534 (“From the beginning, the central focus of the federal regulatory structure has been disclosure.”); *see* *Doran v. Petroleum Mgmt. Corp.*, 545 F.2d 893, 904 (5th Cir. 1977).

93. Goforth, *supra* note 3, at 1280. The most widely used antifraud provision of the federal securities laws is section 10(b) of the Exchange Act, which states that it is 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) (1994).

94. 375 U.S. 180 (1963).

95. *Id.* at 186 (citing H.R. REP. NO. 73-85, at 2 (1933), *quoted in* *Wilko v. Swan*, 346 U.S. 427, 430 (1953)).

96. *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967) (“One of [the securities laws’] central purposes is to protect investors through the requirement of full disclosure”); *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964) (“[A]mong [the securities laws’] chief purposes is ‘the protection of investors’”); *see also* Goforth, *supra* note 3, at 1281 & n.230 (suggesting disclosure is most important when securities are marketed to small, passive investors); Welle, *supra* note 90, at 534.

97. Goforth, *supra* note 3, at 1281.

98. *Id.* at 1282.

99. *Id.*

100. *Id.*

101. *Id.*

of the potential loss of partnership tax advantages.¹⁰² Therefore, both member-managed and manager-managed LLC investments are likely to be privately negotiated transactions targeted to small groups of potential investors.

In *Marine Bank v. Weaver*,¹⁰³ the Supreme Court used the distinction between publicly traded and privately negotiated instruments to find a transaction was not a security.¹⁰⁴ The Court noted that “[t]he unusual instruments found to constitute securities in prior cases involved offers to a number of potential investors, not a private transaction as in this case.”¹⁰⁵ The Court concluded that “[t]he unique agreement, negotiated one-on-one by the parties, is not a security.”¹⁰⁶ The Supreme Court also distinguished publicly traded and privately negotiated transactions in *Reves v. Ernst & Young*.¹⁰⁷ While the decisions in *Weaver* and *Reves* do not assure that LLC interests are not securities under current judicial analysis,¹⁰⁸ in these decisions, the Supreme Court appears to accept the proposition that mandatory disclosure may not be necessary to protect investors in privately negotiated transactions.

Ordinarily, an investor negotiating a private transaction to invest in an LLC will have sufficient bargaining power to demand the proper disclosure.¹⁰⁹ While the argument can be made that LLC interests could be marketed to a few unsophisticated investors who lack the power to demand such disclosure, the likelihood that such an investor would actually read and comprehend any mandatory disclosure information

102. Partnership interests that are traded publicly lose their pass-through tax advantage and are taxed as corporations. See I.R.S. Notice 88-75, 1988-2 C.B. 386-87. Likewise, LLC interests that are publicly traded are likely to lose their pass-through tax advantage and therefore are unlikely to be marketed broadly. See Goforth, *supra* note 3, at 1282 (“[I]t is unlikely that [LLC] interests will be marketed broadly.”); McGinty, *supra* note 3, at 425 (“[M]ost LLC interests will be sold in private placements.”).

103. 455 U.S. 551 (1982).

104. See *id.* at 559-60; McGinty, *supra* note 3, at 412; see also Dennis S. Karjala, *Federalism, Full Disclosure, and the National Markets in the Interpretation of Federal Securities Law*, 80 NW. U. L. REV. 1473, 1509-10 (1986) (supporting the use of trading as a relevant category for defining a security).

105. *Weaver*, 455 U.S. at 559.

106. *Id.* at 560.

107. 494 U.S. 56, 66 (1990) (concluding that the plan of distribution of a note is a valid factor for determining if the note is a security); see McGinty, *supra* note 3, at 412.

108. See, e.g., *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953). In *Ralston*, the Supreme Court suggested that an offer to only one offeree could constitute a public offering. *Id.* at 125. McGinty points out that many transactions that are considered securities but are exempt from registration are privately negotiated. McGinty, *supra* note 3, at 413.

109. Goforth, *supra* note 3, at 1281. Goforth explains:

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.

Id. (footnotes omitted).

is minuscule.¹¹⁰ Thus, the mandatory disclosure required by the Securities Act and the Exchange Act appears unnecessary for both member-managed and manager-managed LLC interests.

