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I. Introduction

The federal securities laws apply to any investment described by the broad statutory definition of a "security"[1] unless an exemption applies. This

1. This Article discusses the two principal securities laws, the Securities Act of 1933, 15 U.S.C. §§ 77a-77bbbb (1988 & Supp. 1991) [hereinafter 1933 Act], and the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78kk (1988 & Supp. 1991) [hereinafter 1934 Act]. "Security" is defined in § 2(1) of the 1933 Act as follows:

> The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or

suggests that the type of business association and other aspects of the investment's external form should not matter, and that the securities laws should apply whenever appropriate for the protection of investors. Indeed, the Supreme Court often has expressed this view.[2]

Yet this "substance-over-form" approach presents serious problems. At its full extension, the approach would require the courts to analyze each investment in the light of the function of the securities laws. Neither investors nor issuers could ever know without litigation or an administrative hearing whether the securities laws apply. This would not only increase litigation, but also would make it difficult for the parties to make and price their contracts with regard to the applicable level of regulation. These problems will become more serious as investment markets develop new types of business associations and "derivative" and other securities.[3]

So "form" must matter. The only question is, how much? Courts have, in fact, emphasized form over substance by holding that a general partnership interest is presumptively a nonsecurity, and that corporate stock is per

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> 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.

15 U.S.C. § 77b. The 1934 Act defines "security" in similar terms, with minor exceptions relating to mineral leases and the exclusion of instruments with a maturity of nine months or less. *See* 15 U.S.C.A. § 78c(a)(10).

2. *See infra* text accompanying note 7.

3. *See* Jeff Strnad, *Taxing New Financial Products: A Conceptual Framework*, 46 STAN. L. REV. 569 (1994) (discussing costs of discontinuity and inconsistencies in tax rules relating to new financial products). For other descriptions of possible legal implications and complications associated with new investment products, see Daniel R. Fischel, *Regulatory Conflict and Entry Regulation of New Futures Contracts*, 59 J. BUS. S85 (1986); David J. Gilberg, *Regulation of New Financial Instruments Under the Federal Securities and Commodities Laws*, 39 VAND. L. REV. 1599 (1986); Henry T.C. Hu, *Swaps, The Modern Process of Financial Innovation and the Vulnerability of a Regulatory Paradigm*, 138 U. PA. L. REV. 333 (1989); Thomas A. Russo & Marlisa Vinciguerra, *Financial Innovation and Uncertain Regulation: Selected Issues Regarding New Product Development*, 69 TEX. L. REV. 1431 (1991); *Symposium—New Financial Products, the Modern Process of Financial Innovation, and the Law*, 69 TEX. L. REV. 1273 (1991).

se a security.[4] Thus, current law essentially lets the parties to closely held firms choose whether the securities laws will apply by selecting their business form.

The rapid acceptance of a relatively new form of business enterprise—the limited liability company (LLC)—raises new questions about the application of this form-over-substance approach to closely held firms. Like partnerships, LLCs are noncorporate firms whose members commonly participate directly in management and so arguably have less need than public corporation shareholders for mandatory disclosure rules. Yet, unlike partners, LLC members have limited liability and sometimes do not participate directly in management unless the agreement provides otherwise. It is not clear, therefore, whether the general-partnership-as-"security" analysis should be applied to LLC interests. While prominent securities law commentators have discussed the application of the securities laws to LLCs,[5] none have addressed the critical underlying form-over-substance issue.

This Article concludes that LLC interests, like partnership interests, should be at least strongly presumed not to be "securities."[6] This conclusion is based on an analysis of the extent to which courts should rely on investment form rather than substance—that is, "economic reality"—in defining a security.

Part I of this Article reviews the reasons for treating general partnership interests as presumptively nonsecurities. Part II discusses potential distinctions between partnerships and LLCs that might justify a different result in the latter situation. Part III undertakes a more detailed analysis of the form-over-substance theory underlying the general partnership cases in order to determine whether the courts should extend the general partnership rule to LLCs. Part III shows why, in the light of this broader form-over-substance theory, LLCs should be treated substantially like general

4. *See generally* Larry E. Ribstein, *Private Ordering and the Securities Laws: The Case of General Partnerships*, 42 CASE W. RES. L. REV. 1 (1992).

5. *See* William J. Carney, *Limited Liability Interests as Securities in Georgia*, 30 GA. ST. B.J. (forthcoming summer 1994); Mark A. Sargent, *Are Limited Liability Company Interests Securities?*, 19 PEPP. L. REV. 1069 (1992); Marc I. Steinberg & Karen L. Conway, *The Limited Liability Company as a Security*, 19 PEPP. L. REV. 1105 (1992).

6. I have discussed this issue previously and briefly stated the conclusion I reach in the present Article, but I did not fully articulate the reasoning supporting my conclusion. *See* LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN & KEATINGE ON LIMITED LIABILITY COMPANIES § 14.02, at 14-5 (1992 & Supp. 1994).

partnerships. Part IV discusses specific issues in applying the theory, while Part V discusses possible qualifications of the analysis. Part VI contains concluding remarks.

II. The Basic Theory: General Partnerships as Nonsecurities

This Part reviews the starting point for analysis of LLC interests under the securities laws—the law and policy of general partnerships as non-"securities."

A. Economic Reality vs. Private Ordering

The Supreme Court has stated that "in searching for the meaning and scope of the word 'security' . . . form should be disregarded for substance and the emphasis should be on economic reality."[7] This means that in each case the courts must apply the general test for "investment contracts" articulated in *SEC v. W.J. Howey Co.*:[8]

> [A]n investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is 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.[9]

The *Howey* factors can be explained in terms of the economic rationales for mandatory federal disclosure.[10] Specifically, the "efforts of others" factor identifies situations in which investors need the sort of detailed disclosures and standardized formatting the securities laws mandate. The "common enterprise" factor identifies situations involving public marketing of securities in small lots to relatively passive investors in which centralized disclosure is more cost-effective than leaving research to individual investors.[11]

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7. Tcherepnin v. Knight, 389 U.S. 332, 336 (1967).

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

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

10. *See* Ribstein, *supra* note 4, at 18-24.

11. The formatting and investment-in-information bases for *Howey* rely heavily on the rationales for mandatory disclosure articulated in Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669 (1984).

Howey assumes that the *law* should determine what disclosures must be made. A contrasting "private ordering" approach to interpreting the reach of the securities laws would let the parties themselves determine whether the securities laws apply.[12] The rationale for this approach is that contracting parties ordinarily are better suited than courts or regulators to determine the amount of disclosure that is appropriate in specific contexts.[13] Under this approach, a court would enforce clear waivers even in transactions for which mandatory disclosure otherwise seems appropriate under the *Howey* test. The courts might permit exceptions to private ordering when there are specific reasons for not enforcing the waiver, such as uncertainty about the investors' intent to waive protection, or the investors seem incapable of protecting their own interests.

The courts also could apply what might be called an "intermediate private ordering" approach. Under this approach, the courts could hold that the securities laws do not apply when investors were led by the *form* of the transaction not to expect protection. This approach avoids the statutory prohibition against waiver.[14] Rather than enforcing a "waiver," the courts would consider the policy considerations favoring private ordering in determining whether the nebulous term "investment contract" should be deemed to refer to a particular transaction. This approach to waiver also is consistent with the intent of the securities laws in that it accommodates investor protection. Because the waiver is based on investor expectations, it will not surprise unwary investors. Moreover, courts can fashion the

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12. *See generally* Ribstein, *supra* note 4.

13. For discussions of whether investors ought to be able to contract for the amount of liability for securities fraud, see Ian Ayres, *Back to Basics: Regulating How Corporations Speak to the Market*, 77 VA. L. REV. 945 (1991) (arguing that investors probably would want managers to warrant truthfulness of corporate speech to correct market inefficiency, and that in all events, corporations should make clear whether their speech is warranted); Marcel Kahan, *Games, Lies, and Securities Fraud*, 67 N.Y.U. L. REV. 750 (1992) (showing how liability for certain types of lies may be beneficial to firms); Jonathan R. Macey & Geoffrey P. Miller, *The Fraud-on-the-Market Theory Revisited*, 77 VA. L. REV. 1001 (1991) (arguing against mandatory warranty of accuracy, noting high costs of such warranty and availability of other means of protecting investors, including verification of corporate information by securities analysts and others).

14. *See* Securities Act of 1933 § 14, 15 U.S.C. § 77n (1988) ("Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the Commission shall be void."). A similar provision prevents waiver of the 1934 Act. *See* Securities Exchange Act of 1934 § 29(a), 15 U.S.C. § 78cc(a) (1988).

waiver to apply only to transactions for which it is generally inappropriate to mandate disclosure.

