WHEN LLC INTERESTS ARE SECURITIES

Robert J. McGaughey[1]

1. Introduction

Since the adoption of Oregon's Limited Liability Company Act (ORS Chapter 63) in 1993, limited liabilities companies ("LLC") have become a popular form of doing business. Lawyers assisting in the formation of LLCs should give careful consideration to the applicability of the securities laws.

Since LLCs are a recent development, as yet there are no reported

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[1] ROBERT J. McGAUGHEY is a founding partner in McGaughey Erickson, Portland, Oregon. His practice focuses on securities, shareholder, partnership and LLC litigation. He is the author of the Oregon Securities Law Handbook, the Oregon Corporate Law Handbook, the Washington Corporate Law Handbook, and co-author of "Oregon Securities Law," 1 Advising Oregon Businesses. He is the past Chair of the OSB Business Litigation Section and past Chair of the OSB Securities Regulation Section. He has long received an "AV" Martindale Hubbell rating and been selected for inclusion on the Oregon Super Lawyers® List.

Oregon cases analyzing whether an LLC interest is a security and there are few cases nationally. However, there are three Oregon cases in which the court assumes the LLC interest at issue was a security, without actually analyzing why it was a security.

In *HLHZ Investments v. Plaid Pantries, Inc.,* 2007 WL 3129985, 2007 US Dist LEXIS 78817 (D Or 2007), Judge King assumed, without deciding, that a membership interest in a manager-managed LLC was a security.

In *Cruze v. Hudler,* 246 Or App 649, 267 P3d 176 (1911), *adhered to on reconsideration,* 248 Or App 180, 2012 Ore App LEXIS 153 (2012), the Court of Appeals assumed without analysis that the LLC interest at issue was a security.

Oregon State Bar Professional Liability Fund v. Benfit, 225 Or App 409, 201 P3d 936 (2009) related to insurance coverage issues arising out of a lawsuit filed against two attorneys who settled a case brought under the securities laws related to the sale of LLC interests. Again, there was no analysis of when the sale of an LLC interest constitutes the sale of a security.

While the definition of a "security" in the Oregon and federal securities laws do not include LLCs, some of the terms contained in that definition may be broad enough to encompass LLC interests. ORS 59.015(19)(a). In the event that an LLC interest falls within the scope of "security" definition, three things must occur: (i) the sale of the interest will need to be registered, unless exempt, (ii) the person selling the LLC interest will need to be licensed, unless exempt, and (iii) the disclosure provisions of the securities law will apply regardless of whether the transaction must be registered or is exempt from registration.

2. Overview of the Definition of a Security

Each of the various state and federal securities statutes contains a definition of the term "security." These definitions tend to be quite similar. The present definition of a "security" in the Oregon securities statutes is contained in ORS 59.015, which states:

> (19)(a) “Security” means a note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in a pension plan or profit-sharing agreement, collateral-trust certificate, preorganization certificate or

> subscription, transferable share, investment contract, voting-trust certificate, variable annuity, certificate of deposit for a security, certificate of interest or participation in an oil, gas, or mining title or lease or in payments out of production under such title or lease, real estate paper sold by a broker-dealer, mortgage banker, mortgage broker or a person described in subsection (1)(b) of this section to persons other than persons enumerated in ORS 59.035 (4), or, in general, any interest or instrument commonly known as a “security,” or any certificate of interest or participation in, temporary or interim certificates for, receipt for, guarantee of, or warrant or right to subscribe to or purchase any of the foregoing.

Court interpretations of the term "security" are much more important than the actual words used in the definition. Although there has been some movement to narrow earlier case law, traditionally, courts have liberally construed the definition of a security in order to effectuate the purposes of the securities law.

In the 70 years following the passage of the first securities law, cases in which the courts were called upon to look at the definition of a security usually involved somewhat exotic investment transactions, rather than traditional instruments such as stocks and bonds. Although the statutory definition lists two dozen things that are a “security”, nearly all of these early cases have focused on one term – "investment contract" (a term appearing in the definition section of the federal, Oregon and most state securities laws). More recent cases have defined two other statutory terms – “stock” (*see: Landreth Timber Co. v. Landreth,* 471 US 681 (1985)) and “note” (*see: Reves v. Ernst & Young*, 494 US 96 (1990); *Lahn v. Vaisbort*, 276 Or App 468, 369 P3d 85 (2016)).

Only the “investment contract” analysis is useful in determining whether an LLC interest is a security – not the analysis for “stock” or “notes.”

3. The Investment Contract Test

The investment contract test has its origins in *SEC v. W J Howey Co.*, 328 US 293 (1946). In that case, the SEC sought to enjoin a Florida company which was selling small orange grove tracts, each coupled with a long-term service contract, to persons living throughout the United States. The service contract specified that, for a fee, the company would maintain, harvest and sell the orange crop and then forward the profit to the "owner." Given the size of each plot and the distance separating that plot from its owner, it was uneconomical to purchase a plot and its orange trees without also purchasing a service contract.

