# I. CURRENT UPDATES AND EMERGING TRENDS

## A. Key Elements of the LLC Act in Delaware

Delaware first adopted its Limited Liability Act ("LLC Act") in 1991. Since 1991, the Act has undergone almost annual updates. Some amendments to the LLC Act have been purely technical, while others have expanded upon its provisions.

One of the first Delaware Supreme Court cases dealing with the meaning of the LLC Act was Elf Atochem North America, Inc. v. Jaffari, 722 A.2d 286 (Del. Supr., April 1999). In the first paragraph of the Decision, the Court state:

> The limited liability company (LLC) is a relatively new entity that has emerged in recent years as an attractive vehicle to facilitate business relationships and transactions. The wording and architecture of the Act is somewhat complicated, but it is designed to achieve what is seemingly a simple concept – to permit persons or entities (members) to join together in an environment of private ordering to form and operate the enterprise under the LLC agreement with tax benefits akin to a partnership and limited liability akin to the corporate form.

The Court goes on to briefly address the formation of the LLC. The Court stated:

> The certificate of formation is a relatively brief and formal document that is the first statutory step in creating the LLC as a separate legal entity. The certificate does not contain a comprehensive agreement among the parties, and the statute contemplates that the certificate of formation is to be complimented by the terms of the agreement.

Later in the Decision, the Court included a subsection titled "General Summary of Background of the Act" and states:

> The phenomenon of business arrangements using "alternative entities" has been developing rapidly over the

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past several years. Long gone are the days when business planners were confined to corporate or partnership structures.

Limited partnerships date back to the 19th century. They became an important and popular vehicle with the adoption of the Uniform Limited Partnership Act in 1916. Sixty years later, in 1976, the National Conference of Commissions of Uniform State Laws approved and recommended to the states a Revised Uniform Limited Partnership Act ("RULPA"), many provisions of which are modeled after the innovative 1973 Delaware Limited Partnership (LP) Act. Difficulties with the workability of the 1976 RULPA prompted the Commissioners to amend the RULPA in 1985.

To date, 48 states and the District of Columbia have adopted the RULPA, in either the 1976 or 1985 form. Delaware adopted the RULPA with innovations designed to improve the Commissioners' product. Since 1983, the General Assembly has amended the LP Act eleven times, with a view to continuing Delaware's status as an innovative leader in the field of limited partnerships.

The Delaware Act was adopted in October 1992. The Act is codified in Chapter 18 of Title 6 of the Delaware Code. To date, the Act has been amended six times with a view to modernization. The LLC is an attractive form of business entity because it combines corporate-type limited liability with partnership-type flexibility and tax advantages. The Act can be characterized as a "flexible statute" because it

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generally permits members to engage in private ordering with substantial freedom of contract to govern their relationship, provided they do not contravene any mandatory provisions of the Act. Indeed, the LLC has been characterized as "best of both worlds."

The Delaware Act has been modeled on the popular Delaware LP Act. In fact, its architecture and much of its wording is almost identical to that of the Delaware LP Act. Under the Act, a member of an LLC is treated much like a limited partner under the LP Act. The policy of freedom of contract underlies both the Act and the LP Act.

* * *

*Policy of the Delaware Act.* The basic approach of the Delaware Act is to provide members with broad discretion in drafting the agreement and to furnish default provisions when the members' agreement is silent. The Act is replete with fundamental provisions made subject to modification in the agreement (e.g.*" unless otherwise provided in the limited liability company agreement..."*).

* * *

*Freedom of Contract.* Section 18-1101(b) of the Act, like the essentially identical Section 17-1101(c) of the LP Act, provides that "it is the policy of [the Act] to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements." Accordingly, the following observation relating to limited partnerships applies as well to limited liability companies: The Act's basic approach is to permit partners to have the broadest possible discretion in drafting their

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> partnership agreements and to furnish answers only in situations where the partners have not expressly made provisions in their partnership agreement. Truly, the partnership agreement is the cornerstone of the Delaware limited partnership, and effectively constitutes the entire agreement among the partners with respect to the admission of partners to, and the creation, operation and termination of, the limited partnership. Once partners exercise their contractual freedom in their partnership agreement, the partners have a great deal of certainly that their partnership agreement will be enforced in accordance with its terms.
>
> In general, the commentators observed that only when the agreement is inconsistent with mandatory statutory provisions will the members' agreement be invalidated. Such statutory provisions are likely to be those intended to protect third parties, not necessarily the contracting parties. As a framework for decision, we may apply that principle to the issues before us, without expressing any views more broadly.

The quoted sections from the ELF opinion, though early in the *juris prudence* of limited liability companies, eloquently expresses the basis concepts and key elements of the Delaware Act.

The basic elements of the Act are (a) formation, merger and consolidation, conversion and series; (b) the relationship among the members and between the members and the company; (c) relationship between the managers and the company, (d) finances, (e) distributions, (f) transfers of limited liability company interests, (g) dissolution, and (h) derivative actions.

(a) The limited liability company is commenced by the filing with the Delaware Secretary of State of a Certificate of Formation. The law does not require any

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further filing by the company to complete the formation. The certificate of formation, as is the case with virtually all other documents filed with the Secretary of State, is signed by an "authorized person." While the term "person" is defined in §18-101(12), the term "authorized person" is not in fact defined in the Act. Often times the term "authorized person" is, however, defined in a company agreement. Sections 18-204(a) and (c) state:

> (a) Each certificate required by this subchapter to be filed in the Office of the Secretary of State shall be executed by 1 or more authorized persons or, in the case of a certificate of conversion to limited liability company or certificate of limited liability company domestication, by any person authorized to execute such certificate on behalf of the other entity or non-United States entity, respectively.
>
> (c) The execution of a certificate by a person who is authorized person an oath or affirmation, under penalties of perjury in the third degree, that, to the best of the authorized person's knowledge and belief, the facts stated therein are true.

Therefore, when the person who is authorized does execute a certificate, there is the legal presumption that the person knew that the contents where true and presumes a level of authorization on that person's part.

(b) <u>Members</u>. Under §18-301, a member is admitted to the company upon the latter of (1) the formation of the limited liability company, or (2) the time provided in and upon compliance with the limited liability company agreement or, if the limited liability company agreement does not so provide, when the person's admission is reflected in the records of the limited liability company.

Section 18-303, *Liability to Third Parties*, provides in pertinent part:

> The debts, obligations and liabilities of the limited liability company, whether arising in contract, tort or otherwise, shall be solely the debts, obligations and liabilities of the limited liability company, and no member or manager of a limited

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> liability company shall be obligated personally for such debt, obligation or liability of the limited liability company solely by reason of being a member or acting as a manager of the limited liability company.

