

When Are LLC Interests Securities

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A limited liability company (LLC) is a popular legal vehicle for setting up a new business or joint venture because, among other things, it affords flexibility to design the capital and governance structure. A common question in this context is whether an LLC interest constitutes a “security” for purposes of determining whether state and federal securities laws apply. If an LLC interest is a “security,” an LLC and holders of LLC interests must analyze and comply with state and federal securities laws in connection with the issuance and transfer of LLC interests. For example, most securities transactions must be registered or satisfy a registration exemption. Also, anti-fraud rules apply to securities transactions, and state and federal securities regulators have jurisdiction over securities transactions. The failure to comply may have significant consequences and may trigger, among other consequences, rescission rights, damages, and civil and criminal penalties.



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Federal courts look to the definition of “security” in the Securities Act of 1933, which includes “investment contract,” “stock,” and “instrument[s] commonly known as a ‘security.’”[1] LLC interests are not included and most case law instead involves an examination of whether an LLC interest is an “investment contract.”

To determine whether an investment is an “investment contract,” federal courts use the test laid out in [U.S. Securities and Exchange Commission v. W.J. Howey Co.](#): an investment contract exists when a transaction involves (1) an investment of money, (2) in a common enterprise, (3) with profits to come solely from the efforts of others, examining the facts and circumstances.[2] Most case law examining LLC interests focuses on the third prong of the test.

A court could instead find that an LLC interest constitutes “stock” or an “investment commonly known as a security.” It is unlikely that an LLC interest would constitute “stock,” as the term appears to be applied narrowly only to traditional stock as opposed broadly to stock-like instruments.[3] Further, courts apply the “investment contracts” analysis when analyzing whether an investment constitutes an “instrument commonly known as a security.”[4] Therefore, analyzing whether an LLC interest is one or the other should presumably reach the same result and not expand the arguments available.

In analyzing the third prong of the Howey test, courts examine the facts and circumstances and focus on the level of control an investor has, either alone or as a group if there are multiple investors, over the profitability of the investment.[5] An investment is less likely to be an investment contract the greater control an investor has.[6] Put differently, a passive investment is more likely an investment contract than an investment where an investor plays an active role, which is more like a joint business endeavor.[7] It is important to note that it is the objective ability of an investor to exercise control that matters, not whether the investor actually intends to or chooses to exercise such control.[8]

Courts take into account multiple factors in making this determination and, presumably, no one factor alone would be determinative. The following is a presentation of frequently examined factors into three groups, each with a common theme.

The first group of factors focuses on an investor's ability to control the terms of the investment and exercise voting rights.

- An investor's ability to amend the terms of an LLC's operating agreement would have the ability to control the profitability of the investment because it would permit the investor to, for example, take direct control or dissolve the LLC.[9]
- The right to vote with respect to "major decisions" or otherwise may be indicative of control if it gives an investor protection from unilateral action by other members.[10]

Courts also examine an investor's ability to influence and control management, operations and assets. This ability may arise from rights provided in the LLC's governing documents or through participation in management. Notably, the lack of a right to influence management or the lack of an ability to do so would be indicative of an expectation of profits from the efforts of others.[11] The following are examples of factors indicative of control:

- The right to appoint and remove managers;[12]
- Control rights over management decisions generally;[13]
- The right to participate in an LLC's governing body;[14]
- Control over the LLC's funds;[15]
- Veto right with respect to sale or encumbrance of assets;[16] and
- Control over distributions.[17]

The last group of factors focuses on investors' ability to make informed decisions and control the investment that way.

- Sophisticated investors with ability to make informed, intelligent decisions are likely to be viewed as controlling the profitability of their investment.[18] Thus, it appears that the right to exercise control may be obviated if an investor is not sophisticated enough to do so intelligently.
- Access to information about an LLC's business is an extension of the foregoing point.[19] Given that most state statutes and operating agreements provide some level of informational right, it is likely a factor that will not be given significant weight in the absence of other indicia of control over an LLC.

As illustrated, there are myriad factors that may weigh one way or another in the investment contract analysis. The fact-specific nature of the analysis leads to great uncertainty as to whether an LLC interest is a security. If in doubt, it would be prudent for issuers and sellers to assume that state and federal laws apply, and purchasers the opposite, in most cases.

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[1] 15 U.S.C.A. § 77b(a)(1).

[2] 328 U.S. 293, 301 (1946).

[3] See *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 686 (1985); *Great Lakes Chem. Corp v. Monsanto Co.*, 96 F. Supp. 2d 376, 388–89 (D. Del. 2000) (finding that LLC interests were not investment contracts, stock nor instruments commonly known as securities).

[4] *United Housing Foundation Inc. v. Forman*, 421 U.S. 837, 852 (1975); *Great Lakes*, 96 F. Supp. 2d at 393–94.

[5] *Ave. Capital Mgmt. II LP v. Schaden*, 843 F.3d 876, 882 (10th Cir. 2016); *Rossi v. Quarmley*, 604 F. App'x 171, 173 (3d Cir. 2015); *Robinson v. Glynn*, 349 F.3d 166, 170–173 (4th Cir. 2003).

[6] *Ave. Capital*, 843 F.3d at 882 (citing *SEC v. ETS Payphones Inc.*, 408 F.3d 727, 732 (11th Cir. 2005)).

[7] Compare *Rocky Aspen Mgmt. 204 LLC v. Hanford Holdings LLC*, No. 16 Civ. 4270(VM) (S.D.N.Y. Feb. 1, 2017) (LLC interests potentially an investment contract where investor was a passive, nonmanaging pledgee of equity securities without any right or ability to operate LLC or vote) with *Hardisty v. Moore*, No. 11cv1591 AJB (BLM), 2012 WL 4845548, at *5 (S.D. Cal. Oct. 9, 2012) (LLC interest not an investment contract, in part, because investor agreed to be builder and developer of project with the understanding that doing so would result in an equity interest) and *Rossi*, 604 F. App'x at 175 (LLC interest not an investment contract but instead a commercial venture).

