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2013 BUSINESS CASE LAW UPDATE

Who Is The Owner?

In re the Estate of Jeanette Elizabeth Grosboll, deceased, 2013 COA 141 (Colo. App. 10/24/2013)[1]

In re the Estate of Jeanette Elizabeth Grosboll is a probate case discussing Colorado's Uniform Partnership Law (the "UPL" at C.R.S. § 7-60-101 *et seq.*) and Uniform Partnership Act (the "UPA" at C.R.S. § 7-64-101 *et seq.*). The case should be of interest to business lawyers as well as estate planners. The facts of the case are relatively complex but can be simplified as follows:

- Jeanette and Ashley Grosboll (wife and husband) had acquired title to Loma Vista Apartments before the formation of Grosboll Manor, L.L.L.P.

- Jeanette and Ashley formed Grosboll Manor, L.L.L.P. in 2004. At formation, Jeanette contributed $750,000 for a 49.5% interest; Ashley contributed $750,000 for a 49.5% interest, and their daughter Jo Ann contributed $100 for a 1% interest.

- Jo Ann testified that when she, Jeanette and Ashley formed Grosboll Manor, they intended that Loma Vista be an asset of the partnership. The accountant for Grosboll

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[1] To be published in the Business Law Section (CBA) Newsletter (January 2014) (available at *www.cobar.org*) as Lidstone, *Who Is The Owner?*

Manor testified that he treated Loma Vista as a partnership asset on the Grosboll Manor books.

- Jeanette and Ashley never formally transferred Loma Vista to Grosboll Manor.

- Jeanette's and Ashley's wills provided that Grosboll Manor would, on the death of the last parent, pass to Jo Ann, while the residuary estate would be divided between their two sons, Robert and Edward.

- Jeanette and then Ashley died in 2009 and 2010, with Loma Vista still formally titled in their individual names.

- Following their death, Jo Ann and the personal representative (brother Edward) agreed to sell Loma Vista. As the purchaser made payments for Loma Vista to the estate, the estate distributed those payments to Jo Ann as a partnership asset.

- Robert had also died during the same period as his parents. Robert's heirs objected to the distribution to Jo Ann, claiming that Loma Vista was an estate asset and not a partnership asset since Loma Vista had been titled in Jeanette's and Ashley's name and not in the name of Grosboll Manor, the partnership.

The trial court had relied on the Colorado statute of frauds in reaching its decision that, without a deed transferring title of Loma Vista to Grosboll Manor, Loma Vista remained an asset of the two individuals. The trial court also found that nothing in the partnership agreement overcame the statute of frauds requirement for a writing to transfer real estate. The Colorado statute of frauds (found in C.R.S. § 38-10-106) provides:

> No estate or interest in lands, other than leases for a term not exceeding one year, nor any trust or power over or concerning lands or in any manner relating thereto shall be created, granted, assigned, surrendered, or declared, unless by act or operation of law, or by deed or conveyance in writing subscribed by the party creating, granting, assigning, surrendering, or declaring the same, or by his lawful agent thereunto authorized by writing.

After analyzing cases from a number of other states on both sides of the issue, the Court of Appeals reversed the trial court's determination, holding that the statute of frauds did not apply to determine ownership of Loma Vista:

> We conclude that the reasoning in the cases holding that a written conveyance satisfying the statute of frauds is not necessary in order to deem real property a

> partnership asset conform most closely with Colorado's treatment of partnership property.[2]

In so ruling, the Court of Appeals looked at both the UPL and the UPA. (The UPA was applicable to Grosboll Manor, a limited liability limited partnership formed in 2004.) The Court of Appeals noted that the UPL (in C.R.S. § 7-60-108(1)) contemplates that property originally brought into a partnership may have been the separate asset of an individual partner:

> All property originally brought into the partnership stock *or* subsequently acquired by purchase or otherwise on account of the partnership is partnership property.[3]

As the Court of Appeals noted, the UPL does not require that a conveyance be executed, and it does not distinguish between personal property and real property. The Court of Appeals also considered the UPA which contemplates that property held in the name of individual partners may be considered a partnership asset, but provides (in C.R.S. § 7-64-204(4)) a rebuttable presumption that it is the partner's separate property if not acquired with partnership assets:

> Property acquired in the name of one or more of the partners, without an indication in the instrument transferring title to the property of the person's capacity as a partner or of the existence of a partnership and without use of partnership assets is presumed to be separate property, even if used for partnership purposes.[4]

Based on the Court of Appeals' analysis of the UPL and UPA, as well as its review of other relevant cases nationwide, the Court of Appeals concluded that a written conveyance was not required if the intention of the parties was sufficiently clear that the assets in question were intended to be partnership assets. The Court of Appeals directed the trial court, on remand, to determine whether Loma Vista was a personal asset of the parents or an asset of Grosboll Manor, and held that the statute of frauds was inapplicable.

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[2] The Court of Appeals cited a number of Colorado cases going back to 1890. *See Meagher v. Reed*, 14 Colo. 335, 358, 24 P. 681, 688 (1890) ("If the land is partnership property, the title is vested in the partnership, and is defined, governed, and controlled by well-settled principles of partnership law; and this is true whether the title is vested in one of the partners, or in all.").

[3] C.R.S. § 7-60-108(1).

[4] C.R.S. § 7-64-204(4).

