LLCs and Securities Law – A Word to the Wise

Business people are often puzzled that securities laws might apply to their funding efforts. They often believe that, because they are not selling "stock" or advertising beyond word of mouth (or word of email), or are selling only to 5 or 6 people, their funding efforts are somehow under the radar of the "Wall Street" laws and regulations. Not so. This article alerts you that securities law is unclear, but expansive, in scope and effect, even to the "small business". A director, officer, "finder", promoter, or professional advisor to a company, might well be personally, even criminally, liable in ways he'd never imagined possible.

As with explaining football, anything I write here will have some exceptions but you need to understand the overall game. This is *not* the Wild-West world of raw business negotiation or caveat emptor. The promoting side owes fiduciary duties to the investing side. Under federal law, although investors bear the entire risk of *business* failure, they ought not bear the risk of *fraud* in connection with the offer and sale of securities. "Fraud" can mean any merely reckless statement or omission, however innocent.

For example, under SEC Rule 10b-5, it is unlawful in connection with the purchase or sale of any "security" to make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made not misleading. Failure to comply with these "anti-fraud provisions", or failure to register a security when required, can mean that all the investors can force a return of their money and/or have legal rights against various participants to recover damages. Any business, no matter how large or small, needs to assess and control that risk.

OK, but what is a "security"? Federal law attempts to differentiate a "security" from other types of business contracts. Certainly, shares of stock are "securities"; the Securities Act says so. For non-corporate interests, courts have focused on the statute's having specified as securities "investment contracts". Courts define "investment contract" generally as a transaction in which a person contributes money in a common enterprise with the expectation of profits *solely from the efforts of others*. A partner in a general partnership usually has an effective right to participate in management and so is not relying on others and does not own a "security". A limited partner in a limited partnership usually has no right to participate in day to day management and so does own a "security", according to SEC Rule 405 and most courts. LLCs are a hybrid entity because members have limited liability, as in corporations, yet can be treated as partnerships for tax purposes. Another complicating attribute is that LLCs can variably structure the rights of members to participate in management – from "all" to "nothing".

So, having an expert draft or examine the LLC operating agreement, and examine the factors influencing control, and examine the applicable state law, will help you better determine whether you are selling a security that must be registered with the SEC, or find a registration exemption. Even with an exemption, the "anti-fraud" rules I mentioned above apply. State laws must always be examined; securities offerings can be by the state of residence of the offerees (yes, all of them), and/or by the state of formation or even principal office.

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