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Milbank

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FEDERAL COURT RULES THAT LIMITED LIABILITY COMPANY INTERESTS MAY CONSTITUTE "SECURITIES"

Court Conducts Factual Analysis, Rather than Establishing a "Bright-Line Rule", in Determining that "Economic Realities" Prevail Over Organizational Documents

On June 11, 2008, the Second Circuit Court of Appeals, in affirming convictions for securities fraud and conspiracy to commit securities and mail fraud, ruled in *U.S. v. Leonard*[1] that interests in various limited liability companies ("LLCs") constituted "securities" for purposes of the federal securities laws. In so ruling, the Court cited the U.S. Supreme Court's "repeated instruction to prize substance over form in our evaluation of what constitutes a security." The *Leonard* analysis is instructive of the process that a court will follow in considering the status of non-traditional securities, such as LLC interests, under the federal securities laws.

The *Leonard* case arises from sales by defendants Paul Dickau and Nanci Silverstein of interests in LLCs formed to finance the production and distribution of movies. Interests in the LLCs were dubbed investment "units" and were priced at $10,000 each. Each sale of a unit generated a hefty commission of 42%-45% of the sale price; however, the offering memoranda used to market the LLC interests reflected a rate of no more than 20%. A federal jury returned guilty verdicts based on the misleading disclosures in the offering memoranda. The Second Circuit affirmed the convictions, focusing its review on the classification of the LLC interests as securities for purposes of the federal securities laws.

The federal securities laws define a security as, *inter alia*, "any note, stock, treasury stock, security future, bond, debenture . . . investment contract . . . or in general, any instrument commonly known as a 'security'."[2] If an interest falls within one of the enumerated categories, such as "stock", then the analysis is fairly simple and the interest is

[1] *U.S. v. Leonard*, 2008 WL 2357233 (2nd Cir., June 11, 2008).

[2] The definitions of "security" contained in the Securities Act of 1933 and the Securities Exchange Act of 1934 are virtually identical, and the U.S. Supreme Court has stated that the definitions "will be treated as such in our decisions dealing with the scope of the term." *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985).

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deemed a "security" under the federal securities laws.[3] On the other hand, if the interest does not fall within one of the enumerated categories, the court must analyze whether the interest constitutes an "investment contract." The U.S. Supreme Court defined an investment contract in the seminal case of *SEC v. W.J. Howey Co.* as "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party".[4] This formulation is commonly referred to as the "Howey Test." Because interests in LLCs are not among the specific types of instruments enumerated in the federal securities law definition of security, the *Leonard* Court analyzed the LLC interests under the Howey Test.

In applying the Howey Test, the Court indicated initially that the term "solely from the efforts of" should not be interpreted by its literal meaning, but rather by considering "whether, under all the circumstances, the scheme was being promoted primarily as an investment or as a means whereby participants could pool their own activities, their money and the promoter's contribution in a meaningful way." Thus, the distinction lies "between companies that seek the 'passive investor' and situations where there is a 'reasonable expectation . . . of significant investor control'."

Next, the Court explained that there can be no bright-line rule regarding the classification of LLC interests as securities because of the myriad variations LLCs may take.[5] Rather, an LLC interest is "the sort of instrument that requires 'case-by-case analysis' into the 'economic realities' of the underlying transaction." In examining the "economic realities" of the LLCs in *Leonard*, the Court gave little credit to the fact that, on their face, the LLCs' organizational documents purport to give LLC members a significant and active role in the management of the companies.[6] More persuasive to the Court were the numerous factors indicating that the investors actually played a very passive role in the management of the companies and exercised little or no control, including:

- The investors rarely voted on issues although the organizational documents gave them voting rights.
- Though the organizational documents allowed for the formation of a number of committees, only two were ever formed and they included only a handful of investors as members.
- The investors' managerial rights did not accrue until the LLCs were fully organized; so-called "interim managers" handled almost every significant issue concerning the making of the films such that the entire picture was essentially produced before the investors had any input.
- The investors did not negotiate any terms of the LLC agreement, which were presented to them on a "take-it-or-leave-it basis", and the fact "[t]hat they played no role in shaping the organizational agreements themselves raises doubts as to whether the members were expected to have significant control over the enterprise."
- The investors "had no particular experience in film or entertainment and therefore would have had difficulty exercising their formal right to take over management of the companies after they were fully organized."
- The large number and geographic dispersion of the investors left them "particularly dependent on centralized management".

Ultimately, the analysis of LLC interests as securities for purposes of the federal securities laws is fact-sensitive. As the *Leonard* Court summed up the issue: "What 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."[7] In *Leonard*, the Court found that the LLC interests did indeed constitute securities and affirm the conviction of the defendants for securities fraud.

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[3] In the words of the U.S. Supreme Court in *Landreth,* "There is no need … to look beyond the characteristics of the instrument to determine whether the [Securities] Acts apply."

[4] *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946)

[5] This is in contrast to general partnership interests. In the words of the Federal District Court in *Great Lakes Chemical Corp. v. Monsanto Co.*, 96 F. Supp. 2d 376 (D. Del. 2000), "As such, the grounds for creating a per se rule, or at least a presumption, that interests in general partnerships are not securities are lacking in the context of LLCs."

[6] According to the Court, "indeed, were we to confine ourselves to a review of the organizational documents, we would likely conclude that the interests … could not constitute securities because the documents would lead us to believe that members were expected to play an active role in the management of the companies."

[7] There are at least two cases in which LLC interests were found *not* to constitute securities due to the control over the enterprise retained by the members. *See Great Lakes Chemical Corp. v. Monsanto Co.,* 96 F. Supp. 2d 376 (D. Del. 2000); and *Keith v. Black Diamond Advisors, Inc.* 48 F. Supp. 2d 326 (S.D.N.Y. 1999).

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