In determining whether the transaction involved a security, the *Howey* Court held that form should be disregarded for substance and emphasized that the economic realities of the transaction were paramount. The US Supreme Court adopted an older state law approach used for determining whether the securities laws apply, which "embodies a flexible rather than a static principle, one that is capable of adoption to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." *Id* at 299. The Court held that this transaction contained all of the elements usually associated with a security: *i.e.,* the investor provided the capital and shared in the profits while the promoters managed, controlled and operated the enterprise. The Court then adopted a test which, with some later modification, remains today the cornerstone of securities law:

> The test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others. *Id* at 300, 301.

The most significant modification of the *Howey* test first appeared in *SEC v. Glenn W. Turner Enterprises, Inc.,* 474 F2d 476 (9th Cir), *cert denied*, 414 US 821 (1973). In that case, the Ninth Circuit (in a case arising out of Oregon) analyzed a transaction which amounted to a "gigantic and successful fraud," which, but for the minimal effort required of the investors in order for them to receive a profit, would otherwise have met the *Howey* test. Recognizing that Congress intended that a flexible approach be employed, the Court held that an investment contract existed when "the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprises." *Id* at 482. This modification, which effectively eliminated the word "solely" from the *Howey* test, is generally applied in all jurisdictions today, including by the US Supreme Court itself in *United Housing Foundation v. Forman,* 421 US 837 (1975). *See also: U.S. v. Wetherald,* 636 F3d 1315 (11th Cir 2011).

The principal investment contract test[2] used in Oregon is equivalent to the

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[2] The other investment contract test is called the “risk capital” test and has been applied by only a handful of states in the 1960s and 1970s. *See: Silver Hills Country*

federal *Howey* test and is set out in *Pratt v. Kross*:

> (1) an investment of money (or money's worth),
> (2) in a common enterprise,
> (3) with the expectation of profit,
> (4) to be made through the management and control of others.
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> *Pratt v. Kross*, 276 Or 483, 498, 555 P2d 765 (1976).

Most LLC interests easily fall within the first three prongs of this four prong test. Whether or not a particular LLC has sufficient "management and control" by "others" will likely determine whether the securities laws will apply.

> determining whether the investor has meaningfully participated in the management of the partnership in which it has invested such that it has more than minimal control over the investment's performance," begins and ends with the operating agreement. The Court is to look at the agreement as a whole, considering the arrangements the parties made for the operation of the investment vehicle in order to determine who exercised control in generating profits for the vehicle. This issue does not turn on whether the investor actually exercised its rights, but rather on "what 'legal rights and powers [were] enjoyed by the investor. (Internal quotation marks & citations omitted) *Handong Wen v. Willis,* 117 F Supp 3d 673 (ED Pa 2015).

4. Limited partnership interests

In the 1970s and early 1980s, limited partnerships were popular vehicles for investments. A significant number of lawsuits were filed, claiming the sale of a limited partnership interest fell within the scope of the securities laws.

Although the term "limited partnership interest" does not appear in the definition of a security under federal, Oregon and most other state securities statutes, courts almost universally held that the sale of a limited partnership interest was an 'investment contract" security. *See for example: Pratt v. Kross,* 276 Or 483, 555 P2d 765 (1976); *Reeves v. Teuscher,* 881 F2d 1495 (9th Cir 1989); *In re Longhorn Securities Litigation,* 573 F Supp 255 (WD Okla 1983).

Courts so held because most limited partnership interests meet all four

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Club v. Sobieski, 55 Cal 2d 811, 13 Cal Rptr 186, 361 P2d 906 (1961); *People v. Black*, 8 Cal App 5th 889, 214 Cal Rptr 3d 402 (2017); *State ex rel Healy v. Consumer Business Systems, Inc.,* 5 Or App 19, 482 P2d 549 (1971); *State v. George,* 50 Ohio App2d 297, 362 NE2d 1223 (1975). It may not be a viable test any more. *Computer Concepts, Inc. v. Brandt*, 98 Or App 618, n 7, 780 P2d 249 (1989), *affirmed,* 310 Or 706, 801 P2d 800 (1990). This author knows of no case where the court applied this "risk capital" test to LLC membership interests.

prongs of the investment contract *Howey* test. When an investor purchases a limited partnership interest, there is: (1) an investment of money, (2) in a common enterprise, (3) with the expectation of profit, (4) to be made through the management and control of others.

The key element in the analysis of a limited partnership interest is "management and control." Under the Uniform Limited Partnership Act, a limited partner (unlike a general partner) can have no significant input into the management and control of the limited partnership.