Joint Venture Interests as Securities
Joseph v. HEI Resources, Inc., et al. (Denver Dist. Ct. 10/17/2013)[5]
Joseph v. Mieka Corporation, 2012 COA 84 (Colo. App. 5/10/2012)[6]
SEC v. Shields, 2012 WL 3886883 (D. Colo. 9/6/2012)[7]

Colorado courts have addressed several cases involving the question whether interests in oil and gas drilling joint ventures are "securities" for the purposes of federal and state securities laws. Most recently, these include the Colorado Court of Appeals' affirmation of a cease and desist order issued by the Colorado Securities Commissioner in *Joseph v. Mieka Corporation* and *SEC v. Shields* where the Colorado federal district court dismissed a similar case brought by the Securities and Exchange Commission.

The most recent case was decided by the Honorable Michael A. Martinez of the Denver District Court when he issued his opinion and final judgment in *Joseph v. HEI Resources, Inc., et al.* In his order, Judge Martinez reviews a number of drilling ventures formed by HEI Resources, Inc. ("HEI") and specifically focuses on the character of the venturers who contributed funds for the drilling of the promised wells. Judge Martinez's order followed an earlier opinion by the Honorable Morris B. Hoffman.[8]

Both Judge Martinez and Judge Hoffman applied the Fifth Circuit case of *Williamson v. Tucker*[9] to determine whether the joint venture interests offered by HEI were "securities" under Colorado law. Judge Martinez went on to consider whether the Commissioner's alternative argument, the "economic realities test," would change the analysis. In the end, Judge Martinez found that the joint venture interests offered were not securities, and that such finding was "dispositive of all claims raised by Plaintiff" and vacated the May 2014 trial.

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[5] *Joseph v. HEI Resources Inc., et al.*, Case No. 09 CV 7181 (Denver Dist. Ct. 10/17/2013), originally appearing in the Business Law Section (CBA) Newsletter (October 2013) (available at *www.cobar.org*) as Lidstone, *The Denver District Court Decides: Joint Venture Interests are Not Securities*.

[6] *Joseph v. Mieka Corp.*, 2012 COA 84, 282 P.3d 509 (Colo. App. 5/10/2012), originally appearing in the Business Law Section (CBA) Newsletter (May 2012) (available at *www.cobar.org*) as Lidstone, *Joint Venture Interests As Securities*.

[7] *SEC v. Shields*, 2012 WL 3886883 (D. Colo. 9/6/2012), originally appearing in the Business Law Section (CBA) Newsletter (September 2012) (available at *www.cobar.org*) as Lidstone, *More Joint Venture Interests, but NOT Securities!*

[8] *Joseph v. HEI Resources, Inc.*, Case no. 09 CV 7181 (Denver Dist. Ct. 1/6/2011).

[9] 645 F.2d 404 (5th Cir. 1981).

The Oil and Gas Drilling Joint Ventures

HEI, along with many other oil and gas operators, developed working interest programs in which people could invest money and become working interest owners in a drilling venture. The joint ventures formed by HEI were formed as general partnerships subject to Texas law. The documentation generally provided that the venturers had to vote at material steps along the way, and the documentation included the following warning:

> Participants in this Joint Venture are provided extensive and significant management powers. Participants are expected to exercise such powers and are prohibited from relying on the Managing Venturer for the success or profitability of the Venture.

In their investor questionnaires and applications, the prospective venturers acknowledged "under penalties of perjury" that their participation would be required and that they had the necessary sophistication and experience to participate. Many of the investors were found by solicitors making "cold calls" "without regard to their experience or interest in oil and gas exploration." If the person called expressed interest, HEI provided the prospective venturers with a confidential information memorandum containing a turnkey drilling contract, a separate contract for completion, and a significant amount of other disclosure.

In the eight joint ventures which Judge Martinez reviewed, there were more than 500 venturers from at least 30 states. Seventeen venturers testified at trial, ranging in age from 48 to 78. Judge Martinez concluded that, "[a]s a group, the joint venture partners possessed significant knowledge and experience in business affairs" and that the "partners in the Joint Ventures were capable of intelligently exercising the partnership powers granted to them in the joint venture agreements."

During the operation of the joint ventures, HEI (and in some cases, the venturers) called meetings and the venturers voted. HEI kept records of the votes and presented them as evidence that in fact the venturers (including those who testified) participated. Judge Martinez also noted that some of the venturers continued to invest in subsequent ventures even after receiving little or no return on earlier joint ventures.

Williamson v. Tucker

Important to this case, in both Judge Hoffman's 2011 opinion and Judge Martinez's October 2013 opinion, is the *Williamson v. Tucker* case. In *Williamson*, the Fifth Circuit held that there is a strong presumption that interests in general partnerships were not securities. The Court held that the presumption can be overcome, and an interest in a general partnership can be a security, if the investor can establish any one of three factors:

1. The agreement among the parties leaves so little power in the hands of the partner that the arrangement in fact distributes power as would a limited partnership;

2. The partner is so inexperienced and unknowledgeable in business affairs that he is incapable of exercising his partnership powers; or

3. The partner is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership powers.

In his 2011 opinion, Judge Hoffman reviewed the facts presented by the Commissioner and determined that the Commissioner could not prove *Williamson* factors no. 1 or no. 3, the agreements provided significant power and authority to the venturers, and the oil and gas industry is not dependent on some unique entrepreneurial or managerial ability of any person (which Judge Martinez later determined as well). Judge Hoffman had left for determination by subsequent trial whether the Commissioner could prove *Williamson* factor no. 2 (that the individuals were incapable of exercising their powers through a lack of experience or knowledge) and whether the "economic realities" test proffered by the Commissioner would lead to a different conclusion.

In determining that the Commissioner had not met his burden of showing the applicability of *Williamson* factor no. 2, Judge Martinez looked at federal authority which reflected that "a partner in a general partnership must have experience and knowledge in business affairs *generally*, and a partner is not required to have industry specific knowledge in order to preclude a finding that a joint venture interest is a security."[10] As noted above, Judge Martinez found that the venturers as a group, and each of the venturers who testified, were sufficiently experienced and knowledgeable business people to withstand the application of the second *Williamson* factor.

