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SQUARE PEGS IN ROUND HOLES: LLCs UNDER OTHER STATUTES

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SQUARE PEGS IN ROUND HOLES: LLCs UNDER OTHER STATUTES

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I. BANKRUPTCY.

A. Applying Bankruptcy Law to LLCs.

1. Eligibility of an LLC to File a Bankruptcy Petition.

Title 11 of the United States Code (the "Bankruptcy Code") permits "persons" to file bankruptcy petitions, and the statutory definition of "person" includes "individual, partnership, and corporation." Bankruptcy Code § 101(41). Although an LLC is not a "partnership" in a state law sense, the Bankruptcy Code defines "corporation" to include:

> (ii) partnership association organized under a law that makes only the capital subscribed responsible for the debts of such association; [or]
>
> ***
>
> (iv) unincorporated company or association;

Bankruptcy Code § 101(9)(A). For the purposes of determining an LLC's eligibility to file a bankruptcy petition, an LLC should be able to fit within either of the subsections cited above. It might be possible to argue with the characterization of an LLC as a corporation because §101(9)(B) specifically excludes limited partnerships from the definition of corporations, but this distinction is unlikely to matter in any event. The definition of "person" lists individuals, partnerships and corporations as entities "included" within the definition, but is not so exclusive as to prevent another type of entity not listed in the statute from also being characterized by a court as a "person."

It is also worth observing that the classification of an LLC as a partnership or as a corporation for purposes of determining the applicability of the Bankruptcy Code should have little other effect on the disposition of a bankruptcy proceeding. Most of the provisions of the Bankruptcy Code that apply specifically to partnerships relate to issues, such as the liabilities of general partners, that are not likely to apply in an LLC context.

2. Authority to File a Bankruptcy Petition.

As a general proposition, state law determines who may file a bankruptcy petition. With respect to general partnerships, the federal bankruptcy rules provide that a bankruptcy petition may be filed by any general partner, provided that all general partners consent, see Fed. Bankr. R. § 1004(a), but in corporate and other contexts, the power to file a petition will depend on the actual authority of those wishing to do so. The decision will usually rest with a corporation's board of directors, but in an LLC setting, the authority of managers is not as clear. State LLC statutes do not prescribe whether members or managers have the power to file federal bankruptcy petitions, and this determination will require an analysis of the terms of the LLC's governing documents. If the articles of organization and the operating agreement do not describe the authority of members or managers to file for bankruptcy, the answer to this question will depend on whether the LLC is member-managed or manager-managed, and the extent to which the articles and operating agreement otherwise delegate actions to managers and reserve actions to members. For example, if an LLC's managers are given relatively broad authority to take significant business actions on behalf of the LLC, it might be appropriate for a bankruptcy court to conclude that the managers also have authority to file a bankruptcy petition. By contrast, if an LLC operating agreement reserves almost all significant business decisions to the members collectively (by whatever voting rule), the members will probably be deemed to have the authority to make the bankruptcy filing decision. The risk that a bankruptcy court will be vested with the power to determine which managers or members have the power to file a bankruptcy petition should provide sufficient justification for careful drafting of an operating agreement provision.

3. Effects of an LLC Bankruptcy Filing.

a. LLC Bankruptcy Filing as a Dissolution Event.

The LLC statutes do not define a bankruptcy filing by an LLC as an event of dissolution or dissociation, and so it is unnecessary to determine whether the winding-up process will be triggered by such a bankruptcy.

b. Composition of the Bankruptcy Estate.

The "estate" of a bankrupt partnership will include "all legal or equitable interests" of the LLC as of the time of filing. Bankruptcy Code § 541(a). In addition to the LLC's property, these interests will include all rights of the LLC under an operating agreement to additional member contributions or required member loans.

c. Preferences.

Under Bankruptcy Code § 547(b)(4), the "insiders" of a debtor are subject to a one year preference period. Managers of an LLC are likely to be considered

insiders, and members in a member-managed LLC will probably have the same status. It is possible that investor members of an LLC that do not otherwise participate in the LLC's business might fall outside the "insider" preference period.

d. Applicability of Stay to Members.

In contrast to the partnership context, where a stay that extends to the property of individual partners may be appropriate in order to protect creditor access to the assets of the partners, it would not be appropriate for a stay to be made applicable to the members of an LLC. As a general proposition, the members and managers of an LLC are not liable, by reason of their status as such, for the obligations of the entity. See Uniform Limited Liability Company Act ("ULLCA") § 303.

B. Bankruptcy of a Member.

1. Nature of a Bankrupt Member's Bankruptcy Estate.

As observed above, the bankruptcy estate of a debtor includes all of the debtor's legal or equitable interests as of the filing of the bankruptcy petition. In the many cases that have addressed the bankruptcy of a partnership's general partner, it has been observed that the partner's interest in the partnership consists of the partner's economic rights, the partner's management rights, and the partner's rights as a co-owner of partnership property. In re Cardinal Industries, Inc., 116 B.R. 964, 970-71 (Bankr. S.D. Ohio 1990). The concept of co-ownership of partnership property flows from sections 24 and 25 of the Uniform Partnership Act, which specify that a partner holds partnership property as a tenant in partnership with the other partners.

Because the members of an LLC do not have any interest in an LLC's property, see ULLCA § 501(a), a member's bankruptcy estate will consist of the member's economic rights in the LLC (referred to in ULLCA as the member's "distributional interest"), and the member's management rights in the LLC.

2. Provisions of State Law and Operating Agreements that Apply in Bankruptcy.

The Virginia LLC Act provides, as a default rule, that unless otherwise agreed by an LLC's members, the bankruptcy of a member will be an event of dissolution. See ULLCA § 601(7). Most operating agreements will address the extent to which a bankruptcy filing by a member will trigger dissociation or dissolution, but this contractual language will often be co-extensive with the statutory default rules.

To the extent that the remaining members of an LLC elect to continue the business of an LLC following an event of dissolution, both statute law and operating

agreements will generally provide that the bankrupt member loses its status as a member and thereby ceases to have any management rights in the LLC. At that point, the member's rights in the LLC will be limited to economic or "distributional" rights. See ULLCA § 803(b)(1). The bankrupt member will have the status of a transferee or assignee of an LLC interest, and cannot again take on the status of a member unless admitted to membership by the requisite vote of the remaining members. See ULLCA § 503(a). The effect of these general statutory and contractual rules in the bankruptcy context is addressed in the following section.

3. Enforceability of Statutory and Operating Agreement Provisions in the Bankruptcy Context.

a. Operating Agreement as Executory Contracts.

