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## WARNING: YOUR LLC INTEREST MIGHT BE A SECURITY

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If an interest in a limited liability company (“LLC”) is a security — whether under federal law, Idaho law, or both — there are serious implications. Securities cannot be offered or sold without either registering them or satisfying an exemption from registration.<sup>1</sup> Moreover, securities are subject to the antifraud provisions of the Securities Exchange Act and the Idaho Uniform Securities Act.<sup>2</sup> Yet, despite these important implications, the question of whether an LLC interest is a security under federal law and/or Idaho law is far from clear.

This article offers some clarity as to whether an LLC interest is a security. First, it analyzes the question under federal law, recommending specific ways to lower the likelihood that an LLC interest will qualify as a security under federal law. Second, it analyzes the question under Idaho law, explaining that the Idaho Uniform Securities Act arguably defines “security” more broadly than federal law in the context of LLC interests. Finally, it posits that, despite this arguable reading of the Idaho statute, courts should interpret Idaho law on this issue consistently with federal law.

### Is your LLC interest a security under federal law?

The Securities Act and the Securities Exchange Act, the primary federal statutes regulating securities, each defines the term “security,”<sup>3</sup> and the U.S. Supreme Court has interpreted these two definitions as “essentially identical.”<sup>4</sup> Each definition includes a laundry list of items, such as “stock” and “investment contracts,” that qualify as securities. LLC interests are not mentioned by name in these definitions, but they may qualify as “investment contracts.”<sup>5</sup>

The U.S. Supreme Court has identified four elements that must be met in order to qualify as an investment contract under the federal securities acts: (1) an investment of money; (2) in a common enterprise; (3) with an expectation of profits; (4) based solely on the efforts of others.<sup>6</sup> The first



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three elements of this test are typically met with respect to LLC interests. First, the “investment of money” prong can be satisfied by investing goods or services, rather than merely by investing cash.<sup>7</sup> Second, the “common enterprise” prong, as interpreted by the Ninth Circuit, is satisfied if the investors’ interests are pooled (so-called “horizontal commonality”) or if the “fortunes of the investors are linked with those of the promoters”<sup>8</sup> (so-called “vertical commonality”).<sup>9</sup> Third, most LLC investors anticipate profits, absent unusual circumstances.

The ambiguity in analyzing whether an LLC interest is an investment contract usually arises with the fourth element — the “solely on the efforts of others” prong. The Ninth Circuit, among others, has declined to interpret the word “solely” literally, adopting instead the following more realistic test: “whether the efforts made by those other than the investor are undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.”<sup>10</sup>

Many courts, when analyzing whether the “solely on the efforts of others” prong is met with respect to LLC interests, analogize interests in manager-managed LLCs to limited partnership interests and interests in member-managed LLCs to general partnership interests because of the similarities among these business entities. Limited partnership interests, whose owners usually do not exercise control over the partnership, are usually securities.<sup>11</sup> By analogy, interests in manager-managed LLCs are more likely to be securities.<sup>12</sup> General partnership interests, whose owners usually exercise at least some control over the partnership, are presumed not to be securities, absent a circumstance in which “the investor nonetheless can demonstrate such dependence on the promoter or on a third party that the investor was *in fact* unable to exercise meaningful partnership powers.”<sup>13</sup> By analogy, interests in a member-managed LLC are less likely to be securities.<sup>14</sup>

Although this analogy to limited and general partnerships is convenient, it is not completely apt. That is, limited partners are often statutorily barred from exercising any meaningful control over the limited partnership, lest they lose their limited liability,<sup>15</sup> while members of manager-managed LLCs are subject to no such restriction.<sup>16</sup> As a consequence, members of manager-managed LLCs may rely less on the efforts of others than limited partners of limited partnerships.<sup>17</sup> Moreover, partners of general partnerships are subject to personal liability,<sup>18</sup> thus encouraging them to be active in the management of the business. Members of member-managed LLCs are protected from personal liability,<sup>19</sup> however, suggesting that they may be less motivated to engage actively in the business.<sup>20</sup>

Therefore, the “solely on the efforts of others” analysis should not end with the distinction between member-managed and manager-managed LLCs. For instance, courts have considered the following additional factors when analyzing whether an LLC interest is a security: (1) whether the members have the right to manage the business;<sup>21</sup> (2) whether the members have the power to participate in the authorization of distributions;<sup>22</sup> (3) whether the members have the right to call meetings;<sup>23</sup> (4) whether the members’ power is diluted;<sup>24</sup> and (5) whether the members have the power to remove the manager for cause.<sup>25</sup>