[8] See *Nelson v. Stahl*, 173 F. Supp. 2d 153, 166 (S.D.N.Y. 2001); *Ave. Capital*, 843 F.3d 876, 884.

[9] See *Ave. Capital*, 843 F.3d at 883 (LLC interests not investment contract, in part, where investors collectively owned approximately 80 percent, permitting them to freely amend LLC agreement); see also *Braun v. Schwartz*, No. 12–6224 (ES)(JAD), 2013 WL 5467084 at *23–24 (D.N.J. Sept. 30, 2013) (LLC interest not investment contract, in part, because investor was controlling member and had power to dissolve LLC); *Great Lakes*, 96 F. Supp. 2d at 392 (LLC interests not investment contracts, in part, because investor had power to dissolve LLC).

[10] See Rossi, 604 F. App'x at 174–75 (LLC interest not investment contract where investor had right to call special meetings with one other member, examine financial document and vote in proportion to his share); Keith v. Black Diamond Advisors Inc., 48 F. Supp2d 326, 333–34 (S.D.N.Y. 1999) (LLC interest in member-managed LLC not an investment contract where investor had right to vote in proportion to holdings, protection from other members acting individually on behalf of LLC, protection from additional capital calls, which required two-thirds member approval, the right to participate in cash flow distribution structure and right to call member meetings); Robinson, 349 F.3d at 171 (LLC interest not investment contract, in part, because of investor's ability to consent to certain major decisions).

[11] See Rocky Aspen; Venezia Amos LLC v. Favret, No. 3:07cv146/MCR, 2008 WL 410163 *8 (N.D. Fla. Feb. 12, 2008) (LLC interest was investment contract where managing member, not investor, controlled operations, funds and distributions); Cogniplex Inc. v. Ross, No. 00C7463, 2001 WL 436210, at *10 (N.D. Ill. Apr. 27, 2001) (LLC interest may be investment contract where investors provided capital and defendant operated LLC).

[12] See Great Lakes, 96 F. Supp. 2d at 392; Ave. Capital, 843 F.3d at 883; Robinson, 349 F.3d at 170.

[13] See Nelson, 173 F. Supp. 2d at 165–66 (LLC interests not investment contract where LLC agreement gave members complete control over management decisions and plaintiffs owned 60 percent); Keith, 48 F. Supp2d at 333–34 (LLC interests not investment contract, in part, because plaintiff had right to manage LLC); Shirley v. JED Capital LLC, 724 F. Supp. 2d 904 (N.D. Ill. 2010) (LLC interest in manager-managed LLC was investment contract where manager controlled expenditures and distributions and could not be replaced without consent); Venezia Amos, 2008 WL 410163, at *8.

[14] See Robinson, 349 F.3d at 170–71 (LLC interest not investment contracts where plaintiff assumed a seat on board, served as vice chairman of the board, was a member of a four-person executive committee with “extensive” responsibilities, and served as treasurer, with the ability to select outside financial and legal consultants, and to consult with LLC's chief financial officer on all financial matters relating to LLC); Hardisty, 2012 WL 4845548, at *5 (LLC interest not investment contracts where plaintiff was “chief manager”).

[15] Endico v. Fonte, 485 F. Supp. 2d 411, 414 (S.D.N.Y. 2007) (LLC interest not investment contract where plaintiff had veto power of sale or encumbrance of LLC assets and was only authorized signatory of bank account); Venezia Amos, 2008 WL 410163, at *8.

[16] Endico, 485 F. Supp. 2d at 414; Robinson, 349 F.3d at 171 (LLC interest not investment contracts, in part, because plaintiff served as treasurer, with the ability to select outside financial and legal consultants and consult with CFO on all financial matters, and LLC could not incur indebtedness outside the normal course of business without plaintiff's approval).

[17] Shirley, 724 F. Supp. 2d at 911; Braun, 2013 WL 5467084 at *8 (LLC interest not investment contract, in part, because plaintiff was controlling member with right to call

member meetings, vote, dissolve LLC and make distributions in his discretion); Venezia Amos, 2008 WL 410163 at *8; Keith, 48 F. Supp2d at 333 (LLC interest not investment contract, in part, where plaintiff had right to participate in cash flow distribution structure).

[18] See Ave. Capital, 843 F.3d at 883 (LLC interests not investment contracts, in part, because investors were sophisticated, made informed decisions, could intelligently exercise control and had access to financial information and LLC books); Robinson, 349 F.3d at 171–72 (LLC interest not investment contract, in part, because plaintiff was a savvy and experienced businessman, actively exercising management rights); Rossi, 604 F. App'x at 174–75 (LLC interest not investment contract, in part, because plaintiff was sophisticated, had founded other companies with defendants in the past and successfully managed such businesses); Hardisty, 2012 WL 4845548 *5 (LLC interest not investment contract, in part, because plaintiff was sophisticated businessman); Cogniplex, 2001 WL 436210 at *10 (LLC interest was investment contract, in part, because plaintiffs lacked experience); SEC v. Parkersburg Wireless LLC, 991 F. Supp. 6, 7–8 (D.D.C. 1997) (LLC interests investment contracts when sold to unsophisticated investors without management control).

[19] See Nelson, 173 F. Supp. 2d at 166 (LLC interest not investment contract, in part, because investor had right to audit, examine and make copies of books and records in member-managed LLC); Ave. Capital, 843 F.3d at 883; Rossi, 604 F. App'x at 174.