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SEC v. Merchant: "Substance Over Form" Analysis Finds Interests in RLLP are "Investment Contracts" Under Federal Securities Laws

On April 4, 2007, in its decision in *SEC* v. *Merchant Capital, LLC,* ("*Merchant"*), the United States Court of Appeals for the Eleventh Circuit[1] held that partnership interests in a registered limited liability partnership ("RLLP") were "investment contracts" within the definition of "securities" under the Securities Act of 1933, as amended (the "Securities Act"), and the Securities Exchange Act of 1934, as amended (the "Exchange Act"),[2] and therefore covered by the Federal securities laws. *Merchant* reaffirms the applicability of the landmark *SEC* v. *Howey* and its case-by-case, "substance over form" approach to determining whether interests in entities organized as RLLPs, limited liability companies ("LLCs") or limited liability partnerships ("LLPs") may come within the regulatory scope of the federal securities laws. While in *Merchant* the Eleventh Circuit did not establish a *per se* rule with respect to the treatment of interests in RLLPs, LLCs, and LLPs, the opinion makes clear that form alone will not suffice to support an argument that an investment is not a security. In light of the variability of new business formations, addressing the inquiry otherwise, as the *Merchant* court stated, "would be an invitation to artful manipulation of business forms to avoid investment contract status."[3]

I. FACTS AND PROCEDURAL HISTORY

Defendants Steven Wyer and Kurt Beasley formed Merchant Capital, LLC ("Merchant") to participate in the debt-purchasing business. Merchant planned to purchase fractional shares in consumer debt pools via a third-party, wholesale debt-purchaser, who would collect funds from various sources, purchase debt from financial institutions, and then outsource the collection to a col-

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1 *SEC* v. *Merchant Capital, LLC*, No. 06-10353, 2007 WL 983082 (11th Cir. Apr. 4, 2007).

2 15 U.S.C. §§ 77b(a)(1), 78c(a)(10).

3 *Merchant*, 2007 WL 983082, at *11.

lection company.[4] Through a team of recruiters, Merchant solicited the general public and sold interests in twenty-eight Colorado RLLPs to 485 individuals, for a total capitalization of over $26 million. Each partnership had a three-year term, at the expiration of which the partnerships were to be dissolved and assets distributed to the partners and the managing general partner ("MGP"). The business, a novel enterprise for both Wyer and Beasley, was a failure from the outset and within fifteen months from its start, the partnership was performing nearly 40 percent below targeted performance goals.[5]

Following its investigation of Merchant, the SEC commenced an enforcement action against Wyer, Beasley and Merchant alleging violations of the registration and antifraud provisions of the federal securities laws. After a bench trial, the district court found for defendants on all counts and held RLLP interests were not investment contracts and therefore not securities.[6] Alternatively, it concluded that the defendants had not committed securities fraud. The SEC challenged both of these determinations on appeal,[7] and the key issue addressed by the Eleventh Circuit was whether the RLLP interests marketed by Merchant were "investment contracts" covered by the Federal securities laws.

II. LLC, LLP AND RLLP INTERESTS AS "INVESTMENT CONTRACTS"

In general, all "investment contract" analyses begin with the *Howey* test which provides an interest is an "investment contract" within the definition of the term "securities" under the Securities Act and the Exchange Act[8] if it constitutes "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."[9] In considering the status of a general partnership or hybrid-form interests (such as LLC and LLP interests), the first two *Howey* elements are usually easily met. It is the third prong —the "profits solely from the efforts of others" prong— that has been subject to the most judicial interpretation. In *Williamson* v. *Tucker*,[10] for example, the Fifth Circuit (predecessor to the Eleventh Circuit) expanded on the last element of *Howey* by setting out a non-exhaustive, three-factor inquiry to evaluate investors' dependence on managers for investment profits. Under *Williamson*, an interest in a general partnership would be an "investment contract" if the investor could establish that:

> (1) an agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership; or (2) the partner or venturer is so inexperienced and unknowledgeable in busi-

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4 *Id.* at *2.

5 *Id.* at *4.

6 *Id*. at *11.

7 *Id.* at *12.

8 15 U.S.C. §§ 77b(a)(1), 78c(a)(10).

9 *SEC* v. *W .J. Howey Co.*, 328 U.S. 293, 298-99 (1946).

10 *Williamson* v. *Tucker*, 645 F.2d 404 (5th Cir. 1981).