Of course, the argument can be advanced that federal securities law protection is needed for LLC interests to protect investors from fraud.¹¹¹ However, the common-law doctrine of fraud offers investors adequate protection from false or misleading disclosure by LLC organizers. The *Restatement (Second) of Torts* states that “[a] representation stating the truth so far as it goes but which the maker knows or believes to be materially misleading because of his failure to state additional or qualifying matter is a fraudulent misrepresentation.”¹¹² Similarly, the antifraud provisions of the Exchange Act provide that it is unlawful “to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made . . . not misleading.”¹¹³ Thus, if disclosure is made by an LLC, the investor is protected from fraud by the common-law doctrine of fraud.¹¹⁴ However, if no disclosure is made by an LLC, the fraud provisions afforded by the federal securities laws offer little added benefit to investors.¹¹⁵ Because mandatory disclosure for LLC interests is unnecessary and the common-law-fraud remedy offers investors adequate protection, the benefits of securities law coverage for LLC interests are marginal at best.

B. The Costs of Finding That LLC Interests Are Securities

Based on the above discussion, the protection offered by securities law coverage for LLC interests does not appear to be significant. Of course, even a marginal benefit to investors would be a rational reason for concluding LLC interests are securities, if there are no additional costs associated with the determination. However, there are substantial costs associated with extending securities law coverage to LLC interests.¹¹⁶

110. *Id.* at 1283 n.243.

111. See Welle, *supra* note 90, at 546-52 (arguing that the antifraud provisions of the securities laws are necessary to protect LLC investors).

112. RESTATEMENT (SECOND) OF TORTS § 529 (1977).

113. 17 C.F.R. § 240.10b-5(b) (2000).

114. McGinty correctly points out that even without mandatory disclosure, “[r]ealistically . . . few firms will make absolutely no disclosure.” McGinty, *supra* note 3, at 438. He goes on to state that “[o]nce [an LLC] does disclose, the common law of fraud prohibits such firm from omitting to state any material fact necessary in order to make the statements made not misleading.” *Id.*

115. It is true that the sale of securities that are exempt from the mandatory disclosure requirements of the federal securities laws are covered by the antifraud provisions. See 17 C.F.R. § 240.10b-5(c) (stating that the antifraud provisions of this rule apply to “the purchase or sale of any security”). Such coverage appears to duplicate the protections of common-law fraud. The question of whether the antifraud provisions of the federal securities laws are necessary in general is outside of the scope of this Note. However, the antifraud protections afforded by the federal securities laws appear to be a weak argument in support of LLC interests being considered securities under the federal securities laws.

116. The largest cost associated with LLC interests as securities is the cost of uncertainty given the current judicial approach to the issue. See *supra* Part I.C.

Goforth has considered the cost versus benefit question regarding LLC interests and securities law coverage.¹¹⁷ Goforth expresses the reality of mandatory disclosure by stating that “[m]andatory disclosure includes direct costs such as the expense of compiling and disseminating the required information together with the indirect costs . . . that would occur when the formidable obstacle of mandatory disclosure leads to the abandonment of potentially profitable ventures.”¹¹⁸ In addition to these regulatory-compliance costs, Goforth also notes that LLC interests as securities may prohibit the use of the cash method of accounting by such entities.¹¹⁹ She concludes that these costs outweigh the benefits of securities law coverage for LLC interests.¹²⁰ Even Welle, who argues that federal securities law protection is needed for LLC investors, admits “securities regulation may have gone too far in attempting to protect investors by imposing complicated, costly, and sometimes burdensome regulations to achieve its objectives.”¹²¹

When the uncertainty of the current judicial analysis of LLC interests as securities is also considered, the costs of securities law coverage (at least in its current form—application of the investment-contract analysis) is even greater. As discussed above, the uncertainty associated with the current judicial analysis raises both the compliance and litigation costs of LLC transactions.¹²² In fact, the current judicial approach to the issue “may impose significant costs by requiring an adjudicator to make a difficult fact-specific inquiry in each case about the need for disclosure.”¹²³

The regulatory-compliance costs along with the costs associated with the current judicial analysis seem to outweigh the marginal benefits provided to LLC investors. As discussed above, mandatory disclosure will provide little benefit to LLC investors in a position to negotiate privately with the LLC promoter. In addition, mandatory disclosure will not help the unsophisticated investor because such an investor is unlikely to comprehend or use the disclosed information in an investment decision. Finally, the antifraud protection of the federal securities laws offers the investor similar protection to that already available from the common-law-fraud remedy. Therefore, the logical conclusion is that LLC interests should not be considered securities under the federal securities laws.

117. See Goforth, *supra* note 3, at 1285-88.

118. *Id.* at 1285.

