MANAGEMENT RESPONSIBILITIES OF GOVERNING PERSONS OF CORPORATIONS AND LIMITED LIABILITY COMPANIES

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May 19, 2017
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CHAPTER 9

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Series LLCs," *Business Law Today* (February 2013); and "The Series LCC: A New Planning Tool" by Adrienne Randle Bond and Allen Sparkman, 45 *Texas Journal of Business Law* (Fall 2012). Mr. Sparkman is a contributing author to Practitioner's Guide to Colorado Business Organizations (Colorado Bar Association, Allen E. F. Rozansky and E. Lee Reichert, Managing Editors), and Guide for Colorado Nonprofit Organizations (Colorado Bar Association, Karen E. Leaffer, Managing Editor).

Mr. Sparkman has served several times as an expert witness in Colorado, Texas, and California in cases involving duties of directors, director deadlock, duties of managers, duties of partners, construction of operating agreements, construction of partnership agreements, construction of contracts, veil piercing, and attorney malpractice. Mr. Sparkman has been qualified as an expert witness in the district court for Denver, Colorado.

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MANAGEMENT RESPONSIBILITIES OF GOVERNING PERSONS OF CORPORATIONS AND LIMITED LIABILITY COMPANIES

I. THE SOURCE AND NATURES OF DUTIES IN LLCS AND CORPORATIONS

A. Corporate Directors

Although this paper will focus primarily on LLCs, it is worthwhile to consider the duties typically imposed on corporate directors, as the same duties show up in cases involving LLCs. Directors have a duty to discharge their responsibilities in accordance with the duty of care, the duty of loyalty, and the duty of obedience. The duty of care mandates that a director discharge his or her responsibilities with the care that an ordinarily prudent person would exercise in similar circumstances. Corporate statutes based on the Model Business Corporation Act use the phrase "an ordinarily prudent person in a like position would exercise under similar circumstances."[1] This statutory language allows a court to look to a particular organization rather than a hypothetical entity. Applying this standard, a court may consider the background, qualifications, and experience of a director and the role the director plays in the corporation when measuring the director's conduct. The ordinarily prudent person standard is associated with tort-law and simple negligence, but in the corporate world, it has been incorporated into the duty of care and case law applies a gross negligence standard. Directors also usually enjoy the benefits of the business judgment rule. The duty of loyalty requires a director to act in good faith in what the director reasonably believes to be the best interests of the corporation and to not derive a personal profit or advantage at the expense of the corporation.[2] The duty of loyalty comes into play if a director or officer wants to compete with the corporation or take an opportunity of the corporation for the director's own benefit. The duty of obedience dictates that a director obey the law and the corporation's organizational documents.[3] Corporate statutes commonly provide a procedure for approval of a director's conflicting interest transaction.[4] Most corporate statutes now permit the corporation's formation document to relieve directors from monetary liability for breaches of the duty of care.[5] The provisions of the TBOC governing for-profit corporations (like the predecessor Texas Business Corporation Act) do not explicitly set forth or define the fiduciary duties of corporate directors; however, case law generally recognizes that directors owe a duty of obedience, a duty of care, and a duty of loyalty. *See Gearhart Indus, Inc. v. Smith Int'l, Inc.,* 741 F.2d 707, 718 (5th Cir. 1984); *FDIC v. Harrington,* 844 F. Supp. 300, 306 (N.D. Tex. 1994); *Resolution Trust Corp. v. Norris*, 830 F. Supp. 351 (S.D. Tex. 1993).

B. LLCs

Managers and members of LLCs have duties of sometimes uncertain scope and extent, including some duties that on occasion are described as fiduciary duties.[6] The TBOC does not address whether LLC manager or member duties exist, but implicitly recognizes that they may exist by statutory provisions that permit duties to be expanded or restricted. The TBOC provides:

> The company agreement of a limited liability company may expand or restrict any duties, including fiduciary duties, and related liabilities that a member, manager, officer, or

[1] E.g., Colorado Revised Statutes § 7-108-401(1)(b).
[2] E.g., *Lyondell Chemical v. Ryan*, 970 A.2d 235 (Del. 2009).
[3] *Gearhart Industries, Inc. v. Smith Intern. Inc.*, 741 F.2d 707, 719 (5th Cir. 1984).
[4] E.g., 8 Del. Code § 144; TBOC § 21.418. Generally, these statutes require disclosure of the material facts of the transaction and approval by disinterested directors or by the shareholders or a determination that the transaction is fair to the corporation when approved or ratified by the directors or shareholders.
[5] E.g., 8 Del. Code § 102(b)(7); TBOC § 7.001. LLCs may also now relieve their governing persons of monetary liability for breaches of the duty of care in the certificate of formation or company agreement. TBOC § 7.001(d)(3).
[6] The application of fiduciary duties derives from 18th century English real property law where "it emerged as a means of moderating the tension between current and future interests in land." Helfman, "Origins of Fiduciary Duty," 41 *Real Prop. Prob. & Tr. J.* 651 (2006). In *Bishop of Winchester v. Knight*, 24 Eng. Rep. 447 (Ch. 1717), the tenant leased property and then proceeded to mine copper instead of conducting the traditional farming operations. The Lord Chancellor said: "the tenant is a sort of a fiduciary to the lord, and it is a breach of the trust which the law reposes in the tenant, for him to take away the property of the lord." The jury found for the bishop on the ground that it "could not find that the customary tenant without the license of the lord, might by custom dig and open new copper-mines . . . so that . . . neither the tenant without the license of the lord, nor the lord without the consent of the tenant, could dig in these copper-mines, being new mines." Justice Cardozo described fiduciary duty as follows: "Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior." *Meinhard v. Salmon*, 164 N.E. 545, 249 N.Y 458, 436-64 (N.Y. 1928).

> other person has to the company or to a member or manager of the company.[7]

As noted, the provisions of the TBOC governing LLCs (like the provisions of the predecessor Texas Limited Liability Company Act)[8] do not define or expressly impose fiduciary duties on managers or members of an LLC. However, Professor Elizabeth Miller has observed that:

> Commentators and practitioners have generally assumed that managers in a managed-managed LLC and members in a member-managed LLC have fiduciary duties along the lines of corporate directors or general partners in a partnership. These duties would generally embrace a duty of obedience, duty of loyalty, and duty of care to the LLC. Duty of loyalty concerns underlie statutory provisions addressing interested manager transactions and renunciation of business opportunities. See Tex. Bus. Orgs. Code §§ 2.101(21), 101.255. … Provisions of the BOC permitting governing persons to rely on various types of information in discharging a duty implicitly recognize that such persons are charged with a duty of care in their decision making. Tex. Bus. Orgs. Code § 3.102; see also Tex. Bus. Orgs. Code § 3.105 (reliance by officers on information in discharging a duty). … [T]he BOC provides that, to the extent managers or members are subject to duties and liabilities, including fiduciary duties, the company agreement may expand or restrict the duties and liabilities. Tex. Bus. Orgs. Code §§ 101.401, 101.052.[9]

Note that the TBOC, unlike the Delaware statute,[10] does not mention the contractual duty of good faith and fair dealing. Perhaps one reason for this omission lies in the fact that the TBOC allows only restriction of duties, not elimination of duties as does Delaware. An additional reason may be that there is no general duty of contractual good faith and fair dealing in Texas case law. Rather, the duty arises in Texas only when there is a special relationship between the contracting parties.[11] The court has recognized a special relationship when there is unequal bargaining power between the parties and there is a risk that one of the parties will take advantage of the other based on the imbalance of power, e.g., insurer/insured.[12] In addition to the duties that Professor Elizabeth Miller has observed that commentators and practitioners assume apply to the governing persons of LLCs,[13] persons who are governing persons of LLCs are agents of the LLCs.[14] An agent has a fiduciary duty to act loyally for the principal's benefit in all matters connected with the agency relationship.[15] At least one court has held that due to the fiduciary nature of the principal-agent relation, the principal owes the agent a duty of good faith and fair dealing.[16] Because of the agent's duty to act loyally for the principal's benefit, it appears likely that a court would hold that an agent owes the agent's principal a duty of good faith and fair dealing. Agency law expressly requires agents to act in good faith when seeking the principal's consent to a modification of the agent's duties.[17] Interestingly, the Partnership Chapter of the TBOC states that:

> A partner shall discharge the partner's duties to the partnership and the other partners under this code or under the partnership agreement and exercise any rights and powers in the conduct or winding up of the partnership business:

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[7] TBOC § 101.401.

[8] Elizabeth S. Miller, "Overview of Fiduciary Duties, Exculpation, and Indemnification in Texas Business Organizations," paper prepared for State Bar of Texas Choice & Acquisition of Entities in Texas, May 23, 2014.

[9] *Id*. at 8.

[10] The Delaware LLC Act provides:

> To the extent that, at law or 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.
>
> 6 Del. Code § 18-1101(c).

[11] *Subaru of America v. David McDavid Nissan*, 84 S.W.3d 212, 225 (Tex. 2002).

[12] *See Arnold v. Nat'l County Mut. Fire Ins. Co.*, 725 S.W.2d 165,167 (Tex. 1987).

[13] See note 9, *supra*, and accompanying text.

[14] TBOC § 101.254.

[15] *Restatement (Third) of Agency* § 8.01.

[16] *Lawrence Warehouse Co. v. Twohig*, 224 F.2d 493 (8th Cir. 1955).

[17] *Restatement (Third) of Agency* § 8.06(1)(a)(i).

(1) in *good faith*; and
(2) in a manner the partner reasonably believes to be in the best interest of the partnership.[18]

The quoted provision of the Partnership Chapter shows that the Legislature knows how to impose an obligation of good faith when it so desires. The plain language of the statute, however, implies that the obligation of good faith in the Partnership Chapter is a fiduciary duty of good faith, not the contractual duty of good faith and fair dealing.[19] The *Gerber* decision of the Delaware Supreme Court discusses this distinction in Delaware law.[20] In the corporate context, the Delaware Supreme Court has noted that [t]he failure to act in good faith may result in liability because the requirement to act in good faith 'is a subsidiary element [,]' i.e., a condition, 'of the fundamental duty of loyalty.'"[21] The Chancery Court opinion cited by the Delaware Supreme Court for this proposition stated:

> Although the *Caremark* decision is rightly seen as a prod towards the greater exercise of care by directors in monitoring their corporations' compliance with legal standards, by its plain and intentional terms, the opinion articulates a standard for failures of oversight that requires a showing that the directors breached their duty of loyalty by failing to attend to their duties in good faith. Put otherwise, the decision premises liability on a showing that the directors were conscious of the fact that they were not doing their jobs.[22]
>
> A director cannot act loyally towards the corporation unless she acts in the good faith belief that her actions are in the corporation's best interest. For this reason, the same case that invented the so-called "triad[]" of fiduciary duty, see *Cede & Co. v. Technicolor, Inc.,* 634 A.2d 345, 361 (Del. 1993) ("Cede II"), also defined good faith as loyalty. …
>
> It does no service to our law's clarity to continue to separate the duty of loyalty from its own essence; nor does the requirement that good faith is essential to loyalty demean or subordinate that essential requirement. There might be situations when a director acts in subjective good faith and is yet not loyal (e.g., if the director is interested in a transaction subject to the entire fairness standard and cannot prove financial fairness), but there is no case in which a director can act in subjective bad faith towards the corporation and act loyally. The reason for the disloyalty (the faithlessness) is irrelevant, the underlying motive (be it venal, familial, collegial, or nihilistic) for conscious action not in the corporation's best interest does not make it faithful, as opposed to faithless.[23]

In *Gerber v. Enterprise Products Holdings, LLC,*[24] the Delaware Supreme Court noted that the case before it involved, in part, the difference between a fiduciary duty of good faith and the implied contractual covenant of good faith and fair dealing. The court in *Gerber* then stated:

> In *ASB Allegiance Real Estate Fund v. Scion Breckenridge Managing Member, LLC* [68 A.3rd 665 (2013)], the Court of Chancery articulated the important differences between the implied covenant and the fiduciary duty concepts of good faith. We adopt this well-reasoned analysis as a correct statement of our law:
>
> The implied covenant seeks to enforce the parties' contractual bargain by implying only those terms that the parties would have agreed to during their original negotiations if they had thought to address them. Under Delaware law, a court confronting an implied covenant claim asks whether it is clear from what was expressly agreed upon that the parties who negotiated the express terms of the contract would have agreed to proscribe the act later complained of as a breach of the implied covenant of good faith—had they thought to negotiate with respect to that matter. While this test requires resort to a counterfactual world—what if—it is nevertheless appropriately restrictive and commonsensical. The temporal focus is critical. Under a fiduciary duty or tort analysis, a court examines the parties as situated at the time of the wrong. The court determines whether the defendant owed the plaintiff a duty, considers the defendant's obligations (if any) in light of

[18] TBOC § 152.204(b)(emphasis supplied).
[19] TBOC § 152.204(b)(1) (emphasis supplied).
[20] *See* notes 24-25, *infra*, and accompanying text.
[21] *Stone v. Ritter*, 911 A.2d 362 (Del. 2006), citing *Guttman v. Huang*, 823 A.2d 492, 506 n. 34 (Del. Ch. 2003).
[22] *Guttman v. Huang*, 823 A.2d 492, 506 (Del. Ch. 2003).
[23] *Id*. n. 34.
[24] 67 A.3d 400 (Del. 2013).

> that duty, and then evaluates whether the duty was breached. Temporally, each inquiry turns on the parties' relationship as it existed at the time of the wrong. The nature of the parties' relationship may turn on historical events, and past dealings necessarily will inform the court's analysis, but liability depends on the parties' relationship when the alleged breach occurred, not on the relationship as it existed in the past. An implied covenant claim, by contrast, looks to the past. It is not a free-floating duty unattached to the underlying legal documents. It does not ask what duty the law should impose on the parties given their relationship at the time of the wrong, but rather what the parties would have agreed to themselves had they considered the issue in their original bargaining positions at the time of contracting. "Fair dealing" is not akin to the fair process component of entire fairness, *i.e.,* whether the fiduciary acted fairly when engaging in the challenged transaction as measured by duties of loyalty and care whose contours are mapped out by Delaware precedents. It is rather a commitment to deal "fairly" in the sense of consistently with the terms of the parties' agreement and its purpose. *Likewise "good faith" does not envision loyalty to the contractual counterparty, but rather faithfulness to the scope, purpose, and terms of the parties' contract. Both necessarily turn on the contract itself and what the parties would have agreed upon had the issue arisen when they were bargaining originally.* The retrospective focus applies equally to a party's discretionary rights. The implied covenant requires that a party refrain from arbitrary or unreasonable conduct which has the effect of preventing the other party to the contract from receiving the fruits of its bargain. *When exercising a discretionary right, a party to the contract must exercise its discretion reasonably.*[25] (emphasis in original).