### Is your LLC interest a security under Idaho law?

The Idaho Uniform Securities Act, like the federal securities acts, defines the term “security” as including “investment contracts.”<sup>26</sup> In addition, the Idaho statute codifies the U.S. Supreme Court’s four-part test to qualify as an investment contract: “‘Security’ includes as an ‘investment contract’ an investment in a common enterprise with the expectation of profits to be derived primarily from the efforts of a person other than the issuer.”<sup>27</sup>

Consistent with the Ninth Circuit's interpretation of this test, Idaho's securities act replaces the troublesome word "solely" with the word "primarily" and recognizes that the "common enterprise" element can be satisfied by both horizontal and vertical commonality.<sup>28</sup> If the Idaho Uniform Securities Act contained no additional references to LLC interests, the analysis of whether an LLC interest is a security would be identical under federal and Idaho law.

The Idaho statute, however, includes the following additional provision: "'Security' includes as an 'investment contract,' among other contracts, an interest in a limited partnership and a limited liability company and an investment in a viatical settlement, life settlement or senior settlement or similar agreement."<sup>29</sup> This provision is capable of two interpretations: (1) an LLC interest is always an investment contract, regardless of whether it satisfies the four-part investment contract test; or (2) an LLC interest is an investment contract only if it satisfies the four-part investment contract test. No Idaho court has resolved this issue; this article briefly outlines the arguments in favor of each interpretation.

The first interpretation — that an LLC interest is always an investment contract under Idaho law — is supported by the most straightforward reading of the following statutory language: "'Security' includes as an 'investment contract' . . . an interest in . . . a limited liability company."<sup>30</sup> Indeed, several secondary sources, citing this provision, have interpreted Idaho law in this manner.<sup>31</sup> Moreover, in an opinion letter about an interest in a limited partnership (which is also listed in the provision), the Idaho Securities Bureau appeared to treat this statutory language as creating a per se rule that limited partnership interests are securities.<sup>32</sup> Further, when adopting the Uniform Securities Act, some other states explicitly adapted this provision so as to include only those LLC interests that satisfy the four-part investment contract test.<sup>33</sup> Additionally, a federal district court in Michigan, analyzing this provision of the Uniform Securities Act in the context of a viatical settlement (which is also listed in this provision), treated this language as creating a per se rule that all interests listed therein are securities, regardless of whether they satisfy the four-part investment contract test.<sup>34</sup> Finally, this per se interpretation of the Idaho statute would further the policy interest of certainty by providing a clear answer to the question of whether an LLC interest is a security under Idaho law.

*No Idaho court has resolved this issue; this article briefly outlines the arguments in favor of each interpretation.*

The second interpretation — that an LLC interest is an investment contract under Idaho law only if it satisfies the four-part test — is supported by a more nuanced interpretation of the Idaho statute. Arguably, if the drafters intended to define all LLC interests as securities, LLC interests would have been included in the laundry list alongside investment contracts, rather than as a subset of investment contracts. By treating LLC interests as a subset of investment contracts, the statute arguably applies the four-part investment contract test to LLC interests. Indeed, the Commentary to the Uniform Securities Act — the source of this provision — explains that this provision is intended to clarify that LLC interests are securities "when consistent with the court decisions interpreting the investment contract concept."<sup>35</sup> Moreover, this interpretation is consistent with the "uniformity principle" recognized elsewhere in the Idaho Uniform Securities Act, pursuant to which "maximizing uniformity in federal and state regulatory standards" is a policy consideration.<sup>36</sup> Further, this interpretation would further the policy interest of efficiency by allowing business owners to perform a single analysis of the question of whether an LLC interest is a security under federal and Idaho law.

This article endorses the second interpretation because it further advances the delicate relationship between federal and state regulation of securities. Federal law supplants state law in some circumstances, such as by exempting certain "covered securities" from state regulation when it would be duplicative.<sup>37</sup> Similarly, federal law defers to state law in other circumstances, such as by exempting intrastate offerings from federal registration because they pose primarily a state concern.<sup>38</sup> Finally, federal and state law dually regulate securities in many circumstances, including antifraud enforcement.<sup>39</sup> This carefully crafted scheme is premised on the notion that the same interests qualify as securities under federal and state law. It remains to be seen, however, how courts

will interpret the question of whether an LLC interest is a security under Idaho law.

## Conclusion

If you are analyzing whether an LLC interest is a security, you should first apply the four-part investment contract test. If the four-part investment contract test is satisfied, you must ensure compliance with the federal and Idaho securities acts. If the four-part investment contract test is not met, you must assess — in light of the foregoing discussion — whether to nonetheless comply with the Idaho Uniform Securities Act out of an abundance of caution, lest you inadvertently run afoul of the Act's registration requirements.