119. *Id.* at 1286. Goforth notes that virtually all professional services 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. *Id.* She concludes that losing the cash method of accounting could have a “potentially disastrous [effect on] professional service LLCs.” *Id.*

120. *Id.* at 1287-88 (concluding that “the federal securities laws should generally not be applied to LLC membership interests because the potential benefits are so restricted and the costs are likely to be high”).

121. Welle, *supra* note 90, at 587. Welle goes on to admit that “the costs [of securities regulation] may have exceeded the benefits.” *Id.*

122. See *supra* Part I.C.

123. Ribstein, *supra* note 10, at 829.

III. ALTERNATIVE APPROACHES AND A PROPOSED SOLUTION

Given the inherent uncertainty of the current judicial analysis of LLC interests as securities (an analysis that requires a fact-specific application of the investment-contract test), perhaps a new approach is needed.¹²⁴ One possible approach is to declare all LLC interests to be securities per se.¹²⁵ This approach would eliminate judicial uncertainty and would also lower some of the litigation costs associated with LLC interests. However, this approach does not address the problem of regulatory-compliance costs. In addition, finding all LLC interests to be securities offers only marginal benefits to investors and does not serve the purpose of the federal securities laws.¹²⁶

The first two sections of Part III will examine two alternative approaches that move toward LLC interests being excluded from federal securities law coverage. By combining aspects from both approaches, the final section will argue for congressional amendment of the Securities Act and the Exchange Act to definitively exclude LLC interests from the definition of a security in both acts.

A. The Intermediate-Private-Ordering Approach

In *Form and Substance in the Definition of a "Security": The Case of Limited Liability Companies*, Ribstein argues that "[i]nsisting that the federal securities laws be applied on a complex, fact-specific basis does not make sense in light of the high adjudication and predictability costs of applying vague standards."¹²⁷ Therefore, he proposes that courts allow parties to effectively waive federal securities law coverage by selecting the LLC form.¹²⁸ Ribstein calls this approach "intermediate private ordering" and says that, under this approach, "courts could hold that the securities laws do not apply when investors were led by the form of the transaction not to expect protection."¹²⁹

Ribstein notes that most federal courts have held that there is a strong presumption against characterizing general partnership interests as securities under *Howey*.¹³⁰ In

124. See *supra* Part I.B-C (discussing the uncertainty of the current judicial analysis of LLC interests as securities).

125. See Marc I. Steinberg & Karen L. Conway, *The Limited Liability Company as a Security*, 19 PEPP. L. REV. 1105, 1116 (1992).

126. See *supra* Part II.A (discussing the purpose of the federal securities laws and the benefits offered to LLC investors by securities law coverage).

127. Ribstein, *supra* note 10, at 840-41.

128. See *id.* at 832. Ribstein urges that "courts should define 'security' with a view to the appropriate tradeoff between the costs of determining and applying the rule, on the one hand, and congruence with policy objectives on the other." *Id.* at 831-32.

129. *Id.* at 812.

130. *Id.* at 813; see *Williamson v. Tucker*, 645 F.2d 404, 424 (5th Cir. 1981) ("[A]n investor who claims his general partnership or joint venture interest is an investment contract has a difficult burden to overcome."). For cases applying a stronger presumption against security that can only be rebutted by evidence of the operating or management agreement, see *Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.*, 840 F.2d 236, 240-41 (4th Cir. 1988); *Goodwin v. Elkins & Co.*, 730 F.2d 99, 102-07 (3d Cir. 1984).

effect, these courts have applied something like the intermediate-private-ordering approach because they “rely heavily on the existence of a partnership relationship rather than on the details of the partners’ role” in management.¹³¹ Ribstein suggests that the same approach should be applied to LLC interests.¹³²

Ribstein’s proposal addresses the problem of regulatory-compliance costs associated with LLC interests as securities.¹³³ In addition, the intermediate-private-ordering approach is consistent with the purpose of the securities laws.¹³⁴ However, this approach leaves the question of whether LLC interests are securities in the hands of the federal courts.

By leaving the ultimate decision with the federal courts, this approach does nothing to alleviate the problem of uncertainty regarding the issue. In every area of law, “policy preferences play an important role in predisposing courts to construe a statute” narrowly or broadly.¹³⁵ McGinty points out, quite correctly, that “judges deciding securities cases are motivated by a variety of visions of the common good.”¹³⁶ Expansionist judges are likely to find LLC interests to be securities under *Howey* (and its subsequent liberal interpretation) regardless of the presumption against security status.¹³⁷ Therefore, although the intermediate-private-ordering approach is theoretically sound,¹³⁸ in practical terms, it offers little relief from the costs and uncertainties caused by the current judicial analysis of LLC interests as securities.