It is well established that partnership agreements, to the extent they delineate material unperformed obligations of the partners, are executory contracts within the meaning of the Bankruptcy Code. The few cases that have thus far addressed bankruptcy issues in the LLC context have likewise held that operating agreements are executory contracts. See In Re Daugherty Construction, Inc., 118 B.R. 607 (Bankr. D. Neb. 1995), ("Daugherty"); In Re DeLuca, 194 B.R. 65 (Bankr. E. D. Va. 1996) ("DeLuca I"); In Re DeLuca, 194 B.R. 79 (Bankr. E. D. Va. 1996) ("DeLuca II"). Operating agreements will contain numerous provisions relating to ongoing agreements and covenants of the parties, and for this reason, is appropriate that they also be classified as executory contracts for purposes of the Bankruptcy Code.

b. Applicable Bankruptcy Law Provisions.

Section 365(a) of the Bankruptcy Code provides that the bankruptcy trustee, subject to court approval, may assume or reject any of the debtor's executory contracts. Section 365(f) further provides that except as provided in Section 365(c), the trustee may assign an executory contract notwithstanding any contrary provision in any contract or under applicable law. Note that for the purposes of Chapter 11 of the Bankruptcy Code, references to the "trustee" should be considered to refer also to a debtor in possession. Bankruptcy Code § 1107.

The general rule is that the trustee or debtor in possession is permitted to assume an executory contract even if nonbankruptcy law or the contract itself would forbid such an assumption. Section 541(c) of the Bankruptcy Code overrides any restriction on the transferability of an asset in the bankruptcy estate that may be imposed by an agreement or nonbankruptcy law, and Section 365(e)(1) permits the avoidance of so-called *"ipso facto"* clauses that would otherwise provide for the termination or modification of a contract or contract right that might be triggered by the debtor's commencement of the bankruptcy case or insolvency or financial condition prior to the termination of the bankruptcy case. Two other sections of the Bankruptcy Code, however, hold out the possibility that it

might still be possible to enforce statutory and agreement provisions that are triggered by a partner's or member's bankruptcy.

Section 365(c) of the Bankruptcy Code provides that the trustee or debtor in possession may not assume or assign an executory contract if:

> (1)(A) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and
>
> (B) such party does not consent to such assumption or assignment;

Bankruptcy Code § 365(c). This section is consistent with similar language in § 365(e)(2), which exempts the same categories of executory contracts from the provisions cited above that would otherwise override *ipso facto* clauses.

> Paragraph (1) of this subsection does not apply to an executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if (A)(i) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to the trustee or to an assignee of such contract or lease, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and (ii) such party does not consent to such assumption or assignment.

Based on a strict construction of the statutory language, therefore, it would seem that a trustee (including even the debtor in possession) will not be permitted to assume an operating agreement if it can be determined that the agreement is of a type as to which state law excuses a nonbankrupt member from accepting performance from or rendering performance to any party other than the debtor or the debtor in possession.

c. <u>The Right Of A Debtor Member To Assume An Operating Agreement</u>

At the time this outline was compiled, only two courts had addressed whether a debtor in possession or trustee could assume an operating agreement,

notwithstanding state law provisions that would provide for bankruptcy as a disassociation or dissolution event. In the absence of bankruptcy law provisions that override state law, the bankruptcy of a member would, at least in member-managed LLCs, trigger an opportunity for the remaining members to vote whether to continue the LLC. In any event, the bankruptcy would cause the bankrupt member's status as a member to cease.

(1) Daugherty.

In Daugherty, which was decided in October 1995, the bankruptcy court concluded that the provisions of the Nebraska Limited Liability Company Act were overridden by the Bankruptcy Code, and that the bankruptcy of a member did not trigger a dissolution of the LLC. The court held that even under an operating agreement, Section 365(c)(1) does not permit a party to avoid accepting from or rendering performance to a debtor in possession. 188 B.R. at 614. This analysis is consistent with the majority rule in partnership cases, and the leading case in partnership area is In Re Cardinal Industries, Inc., 116 B.R. 964 (Bankr. S.D. Ohio 1990). The Daugherty court specifically rejected a separate line of cases which have held that a partnership dissolves, and a partner's status as such ceases, upon a partner's bankruptcy filing.

(2) The DeLuca Cases.

Both of the DeLuca cases arose from the bankruptcy filings of a husband and wife who are involved in numerous entities, including several LLCs. In DeLuca I, the principal question was whether the remaining members of the LLC could remove the DeLucas as managers of the LLC and insert a new manager, when the underlying operating agreement required unanimous member consent for the appointment of a new manager. The court concluded that the pre-petition removal of the DeLucas as managers was valid because the operating agreement was silent on removal but state law permitted removal upon a majority vote of the members. The court also found that a new manager could be appointed by the remaining members after the bankruptcy petition because the bankruptcy petition of the DeLucas had the effect of terminating the DeLucas' status as members.

In DeLuca II, the DeLucas were members of an LLC that was itself one of two members of a second LLC. The other member of the second LLC sought the court's determination that the DeLucas' bankruptcy caused a dissolution of the first LLC (because there were no non-bankrupt members of that LLC who could vote to continue), and that the dissolution of the first LLC therefore triggered the dissolution of the second LLC. Again, the court gave effect to state law provisions and agreed that the second LLC had dissolved as a result of the DeLucas' Chapter 11 filing. However, without reaching the question whether the DeLucas had unlawfully dissolved the second LLC, the court concluded that it would not disturb the prior appointment of a bankruptcy trustee in favor of allowing the remaining member of the second LLC to wind up the LLC's business. The applicable Virginia

statute would have permitted all members (presumably including the first LLC) that had not "wrongfully dissolved" the LLC to participate in the winding up.

In both of the DeLuca cases, the court relied primarily on Breeden v. Catron, 158 B.R. 624 (Bankr. E. D. Va. 1992), aff'd, 158 B. R. 629 (E. D. Va. 1993), aff'd, 25 F.3d 1038 (4th Cir. 1994), a general partnership case in which the lower courts and in the Fourth Circuit concluded that the language of Section 365(c) should be read literally to prevent the debtor in possession's assumption of a partnership agreement because applicable state law would not require the remaining partners to perform their obligations under the partnership agreement or to accept the performance of the bankrupt partner's obligations from any party other than the bankrupt partner. In such circumstances, the Catron court concluded, neither the trustee nor the debtor in possession could assume the contract. In the DeLuca cases, the court likened the partnership agreement at issue in Catron to the operating agreements involved in the DeLuca cases, and concluded that the state law provisions governing dissolution and the status of a bankrupt member should be given effect notwithstanding the Bankruptcy Code's general preference toward permitting the assumption of executory contracts.

For a complete discussion of the DeLuca cases and the underlying legal issues, see Wheaton, "Dumping Deadbeats: Enforcing Limited Liability Company Agreements in Bankruptcy," Journal of Limited Liability Companies, Fall 1996, at 60.

