UNDERSTANDING THE WORLD OF MINORITY RIGHTS AND FIDUCIARY OBLIGATIONS

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A. The Source and Nature of Fiduciary Obligations in LLCs

1. Resolving the Partnership/Corporation Conundrum

In limited liability companies, as in partnerships and corporations, management authority brings with it certain responsibilities that come under the rubric of fiduciary duty[2]. The LLC approach to these duties draws upon concepts of both partnership and corporation law[3].

Given that the LLC is a hybrid entity – i.e., a combination of the tax attributes of a partnership with the liability shield of a corporation – differences in treatment of fiduciary obligations in the partnership and corporation forms affect how the various LLC enabling statutes have addressed these duties.

2. The Nature of Fiduciary Duties

a. Duty of Care

i. Generally

The duty of care is expected of those who manage partnership and those who direct corporations. The same goes for those who manage or are members of an LLC. The duty is not to run the business with perfection, but to attend to the business, avoid neglect and exercise judgment.[4] There are essentially two components to the duty – standard of care and a context for determining the standard of care. The various standards adopted by state LLC statutes fall into five categories – ordinary care, gross negligence/willful misconduct, good-faith business

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[1] Much of these materials are derived from *Limited Liability Companies: Tax and Business Law*, authored by Carter G. Bishop and Daniel S. Kleinberger. I was fortunate to be a student of Professor Kleinberger's at William Mitchell College of Law many years ago, and this treatise (and its co-author) was then, and is now, an invaluable resource for me regarding all matters pertaining to limited liability companies.
[2] Carter G. Bishop and Daniel S. Kleinberger, *Limited Liability Companies: Tax and Business Law* § 10.01(1) (2008).
[3] *Id*.
[4] Stern, "Circumventing Lax Fiduciary Standards: The Possibility of Shareholder Multistate Class Actions for Directors' Breach of the Duty of Due Care," 72 Neb. L. Rev. 1, 10 (1993).

judgment, recklessness and the Delaware Statute, which requires a duty of care for managers who rely on information provided by others.[5]

1. Ordinary Care

Statutes that require the standard of ordinary care typically fall directly in line with the Revised Model Business Corporation Act (RMBCA). Minnesota's duty of care statute falls into this category and requires that managerial duties be performed "with the care an ordinarily prudent person in a like position would exercise under similar circumstances."[6]

These statutes also provide detailed rules on the right to rely on information provided by others.[7] Minnesota's reliance statue is typical and provides as follows:

> **Subd. 2. Reliance.**
>
> (a) A governor is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, in each case prepared or presented by:
>
> > (1) one or more managers or employees of the limited liability company whom the governor reasonably believes to be reliable and competent in the matters presented;
> >
> > (2) counsel, public accountants, or other persons as to matters that the governor reasonably believes are within the person's professional or expert competence; or
> >
> > (3) a committee of the board of governors upon which the governor does not serve, duly established in accordance with section 322B.66, as to matters within its designated authority, if the governor reasonably believes the committee to merit confidence.
>
> (b) Paragraph (a) does not apply to a governor who has knowledge concerning the matter in question that makes the reliance otherwise permitted by paragraph (a) unwarranted.[8]

These reliance provisions only apply when the person relying on the information has sought the information "in good faith for the benefit of the company."[9] Therefore, when a manager

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[5] Bishop and Kleinberger, *supra* n. 2 at § 10.02(1)(a).
[6] Minn. Stat. § 322B.663, subd. 1(1994).
[7] Bishop and Kleinberger, *supra* n. 2 at § 10.02(1)(a).
[8] Minn. Stat. § 322B.663, subd. 2 (1994).
[9] Bishop and Kleinberger, *supra* n. 2 at § 10.02(1)(a) (citing *Flippo v. CSC Assocs. III, LLC*, 547 S.E.2d 216, 222 (Va. 2001)).

sought legal advice to further his own estate-planning interests, his reliance did not protect him against a breach of fiduciary claim.[10]

2. Gross Negligence/Willful Misconduct

The gross negligence/willful misconduct statutes are succinct in providing that member with managerial responsibilities will not be liable for damages to the LLC solely by reason of an act or omission on behalf of the LLC “unless such act or omission constitutes gross negligence or willful misconduct.”[11]

These statutes present the image of immunity from liabilities but they do place affirmative duties on the managers and/or members.[12] The liability begins where the immunity ends and the liability is a reflection of the duty.[13]

