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BLI Case Law Update

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CASE LAW UPDATE

COLORADO CASE LAW

I. Foxfield Villa Associates, LLC v. Robben, 967 F.3d 1082 (10th Cir. 2020).

Introduction

This case involves a federal securities fraud claim relating to the issuance of LLC interests.

Relevant Facts

Mr. Robben, a real estate developer, formed Foxfield, LLC ("Foxfield"), an entity that intended to purchase tracts of real estate. Foxfield was owned 50/50 by two entities: Bartlett Family Real Estate Fund, LLC ("Bartlett") and PRES, LLC ("PRES"). Bartlett was owned by a husband and wife and PRES was owned 50% by Mr. Straub and 50% by Mr. Robben. Each member contributed $200,000 to Foxfield.

The Foxfield operating agreement stated that: (1) Robben acted as President and Treasurer of Foxfield and that Bartlett and Straub were each officers; and (2) most decisions, including acquiring real estate, required just a majority interest (more than 50%); while other decisions, like loaning money to people or entities, required a super majority (65% or greater). Because Foxfield was only comprised of two members, with equal interest, by definition, unanimous consent was required for all decisions. The operating agreement also required Bartlett and Straub to devote a reasonable amount of time to the enterprise. Each member had a right to inspect Foxfield's financial records.

After formation of Foxfield, Bartlett and PRES passed a unanimous resolution that allowed Robben to execute an array of bank documents (mortgages, promissory notes, etc.) on Foxfield's behalf in connection with the acquisition of lots, construction of residences, and sale of residences. This consent allowed Robben to bind Foxfield and its assets without first obtaining Bartlett and PRES's approval.

Foxfield was never profitable, so Straub, Bartlett, PRES, and Foxfield itself brought suit against Robben for one federal claim of securities fraud and 23 claims based on state law alleging that Robben fraudulently induced them to purchase ownership interests in Foxfield.

Procedural History

District Court granted summary judgment to Robben on the sole ground that membership interests in Foxfield that were owned by Bartlett and PRES were not securities.

Plaintiffs appealed the summary judgment ruling, arguing that the district court's conclusion that the membership interests in Foxfield were not securities under the 1934 Securities Act was erroneous.

Holding / Analysis

The court started by saying, under U.S. Supreme Court precedent, a security is "virtually any instrument that might be sold as an investment" including, as relevant here, investment contracts, certificates of interest or participation in a profit-sharing agreement, or instruments commonly known as securities. The court analyzed each of these three terms under the 1934 Securities Act.

First, the membership interests were not investment contracts because the profits that the LLCs expected to gain as a result of the investments were not "to come solely from the efforts of others." This is the third prong of the Howey investment contract test. The Court listed 6 factors to consider in determining the degree of control:

1. **The investors' access to information;**
    a. The principle purpose of the Securities Act is to protect investors by promoting full disclosure of information necessary to informed investment decisions.
    b. Here, Foxfield's operating agreement allowed Bartlett and PRES to inspect and copy all Foxfield's financial records and documents.
2. **The investors' "contractual powers";**
    a. Regardless of whose efforts actually affect the success or failure of the enterprise, an investor who has the contractual power to control the enterprise—even if he does not use that power—has the sort of influence that "protects him against a dependence on others."
    b. Here, Bartlett's and PRES's contractual powers were extensive and the operating agreement stated the LLC was member-managed.
3. **The investors' "contribution of time and effort to the success of the enterprise";**
    a. This test does not live and die by the investors' contractual powers—the investors actual involvement in the LLC (or lack thereof) can clarify whether they had the ability to control the profitability of their investments.
    b. A court will generally only find practical inability to control when: (1) the investors powers as exercised are so insubstantial, ineffective, or illusory that the LLC is virtually indistinguishable from a Limited Partnership; (2) when the investors themselves are so inexperienced and unknowledgeable in business affairs that they are incapable of intelligently exercising their powers under the LLC; or (3) when the manager or promoter of the LLC is so unique that, even if the investors do retain some practical control over the LLC, they still have no realistic alternative to the manager or promoter.
    c. Here, because Bartlett and PRES were the only two members of Foxfield, every decision required mutual assent and none of the three factors above were satisfied.
4. **The adequacy of financing;**
5. **The nature of the business risks**

6. **The level of speculation**
    a. Factors 4 – 6 are the least relevant and can only confirm whether the LLC interests are investment contracts.