4. Proposed Bankruptcy Code Amendments.

The National Bankruptcy Review Commission made a number of proposals in October 1997 that would affect LLCs. These proposals, which were submitted to Congress but which have not been adopted, would provide for members of member-managed LLCs and managers of manager-managed LLCs to be treated like general partners under the Bankruptcy Code. The proposals would also exclude partnership and operating agreements from treatment under Section 365, invalidate any *ipso facto* provisions relating to a member or manager's post-bankruptcy rights, and provide in certain circumstances for a partnership or LLC to pay a specified "buyout price" to the bankruptcy estate in the event that a member or partner is not admitted to the partnership or LLC pursuant to a non-*ipso facto* provision.

II. SECURITIES LAWS.

A. Are Limited Liability Company Interests Securities?

The status of LLC interests as "securities" is an emerging issue that could limit the attractiveness of LLCs in some contexts where compliance with the federal and state securities laws would be burdensome. However, because corporate stock and limited partnership interests are universally regarded as securities, the application of the securities laws

will generally present a new challenge only if the choice of entity decision involves using an LLC instead of a general partnership.

1. Definition of a Security.

Both Section 2(1) of the Securities Act of 1933 (the "1933 Act") and Section 401(l) of the Uniform Securities Act (the "Uniform Act"), which is the basis for most state "blue sky" laws, enumerate various types of "securities."

As a general rule, even though both the 1933 Act and the Uniform Act (but not all state statutes) preface all definitions or the definition of "security" with the proviso "unless the context otherwise requires," an item found in these lists will be presumed a security, subject to very limited exceptions. For example, because "stock" is listed in both statutes, an ownership interest denominated as stock will nearly always trigger securities coverage. LLC interests are not listed as securities by the 1933 Act or the Uniform Act, but another listed item, "investment contract," has become the catch-all through which interests that are not otherwise listed can be drawn within the coverage of the securities laws. In addition, as noted below, many states have revised their statutory definition to list LLC interests as a "security."

2. What is an Investment Contract?

The Supreme Court set forth its analysis of the meaning of "investment contract" in SEC v. W.J. Howey Co., 328 U.S. 293 (1946). Under the Howey test, an investment contract is a transaction in which 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." Id. at 299. The Howey definition appears very narrow, because of the apparent requirement that an investment contract involve an investment where the expectation of profit is "solely" derived from the efforts of others. However, subsequent lower court cases have broadened the definition so that as a general rule, an investment may be considered an investment contract if the expectation of profit derives "substantially" from the efforts of the venture's promoters or insiders. In a case more recent than Howey which addressed the investment contract definition, the Supreme Court restated the Howey rule by describing an investment contract as "an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others." United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 852 (1975). The Supreme Court's omission of the word "solely" from the Howey definition in that case is consistent with the approach that has been taken by the federal circuit courts, as further discussed below.

A number of lower court cases apply the Howey test in various contexts, and the cases most analogous to LLC interests involve partnership interests.

a. Partnership Interests as Securities.

The first part of the Howey test is whether the investment being scrutinized involves an investment of money in a common enterprise. Clearly, to the extent that a partnership or limited liability company represents a pooling of interests with an expectation of economic gain, the first prong of the Howey test will always be met. The second part of the test, whether the profits to be realized are expected to be gained through the efforts of others, is the issue upon which the cases involving general and limited partnerships have turned.

(1) Limited Partnerships.

Limited partnership interests are generally recognized as investment contracts because by definition, an investing limited partner places responsibility for his or her investment in the general partner's hands. In some state blue sky statutes, limited partnership interests have been listed separately as securities.

(2) General Partnerships.

The courts have had much more difficulty deciding when a general partnership interest is a security. In theory, because every partner in a general partnership possesses agency authority, an argument can be advanced that the partner's interest in the general partnership should not be classified as a security because the partner always has legal power over matters affecting the investment in the partnership. However, the federal circuit court cases that have evaluated the status of general partnership interests as securities have tended to adopt tests that reflect the economic realities of the partnership, rather than technical legal rights that can be asserted by general partners. One formulation that has been adopted widely was set out in SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476 (9th Cir.), cert. denied, 414 U.S. 821 (1973). In Turner, the Ninth Circuit rephrased the Howey question as "whether 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 enterprise." 474 F.2d at 482.

The Turner formula was addressed by the Fifth Circuit in Williamson v. Tucker, 645 F.2d 404 (5th Cir.), cert. denied, 454 U.S. 897 (1981). In Williamson, the court recognized that although prior decisions had held that general partnership interests were generally not considered investment contracts for the purposes of the federal securities laws, "the mere fact that an investment takes the form of a general partnership or joint venture does not inevitably insulate it from the reach of the federal securities laws." 645 F.2d at 422. The court found that if an investor general partner irrevocably delegates his or her powers or is incapable of exercising them, or is so dependent on a particular expertise of the promoter or managing partner that he or she has no reasonable alternative to reliance on the managing promoter or manager, then the investment in the partnership may be characterized as an investment contract. The court concluded that an

investor who claims that a general partnership interest is a security must overcome a presumption that the general partnership interest is not an investment contract, but can establish the existence of securities by showing that:

- the partnership agreement leaves so little power in the investor that the arrangement is akin to a limited partnership;

- the investor is so inexperienced and unknowledgeable in business affairs that he or she cannot intelligently exercise partnership powers; or

- the investor is so dependent on unique entrepreneurial or managerial abilities of the promoter/manager that he or she cannot replace the manager *or* exercise partnership powers.

Id. at 424.

(3) Other Circuits.

The majority of the federal circuits have generally embraced the Williamson formulation, but in some cases have moved away from the subjective investor-by-investor approach that may be implied by the second Williamson factor listed above.

In the Fourth Circuit, the leading case is Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc., 840 F.2d 236 (4th Cir. 1988). In Rivanna Trawlers, in an opinion by Justice Powell, the court found that the general partnership interest at issue was not a security. The court stated the general proposition that "[g]eneral partnerships ordinarily are not considered investment contracts because they grant partners-the investors-control over significant decisions of the enterprise." Id. at 240. The court analyzed the partnership's partnership agreement, recited the numerous powers reserved to the non-managing partners, including a power to remove the general partner that had been exercised twice, and concluded that the general partners possessed not only sufficient legal power under the partnership agreement, but also actual power in fact.

The leading case in the Third Circuit embraces less of the Williamson formulation than Rivanna Trawlers. In Goodwin v. Elkins & Co., 730 F.2d 99 (3rd Cir.), cert. denied, 469 U.S. 831 (1984) the principal opinion looked solely to the New Jersey Uniform Partnership Act, and concluded that the statutory provisions were sufficient to give an investing partner significant managerial powers and to take the general partnership interest out of the definition of investment contract. The concurring opinion of two judges looked to the partnership agreement to reach the same conclusion.

b. Summary.