B. The Legislative-Opt-Out Approach

In *The Limited Liability Company: Opportunity for Selective Securities Law Deregulation*, McGinty proposes that “LLCs should be able to opt in or out of the federal securities laws, provided that those that opt out clearly notify prospective investors (i) that no protections of federal securities laws cover such interests and (ii) what kind of disclosure they are making.”¹³⁹ Under this approach, LLCs will fall into

131. Ribstein, *supra* note 10, at 813.

132. *See id.* at 824. Ribstein justifies the extension of this approach to LLC interests based on both the costs of securities regulation and the purpose of the securities laws. *Id.*

133. *See id.*; *see also supra* Part II.B (discussing the costs associated with finding LLC interests to be securities).

134. *See* Ribstein, *supra* note 10, at 824 (“By facilitating contracting over disclosure rights, emphasizing the form of the transaction tends to produce an optimal amount of disclosure.”).

135. McGinty, *supra* note 3, at 434.

136. *Id.* at 435.

137. *Id.* at 434. McGinty states that “[j]udges are inclined to expand or restrict the concept of ‘security’ on the basis of how they assess the relative costs and benefits of securities law coverage.” *Id.* McGinty explains that expansionist judges are often “willing to make the tradeoff” between deterring fraud and the “economic costs . . . produced by the reduction in fraud.” *Id.* Likewise, a conservative judge is likely to restrict the boundaries of the investment-contract analysis based on a balance of economic costs and benefits. *Id.*

138. The intermediate-private-ordering approach is theoretically sound because it holds LLC interests not to be securities. Thus, it both solves the compliance-cost problem and serves the purpose of the securities laws. *See generally supra* Part II (discussing the purpose of the securities laws and the costs of finding LLC interests to be securities).

139. McGinty, *supra* note 3, at 437.

three distinct categories: (1) LLCs that are SEC protected, (2) LLCs that voluntarily disclose, and (3) LLCs that do not disclose.¹⁴⁰ McGinty concludes that by “[g]iving clear notice to investors, this regime would allow both LLCs and investors to reach a more voluntary equilibrium over how much disclosure and securities regulation they want.”¹⁴¹

In order to accomplish this regime, McGinty suggests that Congress should amend the Securities Act and the Exchange Act to allow for LLC opt-out provisions.¹⁴² The regime would further require that written notice of the opt-out decision be provided in the LLCs articles of organization and on each certificate evidencing the interests.¹⁴³ Finally, the opt-out regime proposes that “[t]o provide optimal notice, the Commission could draft rules and regulations governing this minimal disclosure, including what notice is required when the holder of an LLC interest sells it to another.”¹⁴⁴

On the surface, the legislative-opt-out approach appears to eliminate the problem of judicial uncertainty concerning LLC interest as securities. Because Congress would be making the decision, it appears that courts would be left with little leeway. However, McGinty’s proposal suggests that the general definition of a security in the Securities Act and the Exchange Act include “limited liability companies except excluded LLC interests.”¹⁴⁵ This approach indicates a presumption that LLC interests are securities unless specific exclusionary procedures are followed.

By creating this presumption, the legislative-opt-out approach appears to leave the door open for expansionist judges to find LLC interests are securities based on policy decisions coupled with a determination that the notice of waiver was not sufficient.¹⁴⁶ In addition, the proposal would create several categories of LLC interests, depending on their securities status and the amount of disclosure they are willing to give.¹⁴⁷ The multiple categories of LLC interests can only add to investor and organizer confusion. Thus, there is still a potential problem with substantial litigation costs in determining whether the securities laws would in fact cover specific LLCs.

Another problem with the legislative-opt-out approach as suggested by McGinty is that the regime appears to replace one costly regulatory scheme with a new, untested regulatory scheme. By calling for the Commission to promulgate rules and

140. *Id.* at 440.

141. *Id.* at 437.

142. *Id.* Specifically, McGinty proposes that Congress add the following phrase to the definition sections of the securities acts: “interests in limited liability companies other than excluded LLC interests.” *Id.* He also suggests that, in the general definitions sections, a new term “excluded LLC interests” should be added to the definitions “so as to allow LLCs to exclude themselves from coverage on the condition that they disclose that interests therein are not covered or protected by federal or state securities laws.” *Id.*

143. *Id.*

144. *Id.*

145. *Id.*; *see supra* note 142.