B. Recognition of "Intermediate Private Ordering:" Partnership Interests As Nonsecurities

Since *Williamson v. Tucker*,[15] most federal courts have held that there is at least a strong presumption against characterizing general partnership interests as securities under the *Howey* "efforts of others" test.[16] These courts, in effect, apply something like the "intermediate private ordering" approach discussed above in that they rely heavily on the existence of a partnership relationship rather than on the details of the partners' management role in each case.[17] The results in the partnership cases contrast with

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15. 645 F.2d 404 (5th Cir. 1981).

16. *See* Williamson v. Tucker, 645 F.2d 404, 424 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981) (holding that there is strong presumption against general partnership interest's being security that can be overcome by showing that agreement left investor with no more than powers of limited partner or that partners were, in effect, unable to exercise their power because of their lack of sophistication or dependence on promoter's unique skills). For examples of cases applying *Williamson*, see Youmans v. Simon, 791 F.2d 341, 346-47 (5th Cir. 1986) (no security when investors were sophisticated and had power to terminate venture and replace manager); Casablanca Prods., Inc. v. Pace Int'l Res., Inc., 697 F. Supp. 1563, 1567 (D. Or. 1988) (no security because plaintiff had sufficient business expertise to enforce partnership rights). For cases applying an even stronger presumption against security that can be rebutted only by evidence of the agreement itself, as distinguished from the investors' ability to exercise their powers, see Matek v. Murat, 862 F.2d 720, 730-31 (9th Cir. 1988); 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). The authority of *Matek* in the Ninth Circuit was cast in doubt by Koch v. Hankins, 928 F.2d 1471 (9th Cir. 1991), which held that there was a question of fact whether partners in 35 related general partnerships could meaningfully exercise control over the overall enterprise. *Id.* at 1480. On the other hand, another recent case applying *Koch*, relying on the partners' technical powers under the partnership agreement and requiring a strong showing of lack of business expertise sufficient to use those powers, declined to find a security in the general partnership situation. *See* Holden v. Hagopian, 978 F.2d 1115, 1122-23 (9th Cir. 1992) (horsebreeding partnership; court reasoned that investors who were not knowledgeable about horsebreeding business did not show they could not have replaced manager with someone else of similar expertise). The cases are discussed in Ribstein, *supra* note 4, at 47-54.

17. The courts in these cases have refined rather than abandoned the *Howey* analysis. Although the courts continue to apply the "efforts of others" factor, they have recognized a particular fact pattern of general partnership interests as leading to a particular result under

those in otherwise analogous nonpartnership cases in which the courts analyze the investors' reliance on the promoters' efforts.[18]

The courts should go even further than they have so far toward characterizing partnerships as nonsecurities. The courts have been willing only to presume against characterizing general partnership interests as securities.[19] However, the considerations underlying the "intermediate private ordering" approach would justify something approaching a per se rule that partnership interests are not securities. General partners do not expect to be covered by the securities laws because they normally have significant power to control their firm, in contrast to passive investors in corporate stock and other investors who rely on the efforts of third parties to produce profits.[20] In a sense, therefore, they have waived the securities laws by contracting to be partners rather than corporate shareholders. Moreover, because they are willing to undertake personal liability, general partners presumably are sophisticated enough to have relatively little need for mandatory disclosure rules.[21] Indeed, many general partnerships are either professional firms or custom-designed, tax-oriented deals.[22]

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that factor. This hardening of fact patterns into rules is an inherent part of the process of *stare decisis*. It also illustrates the continuum between rules and standards discussed in Part IV(A). *See infra* Part IV.A.

18. *See* Ribstein, *supra* note 4, at 61-64.

19. *See supra* note 16.

20. William Carney argues that even active-participation investments, including partnership interests, should be treated as securities as long as investors buy into an investment structured by others and, therefore, need information about that investment structure. *See* Carney, *supra* note 5; William J. Carney & Barbara G. Fraser, *Defining a "Security": Georgia's Struggle with the "Risk Capital" Test*, 30 EMORY L.J. 73, 94 (1981). This test is considerably broader than the one applied in the *Williamson* line of cases. *See supra* note 16. From a policy standpoint, it is the reliance on another's management skill which produces the special need for information that underlies the securities laws. *See* Ribstein, *supra* note 4, at 15-16. While affirmative disclosure requirements might be efficient in other circumstances, it is difficult to limit the application of the securities laws in a principled way once the efforts-of-others test is abandoned.

21. *See* Ribstein, *supra* note 4, at 43.

22. This statement applies to formal general partnerships. Informal partnerships, in which the parties may not even have explicitly agreed to be partners, may involve financially unsophisticated parties, such as farm families. However, these are the sort of one-on-one idiosyncratic contracts that the Court has held are not "securities." *See* Marine Bank v. Weaver, 455 U.S. 551, 559-60 (1982) (holding that one-on-one profit-sharing arrangement was not "security").

The Supreme Court has not yet considered whether general partnership interests are "securities." However, it has indicated that it is willing to follow an approach similar to that in the general partnership cases rather than insisting on "economic reality" in every case. In *Landreth Timber Co. v. Landreth*,[23] and the related case of *Gould v. Ruefenacht*,[24] the Court held that the securities laws apply to the purchase of close corporation "stock" even in transactions that do not satisfy the *Howey* "efforts of others" factor. To be sure, these cases are based partly on the fact that the securities laws list "stock" as a type of "security" separately from "investment contract," which *Howey* defines. However, the Court had to deal with the argument that no instrument should be characterized as a "security" unless it meets the *Howey* "economic reality" test. Accordingly, the Court had to give policy reasons why "economic reality" should not always control. The Court stressed the importance of the parties' expectations and of clear rules that provide advance notice as to whether the securities laws apply.[25]

The relevance of *Landreth* and *Gould* to general partnerships was reinforced in *Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.*,[26] a Fourth Circuit opinion concerning general partnership interests written by former Justice Powell, the author of *Landreth* and *Gould*. Justice Powell reasoned, as he did in *Landreth* and *Gould*, that the "economic reality" test did not require courts to examine each investor's need for securities law protection.[27]

The Court, in holding that transactions are *not* covered by the securities laws, has shown that it is willing to depart from *Howey*. In *Reves v. Ernst & Young*,[28] the Court refused to apply *Howey* to "notes" that, like "stock," are expressly included in the definition of a "security." The Court said that "[a] commitment to an examination of the economic realities of a transaction

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23. 471 U.S. 681 (1985).

24. 471 U.S. 701 (1985).

25. *See* Ribstein, *supra* note 4, at 57-58 (discussing Court's reasoning).

26. 840 F.2d 236 (4th Cir. 1988).

27. Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc., 840 F.2d 236, 241 n.7 (4th Cir. 1988) (reasoning that "to the extent [the *Williamson* approach] requir[ed] a court to look to the actual knowledge and business expertise of *each* partner . . . . [i]t . . . would unduly broaden the scope of the Supreme Court's instruction that courts must examine the economic reality of partnership interests").

28. 494 U.S. 56 (1990).

does not necessarily entail a case-by-case analysis of every instrument."[29] The Court held instead that a "note" is presumed to be a "security." The presumption can be rebutted by showing either that the instrument is in one of the categories, including consumer loans, that the courts have identified as per se nonsecurities, or that it bears a "family resemblance" to one of these categories. The "family resemblance" test relies heavily on elements that both parties can readily identify at the time of the transaction, including financing and profit motivation, tradability, investor expectations, and the existence of other investor protection regulation. Most of these factors do not directly relate to the investor's need for protection by mandatory disclosure rules.

III. Application of the Theory to LLCs

While the courts have been developing a special test for whether general partnership interests are securities, almost forty states have passed limited liability company statutes.[30] The rapid development and increasing use of the LLC form raises questions whether the case law on general partnership interests will, and should, be applied to LLCs.

LLCs are similar to general partnerships in that most LLC statutes, like the Uniform Partnership Act (UPA), provide for a default rule of direct management by members.[31] Thus, Mark Sargent has argued that, because LLC interests are more closely analogous to general partnership interests than to corporate shares, they should be characterized presumptively as nonsecurities.[32]

On the other hand, LLCs differ from general partnerships in two important respects that relate to the definition of a "security." First, LLC statutes provide that members are not personally liable for the debts of the business.[33] Limited liability suggests that LLC members are no more

29. Reves v. Ernst & Young, 494 U.S. 56, 62 (1990).

30. The statutes are reproduced and discussed in RIBSTEIN & KEATINGE, *supra* note 6; 2 LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES (1992 & Supp. 1994).

31. *See* RIBSTEIN & KEATINGE, *supra* note 6, § 8.02 (discussing statutes); *id.* at 8-47 (table of LLC statutory provisions concerning management structure).