But not all limited partnership interests are securities. Courts have held limited partnership interests are not securities when the limited partner has control over the management of the partnership, such as when the limited partnership interest is owned be a general partner, a director of a general partner, or a parent corporation of a corporate general partner. *See for example: Bamco v. Reeves,* 675 F Supp 826 (SD NY 1987); *Darrah v. Garrett,* 1984 US Dist LEXIS 18649, [1984 Transfer Binder] FED SEC L REP (CCH) ¶ 91,472 (ND Ohio 1984); *Bank of America National Trust & Savings Association v. Hotel Rittenhouse Associates,* 595 F Supp 800 (ED Pa 1984).

5. General partnership interests

The term “general partnership interest” likewise does not appear in the definition of a “security” in federal and state law securities statutes. In some cases, investors have argued that a general partnership interest was an “investment contract.” This argument has usually not been not a successful one.

Unlike a limited partner, general partners usually have the right to participate in the management of the partnership. As a consequence, there is a strong presumption that an interest in a general partnership is **not** a security. *Odom v. Slavik,* 703 F2d 212 (6th Cir 1983); *SEC v. Shields*, 744 F3d 633 (10th Cir 2014); *Joseph v. Mieka Corp.,* 282 P3d 509 (Colo App 2012); *Stuckey v. Geupel*, 854 F2d 1317 (4th Cir 1988).

> Here, the court must apply [the *Howey*] principles to a partnership. Interests in a partnership can satisfy the third *Howey* factor and qualify as an investment contract. But not all partnerships qualify. For example, partners in a general partnership can guard their own interests with their inherent powers and do not

> need protection from securities laws—they can act on behalf of the partnership; bind their partners by their actions; dissolve the partnership; and are personally liable for all liabilities of the partnership. General partners are, in short, entrepreneurs, not investors. Accordingly, general partnership interests typically do not qualify as securities. And a litigant trying to prove otherwise must overcome the strong presumption that a general partnership . . . is not a security. (Citations & internal quotation marks omitted) *SEC v. Arcturus Corp*., 928 F3d 400, 410 (5th Cir 2019).

Dispite this general rule, some general partnership interests can be securities. The most widely accepted test for determining whether or not a general partnership interest is a security was first set out in *Williamson v. Tucker,* 645 F2d 404 (5th Cir), *cert denied*, 454 US 897 (1981). The test is commonly referred to as the *Williamson* test.

> [A]n investor who claims his general partnership or joint venture interest is an investment contract has a difficult burden to overcome. On the face of a partnership agreement, the investor retains substantial control over his investment and an ability to protect himself from the managing partner or hired manager. Such an investor must demonstrate that, in spite of that partnership form which the investment took, he was so dependent on the promoter or a third party that he was in fact unable to exercise meaningful partnership powers. A general partnership or joint venture interest can be designated a security if the investor can establish, for example, that (1) an agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership; or (2) the partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or (3) the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers. (footnotes omitted) *Id* at 424.

See also SEC v. Arcturus Corp., 928 F3d 400, 410 (5th Cir 2019) *SEC v. Sethi,* 910 F3d 198 (5th Cir 2018).

Under this test, a general partnership interest is **not** a security unless the investor can establish ***one*** of the following: (1) the operating agreement excludes the investor from effecting the management of the partnership, (2) the investor is particularly unknowledgeable in business affairs, or (3) the managing partner's expertise is unique.

The *Williamson* test has been applied by nearly all courts analyzing whether a general partnership interest is a security. As discussed below, *Williamson* has also been applied by nearly all courts analyzing whether an LLC membership interest is a security.

6. LLC Interests as Securities

6.1 Statutes

LLC interests do not appear in the definition of the federal securities laws, nor in the securities law definitions of Oregon and most other states.

NOTE: Some states have amended their statutory definition of a security to include membership interests in limited liability companies or to state that a membership interest may be a security or an investment contract security. *See for example:* Alaska Stat §45.55.990(32); Kansas Stat § 17-12a102(28)((E); New Hampshire Rev Stat Ann §421-B:1-102(53)(A); South Dakota Compiled Laws Ann §47-31B-102(28)(E). In California, Section 25019 of the California securities statute provides:

> "Security" means any note; stock; treasury stock; membership in an incorporated or unincorporated association; 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; viatical settlement contract or a fractionalized or pooled interest therein; life settlement contract or a fractionalized or pooled interest therein; voting trust certificate; certificate of deposit for a security; **interest in a limited liability company and any class or series of those interests (including any fractional or other interest in that interest), except a membership interest in a limited liability company in which the person claiming this exception can prove that all of the members are actively engaged in the management of the limited liability company; provided that evidence that members vote or have the right to vote, or the right to information concerning the business and affairs of the limited liability company, or the right to participate in management, shall not establish, without more, that all members are actively engaged in the management of the limited liability company**; . . . .

Neither the Oregon nor the federal definitions of a security specifically mention limited liability company interests. *See, for example:* ORS 59.015(19)(a).