Texas case law discusses duties in the context of the provisions of the Texas statute that do not permit elimination of duties but only modifications. The court in *Allen v. Devon Energy Holdings, L.L.C*, 367 S.W.3d 355 (Tex. App. 2012) concluded that:

> [T]he "special facts" doctrine supports recognizing a formal fiduciary relationship when an LLC's member-manager communicates a redemption offer to the minority members that may benefit the member-manager individually. The "special facts" are particularly acute when a majority owner and member-manager who controls the company's daily affairs, and therefore possesses inside information, communicates a redemption offer that will increase his ownership of the company to minority members who do not participate in the company's daily affairs. Such an offer necessarily requires an evaluation of both the company's present value and its future prospects, an evaluation that the member-manager has a unique capacity to perform. Thus, Texas appellate courts have relied upon the unique nature of a redemption as part of the factors that may create an informal fiduciary duty.[26]

It is important to recognize that although the court in *Allen v. Devon Energy Holdings, L.L.C.* used language suggesting that it was deciding whether the majority member owed duties to the minority member to whom he made a redemption offer, the majority member was also the sole manager of the LLC.[27]

In *Federal Insurance Co. v. Rodman, LLC,*[28] the United States District Court discussed two recognized types of fiduciary duties. The first is a formal fiduciary relationship which arises as a matter of law. Examples include the relationship between attorney and client, principal and agent, partners, and joint venturers. The second is a fiduciary relationship created informally where there is a close personal relationship of trust and confidence. The court went on to say that "neither trust alone nor the fact that the relationship has been a cordial one, of long duration, necessarily transforms a relationship into a fiduciary relationship." Whether an informal fiduciary relationship exists is typically a question of fact.[29] The court pointed out that there had been a long-standing friendship between the parties which, along with the pleadings, was sufficient to plead that the cross-defendant had breached his duties to the plaintiff.[30] The court also pointed out that, as of the

[25] 67 A.3d at 418-19.
[26] 367 S.W.3d at 394-395.
[27] The court in *Allen v. Devon Energy Holdings, L.L.C.* also concluded that an exculpation provision in the LLC's certificate of formation could be read to create a fiduciary duty to the members individually. 367 S.W. 3d at 397-398.
[28] No.3:10-CV-2042-B, 2011 WL 5921529 *3(N.D. Tex. Nov. 29, 2011) at page 3.
[29] *Id.*
[30] *Id.*

writing of the opinion, "no Texas court has held that fiduciary duties exist between members of an LLC as a matter of law."[31]

In *Cardwell v. Gurley*,[32] the United States District Court affirmed the summary judgment of the Bankruptcy Court for the Eastern District of Texas holding that Cardwell, a debtor in a Chapter 7 proceeding, was denied a discharge from a judgment debt obtained by Gurley in a Texas State Court.[33] The District Court made extensive findings relating to the fact that Cardwell was the managing member of an LLC owned jointly by Gurley and Cardwell, that their relationship had been a long one, and that Gurley had placed the utmost trust and confidence in Cardwell's management of the business. The Bankruptcy Court found that Cardwell, as the managing member of the LLC, owed the LLC fiduciary duties of loyalty and due care as a matter of law and since Gurley was the only other member of the LLC, such fiduciary duties accrued and were therefore owed directly to Gurley by Cardwell as a matter of law. In addition, the Bankruptcy Court found that Cardwell owed fiduciary duties directly to Gurley because of his position as Managing Member. Not stopping with those findings, the Bankruptcy Court found that Cardwell owed fiduciary duties to Gurley as a result of their long-standing relationship.[34]

II. AGENCY LAW—ANOTHER SOURCE OF DUTIES

A. Creation of Agency Relationship

The Restatement (Third) of Agency defines agency as follows:

> Agency is the fiduciary relationship that arises when one person (a "principal") manifests assent to another person (an "agent") that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents to act.[35]

A member of a member-managed LLC is an agent of the LLC for apparently carrying on the business of the LLC in the ordinary course; similarly, a manager of a manager-managed LLC is an agent of the LLC for apparently carrying on the business of the LLC in the ordinary course.[36] Other persons, such as officers, will in many cases also be agents of the LLC. Some persons may be agents of an LLC without any formal action having been taken, such as when an employee has regularly ordered certain supplies. "An agency relationship does not depend upon the express appointment or assent by the principal; rather it may be implied from the conduct of the parties."[37]

One unclear question is how much control the principal must have. One Texas case appears to take the control requirement too far:

> The critical element of an agency relationship is the right to control, and the principal must have control of both the means and details of the process by which the agent is to accomplish his task in order for an agency relationship to exist.[38]

The summaries of cases in the Restatement (Third) of Agency demonstrate a variety of formulations of the control requirement, ranging from control of the minutia of the agent's actions (not required) to control only of the final result (something more required).[39]

B. Duties of Agents and Modifications of Those Duties

As discussed above,[40] when acting as an agent of an LLC, the member, manager, officer, or other person owes duties of loyalty and care pursuant to basic agency principles.[41] Cases in Texas are beginning to recognize

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[31] *Id* at page 3.
[32] No. 4-10-CV-706, 2011 WL 6338813 *3, 9-10 (E.D. Tex. Dec. 19, 2011.
[33] *Cardwell v. Gurley*, No. 4-10-CV-706, 2011 WL 6338813 *3, 9-10 (E.D. Tex. Dec. 19, 2011).
[34] *Id*. at page 3 and following.
[35] *Restatement (Third) of Agency* § 1.01.
[36] TBOC § 101.254.
[37] *SJW Property Commerce, Inc. v. Southwest Pinnacle Properties, Inc.*, 328 S.W. 3d 121 (Tex. App.—Corpus Christi, 2011), *no writ*.
[38] *McAfee, Inc. v. Agilysys, Inc*., 316 S.W.3d 820, 829 (Tex. App.—Dallas 2010, no pet.)
[39] *Restatement (Third) of Agency* § 1.01 *cmt f.*
[40] Notes 14-17, *supra*, and accompanying text.
[41] *Restatement (Third) of Agency* § 8.08; *see also Restatement (Second) of Agency* § 379. *See Restatement (Third) of Agency* §§ 8.01-8.06. These sections provide:

- 8.01 — general duty of loyalty in "all matters connected with the agency relationship;"
- 8.02 — duty not to acquire a material benefit from a third party in connection with the agency relationship;
- 8.03 — duty not to act as or on behalf of a party adverse to the principal;
- 8.04 — duty not to compete throughout the duration of the agency relationship;
- 8.05 — duty not to use property of the principal or confidential information of the principal for the agent's own purposes or those of a third party; and
- 8.06 — as we discuss in notes 40-41, *infra*, and accompanying text, § 8.06 permits modification of

agency law as a basis for imposing fiduciary duties in the LLC context.[42] A company agreement that intends to modify duties arising under the TBOC should also provide for corresponding modifications of the duties under agency law.[43] The *Restatement (Third) of Agency* (the "*Restatement of Agency*")[44] permits conduct that would otherwise be prohibited by §§ 8.01 through 8.05 if the principal consents, provided that, in obtaining the principal's consent, the agent:

- Acts in good faith;
- Discloses all material facts that the agent knows, has reason to know, or should know would reasonably affect the principal's judgment, unless the principal has manifested that such facts are already known by the principal or that the principal does not wish to know them; and
- Otherwise deals fairly with the principal.

The principal's consent must "concern either a specific act or transaction, or acts or transactions of a specified type that could reasonably be expected to occur in the ordinary course of the agency relationship."

The *Restatement of Agency* sets out more duties of the agent in the following sections:

- § 8.07 (agent's duty to act in accordance with any contract with the principal);
- § 8.08 (agent's duties of care, competence, and diligence; may be varied by contract);
- § 8.09 (agent's duty to act only within scope of actual authority and to comply with principal's lawful instructions);
- § 8.10 (agent's duty of good conduct);
- § 8.11 (agent's duty to provide information to principal); and
- § 8.12 (agent's duty, subject to any agreement with the principal, not to deal with the principal's property so that it appears to be the agent's; not to commingle; and to keep and render accounts to the principal of money or other property received or paid out on the principal's account; may be varied by agreement).

The *Restatement of Agency* also provides that the principal has certain duties to the agent under:

- § 8.13 (principal's duty to comply with the contract);
- § 8.14 (principal's duty to indemnify the agent, subject to variation by agreement; principal's duty to indemnify does not extend to losses that result from the agent's own negligence, illegal acts, or other wrongful conduct[45]); and
- § 8.15 (principal's duty to deal fairly and in good faith with the agent, including the obligation to provide the agent with information about risks of physical harm or pecuniary loss that the principal knows, has reason to know, or should know are present in the agent's work but unknown to the agent.

The Texas Supreme Court has recognized that a principal and agent may limit the scope of the agency and the duties owed by the agent.[46] In *National Plan Administrators Inc. v. National Health Insurance Company*,[47] the court considered a contract in which National Plan Administrators ("NPA") contracted with National Health Insurance Company, Inc. ("National Health") to provide third-party administrator duties for cancer insurance policies issued by National Health. The court noted that "There was no agreement that NPA would not market policies underwritten by other insurers in direct competition with National Health policies."[48] The court concluded that "The parties agreed that NPA would act as National Health's agent only for specific purposes."[49] Accordingly, NPA did not breach its contract with National Health by administering cancer policies issued by competitors

the duties in §§ 8.01-8.05 if specified requirements are satisfied.

See also Restatement (Second) of Agency §§ 387-398.

[42] *See In re Hardee*, 2013 Bankr. LEXIS 949, 2013 WL 1084494 (Bankr. E.D. Tex. March 14, 2013) (concluding managing member owed LLC formal fiduciary duties based on agency law; managing member owed formal fiduciary duties to LLC based on implication of Texas LLC law that managers and managing members owe fiduciary duties of care, loyalty, and obedience similar to corporate directors; managing member owed no fiduciary duties to other members); *In re TSC Sieber Servs., LC*, 2012 Bankr. LEXIS 4904, 2012 WL 5046820 (Bankr. E.D. Tex. Oct. 2012) (finding individual who took over managerial control of LLC but had no formal office or ownership interest owed LLC a formal fiduciary duty based on agency law and an informal fiduciary duty based on circumstances giving rise to control).

[43] As explained in the text accompanying this note, *Restatement (Third) of Agency* § 8.06 permits waiver of the duty of loyalty if certain requirements are satisfied. *Restatement (Third) of Agency* § 8.08 provides that the duty of care may be waived by agreement.

[44] *Restatement (Third) of Agency* § 8.06.

[45] *Restatement (Third) of Agency* § 8.14, cmt. *b*.

[46] *National Plan Administrators, Inc. v. National Health Insurance Company*, 235 S.W. 3d 695, 702-704 (Tex. 2007).

[47] *Id*.

[48] 235 S.W. 3d at 703.

[49] 235 S.W. 3d at 704.

C. Waivers of Duties Under Agency Law in a Company Agreement

To effectuate waivers under agency law or the LLC Chapter, a manager who is not a member should be a party to the company agreement.[50] As discussed above, the *Restatement (Third) of Agency* (the "*Restatement of Agency*")[51] permits conduct that would otherwise be prohibited by §§ 8.01 through 8.05 if the principal consents, provided that, in obtaining the principal's consent, the agent:

- Acts in good faith;
- Discloses all material facts that the agent knows, has reason to know, or should know would reasonably affect the principal's judgment, unless the principal has manifested that such facts are already known by the principal or that the principal does not wish to know them; and
- Otherwise deals fairly with the principal.

The principal's consent must "concern either a specific act or transaction, or acts or transactions of a specified type that could reasonably be expected to occur in the ordinary course of the agency relationship."

A question that the drafter should address in the LLC context is how should the consent of the principal, i.e., the LLC, be manifested? Particularly, if the persons for whom a waiver or reduction of duties under agency law is being provided are the governing persons of the LLC or are in control of the LLC, qualify the terms and conditions of a waiver under TBOC § 101.255:

> Sec. 101.255. CONTRACTS OR TRANSACTIONS INVOLVING INTERESTED GOVERNING PERSONS OR OFFICERS. (a) This section applies to a contract or transaction between a limited liability company and:
>
> (1) one or more governing persons or officers, or one or more affiliates or associates of one or more governing persons or officers, of the company; or
> (2) an entity or other organization in which one or more governing persons or officers, or one or more affiliates or associates of one or more governing persons or officers, of the company:
>
> (A) is a managerial official; or
> (B) has a financial interest.
>
> (b) An otherwise valid and enforceable contract or transaction described by Subsection (a) is valid and enforceable, and is not void or voidable, notwithstanding any relationship or interest described by Subsection (a), if any one of the following conditions is satisfied:
>
> (1) the material facts as to the relationship or interest described by Subsection (a) and as to the contract or transaction are disclosed to or known by:
>
> (A) the company's governing authority or a committee of the governing authority and the governing authority or committee in good faith authorizes the contract or transaction by the approval of the majority of the disinterested governing persons or committee members, regardless of whether the disinterested governing persons or committee members constitute a quorum; or
> (B) the members of the company, and the members in good faith approve the contract or transaction by vote of the members; or
>
> (2) the contract or transaction is fair to the company when the contract or transaction is authorized, approved, or ratified by the governing authority, a committee of the governing authority, or the members of the company.
>
> (c) Common or interested governing persons of a limited liability company may be included in determining the presence of a

[50] Although the LLC Chapter does not explicitly state that a person who is not a member may be a party to a company agreement, certain provisions strongly imply that it would be proper for a manager who is not a member to be a party. TBOC § 101.052(a) states that "the company agreement of a limited liability company governs:
(1) the relations among members, managers, and officers of the company, assignees of membership interests in the company, and the company itself; and
(2) other internal affairs of the company.
Also, TBOC § 101.052(e) states: "A company agreement may provide rights to any person, including a person who is not a party to the company agreement, to the extent provided by the company agreement."

[51] *Restatement (Third) of Agency* § 8.06.

quorum at a meeting of the company's governing authority or of a committee of the governing authority that authorizes the contract or transaction.

(d) A person who has the relationship or interest described by Subsection (a) may:

(1) be present at or participate in and, if the person is a governing person or committee member, may vote at a meeting of the governing authority or of a committee of the governing authority that authorizes the contract or transaction; or

(2) sign, in the person's capacity as a governing person or committee member, a written consent of the governing persons or committee members to authorize the contract or transaction.

(e) If at least one of the conditions of Subsection (b) is satisfied, neither the company nor any of the company's members will have a cause of action against any of the persons described by Subsection (a) for breach of duty with respect to the making, authorization, or performance of the contract or transaction because the person had the relationship or interest described by Subsection (a) or took any of the actions authorized by Subsection (d).

Any waivers must be specific enough to withstand a charge that they are against public policy. It is likely that a waiver "of all fiduciary duties other than an obligation of good faith and fair dealing" in a family LLC would be found to be sufficiently non-specific as to be unenforceable in many contexts.[52] On the other hand, such a waiver among sophisticated business partners forming a single-purpose LLC may be enforceable. In summarizing cases on partnership, trust, corporate, and other fiduciary law in the United States and England over several centuries, a noted commentator stated:

> Fundamentally, power begets responsibility (in partnership and LLC arenas and in many others — this is fundamentally a philosophical question concerning the nature of responsibility). [If] you don't want some responsibility you shouldn't take some power. In truly shared power relationships ([like a joint venture between GE and GM]), the responsibility diminishes. In other power relationships, the responsibility can be relatively high. One size does not fit all.[53]

D. Knowledge of agent imputed to principal.

In *B.A.S.S. Group, LLC v. Coastal Supply*,[54] the Delaware Chancery Court held that because the individual who was acting as an agent for an LLC purchased real property for the LLC with funds that the agent knew were embezzled, the LLC was not a bona fide purchaser for value because the agent's "state of mind can be imputed to" [the LLC].[55] Vice Chancellor Parsons explained:

> Delaware courts consistently have imputed to a corporation the knowledge of an officer or director of the corporation when acting on its behalf. See, e.g., *Teachers' Retirement Systems of La. v. Aidinoff*, 900 A.2d 654, 671 n.23 (Del. Ch. 2006) (citing *Carlson v. Hallinan*, 2006 WL 771722, at *21 (Del. Ch. Mar. 21, 2006); *In re HealthSouth Corp. S'holders Litig.*, 845 A.2d 1096, 1108 n. 22 (Del. Ch. 2003). I see no reason why the rule would be any different for a member of an LLC who has management rights.[56]

III. MISCELLANEOUS MUSINGS ABOUT DUTIES

A. Potential Duties to Creditors

In *In re Brentwood Lexford Partners, LLC,*[57] although the entity was described as an LLC in the style of the case and in the summary at the beginning of the opinion, the court describes the applicable duties in terms of the duties of corporate directors and states:

> Officers of an insolvent corporation breach their fiduciary duty by transferring funds to themselves, in effect, as equity holders, to the detriment of the corporation's creditors.[58]

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[52] *See* Herrick K. Lidstone, Jr. and Allen Sparkman LIMITED LIABILITY COMPANIES AND PARTNERSHIPS IN COLORADO § 4.3.3 (2d Ed. CLE in Colorado, Inc. 2017). Such a waiver would also be unwise if one of the purposes of the LLC is to achieve estate or gift tax planning goals.