Section 1 8-303 is the key limited liability provision of the Act.

(c) Managers. Section 18-101(7) defines the limited liability company agreement. A limited liability company agreements means any agreement, written, oral or implied, of the member or members as to the affairs of a limited liability company and the conduct of its business. Under §18-401, *Admission of Managers*:

> A person may be named or designated as a manager of a limited liability company as provided in Section 18-101(10) of this Title (10), which defines manager as "a person who is named as a manager of a limited liability company and/or designated as a manager of a limited liability company pursuant to, a limited liability company agreement or similar instrument under which the limited liability company is formed.

Under §18-403, the manager of a limited liability company may make a contribution to the company and share in its profits and losses, however, the manager is not required to make a contribution.

(d) Finances. Section 18-501, *Form of Contribution*. A member's contribution to the company may be in cash, property or services rendered or a promissory note or other obligation to contribute cash or property or to perform services. Under §18-502, the member is obligated for its contribution, including contribution in the form of services, even if the member is unable to perform because of death, disability or any other reason.

Profits and losses of the limited liability company are allocated among the members in the manner provided in the limited liability company agreement. In the absence of an allocation in the agreement, profits and losses are allocated on the basis of the agreed value of the contributions made by each member to the extent that they have

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been received by the company and have not been returned (§18-503). Distributions of cash and other assets of the company are allocated among the members again as provided in the company agreement. In the absence of an agreement, allocations of distributions are made on the basis of the agreed value of the contributions made by each member to the extent they have been received by the company and have not been returned (§18-504).

(e) Distributions. Distributions are made at such time and upon such events as may be specified in the agreement, however, there is no requirement that distributions be made in the absence of an agreement. If the agreement does not provide to the contrary, the member or manager may resign. Upon the resignation of a member, he is entitled to receive the fair value, within a reasonable time after resignation, of the limited liability company interest as of the date of resignation based upon the member's right to share in distributions. The term "fair value" is not defined in the Act. Generally speaking, the right to resign and the right to receive distributions are eliminated in the company agreement.

Under §18-607, the company may not make a distribution to a member to the extent that at the time of the distribution, after giving effect to all other liabilities, other than liabilities to members, exceed the fair value of the assets of the company, except that the fair value of property that is subject to a liability for which the recourse of creditors is limited, shall be included in the assets of the company only to the extent that the fair value of the property exceeds that liability.

(f) Assignment of Company Interests. As is the case under the DGCL, a limited liability company interest is personal property. A member of a limited liability company has no interest in specific limited liability company property (§18-701). A limited liability company interest is assignable, in whole or in part, except as provided in the agreement. The assignee has no right to participate in the management of the company except as provided in the agreement and upon (1) the approval of all members, or (2) compliance with any procedure provided in the agreement. It is common practice for the limited liability company agreement to place limitations or prohibitions upon the members' right to transfer an interest. An assignee has no right to become a member of the company except as provided in the agreement (§18-704).

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(g) Dissolution. A limited liability company is dissolved and its affairs are wound up upon the first to occur of (1) the time specified in the agreement; (2) the happening of an event specified in the agreement; (3) the affirmative vote or written consent of the members of the company who own more than two-thirds of the then current percentages or other interests in the profits of the limited liability company owned by all of the members or by the members of each class or group, as appropriate; (4) at the time there are no members; or (5) the entry of a decree of judicial dissolution under §18-802. Upon the completion of winding up under §18-803 and distribution of assets under §18-804, a certificate of cancellation is filed (§18-203).

(h) Derivative Actions. Any member or an assignee of a limited liability company may bring a derivative action in the Court of Chancery to collect a judgment in favor of the company. In the derivative action, the plaintiff must be a member or an assignee of the limited liability company interest at the time of bringing the action.

**B. Legislative Updates - 2007 Amendments.**

1. Section 18-107(7), *Limited Liability Company Agreement*, was amended to add in the first sentence, after the word "oral," the phrase "or implied." The amendment was in response to a decision of the Court of Chancery which mentioned, but did not hold, that a limited liability company was not required to have a company agreement. The amendment to §18-101(7) resolved that issue, however, the inclusion of the phrase "or implied" was intended to take in any circumstances outside of the included phrases already in the section of "written" or "oral" to permit the Court to find an agreement. By including "written, oral or implied," the drafting committee intended to encompass any form of agreement and to confirm that there must be some form of agreement for a limited liability company agreement.

The amendment to §18-201(d) follows the concept of §18-101(7). The amendment changed the word "may" to "shall" in the sentence "A limited liability company agreement shall be entered into or otherwise existing either before, after or at the time of the filing of the certificate of formation . . ." This confirmed the general understanding within the Bar that an LLC must have a company agreement.

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2. Section 18-203, *Cancellation of Certificate.* This Section was amended to clarify that the filing of a certificate of merger or consolidation (if the Delaware limited liability company is not the surviving entity), the filing of a certificate of transfer or the filing of a certificate of conversion to a non-Delaware entity does not require a certificate of cancellation to be filed.

3. Section 18-215, *Series of Members, Managers, Limited Liability Company Interests or Assets*. The first amendment to this Section changed the title by adding the phrase "or Assets." The amendments to §18-215 were intended to clarify that the series established under this Section could be series of assets, as well as series of interests. It had been the common practice that series could be either series of interests or series of assets, and the amendments were intended to confirm the developing practice.

The amendment to §18-215(b) added the following:

> Assets associated with a series may be held directly or indirectly, including in the name of such series, in the name of the limited liability company, through a nominee or otherwise. Records maintained for a series that reasonably identify its assets, including by specific listing, category, type, quantity, computational or allocational formula or procedure (including a percentage or share of any asset or assets), or by any other method where the identity of such assets is objectively determined, will be deemed to account for the assets associated with such series separately from the other assets of the limited liability company, or any other series thereof.

A new §18-215(c) was created and reads as follows:

> A series established in accordance with Subsection (b) of this Section may carry on any lawful business, purpose or activity, whether or not for profit, with the exception of the business of banking as defined in Section 126 of Title 8. Unless otherwise provided in a limited liability company

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> agreement, a series established in accordance with Subsection (b) of this Section shall have the power and capacity to, in its own name, contract, hold title to assets (including real, personal and intangible property), grant liens and security interests, and sue and be sued.

The new Subsection (c) is significant, as it grants to the series all legal rights, with the exception of the concept of being *sui juris* in its own right.

4. Section 18-216, *Approval of Conversion of the Limited Liability Company*. The amendment added a new Subsection (i), which reads as follows:

> A limited liability company agreement may provide that a domestic limited liability company shall not have the power to convert as set forth in this Section.