146. McGinty recognizes the problem of judicial expansion of the securities laws. *See supra* notes 135-37 and accompanying text.

147. The potential categories include excluded and nonexcluded LLCs, along with different categories for the level of disclosure that excluded LLCs are willing to give. *See supra* notes 139-44 and accompanying text.

regulations governing the notice of waiver and notice of disclosure requirements, McGinty's proposal does not substantially alleviate the compliance costs associated with LLCs.¹⁴⁸ The new regulatory system may in fact have smaller total compliance costs because the disclosure required would be less than required under the current securities laws. However, the costs of complying with the notice requirements proposed by McGinty will certainly be higher than no compliance costs (achieved if LLCs are not considered securities). Therefore, the legislative-opt-out approach falls short of the benefits provided if LLC interests are not considered securities.¹⁴⁹

*C. A Proposed Solution: Definitive Congressional Action
Excluding LLC Interests from Coverage
by the Securities Laws*

A solution to the question of LLC interests as securities can be found by combining the theory of the intermediate-private-ordering approach with the method of the legislative-opt-out approach. The intermediate-private-ordering approach reduces compliance costs and serves the purpose of the securities laws (protection of investors).¹⁵⁰ If the theory of the intermediate-private-ordering approach is implemented using the legislative method of the opt-out approach, the result is a practical solution to the problems of LLC interests as securities.

Thus, Congress should amend the Securities Act and the Exchange Act definitions of security to definitively exclude LLC interests. A statement at the end of each definition of "security" should state "interests in limited liability companies are not securities within the definition of this act and are therefore not protected by the provisions of this act."

This proposal solves the problem of regulatory-compliance costs because there is no required disclosure with which LLC interests must comply. Moreover, litigation costs are reduced because even expansionist judges could not disregard such strong "plain meaning" in the statute. A precise, congressionally enacted amendment excluding LLC interests from the securities laws would effectively remove the decision from the discretion of the judiciary and thereby significantly reduce litigation costs.

Furthermore, congressional exclusion of LLC interests would not affect investor protection. Investors would still be protected from fraud by a common-law cause of action for fraud.¹⁵¹ This antifraud protection would extend to unsophisticated investors that are contacted through general solicitations by LLC promoters.¹⁵² Also,

148. *See supra* note 142 and accompanying text.

149. *See supra* Part II (concluding that LLC interests should be free of securities law coverage based on the marginal benefits, high costs, and the purpose of the securities laws).

150. *See supra* notes 132-34 and accompanying text.

151. *See supra* notes 112-14 and accompanying text.

152. An unsophisticated investor would have a common-law-fraud claim if the disclosures contained in the general solicitation materials were fraudulent. Also, the unsophisticated investor is unlikely to use mandatory disclosure materials; therefore, mandatory disclosure offers the unsophisticated investor no real protection. *See supra* note 109. This scenario is unlikely because an LLC is most likely to be marketed to a relatively small number of investors in a privately negotiated deal. *See supra* notes 96-109 and accompanying text.

investors in LLC interests will likely have sufficient bargaining power to demand adequate disclosure given the private nature of LLC transactions.¹⁵³ Those investors who lack the power can simply choose to invest in interests that offer federal securities law protection.¹⁵⁴

CONCLUSION

This Note has attempted to analyze the issue of LLC interests as securities with a view towards balancing the costs and benefits of regulation while continuing to serve the purpose of the federal securities laws. Although this Note proposes that LLCs should be definitively excluded from securities law coverage, other more moderate proposals are certainly available.¹⁵⁵

However, there should be agreement about the need to remove the issue of LLC interests as securities out of the realm of judicial interpretation. The *Howey* test for an investment contract and its subsequent judicial interpretation simply do not offer planners, organizers, or investors sufficient certainty concerning LLC interests as securities. Although this Note has made an argument that LLC interests should not be considered securities, any congressional action that will alleviate the uncertainty regarding LLC interests is preferable to the current judicial analysis of the issue.

153. See *supra* notes 96-109 and accompanying text.

154. McGinty, *supra* note 3, at 440 (“Investors who really want disclosure and the other significant securities regulations can still choose from the panoply of investments regulated by the current system . . .”).

155. Such proposals include McGinty’s legislative-opt-out approach. See McGinty, *supra* note 3.