6.2 Case law

Most, but not all, commentators and courts who have analyzed whether limited liability company interests are securities have applied the *Williamson* test (originally applied to general partnership interests) to determine whether the limited liability interest is an "investment contract" security. *Williamson v. Tucker,* 645 F2d 404 (5th Cir), *cert denied*, 454 US 897 (1981).

NOTE: At least one law review article, Steinberg & Conway, *The Limited Liability Company as a Security*, 19 Pepperdine L Rev 1105 (1992), proposed that LLC interests should be analyzed under the "stock" tests discussed in *United Housing Foundation v. Forman,* 421 US 837 (1975) and *Landreth Timber Co. v. Landreth,* 471 US 681 (1985). Another early law review article disagreed. Sargent, *Are Limited Liability Company Interests Securities?* 19 Pepperdine L Rev 1069 (1992).

The view that LLC interests should be analyzed under the “stock” tests has not gained much support. Some early decisions have analyzed an LLC interest under both the “investment contract” test and the "stock" test before concluding that the LLC interests in question were ***not*** a security. *Robinson v. Glynn,* 349 F3d 166 (4th Cir 2003); *Great Lakes Chemical Corp. v. Monsanto Co.,* 96 F Supp 2d 376 (D Del 2000). More recently, courts have not analyzed LLC interests under the “stock” test at all.

Applying the *Williamson* test to determine whether an interest is an “investment contract” security, most commentators conclude that most manager-managed LLCs are securities, while most member-managed LLCs are not securities. This is because member-managed LLCs generally do not meet the fourth prong of the Howey test – profits to be “made through the management and control of others.” Members in manager-managed LLCs, however, are usually not relying on their own management, but rather on the management of the manager.

> Members of a manager-managed LLC are more likely to be passive investors in need of the protections afforded by the federal securities laws. By the same token, members of member-managed LLCs who are able to actively participate in the management affairs of the entity are less likely to need such protections. But even these characteristics may differ based on the economic realities and facts of each case, making it difficult to establish bright line rules in this area. *Conde v. SLS West, LLC*, 2005 WL 1661747 (SD Ind 2005).

Another court has said:

> Of all of the possible business structures, LLCs appear to be the most resistant to formulaic applications of the Howey test. *Cogniplex, Inc. v. Hubbard Ross, LLC*, 2001 WL 436210, 2001 US Dist LEXIS 11113 (ND Ill 2001).

See also Shirley v. JED Capital, LLC, 724 F Supp2d 904 (ND Ill 2010).

Although commentators have been virtually unanimous in classifying member managed LLC interests as NOT being securities while manager managed LLC interests ARE securities, sticky facts have resulted in case law

which does not neatly follow dictates of this manager-managed/member-managed classification theory. One court has noted that “because of the sheer diversity of LLCs, membership interests therein resist categorical classification. Thus, an interest in an LLC is the sort of instrument that requires "case-by-case analysis" into the "economic realities" of the underlying transaction.” (citations omitted) *US v. Leonard*, 529 F3d 83 (2d Cir 2008).

See also: In re Brisbin, Case No. 08-12236-SSC (Bankr Ariz 1/19/2010).

Some member-managed LLCs are securities. Several of the earliest cases involved the wireless cable scams perpetrated in the 1990s. These programs raised funds from hundreds of unsophisticated retirees – scattered over many states – through the sale of interests in member-managed LLCs. Despite the fact that these LLCs were member-managed, the only three cases to consider these LLCs all held these interests to be securities. *See: SEC v. Shreveport Wireless,* 1998 WL 892948,1998 US Dist LEXIS 23086, [1998 Transfer Binder] FED SEC L RPTR (CCH) ¶ 90,322 (D DC 1998) (sales to 2000 geographically diverse investors); *Nutek Information Systems v. Arizona Corporation Commission,* 977 P2d 826 (Ariz App 1998) (sales to 920 investors); *SEC v. Parkersburg Wireless LLC,* 991 F Supp 6 (D DC 1997) (sales to 700 investors); *Ak's Daks Commc'ns Inc. v. Maryland Sec Div*, 771 A2d 487 (Md App 2001).

Some manager-managed LLCs are not securities. On the other hand, manager-managed LLCs may not be securities if the non-managing member has sufficient financial strength and sophistication.

Great Lakes Chemical Corp. v. Monsanto Co., 96 F Supp 2d 376 (D Del 2000) is an interesting case in that the plaintiff purchased 100% of the LLC interests from the managing and non-managing members of an LLC. The managing member had contributed $162.9 million for a 81.5% interest; the non-managing member contributed $37.1 million for a 18.5% interest. Plaintiff claimed these interests were securities. The court disagreed, finding that the 18.5% owner had the power to vote to remove the manager (albeit, with only an 18.5%

interest, a power which needed the vote of the manager to prevail). *But see, Venezia Amos v. Favret*, 2008 WL 410163, 2008 US Dist LEXIS 10452 (ND Fla 2008) in which a person who had paid $5 million to acquire a 40% LLC interest in a manager-managed LLC was able to defeat a motion to dismiss for failure to state a claim that the membership interest was a security.