This is another significant conceptual amendment to the Act, as it grants to a limited liability company the power and authority to affirmatively opt out of an affirmative grant of authority under the Act.

5. Section 18-702, *Assignment of Limited Liability Company Interest*. This amendment added a new sentence at the end of §18-702(c) as follows:

> A limited liability company shall not have the power to issue a certificate of limited liability company interest in bearer form.

This amendment was adopted as a result of pressure brought upon the State by the Federal government and international organizations concerned with transparency and money laundering. It was their held belief that bearer shares in both corporations and limited liability companies were being used for money laundering purposes.

**2008 Amendments:**

The 2008 amendments were less substantive that the 2007 amendments, however, they did make important changes to the Act.

6. Section 18-101(12), *The Definition of Person*. The amendment included in the definition of trust as a person the phrase, "(including a common law trust, business trust, statutory trust, voting trust or any other form of trust)."

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7. Section 18-110, *Contested Matters Relating to Managers; Contested Votes*. The amendment inserted a new Subsection (c) which expands on the definition of manager. Subsection (c) reads as follows:

> As used in this Section, the term "manager" refers (i) to a person who is a manager as defined in Section 18-101(10) of this Title, and (ii) a person, whether or not a member of a limited liability company, who, although not a manager as defined in Section 18-101(a) of this Title, participates materially in the management of the limited liability company; provided, however, that the power to elect or otherwise select or to participate in the election or selection of a person to be a manager as defined in Section 18-101(10) of this Title shall not, by itself, constitute participation in the management of the limited liability company.

This same language was inserted at the end of §18-111, *Interpretation and Enforcement of Limited Liability Company Agreement.*

The intent of these amendments was to deal with the long-arm concept that by accepting the position of manager, the "person" consents to jurisdiction in the Delaware courts. (§18-109(a) of the Act, *Service of Process on Managers and Liquidating Trustees*)

8. Section 18-204(a), *Execution*. The concept of authorized person has created a number of administrative issues, particularly upon filing with the Secretary of State. Section 18-204(a), prior to the amendment, reads:

> Each certificate required by this Subchapter to be filed in the Office of the Secretary of State shall be executed by one or more authorized persons.

The amendment adds at the end of the sentence the phrase "or, in the case of a certificate of conversion to limited liability company or certificate of limited liability company domestication, by any person authorized to execute such certificate on behalf of the other entity or non-United States entity, respectively.,"

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Also, in §18-204(b)(1), which before the amendment read as follows:

> A certificate of conversion to limited liability company that has been executed by one or more authorized persons in accordance with Section 18-204 of this Title.

This Subsection was amended by deleting the phrase "by one or more authorized persons.

Section 18-204(c), prior to the amendment, read as follows:

> The execution of a certificate by an authorized person constitutes an oath or affirmation, under the penalties of perjury in the third degree, that, to the best of the authorized person's knowledge and belief, the facts stated therein are true.

The amendment deleted the phrase "authorized person" and inserted in lieu thereof the words "a person who is authorized by this Chapter to execute such certificate," an deleted the words, "the authorized" and inserted in lieu thereof the word "such."

9. Section 18-214, *Conversion of Certain Entities to a Limited Liability Company*. There were two amendments to §18-214. The first, in Subsection (a), adds back a reference to §18-204, the section dealing with executions, to create a reference to the defined term "other entity," which is defined in §18-204(a).

## C. Current Case Law

### Arbitration

**Terex Corporation v. STV USA, Inc.**
2005 WL 2810717, No. Civ.A. 1614-N (Del. Ch. October 20, 2005)

The Court enforced broad arbitration provision "all disputes arising out of or relating to" the LLC Agreement must be resolved through arbitration. The Court further held that a provision permitting interim relief during a negotiation period did not evidence an intent to the contrary. The Court further ruled that the dissolution provisions of the Agreement are also subject to arbitration.

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**<u>Douzinas v. American Bureau of Shipping, Inc.</u>**
888 A.2d 1146, C.A. No. 1496-N (Del. Ch. 2006)

The broad arbitration terms of the company's agreement encompasses an obligation to arbitrate claims of a breach of fiduciary duties. The LLC agreement provided that "except to the extent that any provision hereof is mandatorily required to be governed by the [Delaware Limited Liability Company Act], this agreement is governed by and construed in accordance with the laws of Texas. . ." The Court held: "Our state respects choice of law provisions when the law chosen has a reasonable relationship to the matter at issue." The company operates in Texas and the Court found that to satisfy the requirement.



**<u>James & Jackson, LLC v. Willie Gray, LLC</u>**
___ A.2d __, No. 59, 2006, 2006 WL 659300 (Del. 2006)

The Court adopted the majority view that agreements that contain language that the arbitration will be conducted in accordance with the Rules of the American Arbitration Association evidences clear and unmistakable evidence of the parties' intent to have the arbitrator determine substantive arbitrability**.** In this case, the agreement begins by requiring that any controversy arising under or related to the LLC Agreement be arbitrated using AAA Rules, but goes on to authorize "the non-breaching member to obtain injunctive relief and specific performance in the courts." The Court held that "not all disputes must be referred to arbitration."

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**<u>Brown v. T-Ink, LLC</u>**
C.A. No. 3190-VCP, 2007 WL 4302594 (Del. Ch. Dec. 4, 2007)

Because the business contemplated by the LLC Agreement was worldwide, the Federal Arbitration Act applied. A generic choice of laws section, without more, does not evidence that the parties intend to opt out of the FAA's default standards, therefore, Federal laws and not Delaware laws apply to substantive arbitrability. Delaware laws and FAA laws will, however, generally reach the same result. The LLC Agreement refers disputes on "interpretation or performance" of the LLC Agreement to arbitration. The disputes fall outside this limited language and, therefore, outside of arbitration.



**<u>ELF Atochem North America, Inc. v. Jaffari</u>**
727 A.2d 286 (Del. Supr., April 6, 1999)

This case is important, as it is one of the first decisions by the Delaware Supreme Court to examine the Delaware Limited Liability Company Act.

In this case, the Plaintiff sought to bring a derivative action on behalf of the company.