The Economic Realities Test

The Commissioner has argued a number of times that the courts should not apply the *Williamson* presumption but should apply the "economic realities test." This was discussed in *Mieka* as well as in the earlier cases of *Joseph v. Viatica Mgmt, LLC*[11] and *Toothman v. Freeborn & Peters*.[12] The key question in performing an economic realities analysis is whether the enterprise is promoted primarily as an investment or as a means whereby participants could pool their own activities, money, and the promoter's contributions.[13] In

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10 Emphasis in original.

11 55 P.3d 264, 266 (Colo. App. 2002).

12 80 P.3d 804, 811 (Colo. Ct. App. 2003).

13 *Id.*

the former case, a security would be involved; in the latter case, arguably not. In the May 2012 Business Law Section newsletter I argued that the two tests were similar:

> It can be expected that the Commissioner will continue to oppose application of the *Williamson* presumption on the basis that the presumption increases the Commissioner's burden of proof that a participation in a general partnership entity (including in some cases a joint venture) is a security. On the other hand, the *Williamson* presumption is a rational approach toward determining whether a transaction involves a security. The *Williamson* factors are also relevant to performing an economic realities analysis. Since the burden of proof should be on the Commissioner when bringing an enforcement action in a civil or administrative setting, whether or not the *Williamson* presumption applies does not shift the Commissioner's ultimate burden of proof.

In reaching his conclusion that the joint venture interests in *Joseph v. HEI Resources, Inc.* were not securities under the catch-all economic realities test, Judge Martinez focused on Colorado Supreme Court guidance in *Cagle v. Mathers Family Trust*[14] that provisions of the Colorado Securities Act should be coordinated with federal securities law. In applying applicable precedent, Judge Martinez said that the Commissioner, as plaintiff, "has simply failed to carry its heavy burden of establishing that the joint venture interests . . . are securities under any catch-all economic realities."

Shields

The federal district court dismissed the case against Jeffory Shields and his company which carried a similar fact pattern as the *Mieka* case and the *HEI Resources* case. As required by *Bell Atlantic Corp. v. Twombley*,[15] the federal district court reviewed the SEC's complaint to determine whether, after accepting "all well-pleaded factual allegations of the complaint as true," the complaint "contains enough facts to state a claim to relief that is plausible on its face." The federal district court reviewed the factual allegations and noted that, to determine the existence of an investment contract (and therefore a "security" subject to SEC jurisdiction), the core question was "whether investors were led to expect profits 'solely from the efforts of others.'" The federal district court noted that since the 1946 *Howey* case, the standard has been relaxed. The federal district court defined the current standard as "whether an investor, as a result of the investment agreement itself or the factual circumstances that surround it, is left unable to exercise meaningful control over his investment."

The federal district court went on to describe the *Williamson* test, noting that the joint ventures in question were general partnerships, and "[a] general partnership interest is

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[14] 295 P.3d 460, 467 (Colo. 2013). See further discussion below.

[15] 550 U.S. 544 (2007).

presumed not to be an investment contract because a general partner typically takes an active part in managing the business and therefore does not rely solely on the efforts of others."[16]

In order to determine whether the joint venture/general partnership interests were "investments contracts," the federal district court focused on the rights of the joint venture participants (referred to by the SEC as the "investors") as established in the agreements. Whether the investors exercised those rights was not a material consideration for the federal district court; the important determination was whether the investors had appropriate rights they could exercise should they choose to do so. (Perhaps if the SEC would have alleged that the joint venture participants were not sufficiently sophisticated in oil and gas matters to be able to exercise his or her rights, the federal district court would have allowed the case to proceed further. Of course, the actual "sophistication" of each investor would then have to be measured against the representations the investor made in the joint venture documentation.)

As noted by the federal district court, the thrust of the SEC's arguments in the *Shields* case was that the defendants' subsequent (but alleged) post-investment fraud rendered the investors' contractual rights to participate in the venture meaningless. In granting the motion to dismiss, the federal district court noted that "the SEC has flipped the relevant inquiry on its head, reasoning backwards from the alleged fraud itself to prove that the investors lacked control." The federal district court noted that the investment needs to be judged as of the facts existing at the time of the investment—and not based on subsequent acts no matter how egregious. Since the agreements gave the investors appropriate rights and further, since none of the investors were "so dependent on a particular manager," a security was not involved.

Conclusion

The issues surrounding joint venture interests as securities are not yet settled. The Colorado Securities Commissioner has appealed the *HEI Resources* decision to the Colorado Court of Appeals.

Furthermore, and perhaps more importantly, different facts might lead to different results. Where the documentation of another joint venture may be the same as the HEI documentation described in Judge Martinez's opinion but the investors are inexperienced and unknowledgeable about business affairs, the second *Williamson* factor to overcome the presumption might be met. Where the managing venturer simply made decisions without providing the venturers the opportunity to exercise their right to vote, the first *Williamson* factor might be found to exist.

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[16] As discussed above, it should be noted that the Colorado Securities Commissioner objected to the application of the *Williamson* test for state law purposes.

Forum Selection Clauses

Cagle v. Mathers Family Trust, No. 11SC496 2013 CO 7 (Feb. 4, 2013)[17]

This is another in the long line of cases involving joint venture interests in oil and gas drilling programs issued by HEI Resources, Inc. HEI was incorporated in Texas and is based in Colorado. In this case, plaintiffs from California, Illinois and Vermont had entered into joint venture agreements with HEI for ventures in Alabama, Mississippi, and Texas. The agreements provided (among other things) that any disputes would be resolved in Dallas, Texas in accordance with Texas law.

