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Tenth Circuit Finds Lender's Membership Interests in an LLC Are Not Investment Contracts in Quiznos Restructuring Lawsuit

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On December 13, 2016, the 10th Circuit Court of Appeals addressed for the first time the circumstances under which an LLC membership interest constitutes an investment contract. The Court affirmed the decision of Judge Philip A. Brimmer of the U.S. District Court for the District of Colorado, holding that membership interests in an LLC held by private investment funds were not “investment contracts” under the Securities and Exchange Act of 1934 (Exchange Act) because expected profits from the interests did not come solely from a third party. The case, *Avenue Capital Management II et al. v. Shaden et. al.* involved claims of securities fraud arising out of a transaction to restructure Quiznos' debt. In the transaction, multiple investment funds (“Avenue” and “Fortress”) purchased equity in Quiznos. The restructuring took place through a transaction involving Quiznos, Avenue, Fortress, and others. This transaction made Avenue and Fortress members of a manager-managed limited-liability company that operated Quiznos. Avenue acquired about 70% of the LLC's shares, and Fortress acquired about 10% of the shares. In exchange, Avenue pumped \$150 million into Quiznos and Avenue and Fortress reduced Quiznos' debt. After Quiznos' financial condition plummeted, Avenue and Fortress sued former Quiznos managers and officers, claiming that they had fraudulently misrepresented Quiznos' financial condition and invoking § 10(b) of the Exchange Act and Securities and Exchange Commission Rule 10b-5.

The 10th Circuit upheld Judge Brimmer's ruling that the private investment funds' membership interests are not “investment contracts” under the Exchange Act because the private investment funds' “expected profits from the interests do not come solely from the efforts of a third party.” Rather, the terms of the debt exchange transaction allowed the private investment funds to control the profitability of their investments through their 80% ownership interest and the right to amend the LLC agreement, the right to appoint and remove managers who would select the CEO, and elect the board chair, and as “sophisticated and informed investors allowing them to make informed investment decisions and intelligently exercise control over Quiznos.”

Although the private investment funds also argued on appeal that their membership interests are “stock” or “instruments commonly known as securities,” the 10th Circuit held they forfeited that argument by failing to preserve it in district court and it declined to consider the newly presented

arguments.

PRACTICE TIP: The issue of whether LLC interests are considered to be investment contracts depends heavily on the facts of the case. However, it is a question that can be decided on a motion to dismiss. The 10th Circuit has not adopted a per se rule or a presumption in the context of LLCs. Rather, the 10th Circuit applied the U.S. Supreme Court's control test as stated in *SEC v. W.J. Howey & Co.*, 328 U.S. 293 (1946) and considered whether the expected profits from the LLC interests were "to come solely from the efforts of others." The Court examined the LLC agreement itself and the structure of the LLC interests. The Court stated that the test of control is an objective one. Among the factors considered were:

- whether the LLC members had authority to directly manage or control the LLC's business and affairs;
- whether the members could appoint managers and remove them without cause;
- whether the members could examine the LLC's books and records;
- whether the members retained the right to remove a manager at any time or dissolve the company; and
- whether the managers and officers were irreplaceable or otherwise insulated from the members' ultimate control.

As the 10th Circuit noted, if the LLC members "exercise control" over the LLC, they are not the kind of passive investor the securities laws are designed to protect.

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