> The limited liability company agreement contains an arbitration clause covering all disputes. The clause, Section 13.8, provides that "Any controversy or dispute arising out of this Agreement, the interpretation of any of the provisions hereof, or the action or inaction of any Member or Manager hereunder, shall be submitted to arbitration in San Francisco, California. . ."
>
> Section 13.8 further provides "No action. . . based upon any claim arising out of or related to this Agreement shall be instituted in any Court by any Member except (a) an action

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> to compel arbitration. . . or (b) an action to enforce an award obtained in an arbitration proceeding. . ."
>
> The Agreement also contains a form selection clause, Section 13.7, providing that all members consent to: "exclusive jurisdiction of the state and federal courts sitting in California in any action on a claim arising out of, under or in connection with this Agreement or the transactions contemplated by this Agreement, provided that such claim is not required to be arbitrated pursuant to Section 13.8"; and personal jurisdiction in California.

The Plaintiff sought to avoid the provisions of the LLC agreement by asserting that the company was not party to the agreement. The Court held that the company is bound to the agreement notwithstanding the fact that it was not a party to the agreement. This issue was further resolve by legislative amendment to the Act thereafter.

The Court, after extensively penalizing the Delaware Limited Liability Company Act, went on to hold that the broad nature of the arbitration clause in the subject company agreement was sufficiently broad so as to encompass the Plaintiff's derivative claims. The Court affirmed the dismissal of the action by the Court of Chancery.

**Books and Records Inspection**

**<u>NAMA Holdings, LLC v. World Market Center Venture, LLC</u>**
C. A. No. 2756-VCL, 2007 WL 2088851 (Del. Ch. July 20, 2007)

Records inspection under LLC Agreement. Member threatened to disclose confidential information to a competitor. The Court held that the "reasonable" right to inspect was not unlimited. The LLC could prohibit copying so as to avoid disclosure and could require that a confidentiality agreement be signed. Could not require that only the member and not its representative inspect books and records.

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## Books and Records

**<u>TravelCenters of America, LLC v. Brog</u>**
C.A. No. 3516-Cc, 2008 WL 1746987 (Del. Ch. April 3, 2008)

Books and records request under §18-305 may not be consolidated with any other action.

## Business Judgment Rule

**<u>Minnesota Invco of RSA #7, Inc. v. Midwest Wireless Holdings, LLC</u>**
No. Civ. A. 1887-N, 2006 WL 1596675 (Del. Ch. June 7, 2006)

Applied business judgment rule that "in making a business decision, the directors of a corporate are presumed to act on an informed basis, in good faith, and in an honest belief that the action taken is in the best interest of the Company." "To invoke the rule's protection, directors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them." The Court did not discuss the basis for applying the rule to an LLC, but nevertheless it applied the rule to validate actions taken by the "Board of Directors" of the LLC.

## Derivative Claims

**<u>Wood v. Baum</u>**
953 A.2d 136 (Del. Supr., July 1, 2008)

The Delaware Supreme Court confirmed that in making derivative claims, demand on the company is excused only when it is alleged that the directors made a conscience business decision in breach of their fiduciary duties and when the subject of the derivative suit is a violation of the board's oversight duties. The Plaintiff attempted to create reasonable doubt that the board would have properly exercised its business judgment by alleging that the board was disabled because of a substantial risk of personal liability. In analyzing the issue, the Court pointed out that under the terms of the company's LLC company

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agreement, the directors' liability was limited to claims of "fraudulent or illegal conduct" or "bad faith violation of the implied contractual covenant of good faith and fair dealing." The Court stated that where directors are contractually or otherwise exculpated from liability, a serious threat of liability may only be found to exist if the plaintiff pleads with particularity a non-exculpated claim. In this case, the Plaintiff had failed to do so.

The Court also distinguished a "bad faith violation of the implied contractual covenant of good faith and fair dealing" from the fiduciary duty breaches asserted by the Plaintiff and concluded that the Complaint did not allege any contractual claims, let alone a "bad faith" breach of the implied contractual covenant of good faith and fair dealing.

The Court stated:

> The implied covenant of good faith and fair dealing is a creature of contract, distinct from fiduciary duties that the plaintiff assets here. The implied covenant functions to protect stockholders' expectations that a company and its board will properly perform the *contractual* obligation they have under the operative organizational agreements. Here, the Complaint does not allege any contractual claims, let alone a "bad faith" breach of the implied contractual covenant of good faith and fair dealing. Nor, as discussed above, does the Complaint contain any particularized allegations that Defendants acted with the requisite scienter (in "bad faith"),

In support of its proposition, the Court cites Gail v. Bershad, 1998 WL 118022 (Del. Ch., 1998), which held that:

To allow a fiduciary duty claim to coexist in parallel with an implied contractual claim, would undermine the primacy of contract over fiduciary law in matters involving the essentially contractual right and obligation of [the] shareholders.

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**Dissolution**

**The Follieri Group, LLC v. Follieri/Yucaipa Investments, LLC**
No. Civ.A. 3015-VCL, 2007 WL 2459226 (Del. Ch. Aug. 23, 2007)

A punitive creditor does not have any right to interview in an action to compel dissolution. Creditor rights are protected under §18-803 (winding up), §18-804 (distribution of assets) and §18-804(b)(2). An LLC dissolving must make reasonable provision for the payment of creditors.

**Dissolution**

**Browning-Ferris Industries, Inc. v. U.S.**
101 A.F.T.R.2d 2008-1770, 2008-1 USTC ¶ 50,297,
No. 2007-5144, 2008 WL 1743903 (C.A. Fed. 2008)

Conversion of corporation to Delaware LLC does not result in the dissolution of the company.

**Long-Arm Jurisdiction**

**Christ v. Cormick**
C. A. No. 06-275-GMS, 2007 WL 2022053 (D. Del. 2007)

Single act of formation of LLC is sufficient contact with Delaware to rise to personal jurisdiction if such purposeful activity in Delaware is an integral component of the total transaction to which Plaintiff's cause of action relates.

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## Long-Arm

**Fisk Ventures, LLC v. Segal**
C.A. No. 3017-CC, 2008 WL 1961156 (Del. Ch. May 7, 2008)

Differentiated between members and managers in long-arm jurisdiction. Occasionally consulting with manager is not material participation. Having authority to select a board member is also not material participation.

## Management

**Matlin v. International Registries, LLC**
2008 WL 2440521 (Del. Ch., June 6, 2008)

In this case, the LLC had two members, each with a 50% interest. The LLC company agreement vested management in the members and provided that the decisions holding a majority of all interests shall be controlling. The Court held that a 50% member of the LLC did not have authority to retain counsel for the LLC defendant in a case brought by the other 50% member where the plaintiff member did not consent to the hiring of counsel.