Although the general partnership cases set out varying rules, the principal factors that will determine the securities status of a general partnership interest can be said to include the following:

(1) Statutory Authority of General Partners.

Under the Uniform Partnership Act, a general partner may, among other things, contract for the partnership, receive an accounting, and refuse to consent to the admission of a new partner. Based on these considerations alone, some courts may follow the Third Circuit's analysis and conclude that a general partnership interest is almost never a security.

(2) Terms of the Partnership Agreement.

Assuming that the management of a general partnership is concentrated in one or more managing partners, most courts, under a derivation of the Williamson formula, will evaluate the amount of control that a passive investing partner can reasonably exercise. Relevant powers will include veto rights, majority and supermajority voting requirements, and the ability to remove the managing partners. Most of these powers can be evaluated on the face of the partnership agreement, but other factual considerations, including whether purported rights found in the partnership agreement are in fact not exercisable because of the amount of voting power concentrated in the managers or their affiliates, may require that the examination look beyond the terms of the partnership agreement itself.

(3) Necessary Reliance on the Promoter/Manager.

To the extent that the second part of the Williamson formula appears to allow the existence of a security to depend on the actual business acumen of the investor, the formula creates the possibility that some investing partners will be deemed to have purchased securities, while others, because of the business skill they possess, will not have purchased securities. This unusual result argues in favor of a more objective assessment of the level of dependence on the partnership's promoters or managing partners. The last prong of the Williamson test, which permits a reasonable removal right to overcome the investor's dependence on the "unique entrepreneurial or managerial ability of the promoter," will likely be the more relevant test for a partnership, and may carry over to the LLC context.

3. LLC Interests as Securities.

Absent specific statutory or regulatory pronouncements to the contrary, LLC interests are likely to be evaluated according to the same standards as general partnership

interests. In a limited liability company, the parties drafting an operating agreement have the same contractual flexibility to give to or withhold from the LLC's members the same range of control mechanisms that is available to the drafters of a general partnership's partnership agreement. By comparison, limited partnership interests are almost always classified as securities because a limited partner is without the statutory power to exercise meaningful control over his or her investment. Because there are no adverse liability consequences related to an LLC member's participation in the company's management, an investor in an LLC will be entitled to exercise, subject to contrary agreement, a full range of contractual rights to the extent they are not otherwise unavailable under the governing LLC statute. A determination whether an LLC interest is a security will therefore depend on the statute under which the LLC is organized, and the terms of the LLC's operating agreement. The following factors may be influential:

a. Statutory Powers.

Many LLC statutes contain, at least as default rules, provisions similar to those found in the Uniform Partnership Act and Revised Uniform Limited Partnership Act. Some statutes provide that each member of the LLC is an agent of the LLC except to the extent otherwise provided in the LLC's operating agreement or articles of organization. Virtually all LLC statutes guarantee members certain voting rights in the context of the admission of new members, the admission of transferees of LLC interests as members, and the dissolution of the LLC. The statutes generally contain default rules relating to the members' ability to remove managers. Members are also entitled to detailed information regarding the finances of the LLC, although these rights typically are not more extensive than the rights available to limited partners.

Depending on the extent to which statutory default rules are varied by an LLC's articles of organization or operating agreement, the same powers that permit general partnership interests to avoid classification as securities may be a basis for concluding that an LLC's members can likewise exercise meaningful control over their investment, and that their LLC interests should not be deemed securities.

b. Careful Drafting Consideration is Involved.

If it is important to avoid the classification of an LLC interest as a security, then each of the statutory default rules that implicates control should be considered in a securities law context. For example, the operating agreement of the LLC should be drafted to ensure that the investing members, if not involved in day-to-day activities, have the right to participate in management by exercising a reasonably effective mechanism for removing existing management. The removal factor is part of the last prong of the Williamson test, and seemed to be a pivotal factor in the outcome of the Rivanna Trawlers case. Similarly, to the extent that any statutory default rule appears to place significant power within the hands of the LLC's members, the drafters of an operating agreement should not negate the

rule, and minimize the members' power, without considering possible securities laws implications.

c. Unique Skills of Managers.

As observed above, under the third prong of the Williamson test, the fact that the promoter or manager has unique skills will not necessarily cause an LLC interest to be characterized as a security if an effective removal power is available. However, if the manager does not possess particularly unique skills, or all the members of an LLC have adequate business sophistication, the mere fact that a manager is appointed should not cause the LLC interest to be considered a security.

d. Other Practical Considerations.

The more the formation of a limited liability company looks like a limited partnership distribution, the more likely it is that the LLC interests will be treated as securities. It is unlikely that a court will ignore the realities of a situation in which the class of members is so diffused that the members would find it nearly impossible to exercise any removal right or other powers under the LLC's operating agreement.

Notwithstanding the foregoing, where a group of professionals wishes to organize in LLC form, the fact that the professional practice is centrally managed or that there are a large number of members in the practice should not cause the LLC interests to be characterized as securities. The professionals are probably going to be active in the generation of their economic rewards, and the management skills being utilized by the managers will presumably not be so unique that the members themselves could not otherwise supply them.

By the same token, a closely-held LLC, even with centralized management, should not trigger securities laws coverage. The mere fact that the members of an LLC have delegated day-to-day management of the LLC to one or more managers should not be enough to cause an LLC interest to be classified as a security where the non-managing members retain significant control, or ability to control, and where the members have a real, rather than illusory, ability to exercise their rights.

4. Other Theories Upon Which an LLC Interest Might be a Security.

a. Commonly "known" as a Security.

One set of commentators has expressed the view that an LLC interest should be considered a security because it falls within the statutory language that classifies as a security anything "commonly" known as a "security," or because an LLC interest has the characteristics of stock. M. Steinberg & K. Conway, The Limited Liability

Company as a Security, 19 Pepperdine L. Rev. 1105 (1992). Both arguments are circular. A limited liability company interest is a relatively new concept, and because it can be analogous to a general partnership interest, it seems unlikely that the interest is fairly characterized as one that is "commonly" known as a security. The commentators also expressed the view that because a limited liability company uses the word "company" in its name, and "companies" usually issue securities, that alone may be enough to allow investors to presume that an LLC interest is a security. This argument deserves very little attention.

b. "Risk Capital" Test.

Although the approach has not received any credence under the federal laws, a number of states apply a "risk capital" test as an alternative means of determining whether an investment constitutes a security. Different versions of a risk capital test are applied in different jurisdictions, but common factors evaluated in applying the test include whether the investor's investment is subject to the risks of an enterprise, and whether the investor may exercise direct control over the enterprise's management. Although these factors are similar to factors used in the Howey line of cases, the applicability of a statutory or judicially developed risk capital test in certain jurisdictions may require additional attention to be given to securities laws issues.