[53] E-mail from William Callison, Esq., Faegre Baker Daniels, Denver, Colorado, to the Subcommittee, BL-MODELLLC@MAIL.ABANET.ORG, on Prototype Limited Liability Partnership Agreements (Oct. 12, 2007).

[54] 2009 WL 1743730 (Del. Ch. June 19, 2009).

[55] *Id.* at *7.

[56] *Id.* n. 72.

[57] 292 B. R. 255 (Banktcy. N. D. Tex. 2003).

[58] 292 B.R. at 272.

B. Adverse Fiduciaries

Where fiduciaries were adverse to each other because engaged in litigation against each other, their fiduciary duties were not lessened.[59]

C. Self-Interested Fiduciary

If a fiduciary is self-interested, the fiduciary may not be able to take advantage of the business judgment rule.[60] The court in the cited case stated:

> Fields contends he is protected by both the exculpation clause in the LLC Agreement and by the business judgment rule, and cannot be held liable for making a reasonably informed decision to approve the 2006 Duke Transaction on behalf of Crescent Resources. In other words, Fields claims he was at most merely negligent, but did not act with the heightened state of mind necessary to find him liable in light of the exculpation clause. The summary judgment record, however, raises substantial questions as to whether Fields, as a self-interested director with a financial stake in the approval of the transaction, can even take advantage of the exculpation clause or the business judgment rule. But even if he can, there are significant factual disputes relevant to whether his conduct was merely negligent or something more. For example, the summary judgment record suggests Fields may not have been entitled to the full $55 million offer Duke created and then allegedly used as leverage to give Fields a financial stake in the 2006 Duke Transaction. It also raises the possibility Fields, as a seasoned manager with decades of experience in the industry, knew better than to approve a distribution of more than one billion dollars to Duke based on the economic forecast for Crescent Resources at the time. Fields cannot obtain summary judgment on these claims by simply professing in an affidavit he acted in good faith.[61]

D. Duty to Communicate Fully and Accurately

When fiduciaries communicate with their beneficiaries in the context of asking the beneficiary to make a discretionary decision, there is a duty to disclose all material facts.[62] In the corporate context, the Delaware Supreme Court has held that:

> Delaware law also protects shareholders who receive false communications from directors even in the absence of a request for shareholder action. When the directors are not seeking shareholder action, but are deliberately misinforming shareholders about the business of the corporation, either directly or by a public statement, there is a violation of fiduciary duty. That violation may result in a derivative claim on behalf of the corporation or a cause of action for damages. There may also be a basis for equitable relief to remedy the violation.[63]
>
> No reason appears why this analysis should not also apply in the LLC context.

IV. WAIVERS, MODIFICATIONS, AND ELIMINATIONS OF DUTIES

A. Public Policy Considerations

"While it is presumably true that all parties entering into a long-term contractual relationship in some sense assume that the other parties will conduct themselves in accordance with the positive law, that is just another way of stating the expectation that fiduciaries who operate entities will not knowingly cause the entities to breach the law in conducting their business. The public policy purpose that would be served by replicating that recognized fiduciary duty as a contractual duty inherent in every LLC agreement seems minimal to me, given my understanding that this fiduciary principle cannot be contracted away by private parties, since it involves an important public interest." *Metro Communication Corp. BVI v. Advanced Mobilecomm Technolgies, Inc.*, 854 A.2d 121 (Del. Ch. 2004). "Under Delaware law, a fiduciary may not choose to manage an entity in an illegal fashion, even if the fiduciary believes that the illegal activity will result in profits for the entity." 854 A.2d at 131.

B. TBOC

The TBOC provides that "[t]he company agreement of a limited liability company may expand or restrict any duties, including fiduciary duties, and related liabilities that a member, manager, officer, or other person has to the company or to a member or manager of the company."[64] Note that the TBOC provision allows only the expansion or restriction of duties, but does not expressly state that duties may be eliminated.

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[59] *Texas Standard Oil & Gas, L.P. v. Frankel Offshore Energy, Inc.*, 394 S.W.3d 753, 773-778 (Tex. App.-Houston [14th Dist.] 2012).

[60] *Crescent Resources Litigation Trust v. Duke Energy Corporation*, 500 B. R. 464, 485-86 (W. D. Tex. 2013).

[61] *Id*.

[62] *Bakerman v. Sidney Frank Importing Co., Inc.*, 2006 WL 3927242 (Del. Ch. October 10, 2006).

[63] *Malone v. Brincat*, 722 A.2d 5 (Del. 1998).

[64] TBOC § 101.401.

C. Drafting Limitations on Duties

If the parties to a company agreement want to limit fiduciary duties, they must draft plainly and precisely. In *Feeley v. NHAOCG, LLC*,[65] the Delaware Court of Chancery held that the following language did not eliminate fiduciary duties but instead recognized that they existed and eliminated monetary liability for certain described breaches:

> Limited Liability of Members. Except as and to the extent required under the Delaware Act or this Agreement, no Member shall be (i) liable for the debt, liabilities, contracts or any other obligations of the Company; or (ii) liable, responsible, accountable in damages or otherwise to the Company or the other Members for any act or failure to act in connection with the Company and its business unless the act or omission is attributed to gross negligence, willful misconduct or fraud or constitutes a material breach by such Member of any term or provision of this Agreement or any agreement the Company may have with the Member.

Feeley is an admonition to drafters who intend to modify or waive fiduciary duties to take care that the language chosen does in fact modify or waive duties and not just eliminate monetary liability for breaches. If only monetary liability is waived, equitable remedies, such as injunctive relief, rescission, disgorgement, imposition of a constructive trust, etc. may still be brought to bear.[66]

In *Kelly v. Blum*,[67] the LLC agreement before the court was silent on the issue of duties owed by managers to the LLC and its members, with the exception of Sections 7.5 and 7.9. In its entirety, Section 7.5, entitled "Duties," stated:

> [t]he Board of Managers shall manage the affairs of the Company in a prudent and businesslike manner and shall devote such time to the Company affairs as they shall, in their discretion exercised in good faith, determine is reasonably necessary for the conduct of such affairs.

In relevant part, Section 7.9 stated:

> [i]n carrying out their duties hereunder, the Managers shall not be liable for money damages **for breach of fiduciary duty to the Company nor to any Member** for their good faith actions or failure to act . . . but only for their own willful or fraudulent misconduct or willful breach of their contractual or **fiduciary duties** under this Agreement.[68]

The court in *Kelly* held that the language of Sections 7.5 and 7.9 did not limit or eliminate fiduciary duties. The court explained that Section 7.9 did exculpate the managers from monetary liability for some breaches of fiduciary duty, but did not exculpate the managers from the willful breach of duty alleged in this case. The court further stated:

> Having been granted great contractual freedom by the LLC Act, drafters of and parties to an LLC agreement should be expected to provide parties and anyone interpreting the agreement with clear and unambiguous provisions when they desire to expand, restrict, or eliminate the operation of traditional fiduciary duties.[69]

The following two cases illustrate examples of poor drafting of exculpatory provisions.

In *Bay Center Apartments Owner, LLC v. Emery Bay PKI, LLC*,[70] Section 6.1(b) of the company agreement stated that "the Members shall have the same duties and obligations to each other that members of a limited liability company formed under the Delaware Act have to each other. Section 6.2 of the company agreement provided that "Except for any duties imposed by this Agreement . . . each Member shall owe no duty of any kind towards the Company or the other Members in performing its duties and exercising its rights hereunder or otherwise." For purposes of ruling on defendants' motion to dismiss, the court adopted plaintiff's resolution of the seeming conflict between Section 6.1(b) and Section 6.2 by concluding that Section 6.1(b) meant that the members had default fiduciary duties and that Section 6.2, because by its terms it did not apply to "any duties imposed by this agreement," only eliminated duties that were not traditional fiduciary

[65] *Feeley v. NHAOCG, LLC*, 62 A.3d 649 (Del. Ch. 2012).
[66] 62 A.3d at 664.
[67] 2010 Del. CH. LEXIS 31 (Del. Ch. Feb. 24, 2010).
[68] *Id*. at *46-47 (emphasis original).
[69] *Id.* at *45-46 n. 70. This statement by the court is reminiscent of the 2006 statement by then Vice Chancellor Strine of the Delaware Court of Chancery: "With the contractual freedom granted by the LLC Act comes the duty to scriven with precision." *Willie Gary LLC v. James & Jackson, LLC*, 2006 Del. Ch. LEXIS 3, at *5, 2006 WL 75309, at *2 (Del. Ch. Jan. 10, 2006), *aff'd*, 906 A.2d 76 (Del. Super. Ct. 2006).
[70] 2009 WL 1124451 (Del. Ch. April 20, 2009).

duties or were otherwise not expressly contemplated by the company agreement.

Kahn v. Portnoy[71] considered an LLC company agreement that provided that the "authority, powers, functions and duties (including fiduciary duties)" of its board of directors will be identical to those of a board of directors of a business corporation organized under the Delaware General Corporation Law, unless otherwise specifically provided for in the company agreement. The court found the provision of the company agreement that addressed interested director transactions was ambiguous and, for purposes of the motion to dismiss before it, interpreted that provision in favor of the plaintiff.

> The court then addressed the exculpatory provisions in the company agreement:
>
> The LLC Agreement contains two provisions that exculpate TA directors from personal liability for monetary damages. Both of these provisions contain exceptions for certain conduct that is not exculpated, and the two provisions define these exceptions differently. Section 10.2(a) eliminates personal director liability for money damages for a breach of fiduciary duty except:
>
> (i) for any breach of such director's duty of loyalty to the Company or the Shareholders as modified by this Agreement, (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law, or (iii) for any transaction from which such director derived an improper personal benefit.

Section 10.2(b), which apples "[notwithstanding anything to the contrary" in the LLC Agreement, eliminates liability for monetary damages for any "Indemnitee," which is defined to include directors, unless there has been a final judgment that the person "acted in bad faith or engaged in fraud, willful misconduct or, in the case of a criminal matter, acted with knowledge that the Indemnitee's conduct was unlawful."

It is unclear to the Court why the LLC Agreement includes two different, and arguably conflicting, provisions exculpating directors from personal liability for money damages. After much deliberation, I have been unable to explain these provisions as anything other than poor drafting or a strategy of "if one exculpatory provision is good, then two must be better."

V. FEDERAL SECURITIES LAW ISSUES[72]

A. General

Client advisors must address many collateral issues in connection with securities regulation. Attorneys and other advisors must remember that the principal purpose for compliance with securities laws is to raise money for a client's business. Consequently, the attorney-advisor should assist the client in structuring securities transactions in a manner that is most likely to achieve the client's goals effectively and efficiently. This includes assisting the client in choosing the form of business entity and identifying and quantifying the risk of the transaction, as well as assisting the client in identifying the nature of the investors most likely to consider an investment in the proposed transaction.

The authors believe that, except in the simplest cases, the attorney advising a client with respect to securities law compliance should begin by determining whether a security is involved (and the attendant risks if the conclusion is wrong), and then determine which federal exemptions are potentially available. Often, qualifying under one federal exemption rather than another may make compliance with applicable state laws much simpler. The authors assume that most readers of this paper will be attorneys advising small business clients and that neither the attorney nor the client will be interested in registering the securities to be issued with the SEC — a time-consuming and very expensive process.

B. Potential Liability of Sellers, Control Persons, and Others Under the Securities Act of 1933.[73]

Section 5 of the Securities Act of 1933 (the "1933 Act") requires persons intending to sell securities to ensure either that they have an exemption under § 3 or § 4 of the 1933 Act or that there is a valid registration statement in effect. Section 12(a)(1) of the 1933 Act imposes civil liability on any person who offers or sells a security in violation of § 5. The person purchasing a security from a person who is liable under § 12 make seek rescission with interest, less any income received from the security.[74] *Junker v. Midterra Associates, Inc.* held that a purchaser had waived his right to rescission by accepting income from a partnership after he became

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[71] 2008 WL 5197164 (Del. Ch. (December 11, 2008).

[72] Article V of this paper is taken, in part, from Chapter 14 of Herrick K. Lidstone, Jr. and Allen Sparkman LIMITED LIABILITY COMPANIES AND PARTNERSHIPS IN COLORADO (2d ed. CLE in Colorado, Inc. 2017).

[73] The authors thank Herrick K. Lidstone, Jr. for permission to use Chapter 15 of his Securities Law Deskbook (Bradford Publishing Company, updated annually since 2006) in this paper's discussion of the potential liability of sellers, control persons, and others under the 1933 Act.

[74] 1933 Act § 12(a).

aware that the partnership interests had been sold in violation of § 5.[75] Liability for violations of § 5 extends to those who have "engaged in steps necessary to the distribution of [unregistered] securities issues."[76] Moreover, the term "seller" is not limited to the persons who directly pass title to the purchasers.[77] In addition, § 15 of the 1933 Act makes any person who controls any person who is liable under § 12 jointly and severally liable with and to the same extent as the controlled person. Damages for control person liability are subject to amendments made in 1995 providing for "fair share" or proportionate liability for defendants who act non-knowingly.[78]

Whether a person is a controlling person is "an intensely factual" question.[79] The Eleventh Circuit has held that a person is subject to control person liability if the individual "had the power to control the general affairs of the entity primarily liable at the time the entity violated the securities laws … [and] had the requisite power to directly or indirectly control or influence the specific corporate policy which resulted in primary liability."[80] Although the cases dealing with control person liability under § 15 of the 1933 Act are corporate cases, it is easy to see how the Eleventh Circuit's test could be applied to the governing persons of LLCs.

C. Federal Statutory Exemptions

1. Section 4(a)(2)—the Private Placement Exemption

Section 4(a)(2) of the 1933 Act exempts "transactions by an issuer not involving any public offering." The SEC has issued a safe-harbor in Rule 506 of Regulation D[81] whereby offerings by issuers may qualify under § 4(a)(2). Rule 506 is not exclusive, and an issuer who attempts to comply with Rule 506 but fails for some reason may still qualify under § 4(a)(2).[82] Availability of § 4(a)(2) will depend on satisfying the basic criteria established decades ago by the U.S. Supreme Court in *SEC v. Ralston Purina Co.*:[83]

- Offerees and purchasers possess sufficient knowledge and experience in finance and business matters to evaluate the risks and merits of the investment (*i.e.*, they are "sophisticated investors"), or they are able to bear the investment's economic risk;
- Offerees and purchasers have access to the type of information normally included in a prospectus; and
- Purchasers take with investment intent and not with a view to reselling or distributing the securities.

2. Section 3(a)(11)—the Intrastate Offering Exemption

Section 3(a)(11) of the 1933 Act exempts "any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such State or Territory." This is the familiar intrastate offering exemption. The SEC has promulgated a safe-harbor under § 3(a)(11):

- A corporation, LP, trust, or other business organization that is organized under state or territorial law will be deemed to be a resident of the state or territory under whose law it is formed. Accordingly, Texas corporations, LLCs, LPs, and LLLPs would be deemed to be residents of Texas.
- A general partnership will be deemed to be a resident of the state in which it has its principal office.
- A business organization that is deemed to be a resident of Texas will be deemed to be doing business in Texas if it and its subsidiaries on a consolidated basis derive at least 80 percent of their gross revenues within Texas; and
    - Intends to use and uses at least 80 percent of the net proceeds to the issuer from the offering in Texas; and
    - Has its principal office in Texas.[84]

[75] 49 F.R.D. (S.D.N.Y. 1970).
[76] *SEC v. Chinese Consol. Benev. Ass'n, Inc.*, 120 F.2d 738, 741 (2d. Cir. 1941); *see also SEC v. Murphy*, 626 F.2d 633, 650-651 (9th Cir. 1980).
[77] *Pimter v. Dahl*, 486 U.S. 622 (1988).
[78] Herrick K. Lidstone SECURITIES LAW DESKBOOK § 15.9 (Bradford Publishing Company, updated annually since 2006).
[79] *Arthur Children's Trust v. Keim*, 994 F.2d 1390 (9th Cir. 1993).
[80] *Brown v. Enstar Group, Inc.*, 84 F.3d 393, 396 (11th Cir. 1996), *cert, denied, sub. nom. Brown v. Mandel*, 519 U.S. 1112 (1997).
[81] 17 C.F.R. § 230.506. Regulation D is at 17 C.F.R. §§ 230.500 through 230.508.
[82] 17 C.F.R. § 230.500(c) states: "Attempted compliance with any rule in Regulation D does not act as an exclusive election; the issuer can also claim the availability of any other applicable exemption. For instance, an issuer's failure to satisfy all the terms and conditions of rule 506(b) (§ 230.506(b)) shall not raise any presumption that the exemption provided by section 4(a)(2) of the Act (15 U.S.C. 77d(2)) is not available."
[83] *SEC v. Ralston Purina Co.*, 346 U.S. 119, 125 (1953).
[84] 17 C.F.R. § 230.147. Rule 147's requirements are absolute; there is no "reasonable basis to believe" as in Regulation D.