## Piercing the Corporate Veil

**Deborah-Ann Wellman v. The Dow Chemical Company**
C. A. 05-280-LSR, 2007 WL 842084 (D. Del., March 20, 2007)

In this case, the *pro se* Plaintiff who was employed by a joint venture made up of The Dow Chemical Company and the duPont Company, sought to hold the Defendant liable for employment discrimination. The Court stated that:

> The United States Court of Appeals for the Third Circuit has held that, where the employee of a subsidiary corporation has filed under Title VII against a parent corporation, the parent corporation should be deemed an "employer" only in extraordinary circumstances, e.g., where the parent company dominates its subsidiary. The Court held that the record

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> indicates that the Plaintiff was employed by [the joint venture] at all relevant times; there is no record for the proposition that the [defendant] was involved in the operation of [the joint venture] to any extent, let alone the extent necessary to justify piercing the corporate veil.

The Court does not analyze what factors go into piercing the corporate veil other than domination of the subsidiary. The case is important, however, for the concept that the notion of piercing the corporate veil applies equally to limited liability companies as well as corporations.

### Violation of LLC Agreement

**Eureka VII LLC v. Niagra Falls Holdings LLC**
899 A.2d 95, C. A. No. 1203-N (Del. Ch. 2006)

LLC Agreement required that (1) a named person must at all times maintain voting control over one of the 50% members; (2) transfers were prohibited. Named person who controlled the member caused the member to transfer its interest. By virtue of the repeated violations of the LLC Agreement by the member, the Court had the power under the Act to convert the membership interest into an economic interest only. Based upon the policy of §18-702(b)(3) – a member ceases to be a member upon the assignment of its entire membership interest.

### Registered Agent

**Thompson v. Colonial Court Apartments, LLC**
C. A. No. 05C-09-126-RRC, 2006 WL 3174767 (Del. Super. Nov. 1, 2006)

Failure of LLC to terminate authority of registered agent when winding up does not deprive the Plaintiff the right to serve such agent.

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**<u>United States of America v. Leonard, et al</u>**.
529 F.3rd 83 (2nd Cir., June 11, 2008)

The Court began this securities case by stating:

> Over 60 years ago, the Supreme Court established the test for whether a given financial instrument or transaction constitutes an "investment contract" – and, therefore, a security – for purposes o the federal securities laws. SEC v. W.J. Howey Co., 320 U.S. 293 (1946). We write today to underscore that in applying the *Howey* factors, courts can (and should) look beyond the formal terms of a relationship to the reality of the parties' positions to evaluate whether "the reasonable expectation was one of significant investor control." SEC v. Aqua-Sonic Prods. Corp., 687 F.2d 577, 585 (2 D. Cir. 1982).

In this case, the LLC company agreement provided in part that:

> Each member is required to participate in the management of the Company retaining one (1) vote for each Unit acquired. Each important decision relating to the business of the Company must be submitted to a vote of members. The purchase of interests in the Company is not a passive investment. While specific knowledge and expertise in the day-to-day operation of a film producing and distribution company is not required, Members should have such knowledge and expertise in general business, investment and/or financial affairs so as to intelligently exercise their management and voting rights. . . . Further, each member is required to participate in the management of the Company

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> by serving on one or more committees established by the Members.

The Court found, however, that the members played an extremely passive role in the management operation of the company. The members testified that they voted at most "a couple of times." The Court further found that the members had little if any expertise in movie production and were, therefore, unable to take over the companies after they were fully organized. The Court noting a recent 5th Circuit decision stated that:

> Investors may be so lacking in requisite expertise, so numerous, or so disbursed, that they become utterly dependent on centralized management, counteracting a legal right of control.

The Court further stated:

> 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 *or the factual circumstances that surround it*, is left unable to exercise meaningful control over his investment.

The Court cited SEC v. W.J. Howrey Co. for the following definition of an investment contract:

An investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is lead to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise.

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### Advancement

**<u>Majkowski v. American Imaging Management Services, LLC</u>**
__A.2d__, C. A. No. 1797-N, 2007 WL 3627111 (Del. Ch. 2006)

An LLC Agreement which contains indemnification language that the LLC will "indemnify and hold harmless" but which does not contain the words "advance" or "advancement" does not give rise to an obligation to make advancements.

### Indemnification/Advancement

**<u>DeLucca v. KKAT Management, L.L.C.</u>**
No. Civ.A. 1384-N, 2006 WL 224058 Del. Ch. (Jan. 23, 2006)

LLC Agreement had a broad indemnification/advancement provision. So long as the indemnified person did not act with fraud, gross negligence or willful violation of the law, the person was entitled to advancement for costs and indemnification. The Court found that the Plaintiff was entitled to advancement for costs and was liable to return the advancement if the Plaintiff was guilty of fraud, gross negligence or willful violation of law. Plaintiff was entitled to costs for brining the action.

### Advancement for Expenses

**<u>Bernstein v. TractManager, Inc.</u>**
C. A. No. 2763-VCL, 2007 WL 4179088 (Del. Ch. Nov. 20, 2007)

LLC Agreement provided for indemnification rights but did not provide for advancement rights. Absent specific language, the decision as whether to advance costs and fees rests in the business judgment of the board or manager. Here an LLC converted to a corporation. The LLC Agreement did not provide for advancement, while the corporation's by-laws

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did. The Court held that the right to indemnification upon conversion was preserved under §18-217(b) [preserves all debts, liabilities and obligations of LLC which converts].

### Advancement for Expenses

**Donohue v. Corning**
949 A.2d 574 (Del. Ch., June 20, 2008)

In this case, the Plaintiff had been removed for "cause" as the managing member of a limited liability company. The LLC company agreement required indemnification and advancement in connection with the "defense or disposition" of a proceeding in which a covered person is involved or with which a covered person is threatened. The Court stated that it could not award advancement merely because the Plaintiff had a plausible agreement that he brought suit, at least in part, to advance the interest of the LLC and that advancement in such a situation would comport with public policy behind the allowing of indemnification in corporate disputes. The Court concluded that in view of the broad contractual discretion granted limited liability companies under the Delaware Act with respect to advancement, the Plaintiff must establish his entitlement to advancement under the terms of the LLC agreement itself. The Court found that the conduct of the Plaintiff in filing the action must be responsive or defensive in nature to give rise to an advancement under the agreement. The Court commented that the "in connection with the defense of disposition" language was likely included to avoid the result in corporate cases in which the absence of such language from the by-laws exposed the corporation to liability for indemnification and advancement in proceedings initiated by directors that were not responsive to an existing or threatened proceeding. The Court stated that the "defense or disposition" language would be mere surplusage if it were not interpreted as requiring an action to be defensive or responsive. The Court concluded that the Plaintiff was not entitled to advancement under the LLC company agreement because he did not identify a threatened proceeding that he was defending or disposing by bringing the suit.