3. Good-Faith Business Judgment

Only one state statute, Virginia, requires managers do perform their responsibilities, “in accordance with [their] good faith business judgment of the best interest of the limited liability company.”[14] The statute also permits mere “good faith” reliance on information provided by others, as long as the person relying has no “knowledge or information concerning the matter in question that makes reliance unwarranted.”[15]

Reliance requirements apply to the same categories of information used under the “ordinary care” standard previously presented.[16]

4. Recklessness

Indiana only imposes liability if the conduct reaches the level of recklessness.[17] Indiana’s statute states, “unless otherwise provided in a written operating agreement, a member or manager is not liable for damages to the limited liability company or to the members of the limited liability company for any action taken or failure to act on behalf of the limited liability company, unless the act or omission constitutes willful misconduct and recklessness.”[18]

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[10] Id.
[11] Id. at § 10.02(1)(b) (citing NM Stat. Ann. §53-19-16(B)(Michie Supp. 1993)).
[12] Id.
[13] Id.
[14] Id. at § 10.02(1)(c) (citing Va. Code Ann. § 13.1-1024.1(A) (Michie 1993)).
[15] Id. (citing Va. Code Ann. § 13.1-1024.1(B) (Michie 1993)).
[16] Id.
[17] Id. at § 10.02(1)(d).
[18] Id. (citing Ind. Code Ann. § 23-18-4-2(a) (1994).

This standard, however, is not the statute's only statement on the duty of care; a more rigorous standard for reliance on information provided by outsiders exists within the same section:

> A member or manager of a limited liability company is not liable when relying in good faith upon the records of the limited liability company and on the information, opinions, reports or statements presented to the limited liability company by its other managers, members, agents or employees, or by any other person, concerning matters the member or manager *reasonably believes* are within the other person's professional or expert competence and who has been *selected with reasonable care* by or on behalf of the limited liability company.[19]

5. Delaware LLC Statute

The Delaware statute provides no real duty of care, but does provide a standard for judging reliance on information:

> A member or manager of a limited liability company shall be fully protected in relying in good faith upon the records of the limited liability company and upon such information, opinions, reports, or statements presented to be the limited liability company by any of tis other managers, members, officers, employee or committees of the limited liability company, or by any other person as to matters the member or manager reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the limited liability company.[20]

Embedded in this statute is some duty of care. If information comes from outside the LLC, the source must have been selected with reasonable care and the relying member must reasonably believe the source's professional competence embraces the information at issue.[21] But, care is limited to the "reliance" aspect.

Despite this limitation, Delaware's law probably does impose a general standard of care.[22] The reliance provision comes directly from the Delaware corporate statute, and that statute omits any general duty of care.[23] However, the Delaware Supreme Court has emphatically state that a standard of gross negligence applies to directors of Delaware

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[19] Id. (citing Ind. Code Ann. § 23-18-4-10 (1994).
[20] Id. at § 10.02(1)(e) (citing Del. Code Ann. Tit. 6, § 18-406 (1993)).
[21] Id.
[22] Id.
[23] Id.

corporations.[24] Due to the similarities between LLCs and corporations, that court would likely also impose the same general standard on those who manage Delaware LLCs.

The Delaware Supreme Court has also clarified the meaning of "good faith" in the corporate reliance statute, and that clarification doubtlessly applies to the LLC version as well.[25] The requirement is for "good faith, not blind, reliance."[26]

To summarize, for those who manage Delaware LLCs:

- The standard for relying on information from within the LLC is "good faith, not blind reliance";
- The standard for relying on information from outside the LLC involves a duty of reasonable care; and
- The standard of care for other conduct is gross negligence.

6. Implied Standards of Care

There are nine enabling statutes which provide no express provision on the duty of care.[27] All of the silent statutes contain provisions empowering LLCs to indemnify those who manage the company.[28] Almost all of those provisions exclude indemnification for specified forms of adjudicated misconduct, and some provide standards of conduct that must be met by any person seeking indemnification; both types of provisions can imply a managerial duty of care.[29]

One such provision, in Wyoming, prohibits anyone who has been adjudged "liable to the company for negligence or misconduct in the performance of duty" from being indemnified by the LLC.[30] This statute, therefore, presents that a person will be held liable to the LLC for negligence and is essentially a duty to avoid negligence conduct, a duty of care.[31]

Similarly, Nevada developed a statute that permits indemnification only if the person seeking such "acted in good faith and in a manner in which he *reasonably* believed to be in or