In *Ave. Capital Mgmt. II, L.P. v. Schaden*, 843 F3d 876 (10th Cir 2016), the court found that a non-managing member's LLC interest in a manager-managed LLC was not a security since the non-managing members controlled 80% of the ownership and could amend the Operating Agreement to gain control. The court said on page 882:

> An investor who has the ability to control the profitability of his investment, either by his own efforts or by majority vote in group ventures, is not dependent upon the managerial skills of others." *Gordon v. Terry* , 684 F.2d 736, 741 (11th Cir. 1982). The greater the control acquired by Avenue and Fortress, the weaker the justification to characterize their investments as investment contracts. *SEC v. ETS Payphones, Inc.* , 408 F.3d 727, 732 (11th Cir. 2005) (per curiam).
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> In assessing the degree of control that Avenue and Fortress acquired, we consider their contribution of time and effort to the success of the enterprise, their contractual powers, their access to information, the adequacy of financing, the level of speculation, and the nature of the business risks. *SEC v. Shields,* 744 F.3d 633, 645 (10th Cir. 2014).

Likewise in *Robinson v. Glynn*, 349 F3d 166 (4th Cir 2003), Robinson's membership interest in a manager-managed LLC was held not to be a security because Robinson was "an active and knowledgeable executive" with the LLC who had the power to appoint 2 of the 7 managers of the LLC.

> [B]usiness ventures often find their genesis in the different contributions of diverse individuals - for instance, as here, where one contributes his technical expertise and another his capital and business acumen. Yet the securities laws do not extend to every person who lacks the specialized knowledge of his partners or colleagues, without a showing that this lack of knowledge prevents him from meaningfully controlling his investment. *Id* 171-72.

In *Endico v. Fonte*, 485 F Supp 2d 411 (SD NY 2007), plaintiff was induced to contribute a building he owned to an LLC in exchange for an interest in the LLC. Defendants were the "managing members." In holding that the plaintiff's LLC interest was not a security, the court held that plaintiff was not a passive investor under the investment contract test since he was the sole signatory on the LLC's bank account – thus controlling the LLC's purse-strings –

and since the operating agreement required the members' unanimous consent to sell or mortgage the property.

In *Feldman v. Concord Equity Partners, LLC,* 2010 US Dist LEXIS 49613 (SD NY 2010), the court questioned whether the membership interests were securities because 7 of the 11 members sat on the LLC's board of directors.

See also Nunez v. Robin, 415 Fed Appx 586, 2011 US App LEXIS 4825 (5th Cir 2011).

> **NOTE:** Other courts have noted that the mere fact that the investor has some nominal involvement in the operation of the business is not enough, "the focus is on the dependency of the investor on the entrepreneurial or managerial skills of the promoter or other party." *SEC v. Merchant Capital, LLC,* 483 F3d 747, 755 (11th Cir 2007). This is true even if the non-managing members are able to remove the manager after wrong-doing comes to light. *Burnett v. Rowzee*, 2007 US Dist LEXIS 74275 (CD Ca 2007).

Most cases follow the general rule. In *Keith v. Black Diamond Advisors, Inc.,* 48 F Supp 2d 326 (SDNY 1999), the court held that an LLC interest was not a security in a member-managed LLC because the plaintiff had the right under the operating agreement to actively participate in the management of the LLC, even though in practice, his role was more passive. In *Gilmore v. Gilmore,* 2011 US Dist LEXIS 99441 (SD NY 2011), membership interests in a member managed LLC were held not to be securities while membership interests in a manager-managed LLC were held to be securities.

A membership interest in a manager-managed LLC may be a security where the member's ability to exercise any management control is effectively non-existent. *See KFC Ventures, LLC v. Metairie Medical Equipment Leasing Corp.*, 2000 WL 726877, 2000 US Dist LEXIS 8294 (ED La 2000). In one case where the member was an employee of the LLC and received substantial commissions, his interest was never-the-less held to be a security because he had no right to control the LLC's management – he was a passive investor. *Shirley v. JED Capital, LLC,* 724 F Supp2d 904 (ND Ill 2010).

See also: Sud. Props., Inc. v. Terrebonne Parish Consol. Govt., 2008 US Dist LEXIS 50559 (ED La 2008) (degree of management control too factual for

summary judgment determination); *In re Breastbone*, 2010 WL 276755 (Bankr D Ariz 2010) (membership interest in a manager-managed LLC is a security).

> **NOTE:** Three courts have held that the *Williamson* analysis should also be applied to interests in limited liability partnerships ("LLCs"). *SEC v. Lowery*, 633 F Supp2d 466 (WD Mich 2009); *SEC v. Merchant Capital, LLC,* 483 F3d 747 (11th Cir 2007); *Toothman v. Freeborn & Peters,* 80 P3d 804 (Colo App 2002).