Offers and sales of securities pursuant to Rule 147 may be made only to residents of the state or territory in which the issuer is resident, as determined above, or who the issuer reasonably believes, at the time of the offer and sale, are residents of the state or territory in which the issuer is resident. For purposes of determining the residence of offerees and purchasers:

(1) A corporation, partnership, limited liability company, trust or other form of business organization shall be deemed to be a resident of a state or territory if, at the time of the offer and sale to it, it has its principal place of business, as defined in paragraph (c)(1)(i) of this section, within such state or territory. A trust that is not deemed by the law of the state or territory of its creation to be a separate legal entity is deemed to be a resident of each state or territory in which its trustee is, or trustees are, resident.

(2) Individuals shall be deemed to be residents of a state or territory if such individuals have, at the time of the offer and sale to them, their principal residence in the state or territory.

(3) A corporation, partnership, trust or other form of business organization, which is organized for the specific purpose of acquiring securities offered pursuant to Rule 147 shall not be a resident of a state or territory unless all of the beneficial owners of such organization are residents of such state or territory.

Obtaining a written representation from purchasers of in-state residency status will not, without more, be sufficient to establish a reasonable belief that such purchasers are in-state residents.

In connection with any securities offered for sale under Rule 147, the issuer must place a prominent legend on the certificate or other document evidencing the security stating that: "Offers and sales of these securities were made under an exemption from registration and have not been registered under the Securities Act of 1933. For a period of six months from the date of the sale by the issuer of these securities, any resale of these securities (or the underlying securities in the case of convertible securities) shall be made only to persons resident within the state of Texas."

The issuer shall, at the time of any offer or sale by it of a security pursuant to Rule 147, prominently disclose to each offeree in the manner in which any such offer is communicated and to each purchaser of such security in writing a reasonable period of time before the date of sale, the following: "Sales will be made only to residents of Texas. Offers and sales of these securities are made under an exemption from registration and have not been registered under the Securities Act of 1933. For a period of six months from the date of the sale by the issuer of the securities, any resale of the securities (or the underlying securities in the case of convertible securities) shall be made only to persons resident within the state of Texas."

The precise requirements for a qualifying intrastate offering have made it a seldom-used exemption. Unless the entity is a general partnership with its principal place of business in Texas, only entities formed under Texas law can attempt to take advantage of the intrastate exemption. Conversely, a Texas corporation or LLC could not conduct a qualifying intrastate offering in any state other than Texas. Any issuer contemplating an offering under § 3(a)(11) would be advised to consider other statutory and regulatory exemptions that likely will be available. New Rule 147A, discussed immediately below, may make the intrastate offering more usable.

3. Section 3(a)(11)—the Intrastate Offering Exemption—Rule 147A

The SEC has promulgated new Rule 147A effective April 1, 2017 under which an issuer will be deemed to be a resident of Texas if its principal place of business is in Texas and it is doing business in Texas. The issuer shall be deemed to have its principal place of business in Texas if the officers, partners or managers of the issuer who primarily direct, control and coordinate the activities of the issuer are in Texas.[85] An issuer will be considered to be doing business in Texas if it satisfies at least one of the following requirements:

(i) The issuer derived at least 80% of its consolidated gross revenues from the operation of a business or of real property located in or from the rendering of services within Texas;

(ii) The issuer had at the end of its most recent semi-annual fiscal period prior to an initial offer of securities in any offering or subsequent offering pursuant to this section, at least 80% of its assets and those of its subsidiaries on a consolidated basis located within Texas;

(iii) The issuer intends to use and uses at least 80% of the net proceeds to the issuer from sales made pursuant to Rule 147A in connection with the operation of a business or of real property, the purchase of real property located in, or the rendering of services within Texas; or

[85] Rule 147A(c)(1).

(iv) A majority of the issuer's employees are based in Texas.[86]

Note that new Rule 147A will allow, for example, a Delaware LLC or corporation that meets the residency and doing business tests of Rule 147A to conduct an intra-state offering in Texas. Also note that under new Rule 147A, it is possible that an issuer may change its residency from time-to-time – a change that is not possible under Rule 147 which focuses on the state of formation. Of course, it also possible that an entity may change its state of formation, but happens much less frequently than a change of residency.

Securities offered and sold under Rule 147A must be offered and sold only to residents of the state in which the issuer qualifies. Residency is determined for purposes of Rule 147A on the same basis as under Rule 147.

Rule 147A requires legends and disclosures like those required under Rule 147.

4. <u>Section 4(a)(5)—the Accredited Investor Exemption</u>

Section 4(a)(5) of the 1933 Act exempts offerings of up to $5 million if made exclusively to accredited investors. Issuers seldom rely on this exemption because it does not preempt the application of state law, and it contains limitations that are not contained in SEC Rule 506, which does preempt state law.

5. <u>Section 3(b)(1)—Regulation A and Section 3(b)(2)—Reg. A +</u>

Section 3(b)(1) of the 1933 Act authorizes the SEC to exempt offerings not exceeding $5 million. The SEC has used this authority to promulgate Rules 504 and 505[87] of Regulation D, Regulation A, Rule 701, and Rule 1001. Regulation A,[88] which previously permitted offerings up to $5 million, was not much used because, unlike Rule 506, it provided no exemption from state regulation.

Regulation A has been amended, however, pursuant to Section 3(b)(2) of the 1933 Act (added in 2012 by the JOBS Act[89]), which required the SEC to create an exemption for offerings not exceeding $50 million in a 12-month period (referred to as "Reg A+"). The SEC adopted rules to implement Reg. A+ which were effective on June 19, 2015.[90] As adopted, Reg. A+ provides two tiers for offerings – Tier 1 is available for offerings that are less than $20 million in any twelve-month period; Tier 2 is available for offerings that are less than $50 million in any twelve-month period. For offerings less than $20,000,000, an issuer may elect to proceed under either Tier 1 or Tier 2.[91] The rules are complex, but compliance with Reg. A+ (which permits a public offering at either the Tier 1 or Tier 2 level) is less complex than filing a registration statement. More importantly, securities included in Tier 2 offerings are "covered securities" under 1933 Act § 18(b)[92] and therefore exempt from state securities qualification. Many issuers eligible for Reg. A+ offerings would not be able to qualify a registration statement in many states, and this provision, by itself, makes a Tier 2 Reg. A+ offering attractive for the issuer seeking to raise money publicly. The authors believe that Tier 1 of Reg. A+ provides little benefit for issuers and will not discuss it further here. Because of the "covered security" exemption from state securities regulation and because meeting the continuing reporting requirements makes issuers eligible for over-the-counter market trading, the authors believe that Tier 2 of Reg. A+ is much more useful to prospective issuers. Although neither the Texas Securities Act nor the rules thereunder contain provisions dealing with Reg. A+, presumably the Texas Securities Board will provide rules for Tier 2 Reg. A+ offerings similar to those provide for Rule 506.[93] There are a number of requirements for Reg. A+:

Eligible Issuers. The rules make Regulation A available to United States and Canadian issuers that have a principal place of business in either the United States or Canada, although there are certain exclusions, including, but not limited to, the following ineligible issuers:

- SEC reporting companies;
- Blank-check companies;

[86] Rule !47A(c)(2).

[87] Rule 505 was repealed effective May 17, 2017 (SEC Release No. 10238 October 26, 2016).

[88] 17 C.F.R. §§ 251 through 263.

[89] The Jumpstart Our Business Startups Act of 2012 (the "JOBS Act"), Pub. L. No. 112-106, 126 Stat. 306 (April 5, 2012).

[90] SEC Rel. 33-9741 (Mar. 25, 2015); effective June 19, 2015. Section 401 of the JOBS Act authorized the SEC to adopt rules that would permit a $50 million Regulation A offering.

[91] 17 C.F.R. § 230.251; SEC Release Nos. 33-9741; 34-74578; 39-2502; File No. S7-11-13.

[92] Based on the sale of securities issued in Tier 2 offerings to "qualified purchasers." "Qualified purchasers" are defined for purposes of § 18(b)(4)(D)(ii) to include any persons to whom securities are offered or sold in a Tier 2 offering. States still retain the ability to require certain filings and fees in connection with a Tier 2 offering, as well as the ability to bring enforcement action against fraudulent activities.

[93] In a phone conversation on March 30, 2017, Clint Edgar, Director of Registrations for the Texas Securities Board, confirmed that Tier 2 Reg A+ offerings would be handled under the rules for Rule 506 offerings in Tex. Ad. Code § 114.4

- Investment companies registered or required to register under the Investment Company Act of 1940.

Eligible Securities. The final rules allow issuers to rely on Regulation A as an exemption from registration for offers and sales of equity, debt, warrants, and other convertible equity securities. Offers and sales of asset-backed securities and fractional or undivided interests in oil, gas, or other minerals are not eligible under Regulation A.

Investor Limitations. A company seeking qualification under Tier 2 for securities that will not be listed on a national securities exchange upon qualification must limit the amount of securities that an investor who is not an accredited investor under Rule 501 of Regulation D may purchase to no more than:

- For natural persons, the greater of 10% of such person's annual income or net worth; or
- If not a natural person, the greater of 10% of such person's annual revenue or net assets at fiscal year-end.

Securities Not Restricted. Securities sold in a Regulation A offering are not considered "restricted securities" for purposes of after-market resales.

Selling Security Holders.

- Tier 1 offerings may qualify no more than $6,000,000 in securities annually on behalf of selling security holders that are affiliates of the issuer.
- Tier 2 offerings may qualify no more than $15,000,000 in securities annually on behalf of selling security holders that are affiliates of the issuer.
- Sales by selling security holders are further limited during a company's initial Regulation A offering and any subsequently qualified Regulation A offering within the first twelve-month period to no more than 30% of the aggregate offering price.

Continuous or Delayed Offerings. The final rules permit continuous or delayed offerings under Regulation A in certain circumstances.

Qualification. Before a Regulation A offering statement may be qualified, the SEC's Division of Corporation Finance must take action by issuing a notice of qualification, much the same as a notice of effectiveness in registered offerings.

Testing the Waters. Prospective Regulation A issuers may "test the waters" by using solicitation materials before and after the issuer files the offering statement with the SEC.

Delivery Requirements. The rules adopt an "access equals delivery" model for all final Regulation A offering circulars. Once filed on EDGAR, the final offering circular is deemed delivered to investors.

Bad Actor Disqualification. The final rules adopt amendments to the "bad actor" disqualification provisions found in Rule 262 of Regulation A to match the bad actor disqualification provisions in Rule 506(d) of Regulation D.

Integration. The final rules adopt an integration safe harbor, in which offerings pursuant to Regulation A will not be integrated with certain other offerings, but this must be carefully considered in any Regulation A offering.

Reporting. Regulation A requires the filing of a notification on Form 1-A electronically on EDGAR. The Form 1-A consists of three parts:

- Part I is a fillable form, similar to Form D, to provide basic information about the issuer, eligibility, and offering details;
- Part II—the disclosure document (which includes a description of the issuer's business, a description of the securities being sold, the material risks associated with the offering, plan of distribution and selling security holders, the use of proceeds, management's discussion and analysis, the issuer's executive officers and directors and their compensation, beneficial ownership of the issuer's securities and related party transactions) and financial statements;[94] and

[94] Tier 2 offerings do require audited financial statements reviewed by an independent accountant (although not required to be PCAOB registered) and prepared in accordance with PCAOB standards.

- Part III—attachments including the signatures, exhibits index, and exhibits.

Tier 2 issuers under Regulation A have an obligation to make regular public reports, as follows:

- Annual reports on Form 1-K;
- Semi-annual reports on Form 1-SA;
- Current reports on Form 1-U;
- Special financial reports on Form 1-K and Form 1-SA; and
- Exit reports on Form 1-Z

1934 Act Rule 15c2-11 provides that an issuer's ongoing reports filed with the SEC pursuant to a Tier 2 offering will satisfy the specified information about an issuer and its securities that a broker-dealer must review before publishing a quotation for a security. As a result, a secondary market can develop for securities sold in a Tier 2 offering.

The ongoing reports filed by a Tier 2 issuer will not constitute "adequate public information" or "reasonably current information" for purposes of meeting the information requirements under Rule 144 or Rule 144A. To be considered to have provided "adequate public information" or "reasonably current information" under Rule 144 and Rule 144A, the Tier 2 issuer must be current in its semiannual reporting requirements and must voluntarily file quarterly financial statements on Form 1-U.

The OTC Markets Group, Inc. which owns the over-the-counter markets known as the Pink Sheets, OTCQB, and OTCQX amended their listing rules to allow for secondary trading of securities issued pursuant to Tier 2 of Regulation A.[95] In addition, FINRA has issued rules requiring firms participating in a Tier 1 or Tier 2 offering of securities to file certain information with FINRA and obtain a "no objections" opinion, as well making the retail communication and solicitation rules applicable to Tier 1 and Tier 2 offerings.[96]

6. Section 4(a)(6)—"Crowdfunding"

Crowdfunding is a term used to describe a method of raising money through the Internet. For a number of years, entrepreneurs have used this funding method through websites such as www.kickstarter.com to generate financial support for such things as artistic endeavors like films and music recordings, typically through small individual contributions from a large number of people. Using this method for equity funding has not been legal in the United States; there have been a number of variations of an equity raise that have been used and that probably have at least come very close to the edge of legality. The SEC says (perhaps naively):

> While crowdfunding can be used to raise funds for many things, it generally has not been used as a means to offer and sell securities. That is because offering a share of the financial returns or profits from business activities could trigger the application of the federal securities laws, and an offer or sale of securities must be registered with the SEC unless an exemption is available. [97]

Title III of the JOBS Act[98] added § 4(a)(6) to the 1933 Act to create an exemption under the securities laws so that the crowdfunding method can be easily used to offer and sell securities as well. Implementation of crowdfunding was left to SEC regulation, and the SEC adopted these rules on October 30, 2015.[99] Under the SEC's rules (which became effective May 16, 2016):

- A company would be able to raise a maximum aggregate amount of $1 million through crowdfunding offerings in a 12-month period, but must do so through an intermediary (either a broker-dealer or a "funding portal").
- Investors, over the course of a 12-month period, would be permitted to invest up to:
  - $2,000 or 5 percent of their annual income or net worth, whichever is greater, if both their annual income and net worth are less than $100,000; or
  - 10 percent of their annual income or net worth, whichever is greater, if either their annual income or net worth is equal to or more than $100,000. During the 12-month period, these investors would not be able to purchase more than $100,000 of securities through crowdfunding.

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[95] See OTCQB Standards and OTCQX Rules for U.S. Companies, available at www.otcmarkets.com (last accessed Sept. 20, 2015).

[96] See FINRA Regulatory Notice 15-32, "Regulation A Offerings," (Sept. 2015).