Second, because the member LLCs did not intend to publicly trade their interests in Foxfield, those interests were not certificates of interest or participation in a profit sharing agreement under the 1934 Securities Act.

Third, the interests in Foxfield were not commonly known as securities because they were not securities under the economic realities of those interests.

The summary judgment was affirmed.

II. Thompson v. People, 2020 CO 72 (No. 18SC543).

Introduction

This case dealt with the question of whether a promissory note is a security under the Colorado Securities Act. In making this determination, the Supreme Court first decided to adopt the family resemblance test from *Reves v. Ernst & Young*, 494 U.S. 56, 64–67 (1990), as the test for determining whether a note is a security for purposes of the Colorado Securities Act, CRS §§ 11-51-101 to -1008 (CSA). Under this test the Court held the promissory note was a security and upheld Thompson's conviction.

Relevant Facts

Mr. Thompson owned, and was the sole manager of, SGD Timber Canyon, LLC ("Timber Canyon"). Timber Canyon, owned undeveloped lots in the Timber Ridge neighborhood in Castle Rock, CO. Timber Canyon went into foreclosure in October 2009, filed for bankruptcy in February 2010, so Flagstar Bank, which gave Timber Canyon loans, sought relief and the parties entered into an agreement that Timber Canyon had to make a $6.75M payment to Flagstar Bank by October 2010. In Spring 2010, Thompson signed an LOI whereby he would sell his ownership of Timber Canyon to John Witt. Thompson didn't disclose to John that Timber Canyon was in foreclosure.

When John's parents, the Witts, came to look at the properties, Thompson secured a $400K loan from them, telling them he would use the money to purchase one of the Timber Ridge lots, construct a house on the property, and sell it to a prequalified buyer and get the Witts their money back. Later, Thompson called the Witts about converting their loan into a bridge loan which would be used for additional development. Thompson repeatedly told them the investment was a no brainer; that the property was valued at $31M; and he would repay their loan in full, with a $240K profit and 8% interest by January 12, 2011 – so, they wired him an additional $2M. Thompson used the money for his own personal use.

At no point did Thompson disclose to the Witts: 1) the two properties he put up as collateral were already highly leveraged; 2) Timber Canyon had declared bankruptcy; 3) the

Timber Ridge properties had been in foreclosure and were subject to a forbearance agreement; or 4) Flagstar Bank had valued the properties at only $6.75M

In 2011, when he defaulted on the repayment. John paid them $70K, so they filed a civil suit.

Procedural History

At the trial court level, the jury convicted Thompson and he got 12 years on each securities fraud count, served concurrently, and 18 years on the theft count to be served consecutively. Thompson appealed and his conviction was upheld by a unanimous opinion. This was his appeal to the Colorado Supreme Court.

Holding / Analysis

Thompson argued that the district court improperly applied the family resemblance test out of Reeves to determine whether a note is a security.

The Reeves' family resemblance test says a note is presumed a security UNLESS it fits into one of 7 enumerated categories of non-securities: (1) notes delivered in consumer financing; (2) notes secured by a mortgage on a home; (3) short-term notes secured by liens on a small business or some of its assets; (4) notes evidencing a "character" loan to a bank customer; (5) short-term notes secured by an assignment of accounts receivable; (6) notes that simply formalize an open-account debt incurred in the ordinary course of business; or (7) notes evidencing loans by commercial banks for current operations.

However, the presumption that a note is a security if it does not fit into one of those 7 enumerated categories, can be overcome if it bears a strong family resemblance to one of those types of notes.