> ness affairs that he is incapable of intelligently exercising his partnership or venture powers; or (3) the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers.[11]

Williamson also established a presumption that: "[a] general partnership interest is . . . [not] an investment contract because a general partner typically takes an active part in managing the business and therefore does not rely solely on the efforts of others."[12]

In considering the status of RLLPs (and LLCs and LLPs), the *Merchant* court adopted the *Williamson* approach, but only in part. The court held that: "an RLLP interest [will be considered] an investment contract if one of the [three] *Williamson* factors is present."[13] The *Merchant* court declined, however, to adopt the *Williamson* presumption against investment contract status. In doing so, the court reasoned that "it is not invariably true that partners in an RLLP, [LLC, or LLP] lack the ability to control the profitability of their investments," and that "[t]he powers of partners or members . . . may assume virtually any shape, despite the limitation on liability."[14] Because it declined to assign the presumption, the Eleventh Circuit did not invoke the accompanying "heavy burden" under *Williamson* (adopted by the district court in *Merchant*) to disprove a negative, and in theory lowered the bar to obtaining "investment contract" status for hybrid business forms.[15]

III. THE RATIONALE OF THE COURT: APPLICATION OF THE *WILLIAMSON* FACTORS

A key aspect of *Merchant* is its affirmation of the diminished importance an entity's form may have on the "investment contract" status of an investor's interest in that entity. The *Merchant* analysis suggests that in the context of modern and highly flexible business formations, formal categories will not necessarily be accepted as definitive if the actual implementation of contractual provisions and business realities are at odds with the categorization asserted. The following summarizes the highlights of the *Merchant* court's "substance over form" analysis of the *Williamson* factors:

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11 645 F.2d at 424.

12 *Merchant*, 2007 WL 983082, at *6.

13 *Id. at *7.*

14 Coming as close as it dared to a *per se* rule, the court commented in dicta, that, "[i]f anything, an RLLP is somewhat more likely to be an investment contract because of the incentive against exercising control that is produced by the limited liability shield." *Merchant*, 2007 WL 983082, at *6-7.

15 The district court, however, did invoke the higher burden. It stated: "When the third requirement of the *Howey* test is applied to a general partnership, as is the case here, there is a strong presumption that the general partnership is not a security, and the SEC bears a heavy burden to prove otherwise." *SEC* v. *Merchant Capital, LLC*, 400 F. Supp. 2d 1336, 1365 (N.D. Ga. 2005). The district court's conclusion that the RLLP interests were not investment contracts can be attributed, at least in part, to its taking this more stringent approach.

Factor 1: Distribution of Power Between Partners.

The court selected three powers conferred upon investors in the partnership agreement to evaluate for practical effect: (1) the ability to select the MGP, (2) the power to remove the MGP upon a unanimous vote, for cause, and (3) the exclusive right to approve any act obligating the partnership in an amount exceeding $5000.[16] In this case, the court held all three powers illusory.

First, the court found that "the power to name the MGP was not . . . significant," because the selection process Merchant engineered predetermined the result of the MGP vote. Merchant controlled the ballot content, listed itself as the sole option for MGP (and won) and thus negated any power of selection the agreement had described.[17] Merchant also required that partners submit their ballots and investment simultaneously. The Court noted further that investors had no independent experience in the debt purchasing industry and no way of knowing about alternatives to Merchant as MGP. Therefore, the Court found that the supposed selection power could not measure partners' "ability to control the business after [the] initial investment."[18]

Second, the court concluded the "for cause" and unanimity conditions on partners' power to remove the MGP, were so impracticable that "Merchant [was] effectively unremovable," and the power fictive, as a matter of law.[19] The court emphasized that the "ultimate" inquiry is what investors were "*led*" to believe, not the "strict legal terms" of a written agreement.[20] Because of this, it relied on Wyer's oral representations to investors that "a unanimous vote [to remove Merchant as MGP] was required," over ambiguities in the written partnership materials suggesting removal by a two-thirds majority vote would have been sufficient.[21,22]

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16 *Merchant*, 2007 WL 983082, at *8. The court disregarded "the ability to inspect books and records, participate in committees, and hold meetings [which] did not on their own give the partners the potential to control Merchant's management of the business, . . . and were therefore irrelevant [to the] analysis." *Id.* at *12.

17 *Id.* at *8.

18 *Id.*

19 Id. at *9. The court based its decision on *Albanese v. Florida National Bank*, which held a partnership to be an investment contract "as a matter of law" where "removal [of management could be obtained] . . . only for cause, and the investors [had] no other ability to impact management." *Albanese*, 823 F.2d at 411. In *Albanese*, the promoter sold ice machines and service contracts to individuals and the court found the power to control the location of the ice machines "too insubstantial" to preclude investment contract status on the partnership. *Id.* at 412.