Apparently concerned about whether Texas law would treat the joint venture interests as securities, the plaintiffs brought legal action against HEI and a number of other defendants in Colorado under the Colorado Securities Act,[18] as well as the securities acts of California, Illinois and Vermont. (The complaint included other common law claims, as well, such as fraud, misrepresentation, concealment, negligence, and breach of fiduciary duties by the defendants.) HEI and the other defendants filed motions to dismiss on the grounds the plaintiffs' lawsuit breached the forum selection clause in the joint venture agreement; the trial court granted the defendants' motions. On appeal, a panel of the Colorado Court of Appeals reversed, holding the "anti-waiver" provision of the Colorado Securities Act[19] voids any private agreements that waive compliance with the Colorado Securities Act.

In a long discussion, the Colorado Supreme Court (without dissent) found the anti-waiver provision was not applicable in this case and that the Colorado Securities Act does not require claims under the Colorado Securities Act be brought in Colorado. Instead, the Court held the anti-waiver clause applied to substantive rights under the Colorado Securities Act and not to procedural rights. In analyzing the validity of forum selection clauses, the Colorado Supreme Court discussed *Rodriguez de Quijas v. Shearson/Am. Express, Inc.*[20] in which the U.S. Supreme Court reasoned arbitration clauses were "in effect, a specialized kind of forum-selection clause" and held they should not be prohibited under the similar provision in Section 14 of the Securities Act of 1933 because "arbitration clauses did not undermine a substantive right under the Securities Act and parties did not waive compliance with the Securities Act by agreeing to an arbitration clause."

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[17] Originally appearing in the Business Law Section (CBA) Newsletter (March 2013) (available at *www.cobar.org*) as Lidstone, *Two Important Cases – Colorado Trust Fund Statute and Forum Selection Clauses for Securities Claims.*

[18] C.R.S. §§ 11-51-101, *et seq.*

[19] C.R.S. § 11-51-604(11).

[20] 490 U.S. 477, 482-483 (1989).

Specifically addressing the validity of the forum selection clause, the Colorado Supreme Court discussed 14D Wright & Miller, *Federal Practice & Procedure* § 3803.1 (citing the "substantial number" of cases holding that a forum selection clause is presumed valid) and Restatement (Second) of Conflict of Laws § 80. The Colorado Supreme Court also cited *M/S Bremen v. Zapata Off-Shore Co.*[21] in which the U.S. Supreme Court stated forum selection "clauses are *prima facie* valid and should be enforced unless enforcement is shown by the resisting party to be 'unreasonable' under the circumstances." The U.S. Supreme Court's conclusion was consistent with what the Colorado Supreme Court described as the prevailing trend in the law to honor the parties' choice of forum unless that choice was unfair or unreasonable. The Colorado Supreme Court built on the *Bremen* Court's conclusion that a forum selection clause is presumptively valid unless the party seeking to void the clause shows:

1. The clause was unreasonable and unjust;
2. The clause it was the product of fraud or overreaching; or
3. Enforcement of the clause would contravene a strong public policy of the forum in which suit is brought.

The Colorado Supreme Court accordingly reversed the Court of Appeals and ordered the Court of Appeals with instructions to return the case to the district court to reinstate its order granting the motion to dismiss.

Executive Compensation and the Business Judgment Rule in the Colorado District Court

Swanson v. Weil, 2012 WL 4442795 (D. Colo. 2012).[22]

In September 2012, Judge Wiley Daniel of the United States District Court for the District of Colorado issued a "say-on-pay" decision which is worthy of note because the opinion clearly supports continuing application of the business judgment rule. Under the Colorado Business Corporations Act, § 7-108-401(1) and Delaware case law, courts will not challenge decisions made by the directors of a corporation in good faith, after a reasonable investigation, and in a manner determined by them to be in the best interests of the corporation. There are, of course, distinctions for transactions where members of the board may be self-interested, but absent board member self-interest, the business judgment rule is an important protection for directors.

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[21] 407 U.S. 1, 10 (1972).

[22] Originally appearing in the Business Law Section (CBA) Newsletter (January 2013) (available at *www.cobar.org*) as Lidstone, *Executive Compensation and the Business Judgment Rule."*

The *Swanson v. Weil* case arose when the board of directors of Janus Capital Group, Inc. ("Janus") failed to rescind an executive compensation package (the "2010 executive compensation package") which the Janus shareholders had rejected in a non-binding "say-on-pay" vote under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. In the face of shareholder complaint and this derivative action, the Colorado federal district court supported the directors' business judgment and dismissed the complaint.

As required by Section 951 of the Dodd-Frank Act,[23] the 2011 Janus proxy statement contained a request for an advisory vote by the Janus shareholders approving the 2010 executive compensation package. According to the 46-page description in the Janus proxy statement, the total amount paid to four of five of Janus' highest-paid executives decreased from 2009 to 2010, but not enough to satisfy the shareholders who voted to disapprove the 2010 executive compensation. The fifth director, Richard Weil, had become chairman and CEO of Janus in February 2010 and received a $20,000,000 employment package, which caused the total pay for the five highest-paid executives to increase in 2010.

There were a number of facts that supported shareholder disapproval of the 2010 executive compensation package, including:

- The decline in Janus' stock price during 2010 by 7%;
- Janus' 2010 stock price underperformed the Dow Jones average by 16%; and
- Mr. Weil's statements in a May 2011 article entitled "*Janus CEO Weil faces uphill climb in 2nd year on job*" that "[w]e know that we haven't yet delivered the results that we need to deliver."