Four factors are considered when determining if a note bears a close family resemblance:

1. **Examine the transaction to assess the motivations of what would make a reasonable seller and buyer enter into it**
    a. E.g. if a seller's purpose is to raise money for general business enterprise or finance substantial investments, likely a security; if, instead, used to purchase minor assets, consumer goods, or to correct cash flow issues, likely not a security.
    b. Here, the record demonstrates that Thompson's intention to enter into the transaction was to raise money to buy more properties and pay a lower interest rate than he would if he got the money from another lender -- these facts alone undermine his contention it was to fix a cash flow problem.
2. **Court examines the plan of distribution of the instrument to determine whether it's an instrument in which there is common trading for speculation or investment**

a. This does not mean the seller had to have a plan for distribution of the note to a broad segment of the public, it means the limited distribution of an instrument like what is at issue here, must be weighed against the purchasing individual's need for the protection of securities law.
b. Here, the promissory note and guaranty secured $2.4M loan in a real estate development project, that while supposedly "low risk," still was a speculative venture-- its success was reliant on Thompson's ability to secure a longer-term, permanent financing that would "take out" what was represented as a short term loan and complete the purchase of other lots that would further secure the Witts' investment-- this indicates a security.

3. **The Court examines the reasonable expectations of the investing public**
   a. The court will consider instruments to be securities on the basis of such public expectations, even where economic analysis of the circumstance might suggest that the instrument are not securities as used in that transaction.
   b. Here, a reasonable member of the investing public would find this to be an investment. In fact, Thompson repeatedly referred to it as an investment; he said he would pay back their note in full and with a profit plus interest.
4. **The Court examines whether some factor, such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering the application of the Securities Act unnecessary**
   a. Thompson argues that since the note was secured by 2 properties, the note was not a security; however, the two properties were already heavily leveraged, a fact he failed to disclose to the Witts.
   b. The fact the collateral was provided in name did not reduce the risk of investment as to make the application of securities law unnecessary.

All 4 of the family resemblance test factors are satisfied, so the note is a security.

The Court upheld the Conviction, including consecutive sentencing.

III. Nieto v. Clark's Market, 2021 CO 48 (No. 19SC553).

Introduction

In this case the Colorado Supreme Court considered whether, under the Colorado Wage Claim Act (CWCA), an employer must pay an employee's earned but unused vacation pay upon separation from employment despite an agreement purporting to forfeit the employee's right to such payment.

Relevant Facts

In 2003, the General Assembly added subsection C.R.S. 8-4-101(14)(a)(III), of the CWCA to expressly define "vacation pay" as a type of protected wages and compensation. In this case, the Court addressed the meaning of subsection (14)(a)(III) and its relationship with other provisions of the CWCA for the first time since its adoption.

Clark's Market, Inc. ("CMI") terminated its longtime employee, Carmen Nieto in March 2017, and it declined to pay Nieto any of her accrued but unused vacation pay, citing its policy that an employee who is "discharged for any reason or do[es] not give proper notice . . . will forfeit all earned vacation pay benefits." Nieto argued that CMI's policy requiring forfeiture of her earned vacation pay violates the CWCA.

Procedural History

Nieto sued CMI in district court for withholding her vacation pay, asserting that subsection (14)(a)(III) required CMI to "pay upon separation from employment all vacation pay earned and determinable in accordance with the [employee handbook]" and that the forfeiture clause purporting to waive her right to such payment was void under Section 8-4-121 of the CWCA.

CMI moved to dismiss Nieto's complaint for failure to state a claim, and the district court granted the motion. The court reasoned that because the CWCA "clearly and unambiguously gives employers the right to enter into agreements with its employees regarding vacation pay," CMI's forfeiture clause was valid and Nieto was thus "not entitled to any accrued vacation pay."

Nieto appealed, and a division of the court of appeals affirmed. The division ultimately concluded that, because CMI fired Nieto, her vacation pay—despite being earned—had not "vested" under CMI's policy. In reaching that conclusion, the division reasoned that the CWCA "creates [no] substantive right to payment for accrued but unused vacation time" and "merely 'establishes minimal requirements concerning when and how agreed compensation must be paid.'"

Nieto then petitioned for certiorari review by the Supreme Court, which was granted.