32. *See* Sargent, *supra* note 5, at 1097-98.

33. *See* RIBSTEIN & KEATINGE, *supra* note 6, § 12.02; *id.* at 12-15 (table of LLC statutory provisions for member nonliability).

sophisticated and no more likely to investigate the firm or actively participate in management than corporate shareholders.

Second, LLCs are more conducive to centralized management than general partnerships. Some LLC statutes provide for corporate-type centralized management,[34] while the others provide that LLCs may elect to be centrally managed in their articles of organization or operating agreement.[35] Although general partnerships also may be managed by managing partners,[36] LLC statutes go further by providing a formal structure for centralized management. This structure may have the direct legal consequence of providing a clear default rule that justifies excluding nonmanaging members from participating in the management of centrally managed LLCs.[37] Moreover, this structural difference between LLCs and partnerships means that some LLC investors may not expect to participate in control to the same extent as general partners.

These differences suggest that the "intermediate private ordering" theory does not apply to LLCs with the same force as it does to general partnership interests. However, this Part shows that the distinctions between

34. Only the Colorado LLC statute requires management by managers. *See* COLO. REV. STAT. § 7-80-401(1) (Supp. 1993). Even the Colorado statute does not prevent the members from agreeing that they all will be statutory managers. Some statutes provide for a default of management by managers, but allow the members to contract for management by members. *See* MINN. STAT. § 322B.606 (Supp. 1993); N.D. CENT. CODE § 10-32-69 (Supp. 1993); OKLA. STAT. tit. 18, § 2013 (Supp. 1994); TEX. REV. CIV. STAT. ANN. art. 1528n, art. 2.12 (West Supp. 1994). The Minnesota and North Dakota statutes permit members to take action that otherwise must be taken by managers and permit members to enter into member control agreements. *See* MINN. STAT. § 322B.37, 322B.606(2) (Supp. 1993); N.D. CENT. CODE § 10-32-50, -69(2) (Supp. 1993).

35. *See* RIBSTEIN & KEATINGE, *supra* note 6, § 8.02 (discussing statutes); *id.* at 8-47 (table listing LLC statutory provisions on management form). It is not clear to what extent this variation among LLC statutes should be relevant to the definition of a security. Investors in any state can decide to participate in an LLC created under the laws of any other state. Indeed, investor expectations regarding the LLC form may have been created within a given state prior to that state's adoption of the LLC statute.

36. *See* Uniform Partnership Act § 18 (lead-in) (1914) (providing that all provisions of § 18, including § 18(e) providing that partners participate equally in management, are subject to contrary agreement) [hereinafter UPA].

37. The courts strongly presume against exclusion of nonmanaging members in partnership cases. *See* ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG AND RIBSTEIN ON PARTNERSHIP § 6.03, at 6:41 (1988 & Supp. 1994).

LLCs and general partnerships do not clearly justify treating LLCs differently from partnerships with respect to the definition of a "security."

A. Participation in Management

Although LLCs differ from general partnerships by providing a centralized management structure, inherent features of the LLC, particularly LLC statutory provisions and tax rules, differentiate LLCs from the sort of passive investments that generally are characterized as securities.

1. Comparison with Limited Partnerships

LLCs differ in two critical respects from limited partnerships. First, LLC statutes omit the limited partnership "control rule," which provides that members who participate in control risk the loss of their limited liability.[38] The control rule serves important functions in limited partnerships. The general partners' personal liability aligns their interests with creditors, and the control rule reinforces this alignment by assuring creditors that limited partners will not initiate or approve transactions that are rejected by the general partners without also assuming responsibility for the firm's debts. The rule also helps assure the general partners, who have agreed to be personally liable for the firm's debts, that the limiteds will not increase these debts without the generals' consent. Without the control rule, the limited partners have an incentive to take over management functions and "go for broke" when the firm nears insolvency because most of the risk falls on creditors.[39] Thus, the control rule can significantly affect limited partners' expectations of participating in management when this participation matters most. It follows that the firm's decision not to adopt the limited partnership form and its control rule involves an important governance choice, even if under ordinary circumstances the LLC is managed precisely as it would have been if it were a limited partnership.

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38. *See* Revised Uniform Limited Partnership Act § 303 (1985) [hereinafter RULPA].

39. *See* Credit Lyonnais Bank Nederland, N.V. v. Pathe Comm. Corp., CIV.A. No. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991). In *Credit Lyonnais*, the Delaware Court of Chancery permitted directors of a highly leveraged firm to act in creditors' interests rather than in those of the 98% shareholder and clearly articulated the potential conflict of interest that is inherent in this situation.

Second, limited partnerships differ from LLCs in terms of members' default management rights. Limited partnership statutes give limited partners *no* default management rights.[40] Accordingly, limited partners have only the rights specifically provided for in the partnership agreement. By contrast, many LLC statutes provide specifically for member voting rights.[41] It follows that LLC members, unlike limited partners, usually will be deemed to have certain management rights unless these are explicitly withdrawn by the operating agreement. This may be significant in the event of disputes about the extent of members' agreed rights.

2. *Comparison with Corporations*

LLCs also are inherently distinguishable from corporations regarding the "efforts of others" element because of the difference in background statutory rules that are applicable to the two forms of business. In a standard-form corporation, the board of directors has the exclusive power to initiate important transactions, such as mergers and asset sales.[42] By contrast, LLC statutes normally provide for a default rule of management by members. This means, in effect, that LLC members normally retain any

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40. *See* RULPA § 302 (1985) (providing that limited partners have only those rights provided for in partnership agreement). Section 303(b) does provide that certain limited voting rights do not constitute participation in control. *Id.* § 303(b). However, this is only a safe harbor from the control rule and not an affirmative grant of voting rights. In any event, these voting rights are only a negative "veto" form of control rather than affirmative participation in policy-making.

41. *See, e.g.,* ALA. CODE § 10-12-24 (Supp. 1993) (amendment of operating agreement); ARK. CODE ANN. § 4-32-403(b)(2) (Michie Supp. 1993) (amendment of written operating agreement or authorizing act in contravention of operating agreement); IDAHO CODE § 53-621, -623 (Supp. 1993) (amendment of operating agreement and election of managers); ILL. REV. STAT. ch. 805, para. 180 §§ 5-20, 15-1, -5 (Supp. 1994) (amendments); IND. CODE § 23-18-4-3(c) (Supp. 1994) (unanimous vote required for certain matters); IOWA CODE ANN. § 490A.701 (West Supp. 1994) (same); KAN. STAT. ANN. § 17-7614 (Supp. 1993) (no transactions outside ordinary course of business bind LLC unless approved by majority in interest of members); LA. REV. STAT. ANN. § 12:1318 (West Supp. 1994) (majority vote required on certain matters); N.H. REV. STAT. ANN. § 304-C:24(VI) (Supp. 1993) (amendment of articles); OKLA. STAT. tit. 18, § 2020(B) (Supp. 1994) (majority vote required on certain matters); R.I. GEN. LAWS § 7-16-21 (1992) (same); *see also* RIBSTEIN & KEATINGE, *supra* note 6, § 8.04 (discussing member voting rights).

42. *See, e.g.,* DEL. CODE ANN. tit. 8, § 242 (1991 & Supp. 1992) (amendment of certificate); *id.* § 251 (merger); *id.* § 271 (sale of assets); *id.* § 275 (voluntary dissolution).

power, including the power to initiate transactions, that they do not specifically delegate to managers.[43]

3. *Comparison with Nonstatutory Business Forms*

Significantly, unlike parties to other types of investment contracts, such as the one involved in *Howey*, LLC members have statutory control rights. This clarifies the background default rules that courts will apply to LLCs. By contrast, the purchaser of a distributorship, for example, has only the rights specified in the contract and in the general law of contract. Accordingly, these contracts may involve sales of a "security" if it is not evident from the contract itself that the investor has adequate control rights.[44]

4. *The Relevance of Tax Rules*

Tax rules ensure that LLC members generally will not delegate control to managers. A business is taxed as a partnership under Subchapter K of the Internal Revenue Code and, therefore, generally is not subject to an additional tax on distributions if it is not a "corporation," a term that is defined to include "associations."[45] In *Morrissey v. Commissioner*,[46] the Court approved a test for determining "association" status based on "resemblance" to corporations.[47] The current "resemblance" test set forth in the "Kintner regulations"[48] provides that a business organization is a

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43. *See, e.g.* DEL. CODE ANN. tit. 6, § 18-402 (1993) (providing for management in members except to extent delegated to managers). These considerations do not, of course, apply to closely held corporations. Nor do the tax considerations discussed in section 4, *see infra* Part III.A.4., justify characterizing close corporations as nonsecurities because close corporations are generally taxed as corporations unless they elect to be governed by Subchapter S of the Internal Revenue Code. Moreover, the restricted transferability of close corporation shares (*see infra* section 5) also justifies presuming that close corporation shares are not securities. Close corporation interests are securities under *Landreth only* because they are "stock." *See supra* Part II.B.