Janus' shareholders complained that because the company's directors failed to rescind the 2010 executive compensation package in light of the shareholder disapproval, the directors' inaction violated their fiduciary duties to Janus and its shareholders.

In finding that the shareholders could not maintain a derivative action, the court cited, among other cases, the seminal Delaware case *Aronson v. Lewis.*[24] The *Aronson* court said: "[a] cardinal precept of the General Corporation Law of the State of Delaware is that directors, rather than shareholders, manage the business and affairs of the corporation." It further noted "[t]he existence and exercise of this power carries with it certain fundamental fiduciary obligations to the corporation and its shareholders." *Id.* at 811. Under Delaware law, the right to bring a derivative action is:

> limited to situations where the stockholder had demanded that the directors pursue the corporate claim and they have wrongfully

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[23] Adding Section 14A to the Securities Exchange Act of 1934, *codified at* 15 U.S.C. § 78n-1).

[24] 473 A.2d 805 (Del.1984) (overruled in part on other grounds by *Brehm v. Eisner*, 746 A.2d 244, 246 (Del. 2000)).

> refused to do so or where demand is excused because the directors are incapable of making an impartial decision regarding such litigation.[25]

This is referred to as the "director demand" requirement. Similarly in Colorado, Rule 23.1 of the Rules of Civil Procedure requires that the complaint in a derivative action reflect a demand on the directors:

> [The complaint] shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort.

The *Swanson* complaint alleged that demand on Janus' board of directors would be futile because each was tainted by having been involved in the executive compensation decision making process. In determining whether a plaintiff has established demand futility in connection with a board decision, the court:

> must decide whether, under the particularized facts alleged, a reasonable doubt is created that: (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment.[26]

In this case, the federal district court noted that only a single member of the twelve-person board received a portion of the 2010 executive compensation package, and found the complaint's allegations as to the remaining eleven directors to be conclusory at best and not meeting the *Aronson* requirements.

With respect to the merits of the case, the federal district court noted that executive compensation decisions were subject to the business judgment of the directors. In order to succeed, a plaintiff must plead "particularized facts sufficient to raise (1) a reason to doubt that the action was taken honestly and in good faith or (2) a reason to doubt that the board was adequately informed in making the decision."[27]

Citing *Brehm v. Eisner*,[28] the federal district court noted a plaintiff will fail in his or her challenge to an executive compensation decision if there is:

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[25] *Rales v. Blasband*, 634 A.2d 927, 931 (Del. 1993).

[26] *Aronson*, 473 A.2d at 814.

[27] Citing *In Re JP Morgan Chase & Co. S'holder Litig.*, 906 A.2d 808, 824 (Del. Ch. 2005).

[28] 746 A.2d 244, 263 (Del. 2000).

> *any substantial* consideration received by the corporation, and if there is a *good faith judgment* that in the circumstances the transaction is worthwhile, there should be no finding of waste, even if the fact finder would conclude *ex post* that the transaction was unreasonably risky.

While there are "outer limits" to this rule, "they are confined to unconscionable cases where directors irrationally squander or give away corporate assets." Thus, under Delaware law, the fact that executives "received substantial salaries during a period when [the company] was performing poorly would not, without more, ordinarily sustain a claim."[29]

The *Swanson* plaintiff attempted to use the shareholder vote against the 2010 compensation package as "powerful evidence" that Janus' directors "breached their existing, well-established fiduciary duties of loyalty and good faith." The federal district court easily discarded this argument, pointing to the express language of the Dodd–Frank Act and in the Janus proxy statement that the shareholder vote was "advisory"; and in the Dodd–Frank Act that a shareholder vote does not "overrul[e]" a decision by a board or "create or imply any additional fiduciary duties" to rescind or otherwise respond to a "say-on-pay" vote.

As a result, the federal district court found that the facts pled by the *Swanson* complainant failed to raise a reasonable doubt that the Janus board's 2010 executive compensation decision "was otherwise the product of a valid exercise of business judgment." Therefore, the case was not one of those "extreme cases in which, despite the appearance of independence and disinterest, a decision is so extreme or curious as to itself raise a legitimate ground to justify further inquiry and judicial review." The federal district court accordingly granted the defendants' motion to dismiss, and in doing so, further and correctly strengthened the business judgment rule and its protection of good faith board decisions – in a well-reasoned decision that could apply to interpret the business judgment rule under Colorado law as well.

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[29] Citing *Prod. Res. Grp., L.L.C. v. NCT Grp. Inc.*, 863 A.2d 772, 799 (Del. 2004).

Are LLCs Corporations? The Supreme Court Answers "No."
Weinstein v. Colborne Foodbotics, LLC, 2013 CO 33 (June 10, 2013)[30]

The Colorado Supreme Court went a long way to clear up some confusion caused by lower courts when, on June 10, 2013, it issued its long-awaited decision in *Weinstein v. Colborne Foodbotics, LLC*[31] ("*Colborne*").

The plaintiff, a creditor of the LLC, claimed that managers of the LLC authorized distributions to members which resulted in the LLC's insolvency, thereby leaving it unable to pay the creditor's claim. The plaintiff asserted two claims:

- One against the members for receiving an unlawful distribution in violation of C.R.S. § 7-80-606; and

- One against the managers for their breach of a fiduciary duty allegedly owed to the creditors of an insolvent entity.

The trial court granted the defendants' motion to dismiss both claims, and the Court of Appeals reversed the dismissal. The Supreme Court reversed and reinstated the trial court's dismissal. In reversing the Court of Appeals, the Supreme Court noted that LLCs are not corporations, and it is improper to apply corporate law to LLCs except in the one instance (piercing the veil in C.R.S. § 7-80-107(1)) where the application of corporate law to LLCs was mandated by statute.