Holding / Analysis

The Court interpreted CRS § 8-4-101(14)(a)(III) and other provisions of the CWCA, and concluded that, although the CWCA does not create an automatic right to vacation pay, where an employer chooses to provide such pay, it cannot be forfeited once earned. Accordingly, the Court held that all earned and determinable vacation pay must be paid upon separation and that any agreement purporting to forfeit earned vacation pay is void.

The Court therefore reversed the Court of Appeals' judgment affirming the dismissal of the employee's wage complaint and remanded the case for further proceedings.

IV. CadleRock Joint Venture LP v. Esperanza Architecture & Consulting, Inc., 2021 COA 119 (No. 20CA0919).

Introduction

This case addresses whether a line of credit is a negotiable instrument under C.R.S. Section 4-3-104(a).

Relevant Facts

WestStart Bank (nonparty) issued defendants a $500,000 "revolving line of credit" (the Credit Agreement). The parties later modified the Credit Agreement and increased the line of credit to $750,000. Defendants subsequently defaulted.

CadleRock Joint Venture LP (CadleRock) asserted it was the successor in interest to the defaulted line of credit, but admitted that a prior holder of the loan lost the original Credit Agreement. CadleRock sued defendants for debt due, breach of contract, quantum meruit, and unjust enrichment.

Defendants moved for summary judgment, asserting that the Credit Agreement was a negotiable instrument governed by Colorado Uniform Commercial Code (UCC) Article 3. The defendants therefore alleged that CadleRock was barred from enforcing the defaulted line of credit under several UCC provisions.

Procedural History

The district court granted the motion to dismiss as to all claims except breach of contract. CadleRock appealed and argued that the district court erred, among other reasons, in finding the Credit Agreement was a negotiable instrument and therefore dismissing CadleRock's past due and unpaid installments claim.

Holding / Analysis

On appeal, CadleRock argued that the district court erred in concluding that the Credit Agreement was governed by the UCC because it is not a negotiable instrument. CRS § 4-3-104(a) defines a negotiable instrument as requiring a promise to pay a "fixed amount."

Here, while the Credit Agreement specifies an upper limit to the total amount advanced, it allowed defendants to draw less or more than the limit over the course of the loan by repaying and re-borrowing. Accordingly, the amount defendants promised to pay could fluctuate significantly over the course of the loan, and without knowing the total advanced, the amount defendants promised to pay cannot be determined from the Credit Agreement. Therefore, the Credit Agreement does not reflect a promise to pay a fixed amount and is thus not a negotiable instrument.

Because UCC Article 3 only governs negotiable instruments, CadleRock is not barred from enforcing the past due and unpaid installments claim, and the district court erred. Further, because UCC Article 3 doesn't govern enforcement of the Credit Agreement,

CadleRock is not barred from enforcing the defaulted line of credit because it lacked the original document for the Credit Agreement.

V. Walker v. Women's Professional Rodeo Ass'n, Inc., 2021 COA 105 (No. 20CA0668).

Introduction

This case considered whether members of a nonprofit corporation that is a membership association are entitled to judicial review of the corporate board's interpretation and application of the corporation's internal rules.

Relevant Facts

Plaintiffs were members of the Women's Professional Rodeo Association, Inc. (WPRA), a Colorado nonprofit corporation that has rules governing its operations. Plaintiffs finished in first and second place in a barrel racing competition at a rodeo in Wyoming. However, the day before the Rodeo, the judges declared the arena conditions dangerous, so most other contestants did not compete.

Plaintiffs sued the WPRA, its chief executive officer (CEO), and the Rodeo organizer after the WPRA did not pay plaintiffs the prize money they claimed they were entitled to. In their complaint, plaintiffs alleged that the WPRA and its CEO had engaged in ultra vires acts, breached their fiduciary duty to plaintiffs, and breached a contract with them. Plaintiffs also sought judicial dissolution of the WPRA.

Procedural History

The district court dismissed their claims for failure to state a claim upon which relief can be granted and awarded attorney fees to the WPRA and its CEO. The plaintiffs appealed.