44. *See, e.g.*, SEC v. Aqua-Sonic Prods. Corp., 687 F.2d 577 (2d Cir.), *cert. denied*, 459 U.S. 1086 (1982).

45. *See* I.R.C. § 7701(a)(3) (1988) (definition of "corporation"); *id.* § 7701(a)(2) (definition of "partnership").

46. 296 U.S. 344 (1935).

47. Morrissey v. Commissioner, 296 U.S. 344, 357 (1935).

48. "Kinter regulations" refers to the case that prompted the regulations, in which the I.R.S. unsuccessfully sought to characterize a professional corporation as a partnership. *See*

corporation and not a partnership if it has at least three of the following characteristics: continuity of life, centralized management, limited liability, and free transferability of interests.[49]

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 being taxed under Subchapter K. In light of the uncertainty surrounding these characteristics,[50] this would be a risky course of action. Moreover, a firm that does have centralized management would have to clearly restrict transferability and the power to dissolve at will, which could freeze in members who are unhappy with management. Accordingly, most firms that want to combine centralized management with limited liability and partnership tax treatment should organize as limited partnerships and take advantage of the large number of tax rulings establishing how to avoid characterization as an "association." Conversely, firms that choose the LLC form probably are doing so precisely because of the difference between LLCs and limited partnerships regarding member participation in control.

Although both tax rules and LLC statutes are likely to change over time, unlimited transferability probably never will be deemed compatible with partnership tax treatment because this would open the partnership tax to publicly held firms. Accordingly, as long as the general form of the current tax classification system is retained, some kind of liquidity-based rule probably will be used to distinguish between partnerships and corporate-type entities for tax purposes.[51]

5. *The Relevance of Restricted Transferability*

All LLC statutes restrict transferability of LLC interests.[52] Moreover, for reasons discussed in the preceding section, LLCs have strong tax

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United States v. Kintner, 216 F.2d 418 (9th Cir. 1954).

49. *See* Treas. Reg. § 301.7701-2(a) (as amended in 1993). For leading cases interpreting the Kintner regulations, see Zuckman v. United States, 524 F.2d 729 (Ct. Cl. 1975); Larson v. Commissioner, 66 T.C. 159 (1976).

50. *See* Larry E. Ribstein, *The Deregulation of Limited Liability and the Death of Partnership*, 70 WASH. U. L.Q. 417 (1992).

51. *See* Ribstein, *supra* note 50, at 471-73.

52. *See* RIBSTEIN & KEATINGE, *supra* note 6, § 7.04; *id.* at 7-35 (table listing LLC statutory provisions on transfer of management rights).

incentives to restrict transferability. This restricted transferability effectively limits the passivity of even the most remote owners. As long as transferability is restricted either legally by share transfer restrictions or practically by the lack of an efficient market for the firm's shares, the members cannot respond to problems in the firm simply by selling their shares. Accordingly, the members have incentives to gather information and to take an active role in management. This reduces the need for mandatory disclosure rules that ensure centralized disclosure by the firm.

Restricted transferability has other indirect effects on LLC structure. Because LLC owners must incur higher monitoring costs than passive public corporation shareholders, they are likely to own larger shares of their firms in order to justify these costs. Moreover, publicly distributed LLC interests are unlikely to have much market appeal. Outside public owners would lack both a meaningful voice in control and the availability of an efficient securities market to facilitate exit and monitoring by potential control purchasers.

B. Limited Liability

Although LLC members' limited liability is an apparently important difference between LLCs and general partnerships, on closer analysis it should not make a critical difference in applying the securities laws. First, personal liability has mixed implications as to whether the rationales underlying mandatory disclosure apply in the general partnership context. On the one hand, the partners' personal liability means that individual investors have ample incentives to search for information concerning the risks of the business. Thus, mandatory centralized disclosure may not be cost-justified.[53] On the other hand, these incentives to search for information increase the likelihood that investors as a group will have incentives to overproduce information by duplicating each others' searches.[54] Accordingly, it is unclear whether limited liability should be critical to the existence of a "security."

Second, even if personal liability is significant, the difference between LLCs and partnerships in this regard is less clear than it seems to be. LLC

53. *See* Easterbrook & Fischel, *supra* note 11, at 681 (arguing that investors' under-investment in search costs is one justification for mandatory disclosure).

54. *See id.* at 681-82 (arguing that mandatory disclosure is justified in part to prevent over-investment in search for information).

members can, of course, give personal guarantees. Conversely, general partners not only can contract for nonrecourse liability, but in several states can enter into statutory "registered limited liability partnerships."[55] Moreover, even in conventional partnerships that have not contracted for limited liability, personal liability gradually is merging in several respects with limited liability. The trend toward applying the exhaustion requirement even in cases of joint and several liability,[56] and the clear rule to that effect in the Revised Uniform Partnership Act (RUPA),[57] mean that partners often have no more than the last-resort-type liability that owners of close corporations (and probably also LLCs) can expect to incur as guarantors, or as a result of veil-piercing or direct responsibility for the firm's acts. Also, RUPA allows members to shed their personal liability simply by dissociating from the firm.[58] As a result of these developments, distinguishing between LLCs and general partnerships on the basis of personal liability alone could require courts to make subtle distinctions among types of LLCs and types of partnerships.

C. Conclusion

The above analysis illustrates that investors in LLCs *usually* will not need the protection of the securities laws. Nevertheless, the increased centralization of management and the limited liability of LLCs indicate that mandatory disclosure is more appropriate for LLC interests than for general partnership interests. Accordingly, the next Part considers whether the benefits of achieving the objectives of the securities laws exceed the benefits of a clear rule that the securities laws do not apply.

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55. As this Article went to press, at least 18 jurisdictions had adopted registered limited liability partnership statutes. Two of the original statutes were those in Delaware and Texas. *See* Act of June 24, 1993, 69 Del. Laws ch. 42; Texas Revised Uniform Partnership Act, 1993 Tex. Sess. Law Serv. 917 (Vernon). Also, provisions permitting foreign limited liability partnerships have been adopted in Minnesota, Mississippi, and New Jersey. *See* MINN. STAT. § 322B.901 (1994); 1994 Miss. Laws ch. 390; N.J. STAT. ANN. § 42:2B-1 (West Supp. 1994). The Minnesota and New Jersey statutes define foreign limited liability company to include limited liability partnerships.

56. *See generally* BROMBERG & RIBSTEIN, *supra* note 37, § 5.08(d).

57. *See* Revised Uniform Partnership Act § 307(d) (1994) [hereinafter RUPA].

58. *See id.* §§ 704, 805 (eliminating most post-dissociation liability in firms that file statements of dissociation or dissolution).

IV. The Costs and Benefits of Emphasizing the Form of the Transaction

This Part evaluates the costs and benefits of emphasizing the form of the transaction and concludes that, although some LLC owners might benefit from mandatory disclosure, a presumption against characterizing LLC interests as securities nevertheless is justified. Emphasizing the form of the transaction reduces the costs of complying with and adjudicating disputes under the securities laws. Moreover, emphasizing form is consistent with the functions of the securities laws. By facilitating contracting over disclosure rights, emphasizing the form of the transaction tends to produce an optimal amount of disclosure.

A. Form and Substance Under State Corporate and Federal Securities Law

Relying on the parties' selection of business form appears to be inconsistent with the Supreme Court's injunction that "form should be disregarded for substance and the emphasis should be on economic reality."[59] Indeed, emphasis on the form of the transaction seems to breach the fundamental distinction between state and federal law regarding the rights of owners of business associations. A state business association statute is essentially a standard-form contract that the parties to a firm can fashion to suit their needs. Even if statutory provisions appear to be mandatory, the parties often can customize their relationship by organizing under a different state corporation statute or adopting a different business form.[60] The federal securities laws are based on the different principle that certain rules, primarily relating to disclosure, should be mandatory not only in terms, but in the real sense that the parties cannot easily opt out of the terms simply by choosing their business form or state of organization.[61] This implies that

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59. Tcherepnin v. Knight, 389 U.S. 332, 336 (1967).

60. *See generally* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 1-39 (1991); Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1 (1990).