B. State Blue Sky Law Developments.

1. State Administrative Actions.

a. Enforcement Proceedings.

In a classic case of "bad facts make bad law," a number of jurisdictions have initiated administrative proceedings against wireless cable ventures and similar operations that have been attempting to use limited liability companies as the vehicle through which investments are made. See "New Kind of Company Attracts Many--Some Legal, Some Not," Wall Street Journal, Nov. 8, 1993, at p. B1. In the typical case addressed by the numerous blue sky administrative decisions that have resulted in reported opinions, the promoter has engaged in widespread solicitations of investors through mass marketing, and the investors described in the administrative proceedings have been relatively unsophisticated. The promoter assisted certain of the investors in "organizing" the LLCs and the investors were given the responsibility of managing the limited liability company. However, the actual substantive work, including the preparation of FCC applications and the like, was to be handled for the LLC by an affiliate of the promoter on a contract basis. In each reported decision, the limited liability company interests have been found to be securities. The following proceedings provide examples:

- Arizona. In Nutek Information Systems v. Arizona Corporation Commission, 1998 WL 767176 (Ariz. App. Div. 1 Nov. 5, 1998), an Arizona

court used the *Howey* test to evaluate whether interests in a Texas LLC were securities. The court used the Williamson v. Tucker analysis, considered the fact that the members did not exercise meaningful control and could not reasonably expect to replace the manager, and found that the interests were securities.

- Colorado. In an unpublished decision, the Colorado Court of Appeals applied a *Howey* analysis to find that a manager-managed LLC engaged in the wireless business had issued securities. However, the court held out the possibility that a manager-managed company could avoid being subject to the securities laws in some circumstances. People of the State of Colorado v. Riggle, (Co. App. No. 95CA1476, Jan. 15, 1998).

- Georgia. In In re Express Communications, Inc., State of Georgia, Commissioner of Securities Case No. 50-93-0095 (final order April 14, 1994) the administrative proceeding included lengthy findings of fact and law that involved the straightforward application of the *Howey* analysis to the underlying facts.

- Illinois. See In re Express Communications, Inc., 1994 Ill. Sec. LEXIS 321 (Dec. 13, 1993), which applied analysis similar to the Georgia approach.

- Indiana. See In re Wireless Cable Financial Consultants, 1993 Ind. Sec. LEXIS 168 (Dec. 17, 1993).

Some of the same abuses addressed by the state securities regulators have drawn the attention of the Securities and Exchange Commission, which in March 1994 filed a suit (subsequently resolved by a consent order) against certain LLC promoters. See "SEC Sets Sights on Certain Limited Liability Companies," Wall Street Journal, Mar. 31, 1994, at p. B2. In SEC v. Parkersburg Wireless, Ltd. Liability Company, 991 F. Supp. 6 (D.D.C. 1997), the court applied the *Howey* test to find that a "security" existed for the purposes of the 1993 Act. In SEC v. Shreveport Wireless Cable Television Partnership, Fed Sec. L. Rep. (CCH) ¶ 90,322 (D.D.C. 1998), the court applied the Williamson v. Tucker analysis to reach the same conclusion. By comparison, in a case that did not involve SEC enforcement, Keith v. Black Diamond Advisors, Inc., Fed. Sec. L. Rep. (CCH) ¶ 90,448 (S.D.N.Y. 1999), the court concluded that LLC interests were not securities for the purposes of the 1933 Act because under the *Howey* test, the members had broad powers, and therefore could not expect that their profits would be dependant upon the efforts of others.

Appendix 1 contains excerpts from a set of LLC offering documents for membership interests in a "super high frequency television" venture.

b. No-Action Letters and Informal Interpretations.

In a number of jurisdictions, states securities administrators have issued no-action or other interpretative letters addressing specific fact patterns. Such interpretative letters have been issued, for example, in Kansas, New Jersey, Oklahoma, Maryland and South Dakota. The New Jersey Bureau of Securities has issued a no-action letter stating, without explanation, that it considers all LLC interests to be securities. Blue Sky L. Rep. (CCH) ¶ 40,642 (July 27, 1994).

2. Statutory and Regulatory Blue Sky Definitions.

As noted above, the federal securities laws and typical blue sky statutes include a laundry list of items, including "stock," in their definitions of "security." Because partnership interests are not one of the listed items in most jurisdictions, the courts that have evaluated whether and when partnership interests are securities have relied on the "investment contract" analysis set out in Howey and subsequent federal cases. The Howey analysis is highly fact-specific, and usually turns on an investor's power and ability to influence the management of the entity in which the investment is being made. For this reason, the application of the Howey test to LLC interests allows the wireless schemes described above to be distinguished from smaller-scale transactions, in which the management opportunities and abilities of the potential investors might range along a wide continuum.

Some of the ability of LLC organizers to rely on the Howey test has been eroded in many states by rules that have been embodied in state blue sky statutes and regulations. These rules take a variety of forms:

a. Defining an LLC Interest as a "Security".

One common approach is simply to list LLC interests in the definition of a "security," as has been done in Alaska, New Mexico, Ohio and Vermont. The Kentucky Securities Commission has expressed the policy position that all LLC interests are securities, but also left some wiggle room based on a Howey/Williamson analysis. Blue Sky L. Rep. (CCH) ¶ 27,853. The New Jersey Securities Bureau has taken a similar position. Blue Sky L. Rep. (CCH) ¶ 40,642.

b. Listing LLC Interests as Securities with Management-based Exception.

- California. The California statute added limited liability company interests to the list of securities in California's blue sky statute. See Cal. Corp. Code § 25019. However, an LLC interest will be outside the definition of a "security" if every member is "actively" engaged in the LLC's management. The person claiming this exemption will have the burden of proof, and the members' rights to vote and to information concerning

the business and affairs of the LLC, and their right under the LLC's operative documents to participate in management, will not alone be sufficient to bring an LLC's interests within the exemption.

- Indiana. The Indiana statute includes interests in a limited liability company among the list of investments that are defined to be securities. Ind. Code § 23-2-1-1(k). However, the statute includes an exception that excludes LLC interests if the person claiming that the interest is not a security can prove that all of the members of the LLC are actively engaged in the management of the LLC. A policy statement also provides for the application of the Howey and "risk capital" tests, and focuses on the actual ability of an investor to exercise management authority in a meaningful way. Blue Sky L. Rep. (CCH) ¶¶ 24,101, 24,681. Because the definition requires active management participation by every member, the Indiana statute will eliminate the application of the Howey rule to LLC interests. The Howey rule typically gives significant weight to the power to manage even where an investor may choose not to exercise the power.