Holding / Analysis

On appeal, plaintiffs argued that the trial court erred by granting the motions to dismiss, contending that the WPRA failed to follow or misapplied certain of its rules.

Under the business judgment rule, "[t]he good faith acts of directors of profit or non-profit corporations which are within the powers of the corporation and within the exercise of an honest business judgment are valid." Here, plaintiffs' allegations centered on the WPRA board's interpretation and application of certain rules and they did not allege fraud, arbitrariness, or bad faith. Therefore, under the business judgment rule, a court cannot interfere with the board's decisions. Dismissal under CRCP 12(b)(5) was appropriate because plaintiffs' claims against the WPRA do not meet the plausibility standard articulated in Warne v. Hall, 373 P.3d 588 (Colo. 2016).

The Court of Appeals also determined that the plaintiffs' claims for breach of fiduciary duty and breach of contract against the CEO failed to state a claim upon which relief can be granted because a nonprofit corporation's directors and officers are not personally liable for the corporation's acts and plaintiffs did not plead any exception to this rule.

Finally, the Court of Appeals held that the plaintiffs' claim for judicial dissolution fails because they did not allege the type of oppressive conduct necessary to obtain that drastic remedy. Under the Colorado Revised Nonprofit Corporation Act (NCA), a member of a nonprofit corporation may seek judicial dissolution of the corporation if the directors "have acted, are acting, or will act in a manner that is illegal, oppressive, or fraudulent." The court cited cases that held dissolution of a corporation to be "a drastic remedy and [is] rarely imposed.

The Court of Appeals agreed with the district court that, even if the board of directors of the WPRA owed fiduciary duties to the plaintiffs, and even if the board's failure to maintain adequate corporate records could constitute a breach of fiduciary duty, a "simple allegation of breach of fiduciary duty is not enough to dissolve a corporation that is not closely-held."

DELAWARE & OTHER CASE LAW

I. International Rail Partners LLC v. American Rail Partners, LLC, C.A. No. 2020-0177-PAF (Del. Ch., Nov. 24, 2020).

Summary

In this case the court determined that an advancement provision in a limited liability company agreement required defendant American Rail Partners, LLC ("American Rail" or the "Company") to advance attorneys' fees and expenses to Plaintiffs for first-party claims that the Company asserted against them. In reaching that conclusion, the Court refused to apply the interpretative presumption that fees and expenses for first-party claims are not advanced unless provided for expressly in the contract, instead finding that the statutory provisions concerning advancement in the LLC Act and Delaware public policy favored a broader reading of indemnification and advancement rights.

II. Snow Phipps Group, LLC v. KCake Acquisition, Inc. (Del. Ch. April 30, 2021).

Summary

In this case the Delaware Court of Chancery issued an order for specific performance to compel Kohlberg & Company, LLC (the "buyers") to close the $550 million acquisition of DecoPac Holdings Inc. The court held that the buyers breached their obligation to use reasonable best efforts in connection with the debt financing for the acquisition.

III. Harley V. Franco v. Avalon Freight Services LLC and Doug Houghton, C.A. No. 2020-0608-MTZ (Del. Ch. Dec. 8, 2020).

Summary

This case dealt with the removal of an LLC board member in a tiered LLC structure. The court held that a governing LLC agreement's plain language must be strictly construed; and in this case, it did not provide for unilateral removal of a board member.

IV. Guzman v. Johnson, 137 Nev. Adv. Op. 13 (Mar. 25, 2021).

Summary

In this case, the Nevada Supreme Court held that a plaintiff cannot rebut the business judgment rule as a matter of law simply by challenging an interested fiduciary's corporate dealings. Instead, to hold a director liable for corporate decisions, a plaintiff must "both rebut the business judgment rule's presumption of good faith and show a breach of

fiduciary duty involving intentional misconduct, fraud, or a knowing violation of the law." Because the mere allegation that a director was an interested party was not sufficient to shift the burden to the director to show entire fairness, and the plaintiff had not pled facts showing that the relevant directors were motivated by self-interest, the Nevada Supreme Court affirmed the dismissal of the plaintiff's complaint.