61. Federal rules are significant *only* because they are mandatory, for without this feature federal law would essentially be only one more governmental unit competing with all the others to provide nonmandatory rules. In Canada, for example, the federal government has promulgated a business corporation statute that competes with statutes promulgated by the provinces. For a recent description and critique of the Canadian system,

the parties should not be able to easily avoid the securities laws by choosing the form of their transaction.

Yet the courts cannot completely disregard form. Applying an extreme "economic reality" rule would require courts to analyze the facts of each case to determine whether to apply the federal securities laws. This approach obviously would impose high burdens on courts and business people in conforming to the law and resolving disputes. Not suprisingly, therefore, the Supreme Court has not rigidly followed an extreme "economic reality" approach. In *Landreth*, *Gould*, and *Reves*, the Court held that the *Howey* "economic reality" approach does not apply in cases involving instruments specifically listed in the statutory definition of a "security" other than the catch-all category of "investment contracts."[62] Even in the "investment contract" cases in which *Howey* still reigns, *Howey* does not require the courts to completely reject "form" in favor of "economic reality." *Howey* established certain factors that, in effect, serve as proxies for the ultimate question of when applying the federal securities laws is economically justified. Instead of deciding whether each transaction is appropriate for mandatory disclosure, the courts are to look only at *formal* features of the transaction, such as the efforts-of-others and common-enterprise elements.

The definition-of-a-security cases, instead of neatly dividing into form (*Landreth-Gould-Reves*) and "economic reality" (*Howey*) categories, actually lie on a form/substance continuum. The general partnership cases fall on the "form" part of the continuum because the parties' choice of the general partnership form essentially eliminates further consideration of the highly variable efforts-of-others *Howey* factor. Thus, the basic question, which is discussed in the next Part, is not *whether* the courts should emphasize form, but *how much*.

B. The Form/Substance Tradeoff

The choice between emphasizing "form" or "substance" is essentially one between "rules" and "standards."[63] Emphasizing form is "rule"-

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see Ronald J. Daniels, *Should Provinces Compete? The Case for a Competitive Corporate Law Market*, 36 McGILL L.J. 130 (1991).

62. *See supra* Part II.B.

63. The leading article is Isaac Ehrlich & Richard A. Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEGAL STUD. 257 (1974). Two other often-cited articles are

oriented in that it does not call for the exercise of significant discretion by a decision-maker, but rather depends on the straightforward question of how the parties have characterized the transaction. In contrast, the "economic reality" approach requires the decision-maker to apply several factors to the facts of each case.

As Colin Diver has noted,[64] the choice between rules and standards varies from case to case and requires complex tradeoffs. Diver identified three general policy objectives that must be compromised—transparency, congruence with policy objectives, and accessibility. He defined these characteristics as follows:

> A rational rulemaker will . . . . want to use words with well-defined and universally accepted meanings within the relevant community. I refer to this quality as "transparency." Second, the rulemaker will want his rule to be "accessible" to its intended audience—that is, applicable to concrete situations without excessive difficulty or effort. Finally, of course, a policymaker will care about whether the substantive content of the message communicated in his words produces the desired behavior. The rule should, in other words, be "congruent" with the underlying policy objective.[65]

These factors balance the rule's fit with policy objectives against the costs of applying the rule. Simple, easy-to-apply rules economize on adjudication and contracting costs, but may allow some undesirable conduct to escape discipline.[66] As discussed in Part II, characterizing LLC interests as nonsecurities arguably compromises the securities laws' objectives somewhat more than characterizing partnership interests as nonsecurities. But it is also necessary to consider whether allowing waiver of the securities laws through LLCs appropriately balances the objectives of the securities laws against the costs of applying the "economic reality" test.

Colin S. Diver, *The Optimal Precision of Administrative Rules*, 93 YALE L.J. 65 (1983), and Carol M. Rose, *Crystals and Mud in Property Law*, 40 STAN. L. REV. 577 (1988). For a recent discussion, see Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992).

64. *See* Diver, *supra* note 63.

65. *Id.* at 67 (footnotes omitted).

66. *See* Ehrlich & Posner, *supra* note 63, at 268 (noting tradeoff).

C. Producing Desired Conduct: Congruence

The "economic reality" test ensures "congruence"—the securities laws will produce the desired level of disclosure in investment transactions. As the *Howey* Court noted, the definition of a "security":

> [E]mbodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.[67]

In other words, because it is impossible to design a clear rule that "catches" all undesirable conduct, some such conduct will go unpunished.[68] More to the point, holding that all LLCs are nonsecurities would leave some passive investors who might benefit from mandatory disclosure outside securities law protection.[69] Conversely, clear rules cause some desirable conduct to be punished. That was clearly the case in *Landreth,* when the securities laws were applied to corporate "stock" despite the fact that the *Howey* "efforts of others" test clearly was not satisfied.

It is important to keep in mind, however, in evaluating the "non-congruence" problem, that the federal securities laws apply in contexts in which the parties contract with each other. Default rules need not be perfectly congruent with policy objectives as applied to every fact situation so long as the parties can waive the rules by contract in situations in which mandating disclosure would be inefficient.[70] Permiting investors and

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

68. The problem of undesired conduct going unpunished was stressed in a recent article critical of what the authors characterized as the courts' overly literal approach in the partnership-as-security cases. *See* Douglas M. Branson & Karl S. Okamoto, *The Supreme Court's Literalism and the Definition of "Security" in the State Courts,* 50 WASH. & LEE L. REV. 1043, 1076-85 (1993). At the same time, the authors criticize the "stock" as "security" cases for mandating regulation in situations in which it is inappropriate. *Id.* at 1054-55. The authors do not consider the point made in the text that the combination of the general partnership and "stock" cases let investors choose whether to be covered by the securities laws in cases involving closely held firms.

69. In general, there is a danger of what Carol Rose has referred to as the potential "booby trap" or forfeiture effect of simple rules. *See* Rose, *supra* note 63, at 597.

70. Whether rules can be characterized as mandatory depends to some extent on whether the parties can choose their jurisdiction by contract. The parties can avoid the federal securities laws by ensuring that the transaction does not touch U.S. interests. *See,*

promoters to opt out of the securities laws by selecting the LLC form would allow them to structure transactions that are appropriate for mandatory disclosure rules as corporate "stock" or limited partnerships, and other transactions as general partnerships or LLCs.

If courts enforced contracts waiving securities law liability, noncongruence would be a problem only to the extent that defects in the contracting process cause investors to perversely undervalue securities law coverage. Sellers rarely would have enough bargaining leverage to force investors into bad deals given the thick market for fungible investment opportunities. To be sure, sellers could mislead investors into unwise transactions, and investors might not be able cheaply to obtain information concerning the applicable rule. Yet as long as the general rule of nonliability is notorious and there are many informed investors in the market, the market price probably will reflect the absence of securities law protection. Accordingly, the seller would gain little by not disclosing the rule. Sellers would gain by disclosing the nonsecurity status of the investment, however, because they would strengthen their posture in any subsequent litigation.

While *default* rules that are misaligned with statutory objectives nevertheless may permit efficient bargains, *mandatory* rules may produce conduct that is inconsistent with regulatory objectives. Unless contracts are enforced, the parties cannot adjust for failures by legislators and adjudicators to apply perfectly an "economic reality" test to every investment situation. Moreover, risk-averse parties may have to disclose even in situations in which the economic reality test ultimately would be held not to require disclosure.[71]

D. Costs of Applying the Rule

An "economic reality"-type approach may impose significant costs by requiring an adjudicator to make a difficult fact-specific inquiry in each case about the need for disclosure. Subsection 1 discusses the difficulty of applying the standard. Subsections 2 and 3 discuss the costs that result

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e.g., Zoelsch v. Arthur Andersen & Co., 824 F.2d 27 (D.C. Cir. 1987) (holding U.S. securities laws inapplicable to non-U.S. transaction). State securities regulation would lie more toward the "form" end of the continuum, not because of the substance of the regulation, but because the parties can more easily avoid particular states than the United States.

71. *See infra* Part IV.D.3.

from the difficulty of application both *ex ante*, at the time of entering into the transaction, and *ex post*, at the time of adjudicating disputes.

1. Difficulty of Applying the "Economic Reality" Test

There are at least two types of difficulties inherent in applying the "efforts-of-others" prong of *Howey*'s "economic reality" approach. First, the court must determine the degree of the investors' involvement in management. In a partnership, this would involve determinations, among other things, of the partners' explicit voting or management rights, their "background" right to participate in management under the partnership statute to the extent that it is not specifically negated by the agreement,[72] and their effective veto power implicit in their ability to dissolve the firm at will.[73] These determinations are likely to vary from case to case because partnerships are highly customized arrangements.