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[24] Id. (citing *Smith v. Van Gorkum*, 488 A.2d 858, 873 (1985)).
[25] Id.
[26] Id. (citing *Smith v. Van Gorkum*, 488 A.2d. 858, 873 (1985)).
[27] Id. at § 10.02(2)(a) (Those states include Alabama, Arizona, Illinois, Kansas, Maryland, Nevada, South Dakota, Utah and Wyoming.).
[28] Id. at § 10.02(2)(b)(i).
[29] Id.
[30] Id. (citing Wyo. Stat. § 17-15-104(a)(xi) (1989)).
[31] Id.

not opposed to the best interests of the company."[32] There is a certain minimum amount of care established in Nevada's LLC statutes.

If there are gaps in enabling statutes, courts should look for analogies from the law of partnerships and corporations.[33] For example, if the LLC is member-managed, the courts should use the standard of care referenced in general partnership law. General partnerships and a member-managed LLC have essentially the same management structure, so the attendant duty of care should be the same as well.[34] Courts should apply the duty from the organization whose centralized duty management structure most closely parallels the management structure of the LLC at issue.[35]

b. Duty of Loyalty

i. Generally

The duty of loyalty places an expectation on managers of a duty of selflessness or a duty to yield to the interests of the organization.[36] With informed consent, or if the conducted can be established as "fair to the organization", a manager may profit from their role in the business, otherwise the manager must eschew all financial benefits, opportunities and other advantages connected with the business.[37]

This duty is strongly enforced when a manager does business with its own organization and takes advantage of a business opportunity that may have been useful to the organization.[38] This creates two general categories within the duty of loyalty – conflicts of interest, or self-dealing, and usurpation of business opportunity, which then are approached with four general enabling statute standards – partnership, "same rights", corporate and good faith or reasonable belief.

ii. Conflicts of Interest

Conflicts of interest or self-dealing arise when a manager does business with its own organization. This includes not only transactions between the organization and the manger but also transactions between the organization and some other person or enterprise in which the

[32] Id. (citing Nev. Rev. Stat. § 86-421 (1983)).
[33] Id. at § 10.02(2)(c).
[34] Id. at § 10.02(2)(c)(i).
[35] Id.
[36] Id. at §10.01(1)(b)(citing *Pepper v. Litton*, 308 U.S. 295, 311 (1939)).
[37] Id.
[38] Id.

manager has a financial interest.[39] Typically, if a manager has completed a transaction and profited from it, the manager must show he had the required consent or disgorge all profits.[40] A defense of that it was fair to the LLC, that the profit was reasonably taken or that the price was "below market" is insufficient.[41]

iii. Usurpation of Business Opportunity

Usurpation involves not only direct competition with the organization by a manager, but also indirect conflicts, such as ventures into which the organization might reasonably be expected to expand and preemptive acquisition of key raw materials.[42] Essentially, any opportunity that directly competes with the LLC will be considered usurpation, as well as any opportunity that exploits information belonging to the LLC.[43]

There are two basic approaches to determine a corporate opportunity – the "expectancy" test and the "line of business" test. The "expectancy" test, the narrowest concept, deems a corporate opportunity to exist only when the corporation already has some "legal or equitable beachhead."[44] The "line of business" test is broader and uses a list of factors to determine whether "an opportunity . . . [embraces] an activity . . . which, logically and naturally is adaptable to [the corporation's] business . . . and is . . . consonant with its reasonable needs and aspirations for expansion."[45]

iv. Statutory Standards

1. Partnership Approach

Partnership law provides a strict rule for self-dealing and usurpation: "Every partner must account to the partnership for any benefit, and hold as trustee for it any profits derived y him without the consent of the other partners from any transaction connected with the formation, conduct or liquidation of the partnership or from any use by him of its property."[46]

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[39] Id.
[40] Id. at § 10.03(1)(a)(v) (citations omitted).
[41] Id.
[42] Id.
[43] Id. at § 10.03(1)(a)(vi).
[44] Id.
[45] Id. (citing *Guth v. Loft, Inc.*, 5 A.2d 503, 514 (Del. 1939)).
[46] Id. (citing (UPA § 21(1) (1914) (allows parties to change the rule if they all consent); RULPA § 403(a) (1993) (empowers a limited partnership to vary the rule)).