Oregon case law. Under Oregon law, the business and affairs of an LLC are managed by its members "unless the articles of organization provide otherwise." ORS 63.130. At least in the Ninth Circuit, inquiry on whether or not a general partnership interest is a security focuses on the structure of the partnership at the time that the partnership interest is acquired, not on how the entity functions in practice during its existence. *Holden v. Hagopian*, 978 F2d 1115 (9th Cir 1992). *See also: KFC Ventures, L.L.C. v. Metairie Medical Equipment Leasing Corp.,* 2000 WL 726877, 2000 US Dist LEXIS 8294 (ED La 2000); *Keith v. Black Diamond Advisors, Inc.,* 48 F Supp 2d 326 (SDNY 1999).

In *HLHZ Investments v. Plaid Pantries, Inc.,* 2007 WL 3129985, 2007 US Dist LEXIS 78817 (D Or 2007), Judge King assumed, without deciding, that a membership interest in a manager-managed LLC was a security. In *Cruze v. Hudler,* 246 Or App 649, 267 P3d 176 (1911), *adhered to on reconsideration,* 248 Or App 180, 2012 Ore App LEXIS 153 (2012), the Court of Appeals assumed without analysis that the LLC interest at issue was a security. *Oregon State Bar Professional Liability Fund v. Benfit,* 225 Or App 409, 201 P3d 936 (2009) related to insurance coverage issues arising out of a lawsuit filed against two attorneys who settled a case brought under the securities laws related to the sale of LLC interests. Again, there was no analysis of when the sale of an LLC interest constitutes the sale of a security.

7. Applying *Williamson* to LLCs

7.1 The Agreement distributes power like a limited partnership.

Under the first prong of *Williamson*, a general partnership interest may be a security if:

> an agreement among the parties leaves so little power in the hands of the partner

> or venturer that the arrangement in fact distributes power as would a limited partnership. *Williamson, supra* at 424.

A partner does not need to have the ability to prevail on partnership votes, nor does a member need to have the ability to prevail on LLC votes – the right to vote and participate in management usually makes the interest fall outside the securities laws. *See: Robinson v. Glynn*, 349 F3d 166 (4th Cir 2003); *Great Lakes Chemical Corp. v. Monsanto Co.*, 96 F Supp 2d 376 (D Del 2000).

Several courts have held that LLC interests in manager-managed LLCs are not securities where the "members have the power to elect the managers of the LLC and set their responsibilities," even though "day-to-day decisions were made by the managers." *Tschetter v. Berven*, 621 NW2d 372, 377 (SD 2001). *See also: Automated Teller Machine Advantage v. Moore*, 2009 WL 2431513, 2009 US Dist LEXIS 68724 (SDNY 2009) (giving weight to the fact that the non-managing member had the right to appoint 2 of the 3 members of the LLC board); *Endico v. Fonte*, 485 F Supp 2d 411 (SD NY 2007).

However, an interest in a manager-managed LLC may be a security where the member's ability to exercise any management control is effectively non-existent. *KFC Ventures, LLC v. Metairie Medical Equipment Leasing Corp.*, 2000 WL 726877, 2000 US Dist LEXIS 8294 (ED La 2000). *See also: SEC v. Schooler,* 905 F3d 1107 (9th Cir 2018); *SEC v. Sethi,* 910 F3d 198 (5th Cir 2018); *AFFCO Inv. v. KPMG,* 2008 WL 5070053, 2008 US Dist LEXIS 94396 (SD Tex 2008).

In *SEC v. Merchant Capital, LLC,* 483 F3d 747 (11th Cir 2007), the SEC brought an action against the promoters who sold interests in limited liability partnerships to 485 geographically dispersed investors. The agreement provided for the election of a managing general partner, but the partners only had the opportunity to vote for one candidate (the promoter) at the time of the investment, before the partners knew the identity of the other partners. Removal of the managing general partner could only occur "for cause" and by unanimous vote of the partners. Thus, the court concluded that the entity distributed power as would a limited partnership.

In *Burnett v. Rowzee,* 2007 US Dist LEXIS 74275 (CD Ca 2007), the District Court held for purposes of a show cause hearing that membership interests in a manager-managed LLC were securities, finding that the operating agreement met the first prong of the *Williamson* test because it delegated to the manager sole power to control the LLC.

Many courts have stated that it is the operating agreement which controls, not how the members operate in practice. *Williamson* stated that so long as a partner "retains ultimate control, he has the power over the investment and the access to information about it which is necessary to protect against any unwilling dependence on the manager." *Williamson, supra* at 423. Thus, the test is whether the agreement creates a passive role for the member, not whether the member chooses to act in a passive manner. *Nelson v. Stahl,* 173 F Supp 2d 153, 165 (SD NY 2001).