The Court of Appeals had compared the Colorado Business Corporation Act with the Colorado LLC Act and determined that the distribution provisions were written similarly—comparing C.R.S. § 7-80-606(1) (for LLCs) with C.R.S. § 7-108-403(1) (for corporations). The Court of Appeals then concluded that the corporate case law (principally *Ficor, Inc. v. McHugh*)[32] should be applied to the LLC Act. *Ficor* reasoned that similar provisions of C.R.S. § 7-5-114(3) of the Colorado Corporation Code (now repealed) were intended to protect creditors and, therefore, creditors as a group had standing to sue an insolvent corporation's directors for wrongful distributions. In following *Ficor*, the Court of Appeals chose to ignore the distinction between the corporate form and the LLC form as well as the language of C.R.S. § 7-80-606(1) which provides that members receiving an unlawful distribution should be liable only to the LLC.

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[30] Originally appearing in the Business Law Section (CBA) Newsletter (June 2013) (available at *www.cobar.org*) as Lidstone, *Are LLC's Corporations? The Supreme Court Answers 'No.'*

[31] 2013 CO 33 (June 10, 2013).

[32] Principally *Ficor, Inc. v. McHugh*, 639 P.2d 385, 393-4 (Colo. 1982).

Citing a Delaware case,[33] the Colorado Supreme Court held that, since:

> the LLC Act and the Colorado Business Corporation Act are two different statutes with different schemes and purposes, and because a corporate shareholder is not equivalent to an LLC member, the legislature is free to choose a statutory limitation on an LLC's creditors different from what it chooses for a corporation's creditors.

The Supreme Court held that, absent express statutory authority, an LLC's creditor may not assert a claim against the members of the LLC for unlawful distribution," and "[w]e construe the statute [the Colorado LLC Act] as written and assume 'that the General Assembly meant what it clearly said.'"[34]

In the second claim against the managers for their alleged breach of common law fiduciary duties for approving the unlawful distribution, the Supreme Court again started with the cornerstone of the Court of Appeals' analysis - another corporate case, *Alexander v. Anstine*.[35] In *Anstine*, the Supreme Court determined that directors of an insolvent Colorado corporation acted as 'trustees' for the corporation's creditors and had a "limited fiduciary duty" not to favor themselves over the corporation's creditors. In *Weinstein*, however, the Supreme Court again looked at the Colorado LLC Act and noted that the statute specifically provides in C.R.S. § 7-80-404 and C.R.S. § 7-80-705 that managers are not liable to creditors of the LLC and have no fiduciary duty to creditors. Since the Colorado LLC Act did not extend corporate law to LLCs except (as noted) in the case of piercing the veil, the Supreme Court refused to extend the *Anstine* analysis to LLCs.

In reaching this conclusion, the Supreme Court noted that the Court of Appeals had expressly extended the *Anstine* analysis in the earlier case of *Sheffield Srvs Co. v. Trowbridge*.[36] The Supreme Court put a nail in *Sheffield* holding that "[t]o the extent *Sheffield* holds that an LLC's manager has a fiduciary duty to the LLC's creditors, it is overruled."

This does not mean that an LLC's creditors are without recourse when managers approve distributions which result in insolvency of the LLC. It simply means that neither C.R.S. § 7-80-606 nor common law insolvency duties are the appropriate recourse. As discussed in *CB Richard Ellis, Inc. v. CLGP, LLC*,[37] the Colorado Uniform Fraudulent

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33 *CML V, LLC v. Bax*, 28 A.3d 1037, 1043 (Del. 2011).

34 Citing *Pierson v. Black Canyon Aggregates, Inc.*, 48 P.3d 1215, 1219 (Colo. 2002).

35 152 P.3d 497, 502 (Colo. 2007).

36 211 P.3d 714, 723-4 (Colo. App. 2009).

37 251 P.3d 523 (Colo. App. 2010).

Transfers Act[38] ("CUFTA") may be available. CUFTA specifically gives creditors recourse against recipients of fraudulent transfers in three circumstances, the first requiring specific intent, and the other two provisions requiring insolvency:

- C.R.S. § 38-8-105(1)(a) provides that transfers are fraudulent as to creditors existing at the time of the transfer and future creditors where the debtor makes a transfer with actual intent to hinder, delay or defraud any creditor. C.R.S. § 38-8-105(2) sets forth eleven factors for a court to consider in determining intent, including insolvency as a factor to be considered.

- C.R.S. § 38-8-105(1)(b) provides that transfers are fraudulent as to creditors existing at the time of the transfer and future creditors where the debtor makes a transfer without receiving "reasonably equivalent value in exchange for the transfer" and

  - Where the debtor was engaged or was about to engage in business or a transaction for which the debtor's remaining assets were unreasonably small; or

  - The debtor intended to incur (or believed or reasonably should have believed that the debtor would incur) debts beyond the debtor's ability to pay as they became due.

- C.R.S. § 38-8-106(1) and (2) provides that transfers are fraudulent as to creditors existing at the time of transfer if the debtor was insolvent at the time of the transfer or became insolvent as a result thereof.

CUFTA[39] defines insolvency similarly to the LLC Act, stating that a debtor is insolvent if the sum of the debtor's debts is greater than all of the debtor's assets at a fair valuation. Unlike the LLC Act, CUFTA[40] has a second definition for a rebuttable presumption of insolvency: when a debtor is generally not paying debts as they become due.