2. "Same Rights" Approach

Some states have "same rights" statutes that may be read to permit self-dealing. For example Delaware's statute reads:

> Except as provided in a limited liability company agreement, a member or manager may lend money to, borrow money from, act as a surety, guarantor or endorser for, guarantee or assume on one more obligations of, provide collateral for, and transact other business with, a limited liability company and, subject to other applicable law, has the same rights and obligations with respect to any such matter as a person who is not a member or manager.[47]

These provisions are merely default rules that can be overcome or negated by an agreement between the parties.[48] More so, though the plain language of these statutes can be read to legitimize self-dealing, they have nothing to do with claims a partner may raise against fellow partners.[49] "Same rights" statutes are triggered by the rights of creditors to challenge transactions between the partnership and a partner.

Some "same rights" statutes do, however, address the duty of loyalty. For example, Indiana's enabling statute contains an "account for" requirement,[50] and Colorado contains a set of "corporate-like" managerial duties.[51]

3. Corporate Approach

The corporate approach, though more lenient than partnership law, has different sets of rules for self-dealing and usurpation of corporate opportunity. The corporate approach provides rules for determining whether an opportunity corporate and prohibits directors or officers from taking corporate opportunities without the informed consent of the disinterested directors or shareholders.[52] If a director is found to have usurped a business opportunity, it must disgorge all profits or form a constructive trust to transfer the rewards of the opportunity.[53]

There are just four enabling statutes, including Minnesota, that adopt the corporate approach to the duty of loyalty. These statutes require: (1) those with managerial authority to act with good faith and in a manner they reasonably believe to be in the best interests of the LLC,

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[47] Id. at § 10.03(1)(b)(i) (citing Del. Code Ann. tit. 6, § 18-107 (1993)).
[48] Id.
[49] Id. at § 10.03(1)(b)(ii) (citing RULPA § 107, Official Comment).
[50] Id at § 10.03(1)(b)(iii)(citing Ind. Code Ann. § 23-18-4-(2)(b) (1994)).
[51] Id. (citing Colo. Rev. Stat. Ann. § 7-80-406 (West Supp. 1993)).
[52] Id.
[53] Id. (citing *Morad v. Coupounas*, 361 So.2d 6, 10 (Ala. 1978) aff'd, 380 So.2d 800 (Ala. 1980); *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939)

and (2) provide three safe harbors from self-dealing challenges.[54] For member approval, the Minnesota statute requires either a two-thirds vote of the voting power of disinterested members or unanimous approval by all membership interests.[55]

The three defenses to usurpation and conflicts of interest under the corporate approach include: (1) the disinterested directors gave informed consent (either before or after the fact); (2) the disinterested shareholders gave informed consent (either before or after the fact); or (3) the transaction was fair to the corporation.[56]

4. Good Faith/Reasonable Belief

Some of the state enabling statutes adopt the RMBCA and apply it to managerial duties in general but do not address self-dealing in particular.[57] These statutes require all who are fitted with managerial duties to act in good faith and with reasonable belief that their actions serve the LLC's best interests.[58] Courts often have to fill gaps with these provisions, and should do so as if they are filling statutory gaps.[59]

c. Pre-Formation Duties

Prior to forming the LLC, "members-to-be" may owe each other fiduciary duties. For example, fiduciary duties may be owed and an obligation of good faith and fair dealing may arise if an LLC is being formed through a merger with or conversion from a partnership.[60] Even if there were no pre-existing relationships, a court may view the pre-formation relationship as a joint venture and hold the co-venturers to account for any breaches in fiduciary duty.[61]

Limitations exist regarding pre-formation duties. Typically, to trigger such a duty, a pre-existing relationship needs to be proven. Also, just because the venturers had a pre-existing relationship does not mean they intend to or are guaranteeing participation in the LLC.[62]

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[54] Id. at § 10.03(1)(c)(ii)(citing Minn. Stat. Ann. § 322B.663 (West Supp. 1994)).
[55] Id. (citing Minn. Stat. § 322B.666, subd. 1(2) (West Supp. 1994)).
[56] Id. (citing RMBCA §§ 8.60-8.63 (1991)).
[57] Id at § 10.03(1)(d) (States include Colorado, Florida, Louisiana, Michigan, Oklahoma and Rhode Island).
[58] Id.
[59] Id.
[60] Id. at § 10.01(3).
[61] Id.
[62] Id.