## About the Author

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## Endnotes

- <sup>1</sup> 15 U.S.C. § 77e; IDAHO CODE § 30-14-301.
- <sup>2</sup> 15 U.S.C. § 78j; IDAHO CODE § 30-14-301.
- <sup>3</sup> 15 U.S.C. § 77b(a)(1); 15 U.S.C. § 78c(a)(10).
- <sup>4</sup> *SEC v. Edwards*, 540 U.S. 389, 393 (2004).
- <sup>5</sup> *See, e.g.*, 2 RIBSTEIN & KEATINGE ON LTD. LIAB. COS. § 14.2 (2010) (analyzing whether LLC interests are securities by applying "investment contract" analysis); James J. Wheaton, *Current Status of Securities Issues*, Limited Liability Entities — 2006: New Developments in Limited Liability Companies and Limited Liability Partnerships (ALI-ABA March 16, 2006) ("LLC interests are not listed as securities by the 1933 Act . . . , but another item, 'investment contract,' has become the catch-all through which interests that are not otherwise listed can be drawn within the coverage of the securities laws.")
- <sup>6</sup> *SEC v. Howey*, 328 U.S. 293, 298-99 (1946).
- <sup>7</sup> *Int'l Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 560 n. 12 (1979).
- <sup>8</sup> *SEC v. Eurobond Exch., Ltd.*, 13 F.3d 1334, 1339 (9th Cir. 1993).
- <sup>9</sup> *Hocking v. Dubois*, 885 F.2d 1449, 1459 (9th Cir. 1989).
- <sup>10</sup> *SEC v. Glenn W. Turner Enters., Inc.*, 474 F.2d 476, 482 (9th Cir. 1973).
- <sup>11</sup> *Reeves v. Teuscher*, 881 F.2d 1495, 1500 n.6 (9th Cir. 1989).
- <sup>12</sup> *E.g., Keith v. Black Diamond Adv.*, 48 F. Supp. 2d 326, 333 n.3 (S.D.N.Y. 1999).
- <sup>13</sup> *Holden v. Hagopian*, 978 F.2d 1115, 1119 (9th Cir. 1992).

<sup>14</sup> *E.g.*, *Keith v. Black Diamond Adv.*, 48 F. Supp. 2d 326, 334 (S.D.N.Y. 1999); *SEC v. Shreveport Wireless Cable Tel. P'ship*, No. Civ.A. 94-1781, 1998 WL 892948 (D.D.C. Oct. 20, 1998).

<sup>15</sup> See REV. UNIF. LTD. P'SHIP ACT § 303 (1985) ("RULPA"); but see UNIF. LTD. P'SHIP ACT § 303 (2001) ("Re-RULPA").

<sup>16</sup> See REV. UNIF. LTD. LIAB. CO. ACT § 304 (2006).

<sup>17</sup> *Great Lakes Chem. Co. v. Monsanto Co.*, 96 F. Supp. 2d 376, 391-92 (D. Del. 2000).

<sup>18</sup> See UNIF. P'SHIP ACT § 306 (1997).

<sup>19</sup> See REV. UNIF. LTD. LIAB. CO. ACT § 304 (2006).

<sup>20</sup> *Ak's Daks Comms. v. Maryland Sec. Div.*, 771 A.2d 487, 498 (Ct. of Sp. App. of Md. 2001); *Great Lakes Chem. Co. v. Monsanto Co.*, 96 F. Supp. 2d 376, 390 (D. Del. 2000); *Nutek v. Ariz. Corp. Comm'n*, 977 P.2d 826, 833-34 (Ariz. Ct. App. 1998).

<sup>21</sup> *Compare Nutek*, 977 P.2d at 831 (holding that LLC interests were securities where, among other factors, management agreement turned all principal management functions over to another), with *Keith*, 48 F. Supp. 2d at 333 (holding that LLC interests were not securities where, among other factors, members had right to manage business).

<sup>22</sup> *Compare Shirley v. JED Capital, LLC*, No. 09-C-7894, 2010 WL 2721855, at \*3 (N.D. Ill. July 8, 2010) (holding that LLC interests were securities where, among other factors, manager had sole power to authorize distributions), with *Keith*, 48 F. Supp. 2d at 333 (holding that LLC interests were not securities where, among other factors, members had right to participate in detailed cash flow distribution structure).

<sup>23</sup> *Compare Shirley*, 2010 WL 2721855, at \*3 (holding that LLC interests were securities where, among other factors, membership meeting could not be called without manager's consent), with *Keith*, 48 F. Supp. 2d at 333 (holding that LLC interests were not securities where, among other factors, members had right to call meetings of members).