The Colorado Supreme Court did leave one disturbing note in the *Colborne* opinion. In its discussion of *Anstine*, it spoke as if *Anstine* and the limited fiduciary duty purportedly owed by the directors of an insolvent Colorado corporation to creditors remained extant. In *Anstine* itself, the Supreme Court noted that, during the pendency of the case the General Assembly adopted an amendment to the Colorado Business Corporation Act which said that "[a] director or officer of a corporation ... shall not have any fiduciary duty to any creditor

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[38] C.R.S. § 38-8-101, *et seq.*

[39] C.R.S. § 38-8-103(1).

[40] C.R.S. § 38-8-103(2).

of the corporation arising only from the status as creditor."[41] It has been argued by this author and others that, to the extent the *Anstine* decision accurately reflected the common law at the time, the 2006 CBCA amendment specifically overruled that position. In *Anstine* (footnote 9) and in *Colborne* (footnote 10) the Supreme Court said that the question was not before it in the case and "we do not answer the question of whether *Anstine* is still good law."

The Supreme Court got much right in its *Colborne* decision. Given the posture of the *Colborne* case, it was probably correct to leave the limited fiduciary duty of *Anstine* to another day and another case.

Colorado Trust Fund Statute

Yale v. AC Excavating, Inc., No. 10SC709 2013 CO 10 (Feb. 4, 2013)[42]

In *AC Excavating, Inc.*, the Court of Appeals held Donald Yale, a forty-four percent owner of a limited liability company ("Antelope"), liable to an excavation contractor that had provided services to a real estate development. In doing so, the Court of Appeals applied the Colorado Trust Fund Statute ("CTFS"),[43] which provides that any funds disbursed to a contractor must be held in trust for payment to subcontractors, laborers, or material suppliers who could place a lien on the property. Antelope had entered into an excavating contract with AC Excavating and paid AC Excavating $150,000 of the $190,680.30 that AC Excavating had charged for its services. AC Excavating then performed additional work for which it charged (but did not receive) $7,707.50.

Mr. Yale was not a manager of the LLC at that time, but soon replaced the former sole manager. Upon becoming manager, Mr. Yale realized there was $100,000 in Antelope's bank account yet Antelope owed unpaid invoices exceeding $250,000, including the amount due to AC Excavating. In an effort to save the project, Mr. Yale loaned Antelope $157,500 of his own money and, as manager, applied the proceeds to general business expenses and some of the outstanding subcontractor invoices. While some of the money went to AC Excavating, the company was not paid in full. The Supreme Court noted that "[t]he record establishes that Yale's general practice over the years in lending money to the LLC was to finance general operations, not specific construction work," and Mr. Yale's advancement of the $157,500 was consistent with his prior practice of making loans to Antelope for its general business purposes.

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41 C.R.S. § 7-108-401(5).

42 Originally appearing in the Business Law Section (CBA) Newsletter (March 2013) (available at *www.cobar.org*) as Lidstone, *Two Important Cases – Colorado Trust Fund Statute and Forum Selection Clauses for Securities Claims.*

43 C.R.S. § 38-22-127.

Although the Supreme Court did not address the question, the Court of Appeals in its earlier decision (2010 WL 3432219) seemed to find it important that Mr. Yale, while a manager of Antelope, used $50,000 of his capital infusion to cover interest payments on municipal bonds he held as collateral from Antelope for pre-existing loans. In late 2006, with Antelope's assets depleted and multiple invoices left unpaid and after the interest payment was made, Mr. Yale gave up on Antelope and foreclosed on the municipal bonds and acquired Antelope's underlying property leaving only liabilities in the entity. The Supreme Court said that

> [Mr.] Yale, as the manager of the LLC, was free to apply those funds for the [LLC's] benefit in any manner consistent with his fiduciary obligations to the [LLC], including paying the LLC's "critical bills" in an (ultimately futile) attempt to ensure that the LLC could continue to operate as a going concern and generate revenues to pay off its obligations.

The fact that some of the critical bills were interest on municipal bonds which benefitted Mr. Yale's position was not important to this analysis.

AC Excavating sued Mr. Yale for violation of the CTFS, alleging that Mr. Yale had diverted funds from Antelope to repay himself and to make other non-CTFS expenditures. The trial court dismissed the action after finding the CFTS inapplicable because the funds were not disbursed on a construction project, but rather were a "survival loan" to capitalize the company. A panel of the Colorado Court of Appeals reversed, holding that Mr. Yale's loans to the LLC were disbursed on a construction project and should have been held in trust pursuant to the CTFS.

The Colorado Supreme Court reversed the Court of Appeals, holding the funds Mr. Yale had deposited into the LLC's bank account "were not trust funds under section 38-22-127(1) because, under the circumstances of this case, Yale's voluntary injection of his own money as a "survival loan" to the LLC did not constitute "funds disbursed to any contractor . . . on [a] construction project." The Supreme Court noted that a holding to the contrary would discourage developers from trying to save their companies with financial injections. Notably, the Supreme Court carefully limited its holding to "the circumstances of this case." Attorneys should be aware there may be other cases where the managers of an LLC may find themselves liable under the CTFS for failing to hold money in trust for disbursement with respect to construction projects.

Severability—Do You Want the Contract in One Piece or Many?
CapitalValue Advisors, LLC v. K2D, Inc., 2013 COA 125 (Colo. App. 8/15/2013)[44]

Many contracts contain a term which provides generally that, if a provision of a contract is determined to be unenforceable, the unenforceability of that provision does not impact other provisions of the agreement. The following is an example of a severability clause:

> "If a provision of this Agreement is or becomes illegal, invalid or unenforceable in any jurisdiction, that shall not affect: (a) the validity or enforceability in that jurisdiction of any other provision of this Agreement; or the validity or enforceability in other jurisdictions of that or any other provision of this Agreement."