d. The Business Judgment Rule

The business judgment rule is intended to impede a plaintiff who attacks the performance of business managers. It was developed because of the realization that business decision-making is not an exact science and that a regime of strict liability would deter innovation, risk-taking and competent individuals from doing their jobs.[63] At the heart of the rule and its presumption in favor of managers is the requirement that plaintiffs prove the elements of their case before attacking managerial performance.[64] The burden, therefore, is placed on the plaintiff to show that the manager did not put forth the requisite effort necessary since results of the manager's actions do not matter.[65]

The stringency of this rule depends on the jurisdiction. The stronger versions immunize managers almost completely from liability unless the plaintiff can show dishonesty, disloyalty, a total failure to exercise judgment or judgment so bad that it amounts to waste. This results in an elimination of the duty of care and presumes managers have acted properly.[66] Milder versions add something resembling a duty of care and some set the standard to require the plaintiff to show gross negligence by the manager.[67]

LLCs can ensure application of the business judgment rule by providing for the rule in the operating agreement.[68] But, just because the rule is included, does not mean that claims of disloyalty and self-interested behavior are barred.[69]

3. The Issue of Standing – Case Law Analysis

a. Direct vs. Derivative Claims

Many enabling statutes provide for derivative suits, which provide the idea that least some breach of duty liability claim belongs to the LLC rather than to the members. This is where the LLC's similarity to the corporation becomes clear. Since the corporation is a legal entity distinct and separate from its members, the corporation and not its shareholders have standing in breach-of-duty claims.[70] The LLC follows the same standing pattern – LLC has standing but not the members.

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[63] Id. at § 10.05(1).
[64] Id.
[65] Id.
[66] Id.
[67] Id.
[68] Id at § 10.05(2).
[69] Id.
[70] Id. at § 10.01(2)(b)(i).

b. Case Law Summary

Case law follows the general rule that the LLC not its members have standing to file claims. In a Fourth Circuit case, members attempted to claim half of the proceeds from a patent infringement litigation, but the court held that the proceeds belongs to the LLC, not its members, so the members lacked standing.[71] In bankruptcy proceedings, a member purported to have claims, but the court in *In re Real Marketing Services, LLC*, concluded that "the damage [the member] suffered derives from [the LLC's] damages and [the member] thus has no cause of action independent of [the LLC's] claim."[72]

However, if there is a breach of the LLC's operation agreement, then the member injured by the breach may have a direct claim.[73] In *Lynch Multimedia Corp. v. Carson Communications*, this differentiation became apparent.[74] The operating agreement called for members to present any opportunity within a specific area to the Company first, but any ventures taken by an individual member, as long as the members consented to it, would not be deemed wrongful or improper. The plaintiff member claimed a business opportunity was wrongfully usurped and alleged breach of the operating agreement. The defendants did not question the plaintiff's standing and the court relied on its interpretation of the operating agreement to grant the defendant's summary judgment.[75]

B. Identifying and Protecting the Rights of Minority Interest Holders

a. The Origin of Minority Protective Provisions in the Close Corporation Context

Minority owner oppression is commonly viewed by courts as a problem that arises in the close corporation setting[76]. In the close corporation setting, four primary factors form the seeds of the oppression problem – the lack of exit rights, the norm of majority rule, the deference of the business judgment rule, and the absence of advance planning[77]. Thus, the issue of whether the need for minority owner protections arises in the LLC context turns on the existence of these factors within the LLC structure.

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[71] Id. (citing *General Technology Applications, Inc. v. Exro Ltd.*, 388 F.3d 114, 118-119 (4th Cir. 2004)).
[72] *In re Real Mktg, Servs., LLC v. Protocol Communications, Inc. et al.,* 309 BR 783, 789 (SD Cal. 2004).
[73] *Worms v. WGB Partners, LLC*, 1996 WL 571464 (Conn. Super. Ct. 1996).
[74] *Lynch v. Multimedia Corp. v. Carson Communications, LLC*, 102 F.Supp.2d 1261 (D. Kan. 2000).
[75] Id. at 1263-65.
[76] Douglas K. Moll, *Minority Oppression & The Limited Liability Company: Learning (Or Not) From Close Corporation History*, 40 Wake Forest L. Rev. 883, 895
[77] *Id*., at 916.

Key in this discussion is the LLC's operating agreement. Most state LLC enabling statutes provide for various "default" provisions which can be opted out of within the LLC's operating agreement. This freedom of contract is at the core of the LLC's structure.

b. Protecting Minority Members in LLCs

Minnesota's LLC statute, like its corporation statute, provides for certain "dissenters rights" designed to protect minority members[78]. While these provide a great deal of protection for minority members, other provisions can be included, if desired, within the LLC's operating agreement or member control agreement.