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**Amendment to Certificate**
**Of Formation Not Required**
**When Members Change**

**In re Grupo Dos Chiles, LLC**
No. Civ. A. 1447-N, 2006 WL 668443 (Del. Ch. March 10, 2006)

Person who was named in the Certificate of Formation as the "initial member" was promptly replaced by two "new" members. Question presented was whether the Certificate of Formation had to be amended to remove the "initial member" for the two members to be admitted. The Court held, no. The Certificate of Formation never became "untrue," therefore, no amendment was required under §18-202(b). "There does not appear to be any continuing obligation to amend the certificate of formation any time the members change."

### D. Hot Topics and Trends

In September, 2007, Vice Chancellor Parsons decided the case of Twin Bridges Limited Partnership et al. v. Ford B. Draper, Jr., C. A. 2351, VCP (September 14, 2007). The case itself is a run of the mill family dispute. However, on Page 23 of the Decision in Footnote 47, the Vice Chancellor stated as follows:

> Plaintiff cites *Warner Communications, Inc. v. Chris-Craft Industries, Inc.*, 583 A.2d 962 (Del. C. 1989), for the doctrine of independent legal significance and argue that, under the doctrine, the Amendment and Merger should be treated as separate and independent events. . . . This doctrine, however, is fundamentally rooted in corporate law. *Orzek v. Englehart*, 195 A.2d 375, 378 (Del. Ch. 1963). As the Supreme Court instructs, independent legal significance applies when actions validly taken pursuant to one section of the Delaware General Corporation Law are legally independent from actions that might have been taken under another section. *In Re Sun States Corp. Shareholder*

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> *Litigation*, 788 A.2d 530, 536 (Del. Ch. 2001). Whether the doctrine of independent legal significance applies in the context of a limited partnership dispute is an open question in this State. Because my resolution of the substantive issues in this case does not turn on that question, I need not address it further.

The Vice Chancellor's footnote in Twin Bridges has prompted substantial discussion within the organized Bar, as it had been generally understood that the concept of independent legal significance applied equally to corporations and alternative entities. Whether or not the doctrine applies in the context of alternative entities will, in all likelihood, be determined by legislative action.

A second case has also promoted substantial discussion within the Bar. That is the case of R & R Capital, LLC v. Buck & Doe Run Valley Farms, LLC, C. A. 3803-CC (Del. Ch., Decided August 19, 2008). R & R involved the Petitioners seeking dissolution of several Delaware limited liability companies. Section 18-801, *Dissolution*, in Subsection (a), provides that the company is dissolved and its affairs shall be wound up upon the first to occur of the following listed events. The Act lists five conditions. Of the five conditions, only the third contains the caveat "unless otherwise provided in a limited liability company agreement." That provision deals with the vote or consent of the members of the company to effect a dissolution. The other four conditions do not contain that caveat. In R & R, the fifth condition, "the entry of a decree of judicial dissolution under Section 18-802 of this Title" is the provision in question.

Each of the limited liability companies in their LLC agreements provided that the company would dissolve upon certain occurrences drawn from §18-801(a): "(i) an Event of Withdrawal of a member. . .; (ii) the affirmative vote of all of the members; (iii) upon the sale of all or substantially all of the Company's assets; (iv) the conversion of the Company into a corporation or other Person; or (v) the entry of a decree of judicial dissolution under Section 18-802 of the Act."

The dissolution paragraph does not address §18-801(a)(1), which deals with a specific time for dissolution in the agreement. Section 18-801(a)(2), *Happening of Specific*

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*Events*, is reflected in (i), (iii) and (iv) of the agreement. Subsection (ii) of the agreement reflects §18-801(a)(3). The agreement does not address in the dissolution paragraph §18-804(a)(4) (at the time there are no remaining members), and Subsection (v) deals with §18-801(a)(5), the entry of a decree of dissolution under §18-802.

The agreement, however, deals with §18-802 in a special way. The agreement provided:

> Waiver of Dissolution Rights. The Members agree that irreparable damage would occur if any Member should bring an action for judicial dissolution of the Company. Accordingly, each member accepts the provisions under this Agreement as such Member's sole entitlement to Dissolution of the Company and waives and renounces such Member's right to seek a court decree of dissolution or seek the appointment by a court of a liquidator for the Company.

Up to the time that the Court delivered its opinion in R & R, it had been the opinion of the organized Bar that where the Act does not contain the caveat "unless otherwise provided in a limited liability company agreement," that the provisions of such section of the Act is mandatory and non-waiverable. In R & R, however, the Court held that the waiver of judicial dissolution contained in the agreement was in fact enforceable. The Court noted the apparent conflict between the dissolution section, which in (v) permitted the entry of a decree of judicial dissolution under §18-802, and the waiver of dissolution paragraph which waived judicial dissolution. The Court pointed out that §18-802 provides:

> On application by or for a member of manager, the Court of Chancery may decree dissolution of the limited liability company whenever it is not reasonably practical to carry on the business in conformity with the limited liability company agreement.

The Court pointed out that the application under §18-802 is not necessarily only by a member or manager, but the application may be "by or for" a member or manager, thereby resolving in the Court's mind the conflict between the two provisions of the

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company agreement. The Court held, however, that the absence of what is referred to as the "magical phrase" made the section of the Act nonetheless permissive and subject to modification. The Court proffered that only when the General Assembly has included language such as is found in §18-1101(c), "provided, that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing," only in such circumstances are the provisions non-waiverable.

The issue of waiverability of provisions in the Act which do not contain the affirmative language found in §18-1101(c) but do not contain the "magic language" "unless otherwise provided in the limited liability company agreement," will be subject to additional discussion and potentially statutory amendment.

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II. **UNDERSTANDING THE WORLD OF MINORITY RIGHTS AND FIDUCIARY OBLIGATIONS**.

### A. Source and Nature of Fiduciary Obligations in LLC's.

One of the cornerstones of the Delaware Limited Liability Company Act is §18-1101(b).

> It is the policy of this Chapter to give the maximum effect to the principles of freedom of contract and to the enforceability of limited liability company agreements.

In November 2001, the Delaware Court of Chancery examined the case of Cantor Fitzgerald, L.P. v. Cantor. The limited partnership agreement of Cantor Fitzgerald, L.P. purported to create a fiduciary duty of loyalty owed by the limited partners to the limited partnership itself. The term "duty of loyalty" was not in fact defined in the agreement itself, and the Court was confronted with the term of art and required to define the term. The Court found that the term "duty of loyalty" was distinct from the provisions that limited competition and found that it would be construed as it would be under common law principles derived from the Delaware General Corporation Law. The Court held that "duty of loyalty" was determined to be a term of art which was specifically intended by the drafters to address the common law duty. The Court engrafted this duty onto the relationship between limited partners and the limited partnership even though limited partnerships did not exist at common law and the Delaware Revised Uniform Limited Partnership Act did not impose a duty of loyalty on limited partners. It is remarkable in this case that the Court of Chancery drew upon corporate law to define a term under the Delaware Revised Uniform Limited Partnership Act.