In many cases, the severability clause is included without real thought whether the parties want a contract to survive if a material provision is voided. It is frequently part of the form of contract used and generally does not engender much discussion. It is, after all, "boilerplate."

Sometimes, severability clauses will state that some provisions to the contract are so essential to the contract's purpose that if they are illegal or unenforceable, the contract as a whole will be voided. Occasionally, a contract does not address severability. In Colorado, as discussed in the Court of Appeals decision in *CapitalValue Advisors, LLC v. K2D, Inc.*,[45] this leaves the question of severability of the contract to the court's determination of the intention of the parties.

In this case, CapitalValue entered into an agreement with K2D by which CapitalValue would earn: (1) a 4.5% commission for a sale of less than a majority interest in K2D, Inc.; (2) a 4.0% commission for a sale of more than a majority interest in K2D, Inc.; or (3) a 4.5% commission for helping K2D's parent to obtain debt financing. The agreement had a 24-month "tail" by which CapitalValue would earn its commission should K2D or its parent complete a transaction within that period.

K2D terminated the agreement with CapitalValue and entered into another agreement with another entity which actually obtained a $57 million debt financing package within the tail period. CapitalValue claimed its commission. The litigation followed K2D's and its parent's refusal to pay CapitalValue.

The Weld County District Court granted summary judgment to the defendants, finding that the first two promises (the "sale of a business provisions") were illegal in that

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[44] Originally appearing in the Business Law Section (CBA) Newsletter (August 2013) (available at *www.cobar.org*) as Lidstone, *Severability – Do You Want the Contract in One Piece or Many?*

[45] 2013 COA 125 (Colo. App. 8/15/2013).

they violated the real estate licensing requirements of C.R.S. § 12-61-101(2) and the broker-dealer licensing provisions of § 15(a) of the federal Securities Exchange Act of 1934 and C.R.S. § 11-51-401. The District Court concluded that, as a result, the contract (which did not have a severability provision) was void and unenforceable as a whole.

On appeal, CapitalValue did not challenge the District Court's conclusion that the sale of a business provisions were illegal in light of the real estate and securities broker-dealer licensing requirements. CapitalValue did challenge that the illegality of those provisions would necessarily void the entire contract. CapitalValue also pointed out that there are no licensing requirements for entities procuring a business loan as CapitalValue had promised to attempt and as the successor accomplished.

The Court of Appeals recited black-letter contract law when it said[46] that "[i]n interpreting a contract, our primary goal is to determine and give effect to the intent of the parties." Citing *Reilly v. Korholz*,[47] the Court noted that:

> Where an agreement founded on a legal consideration contains several promises, or a promise to do several things, and a part only of the things to be done are illegal, the promises which can be separated, or the promise, so far as it can be separated, from the illegality, may be valid.

Quoting a Tennessee case,[48] the Court said:

> An agreement can be either an entire contract or a severable contract according to the intention of the parties, and the fact that divisible parts are included within the same document does not preclude them from being considered and enforced as separate contracts.

In determining whether a contract is severable, the Court of Appeals identified "[t]he primary objective is to ascertain the intent of the contracting parties, as such intent is manifested by not only the several terms and provisions of the contract itself, but also as such are viewed in the light of all the surrounding circumstances, including the conduct of the parties before any dispute has arisen."[49]

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46 *CapitalValue Advisors, LLC v. K2D, Inc.*, 2013 COA 125 (Colo. App. 8/15/2013) at ¶ 18.

47 137 Colo. 20, 27, 320 P.2d 756, 760 (1958).

48 *Penske Truck Leasing Co. v. Huddleston*, 795 S.W.2d 669, 671 (Tenn. 1990).

49 *John v. United Adver., Inc.*, 165Colo. 193, 198-199, 439 P.2d 53, 55-56 (1968).

In the end the Court of Appeals held that:

> Because the parties' intent as to whether the Agreement was severable presents a disputed issue of material fact, the court should not have entered summary judgment. . . . Here, the single document—the Agreement—contains multiple promises, each of which may constitute a separate agreement or contract.

The Court of Appeals remanded the case to the trial court to ascertain the intent of the parties as to severability.

A different result was reached in a separate Colorado case[50] where a plaintiff attempted to enforce a non-competition agreement against a former employee which the court found to be unenforceable under C.R.S. § 8-2-113 and common law because it was neither reasonable in time nor scope. The plaintiff asked the court to use its "blue pencil" to amend the agreement to impose a reasonable geographical limitation. In denying the plaintiff's request, the District Court said:

> Unlike some contracts, the Agreement does not expressly provide the Court the right to blue pencil the Agreement. In any event, the Court is not willing to amend the Agreement, which is unenforceable.

A Nebraska law review article[51] argues that courts, even when authorized by the agreement, should not reform non-competition agreements. Such a contractual provision allows the employer to seek significant concessions from the employee when the employer has the negotiating advantage, with the only risk being that some provisions may be cut back. The agreement and the unreasonable provisions, however, have an *in terrorem* effect on the employee.

The *CapitalValue* case points out the importance of recognizing that even the boilerplate provisions can be important and should be considered when negotiating contracts. The contract negotiators should consider how these provisions, like the severability provision, fit into the overall scope of the contract and whether the parties really intend that the contract survive if a material provision is invalidated. Do not count on blue pencil provisions to allow the court to reform the contract. The court may choose not to exercise that right.

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[50] *Lundwell Communications, Inc. v. Batte*, 2006 WL 3933863 (Colo. D.Ct. Arap. Cty. 12/5/2006).

[51] Pivateau, *Putting the Blue Pencil Down: An Argument for Specificity in Non-Compete Agreements*, 86 Neb. L. Rev. 672 (2008).