[97] SEC Fact Sheet for Crowdfunding (Oct. 23, 2013), *available at* www.sec.gov/News/PressRelease/Detail/PressRelease/1370540017677#.U8nyOGK9KSM.

[98] The Jumpstart Our Business Startups Act of 2012 (the "JOBS Act"), Pub. L. No. 112-106, 126 Stat. 306 (April 5, 2012). Title III of the JOBS Act was named the "Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012."

[99] SEC Rel. 33-9974.

Certain companies would not be eligible to use the federal crowdfunding exemption. Ineligible companies include non-U.S. companies, companies that already are SEC reporting companies, certain investment companies, companies that are disqualified under the proposed disqualification rules, companies that have failed to comply with the annual reporting requirements in the proposed rules, and companies that have no specific business plan or have indicated their business plan is to engage in a merger or acquisition with an unidentified company or companies.

The rules adopted by the Texas State Securities Board pursuant to Art. 581-44 of the Texas Securities Act are also restrictive and require that all funds raised flow through an escrow (unless the total amount raised does not exceed $100,000, in which case a segregated account may be used), and that all crowdfunding offerings proceed through an online intermediary. The Texas rules only permit a crowdfunding offering of up to $1,000,000 in any twelve-month period. No individual may invest more than $5,000 in a Texas crowdfunding offering unless the investor is "accredited."[100] A Texas crowdfunding offering must also satisfy certain tests relating to how much of the offering is invested in Texas and must meet the SEC safe harbor for intra-state offerings.

The New York Times reported that, although there have been some notable success stories in the first years of crowdfunding, there have also been many offerings in which the offering companies did not comply with all of the SEC rules.[101]

7. Regulation D

The SEC originally promulgated Regulation D[102] in 1982. Regulation D implements certain exemptions from the registration requirements of § 5 of the 1933 Act. It does not exempt transactions from the antifraud, civil liability, or other provisions of the federal securities laws nor does it eliminate the requirement to comply with applicable state securities laws. However, compliance with certain of the Rules in Regulation D will facilitate compliance with state laws. The National Securities Market Improvements Act of 1996 (NSMIA), codified in § 18 of the 1933 Act, prohibits state securities regulators from requiring any merit review or filings of disclosure documents with respect to a "covered security." For purposes of this discussion, advisors should note that securities sold in an offering under Rule 506 of Regulation D are covered securities as defined by NSMIA.[103] States are permitted to require a notice filing,[104] and often this means filing with the applicable states a copy of the Form D filed with the SEC. States also may still prosecute fraud or deceit.[105] A security is also a covered security if it is offered or sold pursuant to a "qualified purchaser."[106] The SEC proposed defining "qualified purchaser" to mean an accredited investor, but this proposal has not been adopted. There is a definition in the Investment Company Act of 1940 that does not apply under the 1933 Act[107] and that requires substantially greater wealth than does the definition of accredited investor.

8. Important Defined Terms in Regulation D

Regulation D defines a number of terms. The more important are:

- *Accredited Investor*. Many of the provisions of Regulation D depend on whether the offerees are "accredited investors."
  - An individual is an accredited investor if the individual has a net worth, or a net worth with the individual's spouse, exceeding $1 million without consideration of the individual's primary residence or any liability secured by the primary residence up to the value of the residence. If the primary residence secures a liability in an amount exceeding the value of the residence, the excess liability is counted as a liability in determining the individual's net worth.
  - An individual will also be an accredited investor if the individual had income in excess of $200,000 in each of the most recent two years or joint income with the individual's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year.
  - Any director, executive officer, or general partner of the issuer or any director, executive officer, or general partner of a general partner of the issuer is an accredited investor.
  - Any entity in which all of the equity owners are accredited investors is an accredited investor.[108]
  - A trust with total assets in excess of $5 million, not formed for the specific purpose of

[100] Tex. Ad. Code § 139.25.
[101] Nathaniel Popper, "Doubting the Wisdom of the Crowd," *New York Times*, Page B1 (January 25, 2017).
[102] 17 C.F.R. §§ 230.500 through 230.508.
[103] 1933 Act § 18(b)(4)(E).
[104] *Id.*
[105] 1933 Act § 18(c)(1).
[106] 1933 Act §§ 18(b)(3) and 18(b)(4)(d)(ii).
[107] *See* 17 C.F.R. § 270.2a51-1.
[108] If the proposed purchaser is an individual series of a series LLC, it may be unclear what is the "entity" for purposes of this accredited investor definition.

investing in the offered securities, and whose purchase is directed by a sophisticated person is an accredited investor.
- Regulation D defines certain other persons as accredited investors.

- *Purchasers*. Compliance with Rule 506(b) requires that there be no more than 35 purchasers. However, the following are not counted as "purchasers" for purposes of Rule 506(b):

  - Any accredited investor.
  - Any relative, spouse, or relative of the spouse of a purchaser who has the same primary residence as the purchaser.
  - Any trust or estate in which a purchaser and any of the persons related to him or her collectively have more than 50 percent of the beneficial interests.
  - Any corporation or other organization of which a purchaser and any of the persons related to him collectively are beneficial owners of more than 50 percent of the equity interests.

The following are treated as one purchaser:

- A corporation, partnership, or other entity unless not all of the equity owners are accredited investors and the entity was formed for the specific purpose of investing in the offered securities; in that case, each beneficial owner of an equity interest in such entity will be counted as a separate purchaser unless such beneficial owner is not counted under another exclusion.[109]
- A noncontributory employee benefit plan if the trustee makes all investment decisions for the plan.

9. Integration of Offerings

The exemption in Rule 504 of Regulation D has a dollar limit on the amount of securities that may be sold in an offering under that exemption, and the exemption in Rule 506 of Regulation D contain limits on the number of non-accredited purchasers in an offering. Regulation D provides the following rule:

> All sales that are part of the same Regulation D offering must meet all of the terms and conditions of Regulation D. Offers and sales that are made more than six months before the start of a Regulation D offering or are made more than six months after completion of a Regulation D offering will not be considered part of that Regulation D offering, so long as during those six month periods there are no offers or sales of securities by or for the issuer that are of the same or a similar class as those offered or sold under Regulation D, other than those offers or sales of securities under an employee benefit plan as defined in rule 405 under the Act.[110]

Regulation D further provides that if the six-month safe harbor described above is unavailable, "the determination as to whether separate sales of securities are part of the same offering (*i.e.*, are considered *integrated*) depends on the particular facts and circumstances."[111] Regulation D goes on to say that the following factors should be considered in determining whether offers and sales should be integrated for purposes of Regulation D:

- Whether the sales are part of a single plan of financing;
- Whether the sales involve issuance of the same class of securities;
- Whether the sales have been made at or about the same time;
- Whether the same type of consideration is being received; and
- Whether the sales are made for the same general purpose.[112]

Note that Rule 504 in effect has its own integration rule that would apply in addition to the general integration rule. See above in this paragraph 9 and paragraph 13, below, in this V C.

10. Information Required

(a) *General.* Rule 502 of Regulation D requires certain information to be provided in a Rule 506 offering if there any offerees who are not accredited investors. Regulation D does not

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[109] If the proposed purchaser is an individual series of a series LLC, it may be unclear what is the "entity" for purposes of this "one purchaser" definition.
[110] 17 C.F.R. § 230.502(a).
[111] *Id.* (emphasis in original).
[112] *Id.* The cited portion of Regulation D also states that "[g]enerally, transactions otherwise meeting the requirements of an exemption will not be integrated with simultaneous offerings being made outside the United States in compliance with Regulation S." *See* Release No. 33-6863.

require that any information be provided in a Rule 504 offering or if all offerees are accredited investors. Even though Regulation D may not require that information be provided to offerees in a particular instance, issuers and their advisors should remember that the anti-fraud provisions of the securities laws are still applicable. Thus attorneys should advise their issuer clients to provide accurate and complete information whenever their clients are involved in an offer and sale of securities pursuant to any exemption from registration. That may be the issuer's only protection when subsequent litigation develops based on oral representations the purchasers believe they heard.

If an issuer is required to furnish information pursuant to Regulation D, the Regulation distinguishes non-financial statement information and financial statement information. Although not required by Rule 502, Rule 502 states that an issuer who provides information to non-accredited investors should "consider providing such information to accredited investors as well, in view of the anti-fraud provisions of the federal securities laws." That is clearly advisable because, if the issuer has taken the trouble to prepare and provide information to non-accredited investors, there is no good reason that they should not provide the same information to accredited investors.

(b) *Non-Financial Statement Information.* Pursuant to Rule 502(b)(2)(i)(A), where the issuer is required to furnish information under Regulation D, the rule specifies the type of information that must be furnished.

(c) Financial Statement Information—Rule 502(b)(2)(i)(B).

Offerings up to $2 Million. The issuer must furnish the information required by Article 8 of Regulation S-X, except that only the issuer's balance sheet, which must be dated with 120 days of the start of the offering, must be audited.

Offerings up to $7.5 Million. The issuer must furnish the information required by Form S-1 for smaller reporting companies.

Offerings over $7.5 Million. The issuer must furnish the financial statement that would be required in a registration statement filed on the form the issuer would be entitled to use. In offerings over $2 million if an issuer other than a limited partnership cannot obtain audited financial statements without unreasonable effort or expense, then only the issuer's balance sheet, which must be dated with 120 days of the start of the offering, must be audited. If the issuer is a limited partnership and cannot obtain the required financial information without unreasonable effort or expense, it may furnish financial statements that have been prepared on the basis of federal income tax requirements and examined and reported on in accordance with generally accepted accounting principles by an independent public or certified accountant.

The expense and time delays for a privately held company to provide the required financial information and other disclosure often makes it impractical to include non-accredited investors in many Rule 506 offerings. In addition, unless the entity has been carefully managed, the financial information may simply not be available.

(d) Other Information Requirements. Rule 502 contains other information requirements, including the following:

- Rule 502(b)(2)(iv) requires that, at a reasonable time before a sale to a non-accredited investor pursuant to Rule 506(b), the issuer must furnish to the investor a brief description of any material written information provided by the issuer to any accredited investor but has not previously furnished to such non-accredited investor. The issuer is to provide any or all of such information to the non-accredited investor upon written request a reasonable time before purchase. This requirement will be problematic if, for example, the issuer has furnished financial projections to accredited investors that were prepared on the basis that the reader of the projections would be a sophisticated investor.
- Rule 502(b)(2)(v) requires that the issuer must also make available to each purchaser a reasonable time before purchase an opportunity to ask questions and receive answers concerning the terms and conditions of the offering and to obtain any additional information that the issuer has or can obtain without unreasonable effort or expense that is necessary to verify the information furnished under "Non-Financial Statement Information" or "Financial Statement Information," above.
- Rule 502(b)(2)(vii) requires that, at a reasonable time before a sale to any purchaser that is not an accredited investor in an offering under Rule 506(b), the issuer must provide written disclosure that the securities have not been registered under the 1933 Act and, therefore, cannot be resold unless they are registered under the 1933 Act or unless an exemption from registration is available.

11. Restriction on Manner of Offering

Except as provided in Rule 504(b)(1) or Rule 506(c), neither the issuer nor any person acting on its behalf may offer or sell the securities by any form of general solicitation or general advertising, including, but not limited to, the following:

1) Any advertisement, article, notice, or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and
2) Any seminar or meeting whose attendees have been invited by any general solicitation or general advertising.

Publication by an issuer of a notice in accordance with Rule 135c[113] is not considered general solicitation or general advertising for purposes of Regulation D. In addition, if the requirements of Rule 135e[114] are satisfied, providing any journalist with access to press conferences held outside of the United States, to meetings with issuer or selling security holder representatives conducted outside of the United States, or to written press-related materials released outside the United States, at or in which a present or proposed offering of securities is discussed, will not be deemed to constitute general solicitation or general advertising for purposes of this section.

12. Limitations on Resale

Except as provided in Rule 504(b)(1), securities acquired in a transaction under Regulation D have the status of securities acquired in a transaction under § 4(a)(2) of the 1933 Act and cannot be resold without registration under the 1933 Act or an exemption therefrom. The issuer is required to exercise reasonable care to ensure that the purchasers of the securities are not underwriters within the meaning of § 2(a)(11) of the Act, which reasonable care may be demonstrated by the following:

(1) Reasonable inquiry to determine if the purchaser is acquiring the securities for himself or for other persons;
(2) Written disclosure to each purchaser prior to sale that the securities have not been registered under the Act and, therefore, cannot be resold unless they are registered under the Act or unless an exemption from registration is available; and
(3) Placement of a legend on the certificate or other document that evidences the securities stating that the securities have not been registered under the Act and setting forth or referring to the restrictions on transferability and sale of the securities.

While taking these actions will establish the requisite reasonable care, it is not the exclusive method to demonstrate such care. Other actions by the issuer may satisfy this provision. In addition, [Rule 502](b)(2)(vii) requires the delivery of written disclosure of the limitations on resale to investors in certain instances.[115]

13. Rule 504

Rule 504 permits offerings of securities with an aggregate offering price of up to $5 million[116] less the aggregate offering price for all securities sold within the 12 months before the start of and during the offering of securities under Rule 504, in reliance on any exemption under § 3(b) of the 1933 Act, or in violation of § 5(a) of the 1933 Act. Accordingly, if an issuer is about to begin a Rule 504 offering, in determining if the full $5 million authorized by Rule 504 may be sold:

- The issuer would have to consider what dollar amount of securities the issuer had sold in the preceding 12 months under Rule 504 or 505.
- The issuer would not have to consider sales qualifying as a private placement under § 4(a)(2) of the 1933 Act, the accredited investor exemption under § 4(a)(5) of the 1933 Act, or Rule 506, or any of the exemptions (such as the intrastate exemption) established in 1933 Act § 3(a).

Rule 504 is not available to an issuer if the issuer is a reporting company under the 1934 Act, an investment company, or a blank check company.

Rule 504 allows the issuer to use general solicitation and general advertising to market securities offered under Rule 504 if state registration requirements specified in Rule 504 are satisfied. For example, if the securities are registered in one state that requires the public filing and delivery to investors of a substantive disclosure document before sale, and offerings are made in accordance with such requirements, the securities

[113] 17 C.F.R. § 230.135c permits an issuer that is a reporting company under the 1934 Act or that is a foreign issuer exempt from the registration requirements of the 1934 Act to publish written notice that it proposes to make, is making, or has made an offering of securities not registered or required to be registered under the 1933 Act.
[114] 17 C.F.R. § 230.135e.
[115] 17 C.F.R. § 230.502.
[116] As increased effective January 20, 2017 (SEC Release No. 10238 October 26, 2016)..

may also be offered in states that have no such registration or delivery requirements if the substantive disclosure document is delivered before sale to all purchasers (including purchasers in such states that have no such requirements). Alternatively, an issuer may use general solicitation and general advertising if the securities are offered and sold exclusively pursuant to state law exemptions that permit general solicitation and general advertising so long as sales are made only to accredited investors.

14. Rule 505 (Repealed May 22, 2017)

Prior to its repeal,[117] Rule 505 permitted offerings of securities with an aggregate offering price of up to $5 million less the aggregate offering price for all securities sold within the 12 months before the start of and during the offering of securities under Rule 505, in reliance on any exemption under § 3(b) of the 1933 Act, or in violation of § 5(a) of the 1933 Act.

15. Rule 506

(a) **Rule 506 — Traditional.** Rule 506 provides a safe harbor under the private offering exemption of § 4(a)(2) of the 1933 Act for offerings of any size. There can be no more than 35 non-accredited investors and each purchaser who is not an accredited investor either alone or with his or her purchaser representative(s) must have such knowledge and experience in financial and business matters that the purchaser is capable of evaluating the merits and risks of the prospective investment or the issuer reasonably believes immediately prior to making any sale that such purchaser comes within this description.