C. Restrictions on Fiduciary Obligations

a. Who Owes the Duties

Most enabling statutes permit member or manager managed LLCs. Duty provisions in these statutes are structured to apply fiduciary duties to both members and managers, or to those with management authority.[79] One such statute provides that members and managers are not liable for their actions or inactions unless it amounts to gross negligence or willful misconduct.[80] Other statutes specifically provide that either members or managers are subject to all duties and liabilities, depending on their managerial status.[81] In other words, in the event of member-management, members are subject to all the same duties as managers.

In a manager-managed LLC, members may still have decision-making authority. However, most statutes still protect the non-manager members from liabilities arising from fiduciary duties.[82] Regarding the duty of care, if members are not managers, they should not face liability though there is an implied duty of care that exists between the members and to the LLC if the member acts as an agent.[83] Duty of loyalty and self-dealing pose no real problems with non-managing members of a manager-managed LLC because they have no say in the LLC's

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[78] CITE
[79] Bishop & Kleinberger, *supra.* n. 2, at § 10.01(2)(c)(i).
[80] Ark. Code Ann. § 4-32-402(a) (Michie Supp. 1993); *See also* Mont. Code Ann. § 35-8-402(2) (1993); NM Stat. Ann. § 53-19-16(D) (Michie Supp. 1993).
[81] Okla. Stat. Ann. tit. 18, § 2016 (West Supp. 1994).
[82] Mont. Code Ann. § 35-8-402(3) (1993); Ark. Code Ann. § 4-32-402(c) (Michie Supp. 1993); Ga. Code Ann. § 14-11-305(1) (Michie Supp. 1993); Idaho Code § 53-622(3) (Supp. 1993); La. Rev. Stat. Ann. § 12:1314 (West Supp. 1994).
[83] Bishop & Kleinberger, *supra* n. 2 at § 10.01(2)(c)(ii).

decisions, and, assuming a conflict exists, the managers consent to it when they cause the LLC to enter into the transaction.[84]

b. Changing Fiduciary Obligations by Agreement

Some enabling statutes allow fiduciary obligations to be changed in the operating agreement, but are otherwise default rules.[85] Under all such statutes, if the scope and stringency of the fiduciary obligations are increased, it is deemed a contractual obligation.[86] Most operating agreements that modify the fiduciary obligations will do so to the duty of loyalty in order to permit members to engage in activities that might otherwise constitute usurpation of an LLC business opportunity.[87]

However, Delaware's corporate statute and permits corporations to eliminate or limit the liability of directors for breach of duty. Most LLC statutes permit the same including Delaware's which is the most aggressive in allowing expansion, limitation or elimination of fiduciary obligations.[88] Minnesota does not go as far in that it does not permit elimination or limitation on liability for a breach of duty of loyalty, acts or omissions not in good faith or those that involve intentional misconduct or knowing violation of the law, any transaction where the governor derived an improper personal benefit, nor any act or omission that occurred before the articles of organization eliminating such became effective.[89]

D. Securities Law Considerations

a. Introduction

The major federal securities laws use the term "security" to define their reach[90]. Whether the securities laws will apply to a particular instrument, interest, investment, or other arrangement depends on whether the arrangement meets the statutory definition of "security."[91] Thus, if an LLC membership interest is a "security" under federal law, then all who sell,

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[84] Id. (citing *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971); RULPA § 303(b)(1); UPA § 21). Members need to disclose to managers their interest in the transaction to ensure that consent is informed and the conflict is disclosed.
[85] Bishop & Kleinberger, *supra* n. 2 at § 10.06(1)(a).
[86] Id. (see Del. Code Ann. tit. 6, § 18-1101(c) (1993).
[87] Id. at § 10.06(2)(a).
[88] Id. (Citing Del. Code Ann. tit. 6, § 18-1101(c).
[89] Minn. Stat. § 322B.663, subd. 4.
[90] Bishop & Kleinberger, *supra* n. 2 at § 11.01
[91] Id.

purchase, or promote membership interests must comply with a regulatory system of daunting complexity.[92]