What exactly do we mean by the term "fiduciary duties?" Generally speaking, fiduciary duties fall into three categories. The first two are loyalty and care. The third category is the amorphous concept of "good faith."

In 2002, the Delaware Supreme Court decided Gotham Partners, L.P. v. Hollywood Realty Partners, L.P. In Gotham the Court held that while a limited partnership agreement could provide for contractually created fiduciary duties similarly

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mirroring corporate common law fiduciary duties, a limited partnership agreement could not "eliminate" the fiduciary duties or liabilities of a general partner. The Court of Chancery had previously ruled in its decision in Gotham that under §17-1101 the "partner's. . . duties may be expanded or restricted" to include the ability to eliminate one or more of the traditional fiduciary duties analogized to the corporate law.

In August 2004, in part in response to the Cantor Fitzgerald case and its progeny, the Delaware General Assembly adopted §§18-1101(c) through (e). those provisions are as follows:

> (c) To the extent that, at law of in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement, the member's or manager's or other person's duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement; provided, that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing.
>
> (d) Unless otherwise provided in a limited liability company agreement, a member or manager or other person shall not be liable to a limited liability company or to another member or manager or to another person who is a party to or is otherwise bound by a limited liability company agreement for breach of fiduciary duty for the member's or manager's or other person's good faith reliance on the provisions of the limited liability company agreement.
>
> (e) A limited liability company agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a member, manager or other

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> person to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement; provided that a limited liability company agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.

Commentators have differentiated the views regarding fiduciary duties as "status relationships" and "contractual relationships." The Supreme Court in Gotham focused on status relationships which they analyzed in terms of dependency, such as trustees to beneficiary or agent to principal. In the August 2004 amendments established in response to Gotham, the contractual relationships and not status relationships control the duties and liabilities of parties to a contractual entity agreement.

Section 18-1101(c) permits the parties, in their limited liability company agreement, to expand, restrict or eliminate duties, including fiduciary duties, but provides that "the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing." Please note that the Legislature used the term "contractual covenant" and not a term such as "common law obligation." The Legislature expressed a clear intent that in determining the duties which exist under a limited liability company agreement, a court is to look at the agreement itself, the "contract," and not to common law duties which exist under trust or partnership law, or even under the Delaware General Corporation Law.

Section 18-1101(e) provides that the agreement may limit or eliminate "any and all liability for breach of contract and breach of duties (including fiduciary duties) of a member, manager or other person to a limited liability company or to another member or manager or another person who is a party or otherwise bound by a limited liability company agreement." Subsection (e) goes on to provide that the agreement "may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing." Once again, the Legislature

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used the term "contractual" to differentiate between common law or corporate fiduciary duties.

A post-August 2004 LLC agreement may provide for the elimination of fiduciary duties generally. It is, however, a better drafting technique to express the waiver in the context of the three generally accepted fiduciary duties of loyalty, care and good faith. If the agreement provides for the general elimination of fiduciary duties, then it should be clear to any court that an analysis of the actions of the parties must be viewed in terms of the agreement itself and not in common law terms. In its analysis, the court should first look at the agreement to determine whether expressedly and unequivocally eliminates all three of the fiduciary duty principles found in the common law of corporations, then a partner's acts in furtherance of these duties would be scrutinized to determine whether the agreement authorized or empowered the member or manager to take such an act, and second whether the action did or did not breach the implied contractual covenant of good faith and fair dealing. As §18-1101 currently drafted, there would be no focus on fiduciary relationships or any common law principles contained in the common law duties of care or good faith.

Chief Justice Steele in a well-written article in the *Delaware Journal of Corporate Law*, analyzes fiduciary duties as they now exist in contractual entities such as limited liability companies. In his article, he discusses the implied contractual covenant of good faith and fair dealing. He states:

> Stated in general terms, the covenant requires "a party to a contractual relationship to refrain from arbitrary or unreasonable conduct which has the effect of preventing the other party to the contract from receiving the fruits" of the bargain. Thus, parties are liable when their conduct frustrates the "overreaching purposes" of the contract "by taking advantage of their position to control" implementation of the agreement's terms. Traditional contract principles still control, however, as parties may bargain away covenant

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> protections. Furthermore, only parties to the contract can breach the contract.

The Chief Justice goes on to analyze the few Delaware cases dealing with good faith and fair dealing, primarily in the employment relationship. He states that:

> To be actionable, an employer's conduct "must constitute an aspect of "fraud, deceit and misrepresentation."

In a 2002 case, the Delaware Superior Court held:

> A party to a contract has made an implied covenant to act reasonably to fulfill the intent of the parties to the agreement. This implied covenant was created to promote the spirit of the agreement and to protect against one side using underhanded tactics to deny the otherwise the fruits of the party's bargain. In such a claim, the Court must extrapolate the spirit of the agreement through the express terms and determine the terms that the parties would have bargained for to govern the dispute had they foreseen the circumstances under which their dispute rose. . . To state a claim for breach of an implied covenant of good faith and fair dealing, the Plaintiffs must identify a specific implied contractual obligation.

**B. Identifying and protecting the rights of Minority Interest Holders.**

As indicated in the above discussion, Delaware does not provide for the default rule. Delaware would provide for fiduciary duties in the absence of elimination or limitation under §18-1101(c) or (e).

**C. Restrictions on Fiduciary Obligations.**

Not Applicable.

**D. Securities Law Considerations**

The issuance and transfer of limited liability company interests raise unique issues under federal and state securities laws. Unlike stock in a corporation, a limited liability company interests will not always be considered a "security" under the federal securities

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laws and each state's securities laws (commonly referred to as "Blue Sky" laws). As such, when considering securities laws issues in the context of a limited liability company interest, the threshold issue is whether a limited liability company interest is a "security" covered by federal or a particular state's Blue Sky laws. If a particular limited liability company interest is determined not to be a "security" under either federal or any applicable state securities laws, the issuance and/or transfer of such limited liability company interests should not trigger any duties or obligations under such laws. However, if it is determined that a particular limited liability company interest is or could potentially be a "security" under either federal or applicable state securities laws, a determination will need to be made as to what actions must be taken to comply with such laws in connection with the issuance or transfer of the limited liability company interests.