(b) **Rule 506 — Non-Traditional with General Solicitation.** Offerings made under Rule 506 to purchasers that are not accredited investors must comply with the prohibition on general solicitation and advertising. However, pursuant to direction in the JOBS Act, on July 10, 2013, the SEC amended Rule 506 effective September 23, 2013, to add new Rule 506(c), which permits general advertising. Under Rule 506(c), all purchasers must be accredited investors, and the issuer must take reasonable steps to verify that purchasers of securities are accredited investors. Provided that the issuer does not know that a person is not an accredited investor, the issuer will be deemed to have taken reasonable steps to verify if the issuer, at its option, uses one of the "non-exclusive and non-mandatory methods of verifying that a natural person is an accredited investor" set forth in Rule 506(c)(2)(ii) as follows:

- With respect to whether a purchaser is an accredited investor on the basis of income, reviewing any IRS form that reports the purchaser's income for the two most recent years and obtaining a written representation from the purchaser that he or she has a reasonable expectation of reaching the income level necessary to qualify as an accredited investor during the current year. Where the investor does not file taxes in the United States, the SEC has advised that an issuer cannot rely on non-U.S. tax returns, although the SEC also said that the non-U.S. tax returns can be considered in the mix of information where the foreign jurisdiction "imposes comparable penalties for false information."[118] In calculating U.S. dollars from foreign currency, the issuer may use "either the exchange rate that is in effect on the last day of the year for which income is being determined or the average exchange rate for that year."[119]
- With respect to whether a purchaser is an accredited investor on the basis of net worth, reviewing one or more of the following types of documentation dated within the prior three months and obtaining a written representation from the purchaser that all liabilities necessary to make a determination of net worth have been disclosed:
  - With respect to assets: Bank statements, brokerage statements, and other statements of securities holdings, certificates of deposit, tax assessments, and appraisal reports issued by independent third parties; and
  - With respect to liabilities: A consumer report from at least one of the nationwide consumer reporting agencies; or
- Obtaining a written confirmation from one of the following persons or entities that such person or entity has taken reasonable steps to verify that the purchaser is an accredited investor within the last three months and has determined that such purchaser is an accredited investor:

[117] SEC Release No. 10238 (October 26, 2016).

[118] SEC Compliance & Disclosure Interpretation ("C&DI") 255.48.

[119] SEC C&DI 255.49.

  - A registered broker-dealer;[120]
  - An investment advisor registered with the SEC;
  - A licensed attorney who is in good standing under the laws of the jurisdictions in which he or she is admitted to practice; or
  - A certified public accountant who is duly registered and in good standing under the laws of the place of his or her residence or principal office.

- In regard to any person who purchased securities in an issuer's Rule 506(b) offering as an accredited investor before September 23, 2013, and continues to hold such securities, by obtaining a certification by such person at the time of sale that he or she still qualifies as an accredited investor.

The verification methods specified by the SEC in Rule 506(c) are non-exclusive, and the SEC specifically contemplates principles-based verification methods based on the facts and circumstances. These are in addition to the four methods specified by the SEC above. The SEC provided the following instructions to the requirements for taking reasonable steps to verify that someone is an accredited investor:

- An issuer is not required to use the methods specified by the SEC; the methods specified in Rule 506(c) are "examples of the types of non-exclusive and non-mandatory" verification methods.
- In the case of a person who qualifies as an accredited investor based on joint income with the person's spouse, the issuer would be deemed to satisfy the applicable verification requirement by reviewing copies of IRS forms that report income for the two most recent years in regard to, and obtaining written representations from, both persons.
- In the case of a person who qualifies as an accredited investor based on joint net worth with the person's spouse, the issuer would be deemed to satisfy the applicable verification requirement by reviewing such documents in regard to, and obtaining written representations from, both persons.

(c) **Bad Actor Disqualification from Rule 506.** Rule 506(d)(1) provides that Rule 506 is not available if the issuer, a predecessor or affiliate of the issuer, any director, executive officer, or other officer participating in the offering, a general partner or managing member of the issuer, or any beneficial owner of 20 percent or more of the issuer's voting securities, has been convicted, within 10 years before a sale under Rule 506 (or five years, in the case of the issuer or a predecessor or affiliate of the issuer), of a felony or misdemeanor in connection with certain specified securities matters, is subject to a final order of a state or federal authority (other than the SEC) barring the person from activities in connection with securities, insurance, or banking matters, is subject to an order of the SEC barring the person from securities matters, or is subject to other specified orders, suspensions, or expulsions. Disqualification under Rule 506(d)(1) will not apply:

- To any conviction, order, judgment, decree, suspension, expulsion, or bar that occurred or was issued before September 23, 2013;
- Upon a showing of good cause and without prejudice to any other action by the SEC, if the SEC determines that it is not necessary under the circumstances that an exemption be denied;
- If, before the relevant sale, the court or regulatory authority that entered the relevant order, judgment, or decree advises that disqualification under paragraph (d)(1) of Rule 506 should not arise as a consequence of such order, judgment, or decree;
- If the issuer establishes that it did not know and, in the exercise of reasonable care, could not have known, that a disqualification existed under paragraph (d)(1) of Rule 506; or

[120] The Securities Industry and Financial Markets Association (SIFMA, www.sifma.org) has published some standards by which broker-dealers can meet their burden when asked to verify accredited investor status for its customers. The customer must have maintained an account with the broker dealer for at least six months "so that the firm will have had an opportunity to learn about its client/purchaser" and the "purchaser must represent in writing that the purchaser is not borrowing any money to make the investment in the Rule 506(c) offering." The first SIFMA standard is that the customer has a net account of at least $2 million with the broker (giving flexibility for unknown debt). Alternatively, where the customer commits unconditionally to invest at least $250,000 in the offering and represents that such amount is less than 25 percent of the customer's net worth, the broker-dealer can also provide the necessary verification unless the broker-dealer is aware of other facts that would lead to a contrary conclusion. *See* "SIFMA Guidance On Rule 506(c) Verification" (June 23, 2014) available at www.sifma.org.

- To events relating to any affiliated issuer that occurred before the affiliation arose if the affiliated entity is not (i) in control of the issuer or (ii) under common control with the issuer by a third party that was in control of the affiliated entity at the time of such events.

(d) **Disclosure of Prior Bad Actor Events.** Rule 506(e) requires an issuer to furnish to each purchaser, a reasonable time before sale, a description in writing of any matters that would have triggered disqualification under paragraph (d)(1) of Rule 506 but occurred before September 23, 2013. Failure to furnish such information timely will not prevent an issuer from relying on Rule 506 if the issuer establishes that it did not know and, in the exercise of reasonable care, could not have known, of the existence of the undisclosed matter or matters.

(e) ***Blue Sky Preemption.*** Securities issued under Rule 506(b) or 506(c) are "covered securities" under Section 18(b)(4)(E) of the 1933 Act. Consequently, state securities laws are pre-empted by federal law as expressed in Rule 506, although notices and filing fees may still be required on a state-by-state basis. Because of the "covered securities" exemption from state securities laws, issuers need only address the "bad actor" provisions of federal securities law and not any provision of state law to the extent the state law imposes a "bad actor" provision that differs from Rule 506(d).

16. Filing Notice of Sales

An issuer offering or selling securities under Rule 504 or 506 must file Form D with the SEC for each new offering of securities within 15 calendar days of the first sale of securities in the offering. If the 15-day period ends on a day that is not a business day, the period is extended to the next business day. Form D must be filed electronically with the SEC and, before an issuer can file Form D, it must obtain access codes from the EDGAR system.[121] Most states require the filing of a copy of the Form D filed with the SEC. The SEC has taken the position that failure to file Form D does not disqualify a Regulation D offering. Some states may take a different position, or at least impose late fees. However, the SEC has proposed rules[122] that would require the following in connection with Regulation D offerings:

- Require the filing of a Form D before the issuer engages in general solicitation;
- Require written general solicitation materials to include certain legends and other disclosures;
- Require the submission to the SEC, on a temporary basis, of written general solicitation materials; and
- Disqualify an issuer from using Rule 506 for one year if the issuer, or any predecessor or affiliate of the issuer, did not comply, within the last five years, with Form D filing requirements in a Rule 506 offering.

In comment letters, the SEC has asked issuers who have completed private placements of securities years in the past but that have failed to file a Form D to make Form D filings for those offerings — even where the issuer has claimed another exemption to be available. Although these filings may not have the protection of being within the precise confines of Rule 503, late filings appear to be acceptable to the SEC.

VI. TEXAS SECURITIES LAW ISSUES

A. General

State legislatures appreciated the need to regulate securities transactions more than two decades before the U.S. Congress reacted to the events that led up to the Great Depression. The state of Kansas enacted the first domestic law for the regulation of securities transactions in 1911, to prevent "'speculative schemes which have no more basis than so many feet of blue sky.'"[123] By the year 1931, 47 states had enacted blue sky laws.[124]

As discussed in V "Federal Securities Law Issues," client advisors must address malny collateral issues in connection with securities regulation. Attorneys and other advisors must remember that the principal purpose for compliance with securities laws is to raise money for a client's business. Consequently, the attorney-advisor should assist the client in structuring securities transactions in a manner that is most likely to achieve the client's goals effectively and efficiently. This includes assisting the client in choosing the form of business entity and identifying and quantifying the risk of the transaction, as well as assisting the client in identifying the nature of the investors most likely to consider an investment in the proposed transaction.

If the advisor concludes that the issuer's transaction will qualify under Rule 506 of Regulation D, satisfying the Texas requirements will be relatively easy. As we discuss below in VI C 3 "Sale Under Rule 506," Tex. Ad. Code § 114 exempts offers and sales under Rule 506 from registration in Texas. Only a notice filing (copy of Form D) and payment of a fee is

[121] *Available at* www.sec.gov/info/edgar.
[122] Release No. 33-9416 (July 10, 2013), 78 Fed. Reg. 44806 (July 24, 2013).
[123] *Hall v. Geiger-Jones Co.*, 242 U.S. 539, 550 (1917).
[124] Paul G. Mahoney, "The Origins of the Blue-Sky Laws: A Test of Competing Hypotheses," 46 J. L. & Econ. 229 (2013).

required.[125] Also, an offering under Rule 504 or 506, if the issuer has no more than 35 security holders after the sale will qualify for exemption under Texas law without any filing or fee payment if the other requirements of Art. 581-52 are satisfied, including the requirement that the sales be made without any public solicitation or advertising. If not, then analysis of the Texas exemptions described in the next section will be required.

B. Texas Registration Requirements

1. General.

When considering whether a given exemption applies to a securities transaction, the advisor should first review the default rule under the Texas Securities Act, which requires (absent an exemption) that any offer to sell or any sale of a security in Texas must be registered with the Texas State Securities Board.[126] Additionally, the Board requires the filing of the information specified in the Securities Act.[127] Note that while securities attorneys commonly discuss the "registration of securities," to be precise, only securities *transactions* are registered. There are, however, both "exempt" securities and "exempt" transactions.

The Texas Securities Act's basic requirements are further developed under the Rules of the Texas State Securities Board (Rules), commonly referred to as the Texas "Blue Sky Regulations."[128] The Texas Securities Act, as expanded by the Rules, provides that registration may be effected by three primary means: (1) registration by qualification, (2) registration by coordination, and (3) registration by notification.

2. Registration by Qualification.

The first method is "Registration by Qualification," *i.e.*, the offeror of securities must meet all the information and disclosure requirements.[129]

3. Registration by Coordination.

The second, "Registration by Coordination," permits securities for which a registration statement has been filed under the federal "Securities Act of 1933" in connection with the offering of the securities to be registered in Texas by filing the federal registration statement, provided it contains minimum state disclosure and informational requirements.[130] Both a registration statement (Form RC or uniform Form U-1) and a consent to service of process form must be filed with the Division.[131] To become effective, the registration statement and consent to service of process on file with the Division must be accurate as of the time the federal registration statement becomes effective.

4. Registration by Notification.

The third method, "Registration by Notification," permits registration of securities by notification under section 7B of the Texas Securities Act if they are issued by an issuer which has been in continuous operation for not less than three (3) years and which has shown, during the period of not less than three (3) years next prior to the date of registration under section 7B, average annual net earnings after deducting all prior charges including income taxes except charges upon securities to be retired out of the proceeds of sale, as follows:

a. In the case of interest-bearing securities, not less than one and one-half times the annual interest charges on such securities and on all other outstanding interest-bearing securities of equal rank;
b. In the case of securities having a specified dividend rate, not less than one and one-half times the annual dividend requirements on such securities and on all outstanding securities of equal rank;
c. In the case of securities wherein no dividend rate is specified, not less than five percent (5%) on all outstanding securities of equal rank, together with the amount of such securities then offered for sale, based upon the maximum price at which such securities are to be offered for sale. The ownership by an issuer of more than fifty percent (50%) of the outstanding voting stock of a corporation shall be construed as the proportionate ownership of such corporation and shall permit the inclusion of the earnings of such corporation applicable to the payment of dividends upon the stock so owned in the earnings of the issuer of the securities being registered by notification.

Securities that are eligible to be registered by notification must still file a registration statement with the Securities Board, but less information is required than in a registration under section 7A.

[125] Tex. Ad. Code § 114.4(b)(1)(B). The fee is 1/10 of 1.0% of the aggregate amount of securities sold in the Rule 506 offering with a maximum fee of $500.
[126] Tex. Rev. Civ. Stat. Art. 581-7.
[127] *Id.*
[128] *Available at* www.ssb.texas.gov/sites/default/files/2016-10-20_TSSBElectronicRuleBook.pdf.
[129] Tex. Rev. Civ. Stat. Art. 581-7(a).
[130] Tex. Rev. Civ. Stat. Art. 581-7(c); Tex. Ad. Code § 113.2.
[131] *Id.*

5. Broker-Dealer/Sales Representation Registration May Be Required.

The final point to be made is that if the issuer is selling securities under any Texas registration form through other persons, those other persons may have to register under Texas law as a broker-dealer (defined in Art. 581-14 and Tex. Ad. Code § 104.7 and 115.6) in addition to potentially being subject to the federal registration requirements we discuss in X "Finders and Broker-Dealers." Texas law includes an issuer selling its own securities in the definition of "dealer" except for sales made by or through a registered dealer or in a transaction exempt under section 5 of the Texas Securities Act.[132]

C. Exemptions from Securities Registration Under Texas Law

There are a number of exemptions to these registration requirements created both by the Legislature and by rules promulgated by the Texas Securities Board. In general, Articles 581-5 and 581-6 of the Texas Securities Act provide that exemptions from the registration and filing requirements under the Act apply to the security itself or a transaction involving a security may be exempt. The types of securities that are exempt from registration are set forth in Art. 581-4 and are described in sufficient detail as to be self-explanatory.133 Therefore, this discussion will

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[132] Tex. Rev. Civ. Stat. Art. 581-4C.

[133] Tex. Rev. Civ. Stat. Ann. Art. 581-6 that the following are exempt securities when offered for sale, or sold, or dealt in, by a registered dealer or agent of a registered dealer:

A to C. Deleted by Acts 1979, 66th Leg., p. 354, ch. 160, Sec. 3, eff. May 15, 1979.

D. Any security issued or guaranteed either as to principal, interest, or dividend, by a corporation owning or operating a railroad or any other public service utility; provided, that such corporation is subject to regulation or supervision either as to its rates and charges or as to the issue of its own securities by the Railroad Commission of Texas, or by a public commission, agency, board or officers of the Government of the United States, or of any territory or insular possession thereof, or of any state or municipal corporation, or of the District of Columbia, or of the Dominion of Canada, or any province thereof; also equipment trust certificates or equipment notes or bonds based on chattel mortgages, leases or agreements for conditional sale of cars, motive power or other rolling stock mortgages, leased or sold to or furnished for the use of or upon a railroad or other public service utility corporation, provided that such corporation is subject to regulation or supervision as above; or equipment trust certificates, or equipment notes or bonds where the ownership or title of such equipment is pledged or retained in accordance with the provisions of the laws of the United States, or of any state, territory or insular possession thereof, or of the District of Columbia, or the Dominion of Canada, or any province thereof, to secure the payment of such equipment trust certificates, bonds or notes.