<sup>24</sup> *Compare Nutek*, 977 P.2d at 832 (holding that membership interests in a member-managed LLC were securities where, among other factors, large number of geographically dispersed investors diluted power to such extent that prevented members from exercising effective control), with *Great Lakes*, 96 F. Supp. 2d at 392 (holding that LLC interests were not securities where member was sole owner and thus power was not diluted).

<sup>25</sup> *Compare Shirley*, 2010 WL 2721855, at \*3 (holding that LLC interests were securities where, among other factors, manager had veto power over change in manager and operating agreement had no provision for removal of manager for cause), with *Great Lakes*, 96 F. Supp. 2d at 392 (holding that LLC inter-

*Similarly, federal law defers to state law in other circumstances, such as by exempting intrastate offerings from federal registration because they pose primarily a state concern.*

ests were not securities where members had power to remove any manager with or without cause).

<sup>26</sup> IDAHO CODE § 30-14-102(28).

<sup>27</sup> IDAHO CODE § 30-14-102(28)(d).

<sup>28</sup> IDAHO CODE § 30-14-102(28)(d) ("Common enterprise' means an enterprise in which the fortunes of the investor are interwoven with those of either the person offering the investment, a third party, or other investors.").

<sup>29</sup> IDAHO CODE § 30-14-102(28)(e). A viatical settlement is "[a] transaction in which a terminally or chronically ill person sells the benefits of a life-insurance policy to a third party in return for a lump-sum cash payment equal to a percentage of the policy's face value." BLACK'S LAW DICTIONARY 1497 (9th ed. 2009) (defining "viatical settlement" within definition of "settlement").

<sup>30</sup> IDAHO CODE § 30-14-102(28)(e).

<sup>31</sup> PETER M. FASS & DEREK A. WITTNER, BLUE SKY PRACTICE FOR PUBLIC AND PRIVATE DIRECT PARTICIPATION OFFERINGS, App. 13A (2010) ("[In Idaho,] LLC interests are defined as securities."); James J. Wheaton, *Current Status of Securities Issues, Limited Liability Entities – 2006: New Developments in Limited Liability Companies and Limited Liability Partnerships* (ALI-ABA March 16, 2006) ("Under the standard version of the 2002 Uniform Act, LLC interests and limited partnership interests are lumped together and deemed to be within the definition of 'investment contract.' Idaho, Maine, South Dakota and Vermont have adopted this language without modification.").

<sup>32</sup> Idaho Department of Finance, Opinion Letter at 2 (March 20, 2006), available at <http://finance.idaho.gov/Securities/NoActionOpinionLetters.aspx>.

<sup>22</sup> See, e.g., OKLA. STAT. ANN. tit. 71, § 1-102 cmt 5 ("[T]he words 'a third party managed' were added before the phrase 'limited liability company' to

narrow the scope of the definition, with respect to limited liability company interests, to those interests meeting the elements of an investment contract, i.e., investment interests in limited liability companies from which expected profits are to be derived primarily from the efforts of a person other than the investor."); KAN. STAT. ANN. § 17-12a102(28)(E) (clarifying that investment contracts "may include" LLC interests) (emphasis added); MO. ANN. STAT. § 409.1-102(28)(E) (same as Kansas).

<sup>34</sup> *In re Trade Partners, Inc. Investors Litig.*, No. 1:07-MD-1846, 2008 WL 3992168, at \*4 (W.D. Mich. Aug. 22, 2008) (not reported) (applying Oklahoma law) (analyzing viatical settlements pre-dating the enactment of this provision pursuant to the four-part investment contract test and treating viatical settlements post-dating the enactment as securities per se).

<sup>35</sup> UNIF. SEC. ACT § 102 cmt. 28 (2002) ("Section 102(28)(E) is consistent with state and federal securities laws which have recognized interests in limited liability companies and limited partnerships in some circumstances as 'securities.'") (emphasis added).

<sup>37</sup> IDAHO CODE § 30-14-608(b).

<sup>38</sup> 15 U.S.C. § 77r; 142 CONG. REC. S12093-02 (daily ed. Oct. 1, 1996) (statement of Sen. Sarbanes) (discussing the rationales for the National Securities Markets Improvement Act of 1996) ("[D]ual regulation need not mean duplicative regulation.").

<sup>39</sup> 15 U.S.C. § 77c(a)(11); Notice of Adoption of Rule 147 Under the Securities Act of 1933, Securities Act Release No. 5450 (January 7, 1974) ("Section 3(a)(11) was intended to allow issuers with localized operations to sell securities as part of a plan of local financing. . . . In theory, the investors would be protected both by their proximity to the issuer and by state regulation.").

<sup>40</sup> *E.g.*, 15 U.S.C. § 77r(c) (preserving fraud authority of securities commission of any state).

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