But not all courts agree.

> Not surprisingly, the Circuit Courts of Appeal are split on this issue. The Eleventh and Fifth Circuits look to the written agreements between the parties. *Albanese v. Florida National Bank of Orlando*, 823 F.2d 408 (11th Cir.1987); *Williamson v. Tucker*, 645 F.2d 404 (5th Cir.1981). The Eleventh Circuit has found "the crucial inquiry is the [365 Mont. 331] amount of control that the investors retain under their written agreements." *Albanese*, 823 F.2d at 410 (citing *Williamson*, 645 F.2d at 423–24.). "If the investor retains the ability to control the profitability of his investment, the agreement is no security." *Albanese,* 823 F.2d at 410. However, even if the written agreement offers substantial control to the investor, if that control is illusory, the "efforts of others" element can still be met. *Albanese,* 823 F.2d at 412.
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> In contrast, the Second Circuit looks to the "reality of the parties' positions" and evaluates "whether 'the reasonable expectation was one of significant investor control.' " *United States v. Leonard,* 529 F.3d 83, 85 (2d Cir.2008). If there is a reasonable expectation of significant investor control, the protection of securities laws is not needed. *Leonard,* 529 F.3d at 88. It is for the "passive investor" that the securities laws were enacted. *Leonard*, 529 F.3d at 88; *SEC v. Aqua–Sonic Products Corp.*, 687 F.2d 577, 585 (2d Cir. 1982). Thus, despite what the written agreements say on their face, if the promoter sought out and expected passive investors, this element may be met. *Aqua–Sonic,* 687 F.2d at 584. Under this approach, " '[w]hat matters more than the form of an investment scheme is the "economic reality" that it represents. The question is whether an investor, as a result of the investment agreement itself or the factual circumstances that surround it, is left unable to exercise meaningful control over his investment.' " *Leonard,* 529 F.3d at 90 (quoting *Robinson v. Glynn*, 349 F.3d 166, 170 (4th Cir. 2003)) (emphasis in *Leonard*).
>
> *Redding v. Mont. First Judicial Dist. Court,* 365 Mont. 316, 281 P.3d 189, 200 (2012)**.**

7.2 Inexperienced member

The second prong of the *Williamson* test looks to the inexperience of the partner or some other factor which renders the partner unable to meaningfully exercise his partnership powers.

> the partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers. *Williamson, supra* at 424.

With respect to the second prong of *Williamson*, the Ninth Circuit has held that "[t]he proper inquiry is whether the partners are inexperienced or unknowledgeable ‘in business affairs' generally, not whether they are experienced and sophisticated in the particular industry or area in which the partnership engages and they have invested." *Holden v. Hagopian,* 978 F2d 1115 (9th Cir 1992). *See also: Keith v. Black Diamond Advisors, Inc.,* 48 F Supp 2d 326 (SDNY 1999). If this analysis is applied to an LLC, the sophistication of an LLC's members will be an important factor in determining whether the securities laws apply.

The Eleventh Circuit rejected this analysis and held that *Howey* required it to look to whether the investors were inexperienced in that particular business. *SEC v. Merchant Capital, LLC,* 483 F3d 747, 762 (11th Cir 2007). *See, also: Consolidated Management Group, LLC v. Department of Corporations*, 162 Cal App 4th 598, 611, 75 Cal Rptr 3d 795 (2008).

In a joint venture case, the court gave weight to the allegation the plaintiff was a “26-year-old copier salesperson with no real estate or other investment experience, relying on the representations of a man nearly twice her age who professed to (and appeared to) have substantial real estate and development experience” in denying a motion to dismiss at the pleading stage the claim that the interest was a security. *Bollinger v. Marco Bay Homes*, 2008 WL 4844763, 2008 US Dist LEXIS 92663 (MD Fla 2008). *See also Rossi v. Quarmley,* 7 F Supp3d 502 (ED Pa 2014).

In *Rome v. HEI Res., Inc.*, 411 P3d 851 (Colo App 2014), the court also looked to the general business experience of the investors, noting:

> However, the requirement that investors have experience in the business of the venture does not mean that every partner need be an expert in every aspect of the business. Many legitimate general partnerships are comprised of partners with different talents and expertise in different areas that may be relevant to the particular venture.
>
> But there must be substantial collective experience in the specific business of the venture such that the partners, as a whole, need not rely solely on the promoters or third parties for the success of the venture or to meaningfully exercise their partnership powers. (Citations omitted) Id at 862-3.

7.3 Unique promoter

The third prong of the *Williamson* test looks to whether the promoters have some unique management ability such that they cannot be replaced as managers.

> the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers. *Williamson, supra* at 424.