Second, the "efforts of others" test requires courts to evaluate the expected impact of investors' efforts on the success of the enterprise. For example, in a partnership or LLC each owner may have little power to cause the firm to take a particular action, but nevertheless has the power to block actions. It may not be clear what effect a veto or a latent power to veto has on a firm's success. Moreover, 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.[74]

2. Litigation Costs

The difficulty of applying the "economic reality" test can make litigation costly by multiplying the legal and factual issues that must be

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72. *See* UPA § 18(e), (h) (1914); RUPA § 401 (f), (i), (j) (1994) (unless otherwise provided in partnership agreement partners have rights to participate equally in management and to veto admission of new partners and extraordinary acts).

73. *See* UPA §§ 31, 38(1) (1914) (partner has power to dissolve firm at will and, subject to contrary agreement, cause firm to liquidate); RUPA § 801 (1994) (partner has power to dissolve and cause to liquidate partnership at will).

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 (D. Colo. 1970).

determined at trial.[75] Moreover, this difficulty can increase the likelihood of litigation. Because the outcome of the case may be difficult to predict at the time of litigation, the parties may have very different expectations about whether liability will be imposed. This, in turn, decreases the probability of settling the suit prior to litigation.[76]

3. Overdeterrence

The uncertainty inherent in applying the "economic reality" standard can increase the parties' costs of determining in the planning stage whether the standard applies to their transaction. This may cause the parties to avoid transactions or incur disclosure costs to minimize the risk of liability although the law was never intended to require disclosure in the particular situation.[77] In other words, the "economic reality" test may deter desirable conduct.

4. Increasing Contracting Costs

Applying a clear rule is desirable because establishing clear property rights allows people to make contracts based on the known rule.[78] Suppose, for example, that the parties know that the securities laws apply, as they do in post-*Landreth* close corporation cases. If the beneficiary of securities law protection is unwilling to pay the price of the securities law warranty, the parties may attempt to obtain an exemption or choose the partnership form. Conversely, if, as in the general partnership situation, the parties can be fairly sure that the securities laws do not apply, the promoter may lower the price to reflect the fact that the transaction does not come with a warranty of truthfulness. Alternatively, the promoter may

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75. *See* George L. Priest & Benjamin Klein, *The Selection of Disputes for Litigation*, 13 J. LEG. STUD. 1, 13-17 (1984); Larry E. Ribstein, *Takeover Defenses and the Corporate Contract*, 78 GEO. L.J. 71 (1989) (discussing similar effect of applying vague business judgment rule to takeover defenses).

76. *See* Ehrlich & Posner, *supra* note 63, at 265.

77. *See id.* at 262-64 (noting effect of standards on "primary behavior"); *see also* Kaplow, *supra* note 63, at 605 (noting effect of parties' risk aversion on chilling effect problem). For a discussion of this problem in connection with applying the definition of "security" to new hybrid instruments, see Eric A. Chiappinelli, *Reinventing a Security: Arguments for a Public Interest Definition*, 49 WASH. & LEE L. REV. 957 (1992).

78. On the role of clear allocations of property rights in effectuating contracting, see Clifford G. Holderness, *A Legal Foundation for Exchange*, 14 J. LEG. STUD. 321 (1985).

choose to offer an explicit warranty or to restructure the transaction so that the securities laws apply.

Suppose, on the other hand, that the transaction is governed by the "economic reality" approach. Because of the parties' diverging expectations about whether the securities laws apply, it may be costly for them to negotiate the price of this possible securities law protection. Moreover, the parties will discount the value of possible securities law protection to reflect the possibility that it will not apply. This may reduce the value of the waiver to the point where it is not worth it to the parties to incur the costs of obtaining an exemption or designing the transaction. Accordingly, any liability that is imposed would be inconsistent with the contract the parties would have made if the rule had been clear.

Landreth and *Gould* made precisely the *ex ante* predictability point stressed here. The *Landreth* Court stressed that "persons trading in traditional stock likely have a high expectation that their activities are governed by the Acts."[79] Applying the "sale of a business" doctrine would make "coverage by the Acts . . . in most cases . . . unknown and unknowable to the parties at the time the stock was sold"[80] because whether or not the "stock" was a "security" would depend on whether the purchaser acquired control.[81] As the *Gould* Court noted, control would turn not only on the percentage of stock purchased, but also on specific voting rights or the purchaser's expectations of being involved in the management.[82]

This point meshes with the above discussion concerning the importance of contracts to the "congruence" of the rule with the statute's objectives. An important cost of applying the vague "economic reality" test is that it impedes the formation of contracts that would further the statute's objectives by ensuring the optimal amount of disclosure. In short, it is possible both to apply rules congruently with policy objectives and to minimize the costs of applying rules.

E. Conclusion

The courts should define "security" with a view to the appropriate tradeoff between the costs of determining and applying the rule, on the one

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

80. *Id.* at 696.

81. *Id.* at 694-95.

82. *See Gould*, 471 U.S. at 705 (holding that purchase of 50% interest was "security").

hand, and congruence with policy objectives on the other. Consistent with these objectives, the courts should allow parties effectively to waive the securities laws by selecting the LLC form. This would reflect the same sort of judgment that the Supreme Court made in *Landreth* and *Gould* when it let parties opt into the securities laws by investing in corporate stock although the "economic reality" test would not otherwise apply.

It is worth noting that opting out by selecting the transaction form is a second-best rule. Although it is preferable to a case-by-case economic reality approach for LLCs, the best rule is to let investors both waive coverage by specific contracts in corporate "stock" cases and contract for coverage in general partnership and LLC cases. Coupling opt-out and transaction form may force investors to incur the higher costs of adopting a form that may be undesirable for tax and other non-securities-law reasons. The explicit-term approach, however, would contravene the anti-waiver provisions in the securities laws as they are currently written.[83] The federal securities laws reflect the legislative judgment that statutory coverage should not be the subject of conventional private ordering. Until that judgment changes, opting out must be restricted to form-selection.

V. *Specific Issues in Applying the Theory*

This Part elaborates on the general analysis discussed above by discussing specific issues that arise in characterizing LLCs as nonsecurities.

A. *LLC Interests as "Stock"*

Professor Marc Steinberg has argued that LLC interests should be characterized as per se securities. Steinberg reasons that because LLC interests are issued by a "company," investors expect that their interests are "securities" as long as LLC interests have the usual characteristics of "stock" discussed in *Landreth.*[84]

There are several problems with this analysis. First, and most importantly, *Landreth* explicitly applies only to instruments that are denominated "stock" and, therefore, are listed separately from "investment contracts" in the statutory definition of a "security."[85] The Court reasoned

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83. *See supra* note 14 and accompanying text.

84. *See* Steinberg & Conway, *supra* note 5, at 1116.

85. *Landreth*, 471 U.S. at 686.

that an instrument denominated "stock" was necessarily a "security" as long as it had the common attributes of corporate "stock," not that anything that resembled "stock" was a "security."

Second, even if *Landreth* does apply to any instrument that investors would expect to be treated like "stock," investors would not have such expectations merely because of the use of the word "company" in LLCs—a word that is often applied to partnerships.

Third, even if the *Landreth* test does apply, LLC interests are not conventional "stock" under that test. The *Landreth* test emphasizes: "(i) the right to receive dividends contingent upon an apportionment of profits; (ii) negotiability; (iii) the ability to be pledged or hypothecated; (iv) the conferring of voting rights in proportion to the number of shares owned; and (v) the capacity to appreciate in value."[86] LLC statutes usually do not provide for dividend rights (factor (i)),[87] invariably restrict transferability of management rights (factor (ii)),[88] and may allocate voting rights per capita rather than pro rata (factor (iv)).[89] Factor (iii) is no more true of LLC interests than of general partnership interests, and factor (v) applies to virtually any asset.

B. Variations Among LLCs and the Strength of the Presumption

Even if the LLCs generally should be nonsecurities, there is an additional question of how far this form-over-substance rule should be

86. *Id.* at 686 (quoting United Hous. Found., Inc. v. Forman, 421 U.S. 837, 851 (1975)).

87. LLC statutes do not give members default distribution rights, but rather provide that members are entitled to distributions only as specified by the operating agreement. *See* RIBSTEIN & KEATINGE, *supra* note 6, § 6.02 (discussing statutes); *id.* at 6-13 (table listing statutory provisions on right to receive distributions).

88. *See supra* note 52 and accompanying text.