Unfortunately, this question has no simple, categorized answer. The problem inheres in the law's approach to defining "security."[93] Rather than providing a comprehensive, functional definition for the term, each of the two main federal statutes relating to securities, the Securities Act of 1933 (1933 Act) and the Securities and Exchange Act of 1934 (1934 Act), presents a laundry list of instruments, investment vehicles, and other arrangements that qualify as securities.[94] Of course, neither list includes "limited liability company interest" or "membership in a limited liability company," since the 1933 and 1934 Acts predate the first LLC enabling statute by more than forty years.[95]

Absence from the lists, however, does not mean that an LLC interest is not a security.[96] To the contrary, federal securities law has a penchant for "catching" unusual arrangements and has developed extensive case law on the subject. Although this case law has some "black and white" aspects, for reasons discussed below it permits no categorical judgments about LLC membership interests.[97] Each membership interest will require an individual assessment made under general principles drawn from the case law.[98]

b. Investment Contract Concept

Both the Securities Act of 1933 and the Securities and Exchange Act of 1934 use essentially the same list to define "security"; [99] to come within any rubric on the list is to be a security for the purposes of federal securities law.

For arrangements not obviously on the list, both statutes employ the same catch-all category: the investment contract.[100] For this concept, the seminal case is *Securities & Exchange Commission v. W.J. Howey Co.*,[101] decided by the U.S. Supreme Court in 1946. The case involved the sale of strips of cultivatable land in orange groves. Each strip was a formally separate piece of property, and each owner was legally free to cultivate the strip and to market

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[92] Id.
[93] Id.
[94] Id.
[95] Id.
[96] Id.
[97] Id.
[98] Id.
[99] Id. at § 11.02[1]
[100] Id.
[101] Id., citing *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

the produce as it saw fit. The promoters of the venture offered cultivation and marketing services, but the buyers were not required to use the services. As a practical matter, however, joint cultivation and marketing was the only economically feasible approach, since each strip was too small to support an independent venture, and each owner's strips were interspersed with the strips of other owners.[102]

To deem this arrangement a security, the Supreme Court chose and elaborated on the notion of an investment contract. According to the three-factor *Howey* test, a person enters into an investment contract when the person (1) makes an investment (2) in a common enterprise, (3) with the expectation of profit solely from the efforts of others.[103]

Each of the three factors has been subject to further elaboration. Most significantly for the purposes of limited liability companies, cases since *Howey* have removed “solely” from the third factor and substituted “primarily” or “principally.” The third factor functions to separate essentially passive investors from essentially active investors. [104]

The Supreme Court intended the *Howey* test to be flexible, and the test has succeeded in securitizing a wide spectrum of arrangements, from oil and gas leaseholds to general partnerships to pyramid schemes. It doubtlessly applies to LLCs as well. [105]

c. The *Williamson* Approach

The most important general partnership case is *Williamson v. Tucker*,[106] which involved a venture that owned undeveloped real estate. Disappointed investors brought securities claims, and the trial court dismissed, holding that the investors' interests did not constitute securities. The Fifth Circuit en banc reversed, applying *Howey*.[107]

Two of the three *Howey* factors were indisputably present: Each plaintiff had paid for its interest, thereby making an investment, and the venture pooled the resources of many investors, thereby creating a common enterprise. The case therefore focused on the third *Howey* factor—whether the investors expected profit solely from the efforts of others.[108]

Williamson's approach to the third factor contains six major points:

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[102] Id., *citing Howey*, at 294-297.
[103] Id., *citing Howey*, at 299.
[104] Id.
[105] Id.
[106] Id. at § 11.02[3], *citing Williamson v. Tucker*, 645 F.2d 404 (5th Cir. 1981), cert. denied, 454 U.S. 897 (1981).
[107] Id., *citing Tucker*, at 418.
[108] Id., *citing Tucker*, at 418.

1. Plaintiff investors need not show that they expected profits "solely" from the efforts of others; they need only show that they expected others to undertake "those essential managerial efforts which affect the failure or success of the enterprise."[109] The court began its analysis by rejecting the constraints of the word "solely." Echoing and following other courts, the court stated that "'solely'…should not be interpreted in the most literal sense."[110] A literal interpretation would facilitate evasion of the securities laws, and "the Supreme Court has altogether omitted the word 'solely' in its most recent formulation of the investment contract definition."[111] In place of literalism, the decision quoted language from a Ninth Circuit decision and thereby embraced "a more realistic test, 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."[112]

2. In determining investors' expectations, the key question is how the enterprise allocates managerial power. To satisfy *Howey* 's expectation factor, the investors' expectations must be reasonable.[113] If the investors retain "significant" managerial powers, "the investments could not have been premised on a reasonable expectation of profits to be derived from the management efforts of others."[114]