E. Any security issued and sold by a domestic corporation without capital stock and not organized and not engaged in business for profit.

F. Securities which at the time of sale have been fully listed upon the American Stock Exchange, the Boston Stock Exchange, the Chicago Stock Exchange or the New York Stock Exchange, have been designated or approved for designation on notice of issuance on the national market system of the NASDAQ stock market, or have been fully listed upon any recognized and responsible stock exchange approved by the Commissioner as hereinafter in this section provided, and also all securities senior to, or if of the same issues, upon a parity with, any securities so listed or designated or represented by subscription rights which have been so listed or designated, or evidence of indebtedness guaranteed by any company, any stock of which is so listed or designated, such securities to be exempt only so long as the exchange upon which such securities are so listed remains approved under the provisions of this Section. Application for approval by the Commissioner may be made by any organized stock exchange in such manner and upon such forms as may be prescribed by the Commissioner, but no approval of any exchange shall be given unless the facts and data supplied with the application shall be found to establish:

(1) That the requirements for the listing of securities upon the exchange so seeking approval are such as to effect reasonable protection to the public;

(2) That the governing constitution, by-laws or regulations of such exchange shall require:

1st: An adequate examination into the affairs of the issuer of the securities which are to be listed before permitting trading therein;

2nd: That the issuer of such securities, so long as they be listed, shall periodically prepare, make public and furnish promptly to the exchange, appropriate financial, income, and profit and loss statements;

3rd: Securities listed and traded in on such exchange to be restricted to those of ascertained, sound asset or income value;

4th: A reasonable surveillance of its members, including a requirement for periodical financial statements and a determination of the financial responsibility of its members and the right and obligation in the governing body of such exchange to suspend or expel any member found to be financially embarrassed or irresponsible or found to have been guilty of misconduct in his business dealings, or conduct prejudicial of the rights and interests of his customers;

The approval of any such exchange by the Commissioner shall be made only after a reasonable investigation and hearing, and shall be by a written order of approval upon a finding of fact substantially in accordance with the requirements hereinabove provided. The Commissioner, upon ten (10) days notice and hearing, shall have power at any time to withdraw approval theretofore granted by him to any such stock exchange which does not at the time of hearing meet the standards of approval under this Act, and thereupon securities so listed upon such exchange shall be no longer entitled to the benefit of such exemption except upon the further order of said Commissioner approving such exchange. By the same procedure set out in the preceding paragraph with respect to exchanges approved by the Commissioner, the

concentrate on the exemptions applicable to transactions in securities.

The exemptions most commonly applicable to the general practitioner representing the small business client are:

1. Limited Offering Exemption.

Provided such sale is made without any public solicitation or advertisements. the sale of any security by the issuer thereof is exempt so long as the total number of security holders of the issuer thereof does not exceed thirty-five (35) persons after taking such sale into account.[134] The State Board of Securities has expanded the requirements of this exemption by Rule:

> The offer for sale or sale of the securities of the issuer would not involve the use of public solicitation under the Act, §5.I, if the issuer, after having made a reasonable factual inquiry has reasonable cause to believe, and does believe, that the purchasers of the securities are sophisticated, well-informed investors or well- informed investors who have a relationship with the issuer or its principals, executive officers, or directors evincing trust between the parties (namely close business association, close friendship, or close family ties), and such purchasers acquire the securities as ultimate purchasers and not as underwriters or conduits to other beneficial owners or subsequent purchasers.[135]

The use of a registered dealer in a sale otherwise meeting the requirements of §5. I does not necessarily mean that the transaction involves the use of public solicitation. The offer without advertising to a person who did not come within the class of persons described in this subsection does not alone result in public solicitation if the issuer had a reasonable cause to believe and did believe that such person fell within the class of persons described, and that such offer was not made indiscriminately.[136]

The term "well-informed" could be satisfied through the dissemination of printed material to each purchaser prior to his or her purchase, which by a fair and factual presentation discloses the plan of business, the history, and the financial statements of the issuer, including material facts necessary in order that the statements made, in the light of circumstances under which they are made, not be misleading.[137]

In determining who is a sophisticated investor at least the following factors should be considered.

(A) The financial capacity of the investor, to be of such proportion that the total cost of that investor's commitment in the proposed investment would not be material when compared with his total financial capacity. It may be presumed that if the investment does not exceed 20% of the investor's net worth (or joint net worth with the investor's spouse) at the time of sale that the amount invested is not material.

(B) Knowledge of finance, securities, and investments, generally. These criteria may be met by the investor's purchaser representative if such purchaser representative has such knowledge, so long as such purchaser representative:

(i) has no business relationship with the issuer;

(ii) represents only the investor and not the

Commissioner may suspend the exempt status of any trading system exempted by the Legislature on or after January 1, 1989, if that system does not at the time of hearing meet the applicable standards for approval of exchanges prescribed by this Act. The suspension has the same effect as the removal of approval of an exchange. The suspension remains in effect until the Commissioner by order determines that the trading system has corrected the deficiency or deficiencies on which the suspension was based and maintains standards and procedures that provide reasonable protection to the public.

H. Any commercial paper that arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and that evidences an obligation to pay cash within nine months of the date of issuance, exclusive of days of grace, or any renewal of such paper that is likewise limited, or any guarantee of such paper or of any such renewal.

I. Notes, bonds, or other evidence of indebtedness or certificates of ownership which are equally and proportionately secured without reference of priority of one over another, and which, by the terms of the instrument creating the lien, shall continue to be so secured by the deposit with a trustee of recognized responsibility approved by the Commissioner of any of the securities specified in Subsection M of Section 5 or Subsection D of Section 6; such deposited securities, if of the classes described in Subsection M of Section 5, having an aggregate par value of not less than one hundred and ten per cent (110%) of the par value of the securities thereby secured, and if of class specified in Subsection D of Section 6, having an aggregate par value of not less than one hundred and twenty five per cent (125%) of the par value of the securities thereby secured.

J. Notes, bonds or other evidence of indebtedness of religious, charitable or benevolent corporations.

[134] Tex. Rev. Civ. Stat. Ann. Art. 581-5 I.

[135] Rule 109.13(a).

[136] *Id.*

[137] Tex. Ad. Code § 109(a)(1).

issuer; and
(iii) is compensated only by the investor.

(C) Experience and skill in investments based on actual participation. These criteria may be met by the investor's purchaser representative if such purchaser representative has such experience and skill, so long as such purchaser representative:

(i) has no business relationship with the issuer;
(ii) represents only the investor and not the issuer; and
(iii) is compensated only by the investor.[138]

The term "advertisements" does not include the use of the type of printed material as set out in subsection (a) of this section under the discussion of the term "well-informed." Further, the main concept to be considered in a definitional analysis of the term "advertisements," as it is used in §5. I, is the method of use of the printed material. The following circumstances, though not intended to be exclusive, will be considered in determining whether the method of use of any printed material is within the limits of §5. I:

(1) limited printing of the material;
(2) limited distribution of the material only to persons who the issuer, after having made a reasonable factual inquiry has reasonable cause to believe and does believe are sophisticated investors, or to persons who have a relationship with the issuer as set forth in subsection (a) of this section, or to their purchaser representatives;
(3) control of the printing and distribution of the printed material;
(4) recognition of the necessity of compliance with the requirements set forth in this subsection on the part of the issuer and the investor. Such recognition might consist of a printed prohibition on the front in large type that the circular is for that individual's confidential use only, and may not be reproduced; and, the use of a statement warning that any action contrary to these restrictions may place such individual and the issuer in violation of the Texas Securities Act.[139]

In computing the number of purchasers or security holders for §5.1, the following criteria shall be used.

(1) There shall be counted as one purchaser or security holder any purchaser or security holder together with:

(A) any relative or spouse of such purchaser or security holder who has the same home as such purchaser or security holder; any relative of such spouse who has the same home as such purchaser or security holder; any relative or spouse or relative of such spouse who is a dependent of such security holder;
(B) any trust or estate in which such purchaser or security holder or any of the persons related to him as specified in subparagraph (A) or (C) of this paragraph collectively have more than 50% of the beneficial interest (excluding contingent interests); and
(C) any corporation or other organization of which such purchaser or security holder or any of the persons related to him as specified in subparagraph (A) or subparagraph (B) of this paragraph collectively are the beneficial owners of more than 50% of the equity securities (excluding directors' qualified shares) or equity interest.[140]

(2) There shall be counted as one purchaser or security holder any corporation, partnership, association, joint stock company, trust, or unincorporated association, organized and existing other than for the purpose of acquiring securities of the issuer for which the exemption is claimed under §5.1.[141]
(3) Any general partner of a limited partnership who is subject to general liability for the obligations of the limited partnership and actively engages in the control and management of the business and affairs of the limited partnership or of the managing general partner of the partnership shall not be counted as a purchaser or security holder for purposes of §5.1.[142]

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[138] Tex. Ad. Code § 109.13(a)(2).
[139] Rule 109.13(b).
[140] Rule 109.13(c)(1).
[141] Tex. Ad. Code § 109.13(c)(2).
[142] Tex. Ad. Code § 109.13(c)(3).

2. Sale by Issuer.

The sale by an issuer of its securities during the period of twelve (12) months ending with the date of the sale in question to not more than fifteen (15) persons (excluding, in determining such fifteen (15) persons, purchasers of securities in transactions exempt under other provisions of this Section 5, purchasers of securities exempt under Section 6 hereof and purchasers of securities which are part of an offering registered under Section 7 hereof), provided such persons purchased such securities for their own account and not for distribution.[143]

3. Sale Under Rule 506.

Any sale of securities under Rule 506 of Regulation D—filing of copy of Form D within 15 days of federal filing and payment of prescribed fee; filing and payment must be done electronically.[144]

4. Sales to Individual Accredited Investors.

The State Securities Board has exempted from the securities registration requirements of Section 7 of the Securities Act "the offer and sale by the issuer or a registered dealer without advertising of any security to an individual accredited investor, or to any person who the issuer has reasonable grounds to believe and after making reasonable inquiry shall believe to be an individual accredited investor, provided that such security is not part of the same distribution or offering as securities of the same issuer which have been registered or are proposed to be registered under the Securities Act, Section 7."[145] For purposes of this exemption, "issuer" includes any director, officer, or employee of the issuer provided all the following conditions are satisfied:

- the director, officer, or employee was not hired for the purpose of offering or selling such securities;
- the director's, officer's, or employee's activity involving the offer and sale of such securities is strictly incidental to his or her bona fide primary non-securities related work duties; and
- the director's, officer's, or employee's compensation is based solely on the performance of other such duties, i.e., the director, officer, or employee does not receive any compensation for offering for sale, selling, or otherwise aiding in the sale of securities.[146]

This exemption contains a bad actor disqualification.[147]

Sales under this exemption must be made without advertising other than limited use advertisements or the use of the type of printed material as permitted by §109.13(b) of this title (relating to Limited Offering Exemptions) in connection with an offering under Section 5.1 of the Texas Securities Act.[148] Any limited use advertisement used in connection with an offering under this section must be filed with the Securities Commissioner ten days prior to use in this state. A limited use advertisement may be disseminated by any means, direct or indirect. A limited use advertisement shall contain only the statements required or permitted to be included therein by this subsection.

(1) A limited use advertisement shall contain the following items of information:

(A) A brief description of the securities to be offered (e.g., description of class, size of offering, price, percentage of

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[143] Tex. Rev. Civil Stat. Art. 581-5I(c).
[144] Tex. Ad. Code § 114.4(b)(1).
[145] Tex. Ad. Code § 139.16(a).
[146] Tex. Ad. Code § 139,16(b)(2).
[147] Tex. Ad. Code § 139,16(c).
[148] Tex. Ad. Code § 109.13(b) states:
The term "advertisements" does not include the use of the type of printed material as set out in subsection (a) of this section under the discussion of the term "well-informed." Further, the main concept to be considered in a definitional analysis of the term "advertisements," as it is used in Section 5.1, is the method of use of the printed material. The following circumstances, though not intended to be exclusive, will be considered in determining whether the method of use of any printed material is within the limits of Section 5.1:
(1) limited printing of the material;
(2) limited distribution of the material only to persons who the issuer, after having made a reasonable factual inquiry has reasonable cause to believe and does believe are sophisticated investors, or to persons who have a relationship with the issuer as set forth in subsection (a) of this section, or to their purchaser representatives;
(3) control of the printing and distribution of the printed material; recognition of the necessity of compliance with the requirements set forth in this subsection on the part of the issuer and the investor. Such recognition might consist of a printed prohibition on the front in large type that the circular is for that individual's confidential use only, and may not be reproduced; and, the use of a statement warning that any action contrary to these restrictions may place such individual and the issuer in violation of the Texas Securities Act. The "well-informed" discussion referred to above is:
"The term 'well-informed' could be satisfied through the dissemination of printed material to each purchaser prior to his or her purchase, which by a fair and factual presentation discloses the plan of business, the history, and the financial statements of the issuer, including material facts necessary in order that the statements made, in the light of circumstances under which they are made, not be misleading." Tex. Ad. Code § 109.13(a)(1).

commission);

(B) the name, address, and telephone number of the person to contact for additional information concerning the offering;

(C) the address where offering material may be obtained; and

(D) the following statement: "The securities have not been registered with or approved by the Texas Securities Commissioner and are being offered and sold pursuant to the exemption provided by §139.16 of the Rules and Regulations of the State Securities Board. This advertisement was filed with the Texas Securities Commissioner on or about (fill in date). The securities are being offered to, and may be purchased by, only those natural persons whose individual net worth, or joint net worth with that person's spouse, at the time of purchase of the securities, exceeds $1 million, excluding the value of the person's primary residence, or natural persons who have an individual income in excess of $200,000 in each of the two most recent years, or joint income with that person's spouse in excess of $300,000 in each of those years, and who have a reasonable expectation of reaching that same income level in the current year."

(2) A limited use advertisement may include any one or more of the following items of information:

(A) the name and address of the issuer of the securities;

(B) a brief description of the business of the issuer; and

(C) the name and address of the registered dealer(s) acting on the issuer's behalf in connection with the offering.