20 *Merchant*, 2007 WL 983082, at *2.

21 *Id*. at *9. The court also noted that investors' dispersed geographical locations "exacerbated the other difficulties and rendered the supposed power . . . illusory."

22 The fact that one RLLP, RLLP-19, had succeeded in removing Merchant after the original investment

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Lastly, the court concluded that the RLLP partners' contractual "ability to approve all obligations over $5000," by ballot was a "sham." Looking to the mechanics of the process, which had been left to Merchant to design, the court found the ballots completely "devoid of meaningful information."[23] As a result, the process "did not permit partners to make an informed decision about debt purchases" and exercise control over their investment.[24] The court also found the rule by which "unreturned and unvoted ballots were voted in favor of management," "tilted" the voting process inappropriately in Merchant's favor.[25] Additionally, evidence that Merchant repeatedly abused the balloting process by purchasing more debt than the ballots authorized, purchasing debt before the ballots were sent, or purchasing debt before the ten-day ballot return period expired, further demonstrated that investors had no ability to force management to heed the results of their votes.

Factor 2: RLLP Partners' Experience in the Subject Business.

The second factor requires a court to weigh the complexity of the subject business against the experience of the investors, and grants courts latitude to characterize not only the nature of the business, but also the relative sophistication of the investors. According to the *Merchant* court, a conclusion that investors are inexperienced in the relevant business, will support "a finding of investment contract, even if the partner possesses some powers under the arrangement."[26] Here, the Eleventh Circuit criticized the district court's focus on investors' "general business" sense, finding there was no "significant overlap with the debt purchasing business."[27] Protecting investor interests, the court held "members of the general public, . . . [which] included a railroad retiree, a housewife and a nurse" were inexperienced in light of the "indisputably complicated" nature of the business. [28]

Factor 3: Investors' Dependence on the Manager.

The third *Williamson* factor, a corollary to the first, balances the degree of investors' control with their dependence on management's ability, and provides that even if the arrangement gives the partners some control, the interest will be considered an "investment contract" if the inves-

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period did not effect the analysis of what the partners' ability was at the time of the "original investment." At the time Merchant was removed, it "had an active interest in encouraging removal; the SEC investigation was in progress, and Merchant's defense hinged upon showing that the partners were in control." *Merchant*, 2007 WL 983082, at *9.

23 *Id.* at *10-11.

24 *Id.*

25 *Id.* at *11.

26 *Id* at *13.

27 *Id.* at *14, note 12.

28 *Id.* at *14.

tors have "no realistic alternative to the manager."[29] Although the court recognized that Merchant had been approached by suitable alternate managers, it held RLLP partners dependent because, as a practical matter, Merchant had "permanent control over each partnership's assets [for the term of the agreement]."[30] Merchant, the court found, had used its authority under the partnership agreement "to contract with . . . third part[ies]" to sign away its "right to demand the return of the debtor accounts" after investment monies were transferred to the wholesaler. Thus, even if partners managed to coordinate Merchant's removal (nearly impossible under the first factor discussed above) "it would find that its major assets were tied up in fractional share form" in one of the wholesaler's debt pools.[31] Notably, the *Merchant* court neither suggested there was any burden on investors to comprehend potential consequences of the third-party contract provision in their review of the partnership agreement, nor adverted to partners' "access to records" powers as a means to mitigate against management's improper uses of its authority.

Finding the three *Williamson* factors present (though the existence of one factor would have sufficed), the Eleventh Circuit held the RLLP interests were investment contracts covered by the Federal securities laws. It reversed the district court's ruling on the issue, and reversed, vacated and remanded the district court's decisions regarding the Federal securities claims.

IV. Significance of Decision

Merchant serves as a reminder to practitioners that form will not trump substance on the issue of "what is a security." As clearly articulated by the Eleventh Circuit, if the totality of circumstances indicate otherwise, labels and contractual terms which are ineffective in conferring some amount of actual management power on investors who are experienced in the issuer's business will not suffice to overcome a judicial conclusion that an instrument is an "investment contract" for purposes of the Federal securities laws.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or e-mail Jonathan I. Mark at (212) 701-3100 or jmark@cahill.com; or Gina L. Dizzia at (212) 701-3130 or gdizzia@cahill.com.

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29 *Id.* at *15, citing *Albanese* 823 F.2d at 412.

30 *Id.* at *16-17.

31 *Id. at *16.*