- Pennsylvania. The Pennsylvania statute also adds LLC interests to the list of securities. However, a membership interest in an LLC will not be security if the LLC is member-managed, if each member enters into a written commitment to be actively and directly engaged in the management of the LLC, and if each member, in fact, participates actively and directly in the LLC's management. 70 Pa. Cons. Stat. § 1-102(t).

- Iowa. An LLC interest is defined as a "security," unless it is proved that each member of the LLC is actively engaged in management. Iowa Code § 502.102(14), Blue Sky L. Rep. (CCH) ¶ 25,102.

- Nebraska. An LLC interest is not a security if each member enters into a written commitment to be engaged actively and directly in management, and actually actively engages in management. Neb. Rev. Stat. § 8-1101(15), Blue Sky L. Rep. (CCH) ¶ 37,101.

- South Carolina. The South Carolina Securities Commissioner has taken the position that if the members do not manage an LLC, the LLC interests will be deemed to be securities. Blue Sky L. Rep. (CCH) ¶ 51,580.

c. Other Management-based Tests.

- North Carolina. The North Carolina Secretary of State enacted a rule that provides for LLC interests to be presumed to be securities if the LLC's articles of organization provide that all members are not necessarily managers, or in any event where the number of members (even if all of them are managers) is greater than 15. North Carolina regulators will consider evidence to rebut or support the presumption, including information regarding whether investors retain the right under the LLC's operating agreement

to exercise practical and actual control over managerial decisions, whether the number of members of the LLC is so great that the members' managerial powers are rendered insignificant and meaningless, whether the promoter has a particular or special skill necessary for the successful operation and management of the LLC, and whether other special circumstances render the member's managerial powers meaningless. N.C. Rule .1510, Blue Sky L. Rep. (CCH) ¶ 43,474.

- Connecticut. The Connecticut Department of Banking issued an interpretive release in 1995 that explains the extent to which LLC interests will be considered securities under Connecticut's blue sky statute. Blue Sky L. Rep. (CCH) ¶ 14,562. Under the release, an interest in a manager-managed LLC will be presumed to be a security, and an interest in a member-managed LLC will be analyzed under the Williamson test.

- Wisconsin. The Wisconsin securities act presumes a limited liability company interest to be a security if the LLC is manager-managed or if the aggregate number of members of the LLC exceeds 35. An LLC interest is not a security if the number of LLC members is 15 or fewer and the LLC is member-managed. If the LLC is member-managed, and the number of members is greater than 15 but does not exceed 35, the statute establishes no presumption. Wis. Stat. § 551.02(13)(b) and (c).

One odd aspect of the Wisconsin statute is that by its terms, the Wisconsin securities language applies only to Wisconsin LLCs.

d. Other Tests.

- Georgia. The Georgia LLC statute did not amend the Georgia blue sky provisions, but contained a separate provision stating that nothing in the LLC act would be construed as establishing that an LLC interest is not a security. Ga. Code Ann. § 14-11-1107(n). Presumably, this provision does nothing to change current law, and as indicated above, the 1994 state administrative proceeding that took place in Georgia involved the application of the Howey analysis.

- Michigan. The Michigan LLC statute provides that an interest in an LLC is "a security to the same extent as an interest in a corporation, partnership or limited partnership as a security." Mich. Comp. Laws § 450.5103. Of course, because corporate stock is a security per se, while general and limited partnership interests are securities only to the extent they constitute "investment contracts," the statutory definition, which does not distinguish between stock and partnership interests, is ambiguous.

The Michigan Corporations and Securities Bureau has issued an exemption order that makes clear that interests in certain professional LLCs will be exempt from the registration provisions of the Michigan blue sky statute. See Blue Sky L. Rep. (CCH) ¶ 32,630. This Michigan exemptive order only applies to the registration

provisions of the Michigan securities laws, and does not affect the applicability of the antifraud and other provisions of the Michigan securities laws.

The chart attached as Appendix 2 provides a list of states that have embraced some of the foregoing approaches. For a more detailed state-by-state analysis, see Blue Sky L. Rep. ¶ 6551, as well as the chart prepared by Dean Mark A. Sargent of the Villanova University School of Law, which can be located on the Internet at http://www.law.ab.umd.edu/marshall/bluesky/llc.htm.

C. Limited Liability Companies Under Regulation D.

The definition of "accredited investors" for the purposes of Rule 501(a)(3) under Regulation D includes corporations, business trusts and partnerships not formed for the specific purpose of acquiring the offered securities, if such entities have total assets in excess of $5 million. In a recent no-action letter, the SEC ruled that although not included within this portion of the definition of "accredited investor," an LLC would be an accredited investor under Rule 501(a)(3) if the other conditions of that Rule are satisfied. See Wolf, Block, Schorr and Solis-Cohen, Fed. Sec. L. Rep. (CCH) ¶ 77,336.

III. HART-SCOTT-RODINO ANTITRUST IMPROVEMENTS ACT.

The Hart-Scott-Rodino Antitrust Improvements Act (the "HSR Act"), which was adopted in 1976, imposes premerger notification requirements on certain parties before they consummate a transaction. Where the transaction involves the formation of a joint venture (defined by the rule as a "corporate" joint venture), special rules apply. See 16 C.F.R. § 801.40. For HSR Act purposes, the formation of a corporate joint venture may involve the acquisition of "voting securities" that trigger the HSR Act's premerger notification requirements, which will involve substantial disclosure obligations as well as a $45,000 filing fee.

A. Definition of Voting Securities.

"Voting securities" is the only relevant term defined in the HSR Act (all other definitional terms are set forth in the implementing regulations (the "Rules")). Under Section 7A(b)(3)(A) of the HSR Act, "voting securities" means any securities which at present or upon conversion entitle the owner or holder thereof to vote for the election of directors of the issuer or, with respect to unincorporated issuers, persons exercising similar functions.

B. Federal Trade Commission ("FTC") Position on Partnerships.

Under this broad definition, it is not difficult to conceive that a limited partnership (or even a general partnership for that matter) could be deemed an "unincorporated issuer" and that the interests in such a partnership, depending upon the partnership agreement,

could allow the partners to vote to replace the general partners or managers--individuals "exercising similar functions" to a board of directors. However, the FTC has consistently rejected such an interpretation and stated that neither the formation of a partnership (general or limited) nor an acquisition of a partnership interest[1] involves the acquisition of a "voting security."[2] The FTC has based its interpretation on the fact that no particular formalities are a prerequisite to the formation of a partnership--a written agreement is not required and a partnership can arise as a matter of law even without the intention of the participants to form a partnership.[3] See PREMERGER NOTIFICATION PRACTICE MANUAL at Interpretations 93 and 196.