5. <u>Non-Issuer Sales.</u>

An owner of securities who is not the issuer may make offers and sales without registration. The proceeds of the sale must be for the benefit of the owner and not directly or indirectly for the benefit of the issuer. The owner may make no more than 15 sales in any 12-month period in reliance on this exemption, exclusive of sales made:

- To the issuer;
- In compliance with Sections 5.O, 6.f, or 5.H of the Securities Act;
- In compliance with the following:
  - o Tex. Ad. Code §109.4 (relating to Securities Registration Exemption for Sales to Financial Institutions and Certain Institutional Investors;
  - o Tex. Ad. Code §139.7 (relating to Sales of Securities to Nonresidents); or
  - o Tex. Ad. Code §139.13 (relating to Resales under SEC Rule 144 and Rule 145(d)).[149]

6. <u>Sales to Nonresidents.</u>

"The offer and sale of securities by an issuer or its selling agent to a non-Texas resident not present in Texas when the offer is made is exempt from the securities registration provisions of the Securities Act."[150] However, this exemption by rule further provides:

> An issuer or selling agent who makes an offer or sale from Texas, by any means, including use of the mail or telephone, is a dealer and must comply with the dealer registration requirements of the Securities Act. … An offer is not deemed to be made from Texas merely because offering material is prepared in Texas, if such material is still in the possession of the issuer or its selling agent when it leaves the state. A sale is not deemed to be made in Texas merely because a purchaser sends his purchase money to Texas, or because clerical functions connected with the closing of a sale are performed in Texas.[151]

7. <u>Offers Disseminated Via the Internet.</u>

An offer of securities not made from Texas is exempt from the securities and dealer registration requirements of The Securities Act when that offer is disseminated through the Internet and:

- the offer indicates, directly or indirectly, that the securities are not being offered for sale to any person in Texas;
- an offer is not otherwise specifically directed to any person in Texas by, or on behalf of, the issuer; and
- no sales of the issuer's securities are made to any person in Texas as a result of the offer.[152]

Further, "[a]n offer of securities made from Texas is

[149] Tex. Ad. Code § 139.14.
[150] Tex. Ad. Code § 139.7(a).
[151] Tex. Ad. Code § 139.7(b).
[152] Tex. Ad. Code § 139.17(a).

exempt from the securities registration requirements of The Securities Act, but not from the dealer registration requirements of The Securities Act, when that offer is disseminated through the Internet and:

- the offer indicates, directly or indirectly, that the securities are not being offered for sale to any person in Texas;
- an offer is not otherwise specifically directed to any person in Texas by, or on behalf of, the issuer; and no sales of the issuer's securities are made to any person in Texas as a result of the offer."[153]

VII. DISCLOSURE ISSUES

The hallmark of securities regulation is the need for the person offering and selling securities to make full disclosure of all material facts and conditions relating to the security being offered. Many of the federal and state rules set forth disclosure requirements, and each of these are discussed in the rules themselves and in the literature. What is most important, however, is to ensure that the disclosure is accurate and complete in all material respects, and that the investor acknowledges receipt of the disclosure. It is important that the disclosure not only provide information regarding the possible upside to the investment opportunity, but also provide information as to the risks and other downside possibilities. Properly prepared, the disclosure document is not a selling document — rather it is an insurance policy to prevent an investor from winning a fraud lawsuit against the promoter of the investment. A client once asked one of the authors if anyone ever read the private placement memorandums he prepared. Mr. Sparkman replied, "Plaintiffs' lawyers do." In *Zobrist v. Coal-X, Inc.*,[154] the court imputed the knowledge of the contents of the disclosure document (in this case a public offering prospectus) to the purchaser of the securities even though he testified he had not read the prospectus.

VIII. FINDERS AND BROKER-DEALERS

A. Finders and Broker-Dealers Generally

Persons who engage in the business of purchasing or selling securities for their own account or for the account of others, either for all or a part of their time, are likely subject to the requirements under the 1934 Act[155] and state law[156] to register as a "broker-dealer." If a person is purchasing or selling securities strictly for his or her own account, registration as a broker-dealer will be required if the person is considered to be "in the business of" purchasing and selling securities.[157] There have been arguments over the years regarding whether a person merely acting as an introducing agent between an entrepreneur in need of money and prospective investors must register as a broker. The conclusion generally is that, while a "finder" need not register as a broker, distinguishing a finder from a broker-dealer is very difficult. In fact, most people who hold themselves out as finders are truly broker-dealers under the current law.[158] Where financial planners, consultants, insurance agents, tax-planning professionals, and others engage in repeated acts as a finder, they will be classified as broker-dealers and required to register under § 15(b) of the 1934 Act.[159] In its no-action interpretations, the SEC has imposed severe restrictions as to which persons are "finders" and therefore need not register as brokers in the context both of persons "finding" cash investment for businesses and those facilitating merger and acquisition transactions.[160]

The SEC has further explained its position regarding finders in its *Guide to Broker-Dealer*

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[153] Tex. Ad. Code § 139.17(b).

[154] *Zobrist v. Coal-X, Inc.*, 708 F.2d 1511 (10th Cir. 1983).

[155] 1934 Act § 15. Although the terms "broker," and "dealer" are used synonymously in the securities context, they have different meanings. The terms "broker" and "dealer" are separately defined in 1934 Act §§ 3(a)(4) (broker) and 3(a)(5) (dealer). A broker is one who engages in securities transactions as an agent for others, while a dealer is one who does so as a principal. The terms are commonly used together as "broker-dealer" and will be used together in this section.

[156] Tex. Rev. Civ. Stat. Ann. Art. 581-15. The term "dealer" is defined in Tex. Rev. Civ. Stat. Ann. 581-4 C, and Tex. Rev. Civ. Stat. Ann. Art 581-4 H provides that "'Broker' shall mean dealer as herein defined."

[157] 1934 Act § 3(a)(5)(A).

[158] *See* Task Force on Private Placement Broker-Dealers of the ABA Section of Business Law, *Report and Recommendations of the Task Force on Private Placement Broker-Dealers*, 60 *Bus. Law.* 959 (May 2005). The report notes that there is a significant need for finders who raise capital for small businesses in amounts of $5 million and less, and that "a great number of the unlicensed brokers currently operating in the gray market are ethical and honest individuals. These persons are in a situation similar to that of our parents and grandparents who were social drinkers during prohibition; they did not suddenly become 'good people' when the twenty-first amendment to the Constitution was ratified."

[159] *See New Life Corp. of Am.*, SEC No-Action Letter, 1999 WL 152895 (March 16, 1999).

[160] *See, e.g.*, *Paul Anka*, SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) ¶ 79,797, 1991 WL 176891 (July 24, 1991), where the SEC staff agreed to issue a no action letter where Mr. Anka represented that:

- He will provide club officials with names of persons he believes to be accredited investors.
- He will not participate in negotiations with potential investors.
- He will not perform any "due diligence" activities for the investors, assist the investors with financing

Regulation, issued by the Division of Market Regulation in December 2005.[161] In that *Guide*, the staff of the Division of Market Regulation said:

In order to determine whether [a person or business] is a broker [requiring registration under the 1934 Act], we look at the activities that the person or business actually performs. You can find analyses of various activities in the decisions of federal courts and our own no-action and interpretive letters. Here are some of the questions that you should ask to determine whether you are acting as a broker:

- Do you participate in important parts of a securities transaction, including solicitation, negotiation, or execution of the transaction?
- Does your compensation for participation in the transaction depend upon, or is it related to, the outcome or size of the transaction or deal? Do you receive trailing commissions, such as 12b-1 fees? Do you receive any other transaction-related compensation?
- Are you otherwise engaged in the business of effecting or facilitating securities transactions?
- Do you handle the securities or funds of others in connection with securities transactions?

A "yes" answer to any of these questions indicates that that the person in question is not a finder, but rather may need to register as a dealer.

Some judges have called into question the strictness of the SEC's interpretation, which leads to the conclusion that finders do not exist. In *SEC v. Kramer*,[162] the SEC brought an enforcement action against Kenneth Kramer for acting as an unregistered broker when he "expressed enthusiasm" about SkyWay Communications Holding Corp. (SkyWay) and received shares based on the number of shares purchased by his contacts. All of his contacts purchased SkyWay shares through registered broker-dealers. By the time SkyWay filed bankruptcy, Kramer had earned shares with an initial value of about $700,000. Apparently, the court accepted Kramer's argument that he had not had an active role in any negotiation, and he had done nothing more than to say that SkyWay "is a good company" and to encourage his contacts to visit the SkyWay website and read the press releases. In its opinion (which the SEC has appealed),[163] the court said, "The distinction between a finder and a broker . . . remains largely unexplored." The court went on to say that:

> . . . the Commission's proposed single-factor 'transaction-based compensation' test [in *Brumberg*[164]] for broker activity . . . is an inaccurate statement of the law both in 2003 and in 2011. As this order exhaustively explains, an array of factors determine the presence of broker activity. In the absence of a statutory definition enunciating otherwise, the test for broker activity must remain cogent, multi-faceted, and controlled by the [1934] Act.[165]

IX. BUSINESS BROKERS

The Texas Securities Act and the regulations thereunder do not define "business broker," but the State Securities Board has defined the term as follows:

A business broker is a type of securities dealer that is restricted to a narrow scope of securities-related activities. A business broker is a person (including an individual or a company) whose securities activities are restricted to acting as a broker between principals for the sale of a majority of the stock or equity securities of a privately held business pursuant to a privately negotiated purchase agreement, where the managerial control of the business will devolve upon the purchaser(s) and where compensation received by the business broker will be payable for the brokerage activities only.[166]

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such purchases, or offer any valuation of the investment.
• He will not participate in any advertisement or endorsement of the investment.
• He has never previously acted as a broker or engaged in a public or private placement of securities.

[161] SEC Division of Market Regulation, *Guide to Broker-Dealer Regulation*, *available at* www.sec.gov/divisions/marketreg/bdguide.htm at Section II.A.

[162] *SEC v. Kramer*, 778 F. Supp.2d 1320 (M.D. Fla. 2011).

[163] *SEC v. Kramer*, No. 11-12510-DD (11th Cir. 2011). In its opening brief, the SEC continued to support the position that transaction-based compensation, standing alone, is sufficient for broker classification.

[164] *In re Brumberg, Mackey & Wall, P.L.C.*, SEC No-Action Letter, 2010 WL 1976174 (May 17, 2010). The incoming letter was dated December 4, 2008.

[165] In a state court case in Massachusetts, the finder, Maiden Lane, brought suit against the issuer, Perseus, for compensation due under a contract when the finder succeeded in raising $20 million. Perseus counter-claimed that the finder had acted as an unlicensed broker-dealer and therefore the contract was unenforceable under 1934 Act § 29(b). The state court said that transaction-based compensation was not dispositive of the issue, and other factors must be considered, including involvement in the negotiations. The court refused to grant Perseus' motion for summary judgment. *Maiden Lane Partners, LLC v. Perseus Realty Partners, G.P., II, LLC*, 28 Mass. L. Rep. 380 (Mass. Super. Ct. 2011).

[166] FAQs for Dealers and Their Agents 1.D.1. http://ssb.texas.gov/faqs-dealers-and-their-agents.

Any individual or entity that performs these activities must be registered with the Securities Commissioner as a dealer, or agent of a dealer, before acting as a business broker.[167] If the sale of a business is accomplished through a sale of assets rather than through the sale of securities, registration of the business broker is not required.[168]

X. M&A BROKERS

A. The SEC's No Action Letter.

In the context of a merger or acquisition transaction, on January 31, 2014, the SEC staff issued a no action letter entitled "M&A Brokers" in response to a request from a group of lawyers.[169] The no action letter permits a person (an "M&A Broker") to facilitate mergers, acquisitions, business sales, and business combinations ("M&A transactions") between buyers of privately held companies when (among other conditions) following the M&A transaction the buyer will both control and actively operate the purchased company or business.

M&A Brokers following the guidance set forth in the no action letter are exempt from the 1934 Act registration requirements for broker-dealers in 1934 Act § 15(a) and may accept transaction-based compensation. For the purposes of the no action letter, an "M&A Broker" is a "person engaged in the business of effecting securities transactions solely in connection with the transfer of ownership and control of a privately-held company . . . through the purchase, sale, exchange, issuance, repurchase, or redemption of, or a business combination involving, securities or assets of the company, to a buyer that will actively operate the company or the business conducted with the assets of the company" following the transaction. A "privately-held company" is one that does not have a class of securities registered under the 1934 Act § 12, is not subject to the reporting requirements of 1934 Act § 15(d), and is not a shell company.

For the exemption from federal broker-dealer registration to be available, the M&A Broker may not have the power to bind any of the parties to the M&A transaction, may not provide or arrange for financing for the M&A transaction through an affiliate, may not "hold, control, possess or handle" any funds or securities related to the M&A transaction, may not facilitate an M&A transaction for a group of buyers where the M&A Broker assisted in organizing the group, and may not be under certain legal disabilities. The M&A Broker may assist in arranging financing for the transaction through an unaffiliated third party.

The no action letter makes it clear that no party to the M&A transaction may be a shell company, and the securities offered in the M&A transaction may not constitute a "public offering." As a result, the securities involved in the M&A transaction must be "restricted securities" in the hands of the buyer and the M&A Broker (where the M&A Broker's compensation is paid in securities of the deal).

Importantly, the no action letter makes it clear that there are no advertising restrictions. The M&A Broker will be permitted to advertise the sale of the target business and, among other things, the targeted price range.

The no action letter only provides relief to M&A Brokers from the registration requirements of § 15(a) of the 1934 Act. It does not provide any relief from the anti-fraud rules, the requirement to register securities offered for sale unless exempt from registration, investment advisor registration requirements, or state law.

B. Texas Law.

State law remains important for persons intending to act as M&A Brokers. The Texas business broker rules discussed above at X "Business Brokers" would be applicable to M&A Brokers in Texas except that the State Securities Board has promulgated a rule exempting a Mergers and Acquisitions Dealer and the M&A Dealer's agents from registration if the conditions of the exemption are met.[170] The exemption defines an M&A Dealer as "[a] person engaged in the business of effecting securities transactions solely in connection with a Qualifying M&A Transaction."[171] To be a Qualifying M&A Transaction, a transaction must meet all of the following seven requirements:

(1) A Qualifying M&A Transaction is a transfer of ownership and control of a Privately-Held Company to a buyer through the purchase, sale, exchange, issuance, repurchase, or redemption of securities, or a business combination involving securities or assets of the company.

(2) Upon completion of the transaction, the buyer or group of buyers must actively operate the company or the business conducted with the assets of the company.

(3) No Qualifying M&A Transaction can involve

[167] *Id*.

[168] *Id* at 1.D.2.

[169] SEC No-Action Letter re. M&A Brokers (Jan. 31, 2014), *available at* www.sec.gov/divisions/marketreg/mr-noaction/2014/ma-brokers-013114.pdf.

[170] Tex. Ad. Code § 139-27.

[171] Tex. Ad. Code § 139.27(b)(1).

a public offering of securities. Any offering or sale of securities will be conducted in compliance with an applicable exemption from registration under the Texas Securities Act.

(4) No party to any Qualifying M&A Transaction can be a Shell Company, other than a Business Combination Related Shell Company.[172]

(5) The buyer, or group of buyers, in any Qualifying M&A Transaction must, upon completion of the transaction, control the company. A buyer, or group of buyers collectively, would have the necessary control if it has the power, directly or indirectly, to direct the management or policies of a company, whether through ownership of securities, by contract, or otherwise. The necessary control will be presumed to exist if, upon completion of the transaction, the buyer or group of buyers has the right to vote 25% or more of a class of voting securities; has the power to sell or direct the sale of 25% or more of a class of voting securities; or in the case of a partnership or limited liability company, has the right to receive upon dissolution or has contributed 25% or more of the capital.

(6) No Qualifying M&A Transaction can result in the transfer of securities to a passive buyer or group of passive buyers.

(7) Any securities received by the buyer or M&A Dealer in a Qualifying M&A Transaction are restricted securities within the meaning of the Securities Act of 1933, Rule 144(a)(3).[173]

1934 Act registered broker-dealers who are also registered in Texas can also participate in Texas M&A transactions without the restrictions applicable to Business Brokers. For others, however, Texas law and the rules published by the State Securities Board strictly regulate persons who can offer and sell securities in Texas — whether in M&A transactions or for any other purpose.

C. Industry Websites Are Incomplete at Best.

Many industry websites do not provide the necessary information to people who are involved in the offer and sale of securities as a business broker or otherwise. For example, Business Brokerage Press[174] only addresses real estate licensing requirements. The Alliance of Merger and Acquisition Advisors[175] is engaged in discussions regarding licensure with the Securities and Exchange Commission, but has not achieved any real progress. Other associations, such as the Texas Association of Business Brokers,[176] ignore (or at least do not recognize) the securities licensing requirements.

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[172] A Business Combination Shell Company is "a Shell Company (as defined in SEC Rule 405) that is:

> (A) formed by an entity that is not a shell company solely for the purpose of changing the corporate domicile of that entity solely within the United States; or
>
> (B) formed by an entity that is not a Shell Company solely for the purpose of completing a business combination transaction (as defined in SEC Rule 165(n) among one or more entities other than the Shell Company, none of which is a Shell Company.
>
> Tex. Ad. Code § 139.27(b)(5).

[173] Tex. Ad. Code § 139.27(c).

[174] Business Brokerage Press, State Licensing, http://businessbrokeragepress.com/industry-resources/state-licensing/.

[175] Alliance of Merger and Acquisition Advisors, www.amaaonline.org.

[176] TABB, Inc., Texas Association of Business Brokers, www.tabb.org.