3. Determining the allocation of managerial power requires looking beyond the statutory default rules and considering the partnership agreement. In the archetypical general partnership, with power allocated according to the default rules of the UPA, the partners' interests will not be securities. However, if the partnership agreement fundamentally changes that allocation and deprives a general partner of a meaningful managerial role, then that partner's "partnership powers may be inadequate to protect him [*sic*] from the dependence on others which is implicit in an investment contract."[115] Thus, for example, a general partnership in which some agreement among the partners places the controlling power in the hands of certain managing partners may be an investment contract with

[109] Id.
[110] Id.
[111] Id.
[112] Id.
[113] Id.
[114] Id.
[115] Id.

respect to the other partners. In such a case, the agreement allocates partnership power as in a limited partnership, which has long been held to be an investment contract.[116]

4. Determining the allocation of managerial power also requires looking beyond the partnership agreement and considering whether the investors are incapable of exercising the management power they formally possess. If the investors are "incapable of exercising" allocated powers, then the investors "may be led to expect profits to be derived from the efforts of others in spite of partnership powers nominally retained."[117] The incapacity can derive from either or both of two sources. The investors may lack "the business experience and expertise necessary to intelligently exercise partnership powers."[118] The investors may be "forced to rely on some particular non-replaceable expertise on the part of a promoter or manager."[119] However, the fact that an investor lacks expertise in a business' technology does not render the incapable of exercising management power. "Business ventures often find their genesis in the different contributions of diverse individuals—for instance…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."[120]

5. The key management power is the power of "ultimate control." Investors can delegate total day-to-day authority and still not satisfy *Howey*'s third factor, provided that the delegation is revocable, both formally and practically. As long as the investors may take back control, they cannot have *Howey*-like expectations:

The delegation of rights and duties—standing alone—does not give rise to the sort of dependence on others that underlies the third prong of the *Howey* test. An investor who retains control over his investment has not purchased an interest in a common venture "premised on the reasonable expectation of profits to be derived from the entrepreneurial

[116] Id
[117] Id.
[118] Id.
[119] Id.
[120] Id.

or managerial efforts of others," even if he has contracted…for the management of the property.[121]

Thus, for example, if all operational decisions rest with the managers but the investors can fire the managers, then the investors have retained ultimate control and their reasonable expectations cannot satisfy the third prong of the *Howey* test.[122] If, in contrast, the partnership agreement makes the delegation irrevocable, then the investors can satisfy the third prong. They have given up ultimate control. Delegation can be irrevocable in substance even though revocable in form. The more numerous the investors, the more diffuse will be their power. At some point, there will be so many investors that they will be unlikely to take the collective action necessary to exercise the control they share:

[O]ne would not expect partnership interests sold to large numbers of the general public to provide any real partnership control; at some point there would be so many partners that a partnership vote would be more like a corporate vote, each partner's role having been diluted to the level of a single shareholder in a corporation. Such an arrangement might well constitute an investment contract.[123]

6. Whether investors actually choose to exercise their management power is not significant; what matters is the existence of the power. Under *Williamson* , the allocation of power is a surrogate for the up-front expectations of the investors.[124] If an enterprise's management structure allows significant participation by the investors, then the investors cannot reasonably expect "others" to do all the significant managerial work. Whether the investors actually exercise their rights is not probative of their reasonable expectations as they make their investment decision. "[L]atent investor control" is sufficient to negate the third *Howey* factor: "[T]he actual control exercised by the purchaser [of the investment] is irrelevant. So long as the investor has the right to control the asset he has purchased, he is not dependent on the promoter or a third party for 'those essential managerial efforts which affect the failure or success of the enterprise.'"[125]

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[121] Id.
[122] Id.
[123] Id.
[124] Id.
[125] Id.

In sum, under *Williamson*, if the partnership agreement leaves the partners in ultimate control over the business, and the partners have the practical ability to exercise that control (i.e., they are not disabled by their own inexperience or the manager's irreplaceable expertise or by the large number of partners), then, as of the original decision to invest, the partners cannot reasonably expect others to perform all the essential managerial functions[126]. As a result, the partnership interest is not an investment contract and therefore not a security. Since *Howey*'s third prong concerns expectations, the analysis holds even if the retained control consists merely of the right to fire the managers and even if the retained control is never, in fact, exercised[127].

[126] Id.
[127] Id.