89. Statutes that provide for a default rule of member voting per capita include ALA. CODE § 10-12-22(b)(1) (Supp. 1993); ARIZ. REV. STAT. ANN. § 29-681.E (1992); ARK. CODE ANN. § 4-32-403 (Michie Supp. 1993); GA. CODE ANN. § 14-11-308 (Michie Supp. 1993); IDAHO CODE § 53-623 (Supp. 1993); KAN. STAT. ANN. § 17-7612 (Supp. 1993); LA. REV. STAT. ANN. § 12:1318.A (West Supp. 1994); MO. REV. STAT. § 347.079(4) (Supp. 1994); MONT. CODE ANN. § 35-8-403(1) (1993); N.H. REV. STAT. ANN. § 304-C:24(V) (Supp. 1993); N.C. GEN. STAT. § 57C-3-20(b) (1993); *see also* RIBSTEIN & KEATINGE, *supra* note 6, § 8.03, at 8-8 (discussing statutes); *id.* at 8-49 (table listing LLC statutory provisions on allocation of voting rights).

carried. Because LLCs have limited liability, LLC members are more likely than general partners to be passive owners. This means that more LLCs than general partnerships will adopt corporate-type or limited partnership-type centralized management. Thus, characterizing *all* LLCs as nonsecurities involves a significant risk that regulatory costs will exceed the benefits of relying on form. For these reasons, unlike general partnerships,[90] use of the LLC form should generate only a rebuttable presumption of non-"security."

In determining what facts should rebut the presumption, it is important to keep in mind the cost/benefit tradeoff of relying on form. Relying on case-specific factors may increase contracting and litigation costs beyond any regulatory benefit of ensuring conduct congruent with statutory objectives. That would certainly result if, for example, the courts attempted to finely distinguish LLCs based on members' participation in control. It probably also would result if courts made distinctions based on the number of interests sold, unless that number could be established by means of a clear rule rather than through case-by-case adjudication.

C. A Constitutional Basis for the Rule

Characterizing LLCs as nonsecurities may be not only efficient and consistent with the securities laws, but also necessary in order to prevent unconstitutional applications of the securities laws. The basic question is whether requiring registration of LLC interests under the Securities Act of 1933 (1933 Act) is an unconstitutional restriction on advertising under the First Amendment. The securities laws arguably go too far under the First Amendment by prohibiting even truthful advertising without a sufficient government interest.[91] The First Amendment issue is particularly acute in light of recent Supreme Court cases that have struck down restrictions on advertising as not sufficiently compelled by a substantial government interest.[92] Even if the 1933 Act is generally constitutional, the strong

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90. *See supra* text accompanying note 19.

91. *See* Michael E. Schoeman, *The First Amendment and Restrictions on Advertising of Securities Under the Securities Act of 1933*, 41 BUS. LAW. 377 (1986); *see also* Henry N. Butler & Larry E. Ribstein, *Corporate Governance Speech and the First Amendment*, 42 KAN. L. REV. (forthcoming 1994).

92. *See* Ibanez v. Florida Board of Accountancy, 114 S. Ct. 2084, 2086-87 (1994) (striking down censure of CPA for using "Certified Financial Planner" designation on

policy arguments against applying the securities laws in this context[93] suggest that the Act goes too far under the First Amendment if it is construed to compel registration of all LLC interests unless the firms comply with exemptions requiring elaborate disclosures and investor qualifications. The First Amendment may compel at least a presumption that LLC interests need not be registered under the 1933 Act.

VI. Qualifying the Analysis

The analysis so far has focused on the current definition of "security" under the federal securities laws. This Part discusses some limitations on this analysis in applying it to antifraud remedies, to state securities laws, and under a different definition of a "security."

A. Antifraud vs. Registration Provisions

The worst case for holding that LLCs are nonsecurities is when this facilitates fraud rather than merely an exemption from the registration requirements. This result would give promoters a strong incentive to adopt the LLC form, whatever the transaction costs imposed by business form, solely to extract wealth from investors by fraud. By comparison, nonfraudulent promoters usually would have to pay investors to bear any additional risk inherent in unregistered shares. Thus, a strict form versus substance rule should be applied only in connection with registration, and not to application of the antifraud provisions.

Nevertheless, LLC interests probably should not be federal "securities" even for purposes of the antifraud rules. First, this result would be inconsistent with the current structure of the securities laws, which apply

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ground that regulator failed to show that using designation without its required disclaimer was either inherently or potentially misleading); City of Cincinnati v. Discovery Network, Inc., 113 S.Ct. 1505, 1510 (1993) (city's removal of newsracks that distributed magazines consisting primarily of advertising could not be sustained under First Amendment on ground that it would improve appearance of city's streets because singling out 62 "commercial" newsracks from 1500 to 2000 newsracks on public property had inconsequential effect on beautification); Edenfield v. Fane, 113 S.Ct. 1792, 1800 (1993) (state's ban on solicitations by CPAs was not adequately supported by showing that such solicitation would compromise independence of CPAs or result in fraud or overreaching).

93. *See generally supra* Part III.A-C.

virtually the same definition of "security" to both the antifraud and registration provisions.[94] The 1933 Act makes the anti-fraud/registration distinction by exempting certain transactions from registration requirements[95] rather than by defining instruments as nonsecurities for registration purposes only. Second, from a policy standpoint, the federal securities laws are an appropriate supplement to state fraud law only because they provide an efficient way to adjudicate and administer remedies in connection with interstate schemes.[96] This consideration does not justify a federal remedy in connection with firms that, like LLCs, are inherently closely held.

B. *State vs. Federal Securities Laws*

The same considerations that apply to the federal definition of "security" also should apply to state definitions. Not only do state statutes use language that is virtually identical to the federal definition,[97] but precisely the same policy considerations discussed above concerning appropriate tradeoffs between rules and standards apply to state as to federal rules. Professors Douglas Branson and Karl Okamoto nevertheless argue for a different result under state law.[98] They maintain that state securities regulators need not be constrained by federalism concerns, that the need to coordinate federal and state registration requirements does not apply to the scope of the law, and that differing state rules would be a useful laboratory. However, notwithstanding these distinctions between state and federal law, the need for clear-cut rules and the congruence between excluding LLCs and the policy objectives of the securities laws remain. Although Branson and Okamoto point to a trend in state courts toward holding that general partnership interests are securities,[99] the cases they cite in support of this

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94. *See* Securities Act of 1933, 15 U.S.C. § 77b(1) (1988); Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(10) (1988). The latter provision excludes instruments with a term of less than nine months from the definition. *Id.*

95. *See* Securities Act of 1933, 15 U.S.C. § 77d (1988).

96. *See* Easterbrook & Fischel, *supra* note 11, at 679-80.

97. *See* UNIF. SEC. ACT (1956), § 401(l), 7B U.L.A. 580 (1985) (adopted in 35 states); UNIF. SEC. ACT (1985), § 101(16), 7B U.L.A. 77 (Supp. 1994).

98. *See* Branson & Okamoto, *supra* note 68.

99. *Id.* at 1086-88.

trend actually mirror the federal cases in their reliance on the *Williamson* presumption against "security."[100]

Notwithstanding these considerations, two recent administrative hearings in Illinois and Georgia suggest that the states may be leaning toward characterizing LLC interests as securities. The cases involved the same defendant, Express Communications, which sold interests in LLCs that licensed and developed wireless communications systems. In both cases, administrative law judges found violations of state securities law arising out of sales of LLC interests. More importantly, both cases applied the fact-specific version of *Howey* in determining that LLC interests were securities.

In the Illinois case,[101] the judge purported to apply *Williamson*, but reasoned that that case is simply "a word reformulation of the Howey facts and circumstances test."[102] This is inconsistent with the language in *Williamson*, the federal cases that rely on *Williamson*, and the reasoning discussed in this Article supporting a clear rule rather than a highly flexible case-by-case determination.

In the Georgia proceeding,[103] the judge rejected arguments that LLC interests were per se securities[104] or "stock."[105] At the same time, the judge repeatedly emphasized that the issue must be determined by a fact-

100. *See* Casali v. Schultz, 732 S.W.2d 836, 837-38 (Ark. 1987); State v. Ribadeneira, 817 P.2d 1105, 1109-11 (Kan. Ct. App. 1991); State v. Kramer, 804 S.W.2d 845, 848 (Mo. Ct. App. 1991); Probst v. State, 807 P.2d 279, 285 (Okla. Crim. App. 1991); Garrett v. Snedigar, 359 S.E.2d 283, 286 (S.C. Ct. App. 1987); Branson & Okamoto, *supra* note 68, at 1088 n.249. Moreover, *Garrett* reversed a lower court finding that the instruments were securities, *Garrett*, 359 S.E.2d at 286, and *Ribadeneira* involved instruments that were structured essentially as limited partnership interests, *Ribadeneira*, 817 P.2d at 1108. For a current survey of state blue sky developments involving LLCs, see Mark A. Sargent, *Will Limited Liability Companies Punch a Hole in the Blue Sky?*, 21 SEC. REG. L.J. 429 (1994).