1. Is a Limited Liability Company Interest a "Security"? When analyzing whether a particular limited liability company interest is a "security," one of the first issues one must consider is which securities laws are applicable. In addition to the federal securities laws, each state has its own Blue Sky laws that may be applicable to any issuance or sales of the applicable limited liability company interest. In this regard, it is important to note that the question of whether a limited liability company interest is a "security" does not fall under the "internal affairs" doctrine. As a result, the fact that the limited liability company interest is an interest in a Delaware LLC does not mean that Delaware law will control; in fact, Delaware's securities law may not be applicable at all. Instead, the securities laws of any state in which an offer or sale is made will probably be applicable. Thus, the determination of whether a particular limited liability company interest is a security will need to be made under the federal securities laws, as well as under the securities laws of any state in which an offer or sale will be made.

a. Federal Law. The term "security" is defined in Section 2(a)(1) of the Securities Act of 933 as follows:

> The term "security" means any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral trust certificate, pre-organization

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> certificate or subscription, transferable share, **investment contract,** voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

The Securities Exchange Act of 1934 includes a virtually identical definition of "security." Although there is no express reference in the above definition to limited liability company interests, the analysis should not stop there. Courts have relied on the term "investment contract" in the definition to find certain investments that, at first blush, might not appear to be securities to be "securities under the federal securities laws. As a result, an analysis of the case law interpreting the term "investment contract" is necessary to determine whether a particular limited liability company interest is a security under the federal securities laws.

In *SEC v. W.J. Howey Co.,* 328 U.S. 293, 66 S.Ct. 1100, 90 L.Ed. 1244 (1946), the Supreme Court set forth the test to determine what constitutes an "investment contract." The Court in *Howey* defined an "investment contract" as any "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." Therefore, the three factors to determine whether something constitutes an "investment contract" under *Howey* are: (1) an investment of money, (2) in a common enterprise, and (3) the expectation of profits solely from the efforts of others.

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In determining whether an LLC interest is a "security," the determining factor will most likely be the third factor, i.e., whether there is an expectation of profits to come solely from the efforts of others. It should be noted, however, that, since the *Howey* decision, the courts have on numerous occasions applied, interpreted and expounded upon the Howey factors. In particular, the courts have interpreted the word "solely" in the "expectation of profits *solely* from the efforts of others" factor to mean "predominately" or "primarily," otherwise any effort on the part of an investor regardless of how minimal would prevent a determination that a particular investment is an "investment contract."

Using these same factors, courts have generally found that an interest in a general partnership is not a security because each general partner has the right to participate in the management of the partnership and is not relying on the efforts of others for a profit. *(See e.g.,* Williamson v. Tucker 645 F.2d 404 (5th Cir. 1981); Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc. 840 F.2d 236 (4th Cir. 1988); Matak v. Murat, 862 F.2d 720 (9th Cir. 1988)). On the other hand, courts have found that a limited partner's interest in a limited partnership will generally be a "security" under the federal securities laws since limited partners usually do not have managerial powers. *(See* Goodman v. Epstein, 582 F.2d 388 (7th Cir. 1978); Mayer v. Oil Field Systems Corp., 721 F.2d 59 (2d Cir. 1983)).

With respect to limited liability company interests, based on the limited case law to this point, there does not seem to be a presumption one way or the other as to whether the interests should be considered a "security." In *Great Lakes Chemicals v. Monsanto Co.,* 96 F.Supp.2d 376 (D. Del. 2000), the District Court for the District of Delaware found that interests in LLC's are different from both general partnership interests and limited partnership interests, and as a result it determined that, in the context of limited liability company interests, it "is necessary to consider the structure of the particular LLC at issue as provided in its operating agreement." In that case, the court ultimately determined that the limited liability company interests were not securities because, among other reasons, the members' power to control the management of the LLC. Other federal. cases, however, have found LLC interests to be securities under the Howey test.

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Since there is limited case law on this issue, the more cautious approach would be to assume that limited liability company interests will be considered a "security" under the federal securities laws. If, however, the LLC Agreement provides members the power and authority to participate in a meaningful manner in the management of the LLC, the limited liability company interests may not be securities under the federal securities laws.

b. State Law. As noted above, determining whether a limited liability company interest is or is not a security under the federal securities laws is only part of the issue. A Blue Sky analysis of each state in which any offers or sales will be made should also be conducted to determine whether the limited liability company interest at issue would be considered a "security." An analysis of each state's securities laws is beyond the scope of these materials. Nevertheless, it should be noted that the definition of "security" differs from state to state. In fact, some states have amended their securities laws to expressly address limited liability company interests. For example, the Pennsylvania Uniform Securities Act provides as follows:

> "Security" does not include:...A membership interest in a limited liability company where all of the following conditions are satisfied: (A) The membership interest is in a company that is not managed by managers; (B) The purchaser of the membership interest enters into a written commitment to be engaged actively and directly in the management of the company; and (C) The purchaser of the membership interest, in fact, does participate actively and directly in the management of the company.

In addition, while many states use the *Howey* factors to analyze whether a limited liability company interest is an "investment contract," states have modified and interpreted the *Howey* factors differently, so a particular state may be more or less restrictive in determining whether a limited liability company interest is an "investment contract" and as such a "security."

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2. Registration or Exemption. If a particular limited liability company interest is determined to be a security, the limited liability company interest will need to be registered under the applicable securities laws before any offers or sales are made unless there is an exemption from the registration requirements. The federal and each state's securities laws provide certain exemptions from the registration requirements (e.g., private placements), a detailed discussion of which is also beyond the scope of these materials. However, any persons claiming the availability of an exemption from the registration requirements should bear in mind that, at least under federal securities laws, the burden will be on them to prove that the transaction or security in issue is entitled to an exemption. In effect, they will be "guilty" unless they are able to prove themselves innocent.

3. The Antifraud Rules. In addition to the registration requirements, various provisions of the federal and state securities laws include prohibitions against the use of material misstatements or omissions and other similar schemes in connection with the sale and purchase of securities. Collectively, these provisions are commonly known as the "antifraud rules," the best known of which is probably Rule 10b-5 under the Securities Exchange Act of 1934. The antifraud rules operate independently of the registration and exemption provisions, and compliance with one set of rules is no assurance that the other set of rules has not been violated.

4. Liabilities. If the, securities laws are violated, there can be serious consequences imposed not only on the LLC but also its members or managers. These liabilities may include the obligation to refund the full amount of the purchase price or to indemnify and hold a purchaser harmless for any loss sustained plus interest, as well as imposing attorneys' fees in certain circumstances. In aggravated cases, civil fines and criminal sanctions may also be sought and imposed.

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