C. FTC's Old Position on LLCs.

Until March 1, 1999, the FTC took a case-by-case approach to LLCs that had the effect of subjecting certain manager-managed LLCs to the pre-merger notification requirements of Rule 801.40. Essentially, the parties forming an LLC with a corporate-style board of directors were subject to the filing requirements of Rule 801.40 if the board included outside directors, unless the board functioned as the equivalent of a management committee, with day-to-day (*i.e.,* officer-like) responsibilities for the LLC's operations.

D. FTC's New Position on LLCs.

Effective March 1, 1999, the FTC's treatment of LLCs became subject to FTC Formal Interpretation 15. This interpretation was amended by the FTC on June 29, 1999, effective July 1, 1999. Two sets of rules apply, depending on whether the transaction is a formation transaction or involves the acquisition of membership interests in an LLC.

1. Formation Transactions.

The formation of an LLC will be reportable under the premerger notification requirements if

- two or more pre-existing, separately controlled businesses are being contributed to the LLC, and

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[1]Although the acquisition of a partnership interest is not an acquisition of voting security, an acquisition of stock in a corporate general partner is an acquisition of a voting security.

[2]An acquisition of 100% of a partnership is treated by the FTC as an asset acquisition and is potentially reportable if the HSR Act's provisions related to asset acquisitions are met.

[3]It could also be argued that the term "joint venture" in Rule 801.40 is modified by the statement "or other corporations," thus implying that the joint venture would have to be a corporation or corporate-type entity. 16 C.F.R. § 801.40.

- at least one of the members will have an interest entitling the member to 50% or more of the profits of the LLC or 50% or more of the assets of the LLC upon dissolution.

This standard apparently excludes from the pre-merger notification requirements the formation of a two-member LLC in which one of the two parties is merely providing cash, other financing or assets other than a "business." The examples that are part of the Formal Interpretation, for example, provide that management and administrative support services are not "businesses," and their contribution will not involve the contribution of a "business."

Note that the formation of an LLC with three or more parties will not be reportable if no member will have a 50% or greater interest.

2. <u>Acquisition of Membership Interests</u>.

Acquisitions of membership interests will only be reportable if

- the acquisition of a membership interest results in an "acquiring person" holding 100% of the membership interests of the LLC (this test would be applicable only if that acquiring person had not already filed a pre-merger notification), <u>or</u>

- if an acquiring person contributes a business to the LLC in exchange for the interest. In the case of a contribution of a new business, the contribution would then be treated in the same way as the formation of a new LLC, by applying the same 50% test described above.

Note that there is no reporting obligation when the ownership in an existing LLC shifts, except for the two circumstances described above.

A copy of amended Formal Interpretation 15 was published in the June 29, 1999 Federal Register. 64 Fed. Reg. 34,804.

IV. FEDERAL ELECTION LAWS.

Under federal election laws, corporations are prohibited from making any contributions or expenditures in connection with federal elections, but partnerships and other "persons" may make contributions. The Federal Election Commission's ("FEC") long-standing approach is to attribute partnership contributions proportionately to each contributing partner's contribution limit. However, a number of advisory opinions issued by the FEC had concluded that because a limited liability company is neither a partnership nor a corporation, it had the benefit of its own separate contribution limit for each candidate and election. This approach obviously created a loophole by allowing individuals to make virtually unlimited contributions by

funneling them through LLCs. For this reason, in July 1999, the FEC adopted a new ruling that follows the LLC's "check-the-box" status, so that LLCs electing corporate tax status will also be treated like corporations for the purposes of the prohibition on corporate campaign contributions. 64 Fed. Reg. 37397 (July 12, 1999).

V. SMALL BUSINESS INVESTMENT CORPORATIONS.

The Small Business Administration ("SBA") has also experienced difficulty categorizing limited liability companies. In February 1998, the SBA issued a rule and commentary indicating that it would permit LLCs to organize as Small Business Investment Corporations ("SBICs"). However, the SBA made clear that it will accept license applications from an LLC only if the LLC is organized under the Delaware LLC statute. See 63 Fed. Reg. 5859 (Feb. 5, 1998). This approach has no logical basis. Congress fixed another SBIC-related problem in February 1999, through H.R. 68, the Small Business Company Technical Corrections Act. One of the provisions of this statute modified the current income test that applies to SBIC financing in order to allow LLCs to be eligible for financing.

Appendix 1

Author's note: The examples in this appendix are drawn from offering documents used in a capital-raising venture that the author believes would be subject to federal and state securities laws. They are included here for illustration, and not as recommended forms.

Excerpts from LLC Offering Documents

From a marketing brochure:

THE LIMITED LIABILITY COMPANY

FACT SHEET

WHAT IS AN LLC?

An limited liability company (LLC) combines the best attributes of corporations and partnerships. Although there are many unique characteristics of an LLC the two most important aspect are:
1) It provides limited liability protection to its members. This means a member is not liable for the debts, obligations or liabilities of an LLC.
2) For federal income tax purposes, an LLC is treated as a partnership. The LLC files an information return with the Internal Revenue Service. All items of income and expense are passed on to the members based on their respective percentage interest in the LLC.

IN WHAT STATE IS THE LLC FORMED?

This LLC is formed in the State of ______. The ________ LLC Act was passed by the _______ legislature in _______. ________ is one of _____ states that has enacted such legislation. _______ other states have legislation pending allowing for the formation of LLCs. Although certain attributes of LLCs are common to all states, each state determines the specific guidelines under which an LLC will be organized. It is not certain that all states will approve the formation of an LLC in its present form.

AS A MEMBER, WHAT IS MY ROLE IN THE LLC?

Each participant in the LLC is called a member, which is similar to a shareholder. A member may be any person, individual, partnership, limited partnership, LLC, foreign LLC, trust, estate, corporation, custodian, trustee executor, administrator, nominee, or entity in a representative capacity.

WHAT ARE MY LIABILITIES?

This is one of the most significant features of the LLC. Like the shareholders of a corporation and the limited partners of a limited partnership, the members of the LLC enjoy the protection of limited liability. Members and managers are not liable for the debts, obligations or liabilities of the LLC included under a judgment, decree or order of a court. Unlike a general partnership, where partners have joint and several liability for debts, obligations and liabilities of the partnership, LLC members are free from all such liability.

HOW IS THE LLC FORMED?

The LLC is created by the filing of articles or organization with the state in which it is created. The articles of organization of the LLC are similar in form and content to the articles of incorporation of a corporation.

WILL I RECEIVE A CERTIFICATE OF OWNERSHIP?

Yes, each member will receive a Certificate of Membership reflecting the number of units the member has subscribed to.

WILL I BE ABLE TO VOTE ACCORDING TO THE NUMBER OF UNITS I OWN?