101. Express Communications, Inc., No. 9200106 (Ill. Secretary of St. Sec. Dept. Dec. 13, 1993).

102. *Id.* at 16.

103. Cleland v. Express Communications, Inc., No. 50-93-0075 (Ga. Sec. Comm'r Apr. 14, 1994).

104. *Id.* at 41.

105. *Id.* at 46.

specific analysis under *Howey*.[106] The judge appears, therefore, explicitly to have rejected the idea that the form of the transaction should matter.[107] Although the judge purported to apply *Williamson*, as in the Illinois proceeding, the judge did not require the strong showing of reliance on the unique expertise of the promoter that *Williamson* required in the general partnership context.[108] Instead, the judge cited the investors' lack of direct involvement in management,[109] their geographical dispersion, and the technical nature of the investment.

C. *Changing State and Federal Definitions of a "Security"*

The discussion so far has focused on the definition of a "security" in its current form in state and federal securities law statutes. If LLCs are included in this definition, it is only by means of the vague "investment contract" language. As discussed in this Article, an appropriate tradeoff between the costs and benefits of rules and standards justifies a judicial gloss under that language that explicitly excludes LLCs.

The analysis arguably differs if the definition of "security" is changed explicitly to include "limited liability companies." Obviously there would

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106. *Id.* at 43-44 (emphasizing substance over form); *id.* at 46 (issue is whether transactions are securites "under the specific facts and circumstances of this case"); *id.* at 55 (*Howey* requires examination of "economic reality" rather than degree of control by promoter, and emphasizes substance over form). The judge also rejected the argument that the tax characterization of LLCs as partnerships should matter. *Id.* at 53-54. However, the judge apparently did not consider the potential relevance of tax classification to investor expectations of participation in control, *see supra* Part III.A.4., but simply noted instead that the classification factors had nothing to do with *Howey*.

107. The theory that form should matter was presented in expert testimony by this author in both the Illinois and Georgia proceedings.

108. *See supra* note 16 and accompanying text; *see also* Carney, *supra* note 5 (criticizing *Cleland* for failing to require strong showing of reliance on promoter's expertise).

109. The judge curiously interpreted *Williamson* as not concluding that actual control is irrelevant, based on his statement that investors must have "real" power that they can exercise. Cleland v. Express Communications, Inc., No. 50-93-0075, at 59 (Ga. Sec. Comm'r Apr. 14, 1994). There is, however, an obvious difference between real *power* to control and actual *exercise* of control. In light of the weakness of this analysis of *Williamson*, the judge seems to have been more persuaded by the fact that not requiring actual control would "circumvent the 'economic reality' analysis." *Id.*

be no justification for applying the judicial gloss recommended in this Article under this explicit language. More fundamentally, this definition would reduce the problems of *ex ante* predictability and *ex post* litigation costs that are addressed by the suggested judicial gloss.[110] The only remaining problem would be one of noncongruence with policy objectives given the closely held nature of the firm. However, this problem would be ameliorated by the fact that parties to closely held firms could still contract for coverage by the securities laws by choosing between the partnership and LLC-"stock" transaction forms.

The analysis would differ still further under state securities laws whose definition of "security" explicitly covered "limited liability companies."[111] Changing the definition under state, but not federal, law argu-

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110. Including LLCs under the definition of "security" would not entirely eliminate the problems of *ex ante* predictability or *ex post* litigation costs. The courts would still have to determine whether a firm was a "limited liability company." This could be a problem when the firm was not properly formed. For cases involving the analogous "limited partnership" issue, see Solomont v. Polk Dev. Co., 54 Cal. Rptr. 22, 24-27 (1966) (defects prevented formation of partnership so that blue sky law required registration, permitting limited partners to rescind); Garbo v. Hilleary Franchise Sys., Inc., 479 S.W.2d 491, 500 (Mo. Ct. App. 1972) (even if limited partnership not generally security, this one is because of provisions deviating from usual limited partnership). Adding a reference to "limited liability companies" also might present problems as to firms formed under foreign laws differing signficantly from U.S. LLC statutes. For a discussion of the problems of making this determination, see RIBSTEIN AND KEATINGE, *supra* note 6, § 13.03.

111. Some states have changed their definitions to deal explicitly with LLCs, but only one clearly defines an LLC interest as a security. *See* Act effective July 1, 1995, 1994 Alaska Sess. Laws ch. 99, § 3 (defining LLC interest as "security") (to be codified at ALASKA STAT. § 45.55.130(12)); GA. CODE ANN. § 14-11-1107(n) (Michie Supp. 1993) ("Nothing in this Chapter [the limited liability company act] shall be construed as establishing that a limited liability company interest is not a 'security'."); Act effective July 1, 1994, 1994 Ind. Legis. Serv. 1232 (West) (defining LLC interest as "security" unless person claiming it is not "security" can prove that all members are actively engaged in management) (to be codified at IND. CODE § 23-2-1-1(k)(iii)); Act effective Apr. 14, 1993, 1993 Mich. Legis. Serv. 23, § 1103 (West) ("An interest in a limited liability company to which this act applies is a security to the same extent as an interest in a corporation, partnership, or limited partnership is a security."); N.M. STAT. ANN. § 58-13B-2.V (Michie Supp. 1994) (LLC interests are securities, "unless the context requires otherwise"); OHIO REV. CODE ANN. § 1707.01(B) (Baldwin Supp. 1994) (defining "security" to include "membership interests in limited liability companies"); Act of Dec. 13, 1993, 1994 Wis. Legis. Serv. ch. 112, § 351 (West) (presuming LLC interest to be security if right to manage LLC is vested in one or more managers or if LLC has more than 35 members) (to be codified at WIS. STAT. § 551.02(13)(c)); Sargent, *supra* note 100, at 435-38 (discussing

ably would address the "congruence" problem because closely held LLCs, which arguably should not be "securities," could choose to avoid states that defined these interests as securities. Thus, insofar as LLC offerings are genuinely closely held firms, regulatory costs would be internalized in the regulating states. This approach therefore would offer the benefits of "laboratories" of state rules[112] without the potential danger of states' impeding national offerings[113] and imposing regulatory costs on out-of-state promoters for the benefit of local interest groups.[114] While *national* offerings of LLC interests might be impeded by registration requirements in individual states, it is precisely in this situation that the justification for applying the securities laws is strongest. At the same time, a federal rule that attempted to distinguish between large and small offerings on a case-by-case basis under the definition of a "security" would present predictability and adjudication problems.

In short, the best way to approach the characterization of LLC interests under the securities laws may be for individual states to address the issue explicitly. Indeed, refusing to extend the general "investment contract" language to limited liability companies may have the salutary effect of moving regulators to this preferred approach.

VII. Concluding Remarks

Insisting that the federal securities laws be applied on a complex, fact-specific basis does not make sense in light of the high adjudication and

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statutes).

112. *See* Branson & Okamoto, *supra* note 68, at 1048. Branson and Okamoto's argument regarding the states as laboratories ignores the potential problems discussed in the text of externalization of costs and imposing additional registration costs on offerings that do not otherwise have to register.

113. Branson and Okamoto argue that the need for coordination of registration requirements does not apply to the scope of securities laws. *Id.* at 1073-74. However, applying different definitions of "security" at the federal and state levels would require registration of offerings that are exempt at the federal level. This would be inconsistent with the goal of coordination of registration requirements to reduce the marginal costs of complying with state law in national offerings. As discussed in the text, however, this consideration does not apply to closely held firms.

114. *See* Jonathan R. Macey & Geoffrey P. Miller, *The Origin of the Blue Sky Laws*, 70 TEX. L. REV. 347 (1991) (explaining state securities legislation as effort by in-state bankers to preclude competition by out-of-state securities firms).

predictability costs of applying vague standards. The Supreme Court has recognized these problems by making it clear in close corporation cases that the form of the transaction matters. The advent of the LLC should provide an interesting case study of how far the Court is prepared to go in this direction. If the Court joins the nearly universal trend in the lower courts, it will hold that a general partnership is presumptively not a security. This Article shows that it should go one step further and apply a similar rule to interests in limited liability companies.

This Article's analysis has implications that extend beyond LLCs. The costs of applying an open-ended definition of "security" become increasingly important as legislatures develop new types of firms, including limited liability partnerships.[115] Accordingly, the courts and legislatures must find ways to accommodate the goals of the securities laws with those of the financial markets.

This Article also shows how federal and state regulation can play different roles with respect to regulation of LLCs. Perhaps the states should play a greater role than the federal government in regulating this sort of closely held business. However, they should do so by enacting explicit rules rather than by applying open-ended definitions of a "security."

115. *See supra* note 55 and accompanying text.