The Ninth Circuit has held that the promoter/manager must possess some "non-replaceable expertise" which is necessary to the successful management of the partnership. *Holden v. Hagopian*, 978 F2d 1115 (9th Cir 1992). It is not important that the individual partners cannot themselves step into the shoes of the manager. The manager's skill must be such that the manager is not replaceable by **anyone**.

The Ninth Circuit has indicated, however, that a manager might be deemed non-replaceable in situations where the economic realities of the arrangement makes replacement of the manager unfeasible. *Hocking v. DuBois*, 885 F2d 1449 (9th Cir 1989) (Nevada resident purchased single Hawaiian condo unit contributed to larger rental pool); *SEC v. Sethi,* 910 F3d 198 (5th Cir 2018) (managing partner actively sought to stymie passive partners from obtaining information); *Koch v. Hawkins,* 928 F2d 1471 (9th Cir 1991) (35 separate general partnerships each owned small, separate parcels of a much larger jajoba plantation and the smaller parcels alone could not be operated economically).

The Eleventh Circuit has held that a manager of 28 separate limited liability partnerships may be deemed irreplaceable where the assets of those LLCs were tied up in a common pool. *SEC v. Merchant Capital, LLC,* 483 F3d

747, 763-4 (11th Cir 2007).

8. Other factors

In analyzing other instruments under the securities laws, the courts have given weight to the expectations of the parties themselves. *SEC v. R. G. Reynolds Enterprises, Inc.*, 952 F2d 1125 (9th Cir 1991). If the parties refer to the transaction as an "investment," the courts are more likely to apply the investment laws. The courts also give weight to the plan of distribution. *Id.*; *Reves v. Ernst & Young*, 494 US 56 (1990). Mass marketing and high-attendance investment meetings increase the chance that the securities laws are applicable.

9. Different classification based upon role of the owner and the method of acquisition

It is possible that some LLC interests in a particular LLC will be securities and other LLC interests in the same LLC will not. A few courts have held a limited partnership interest not to be a security in circumstances where the limited partner has substantial control over the management of the partnership, such as when the limited partnership interest is owned be a general partner, a director of a general partner, or a parent corporation of a corporate general partner. *See for example: Bamco v. Reeves,* 675 F Supp 826 (SD NY 1987); *Darrah v. Garrett,* 1984 US Dist LEXIS 18649, [1984 Transfer Binder] FED SEC L REP (CCH) ¶ 91,472 (ND Ohio 1984); *Bank of America National Trust & Savings Association v. Hotel Rittenhouse Associates,* 595 F Supp 800 (ED Pa 1984). Applying the same reasoning, an LLC interest held by one of the centralized managers of an LLC with centralized management would likely not be a security, while an LLC interest in the same LLC held by a passive member may well be a security.

Even if an LLC interest is not a security, the assignment of that interest may be a security. ORS 63.249(2) provides that the assignment of an LLC interest does not entitle the assignee to participate in management. The resale of an instrument can fall within the securities laws even though the original issuance of that instrument did not fall within the securities laws. See: *Banco Espanol de Credito v. Security Pacific National Bank,* 973 F2d 51 (2nd Cir 1992); *Commercial Discount Corp. v. Lincoln First Commercial Corp.,* 445 F Supp 1263

(SD NY 1978) (both cases involving the resale of promissory notes). With respect to the assignment of an LLC interest, the resale of the right to share in profits without the transfer of the right to participate in management could well mean that the assignment falls within the securities laws even though the original sale of the LLC interest did not.

> Although the complete membership interest, comprised of the Smul Trust's non-economic and economic interest in RH Lodging may not be a security, the economic interest, when separated from the rights to participate in management and voting, may constitute a security. *Greenstreet Fin., L.P. v. CS-Graces, LLC,* 2011 US Dist LEXIS 44919 (SD NY 2011).

Likewise, the pledge of an LLC interest may constitute the sale of a security. *Rocky Aspen Mgmt. 204 LLC v. Hanford Holdings LLC,* 230 F Supp 3d 159 (SD NY 2017).

10. Summary

In summary, if the courts apply existing case law regarding general partnership interests to LLC interests, most LLC interests will not fall within the securities laws. Factors which may indicate a contrary result include centralized management, unsophisticated members, promoters with unique skills, members living a great distance from the site of the LLC's business, frequent use of the term "investment" in communications between the members and the LLC, mass marketing of the LLC interests, and a high number of LLC members. While some of these factors alone may not be enough to cause the securities laws to apply, a combination of such factors could be worrisome.

Of these factors, centralized management is likely the most important factor. It may be present in situations where the LLC makes an ORS 63.130 election in its organizational documents. It may also be present where the LLC delegates important management duties to promoters or third parties by contract or otherwise and where the termination of that delegation is made difficult by the imposition of supermajority voting requirements, penalties for exercise of that termination power, or contractual impediments to prompt termination (*e.g.,* a 3-year no-cancel clause, a 6-month notice requirement, etc.).