Yes. One vote for each membership unit owned.

IS THERE A LIMITATION ON THE NUMBER OF MEMBERS THE LLC MAY HAVE?

There is no limitation to the number of members in the LLC.

HOW DO I PURCHASE MY MEMBERSHIP UNITS?

EXPLANATION OF SIGNATURE PAGES and COMPANY FOLLOW-UP

Now that you are clear on the opportunity, comfortable with the project and ready to proceed, the following steps need to be taken.

Your _______ L.L.C. sales associate will assist you in completing the signature pages located in the back sleeve, and arrange to have them sent to the management office. After your check is received along with your signed paperwork, we will review them for content and accuracy. You will then be contacted by one of our compliance officers. In a recorded call, the officer will review the relevant terms of your contribution. This call is made to ensure that your sales associate has properly presented the information and that you fully understand the nature of your membership interest.

Upon successful completion of the compliance call, you will be confirmed as a member of ________ L.L.C. and you will then receive properly executed copies of all documents originally signed by you. Additionally, you also will receive a signed and sealed "Certificate of Membership" accurately describing the exact number of membership units you hold title to in the project.

Thereafter, once a month, you will receive a newsletter and status report which will track both the growth and development of your system.

During the term of ownership, members are encouraged to contact either their associate or our Customer Relations Department for any additional information or answers to future questions.

Procrastination...

"For the procrastinator there is not the right season, not the right time of day, simply a lost opportunity and the wonder of what might have been."

Action is what transforms opportunity into success, and it requires only one opportunity of this magnitude to generate a significant positive change in your financial future.

At this time, all of us at _________ L.L.C. would like to take this opportunity to be the first to welcome you aboard!!

From subscription documents:

SIGNATURE PAGE
__________-LLC, a Limited Liability Company
(A _______ Limited Liability Company)

The undersigned hereby declares as follows:

(a) By executing where indicated below, I have become a **Member** of __________-LLC ("The Company") a Limited Liability Company. The Company is formed according to the terms and conditions of the Regulations of the Company, to which this Signature Page shall be attached and become a part of;

(b) I understand that the Company is raising capital to acquire certain rights to (I) certain contracts for FCC license rights for the __________ SHFTV market, (II) broadcast equipment, (III) satellite reception equipment, (IV) leases for offices and warehouses, (V) programming and operation contracts and inventory of subscriber related equipment;

(c) I have read the Company Regulations in their entirety, and I understand the proposed use of proceeds, the indemnity provisions, and the risk factors set forth therein, its contents, and agree to be bound by all of its terms;

(d) My interest in the Company is evidenced by the number of Units allocated to me, as set forth below, and all profits, losses, votes and interest in Company assets are allocated to me in proportion to the number of Units allocated to me; and

(e) I understand that participation in Super High Frequency Television Systems and in this Membership is speculative and may involve some risk; and

(f) I understand that I am a Member, and as such (I) have an absolute right to vote on all matters concerning the Company, according to the terms and provisions of the Company Regulations, (II) may become involved in the day-to-day management of the Company and in decision-making in accordance with the terms of the Company Regulations.

I SPECIFICALLY ACKNOWLEDGE AND UNDERSTAND THAT I AM A MEMBER OF A LIMITED LIABILITY COMPANY. I UNDERSTAND MY INTEREST HEREIN IS NOT TO BE CONSIDERED A SECURITY, THIS INTEREST HAS NOT BEEN REGISTERED WITH THE SECURITIES AND EXCHANGE COMMISSION NOR ANY STATE SECURITIES DEPARTMENT AND I AM AFFORDED NO PROTECTION UNDER THE SECURITIES ACT OF 1933, OR ANY SIMILAR ACT RELATING TO THE OFFER AND SALE OF SECURITIES.

From an operating agreement's "Risk Factors" section:

WHILE _________-LLC ("COMPANY") DOES NOT CONSIDER THE MEMBERSHIP INTERESTS TO CONSTITUTE SECURITIES, MEMBERSHIP INTERESTS MAY SUBSEQUENTLY BE CONSTRUED AS SECURITIES. IF MEMBERSHIP INTERESTS ARE SUBSEQUENTLY CONSTRUED AS SECURITIES BY REGULATORY AGENCIES, THE COMPANY MAY BE SUBJECT TO CERTAIN PENALTIES RELATED TO THE SALE OF UNREGISTERED SECURITIES. THE COMPANY MAY ALSO BE SUBJECT TO CERTAIN REMEDIES AVAILABLE TO PURCHASERS OF UNREGISTERED SECURITIES AND MEMBERSHIP INTERESTS MAY BE REQUIRED TO BE HELD INDEFINITELY UNLESS THEY ARE SUBSEQUENTLY REGISTERED UNDER THE SECURITIES ACT OF 1933 ("ACT") OR AN EXEMPTION FROM SUCH REGISTRATION IS AVAILABLE. FURTHER, SHOULD MEMBERSHIP INTERESTS SUBSEQUENTLY BE CONSTRUED AS SECURITIES, THE MEMBERSHIP INTERESTS MAY THEN ONLY BE OFFERED IN CERTAIN STATES PURSUANT TO THE OFFERING AND SALE EXEMPTIONS WHICH, IN THE OPINION OF THE MEMBERS, APPLY TO THIS PRIVATE PLACEMENT. THE MEMBERSHIP INTERESTS ARE SUBJECT TO SIGNIFICANT RESTRICTIONS ON TRANSFER. THERE IS NO PUBLIC MARKET FOR THE MEMBERSHIP INTERESTS AND NONE IS LIKELY TO DEVELOP. WHETHER OR NOT THE MEMBERSHIP INTERESTS ARE CONSTRUED AS SECURITIES, THE COMPANY SHALL BE UNDER NO OBLIGATION TO REGISTER THE MEMBERSHIP INTERESTS UNDER THE ACT OR TO COMPLY WITH REGULATION "A" OR ANY OTHER EXEMPTION UNDER FEDERAL OR STATE SECURITIES LAWS.

Appendix 2
State Blue Sky Treatments of LLC Interests

Listed or Described as Security in Statute or Administrative Opinion	Listed as Security but with Management Proviso	Non-statutory Howey Analysis	Other management-based rule, statute or interpretive position
Alaska	California	Colorado	Connecticut
New Hampshire	Indiana	Georgia	Missouri
New Jersey	Iowa	Illinois	North Carolina
New Mexico	Nebraska	Kansas	South Carolina
Ohio	Pennsylvania	Louisiana	South Dakota
Vermont		Maryland	Wisconsin
		Mississippi	
		North Dakota	
		Oklahoma	
		Tennessee	
		Texas	
		Utah	
		Virginia	
		Washington	
		Wyoming	