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March 31, 2011

Corporate Governance Group

Client Alert

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DELAWARE COURT PERMITS LLC MEMBER TO INSPECT BOOKS AND RECORDS PRE-DATING HIS MEMBERSHIP IN THE LLC

Employs permissive corporate precedent in analyzing member inspection rights not expressly limited by LLC operating agreement

In *Sanders v. Ohmite Holding, LLC*,¹ the Delaware Court of Chancery recently permitted a books and records inspection by a limited liability company (“LLC”) member seeking to investigate the value of his ownership interest, even though the events that were the subject of the investigation pre-dated his acquiring membership status. In granting the member’s motion for summary judgment, the Court ruled that the Delaware Limited Liability Company Act (the “LLC Act”) – at least absent a contrary provision in the LLC’s governing documents – permits a member who can establish “a proper purpose” to access relevant books and records, regardless of whether the activities in question, and the related books and records, pre-date official membership status.

Background

Ohmite Holding, LLC is a Delaware LLC formed in February 1998 to act as a holding company in connection with the combination of various entities owned, respectively, by Max Sanders and The Heico Companies. As part of the transaction, Sanders loaned \$2 million to James Horne, the president of Ohmite, to enable him “to purchase 20.66 of Ohmite’s 100 membership units, giving him a 20.66% membership interest.” The loan was “secured by ... a collateral assignment of Horne’s equity interest in [Ohmite] ... in favor of Sanders.”

Shortly following its formation, Ohmite underwent a recapitalization through which Horne’s 20.66 units were converted into 15.5 units, representing a 15.5% interest in the Company. Two years later, Ohmite repurchased half of Horne’s units for \$1 million, which was paid directly to Sanders to reduce the loan and release the lien

For further information about this Client Alert, please contact:

Roland Hlawaty
Partner
212-530-5735
rhlawaty@milbank.com

David Schwartz
Of Counsel
212-530-5260
dschwartz@milbank.com

Roxana Azizi
Associate
212-530-5276
razizi@milbank.com

You may also contact any member of Milbank’s Corporate Governance Group. Contact information can be found at the end of this Client Alert. In addition, if you would like copies of our other Client Alerts, please visit our website at www.milbank.com and choose the “Client Alerts & Newsletters” link under “Newsroom/Events.”

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Editor: Bob Reder

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¹ C.A. No. 5145-VCL (Del. Ch. Feb. 21, 2011).

on the repurchased units. Then, on February 28, 2007, Horne assigned his remaining 7.75 membership units to Sanders to discharge the outstanding portion of the loan. After initially refusing to recognize that Sanders had become a member of the LLC, Ohmite eventually “conceded that 7.75 units [had] been transferred” to Sanders.

Upon receiving his first Schedule K-1 as an LLC member in October 2008, Sanders realized that what he believed to be a 7.75% stake in Ohmite was only a 0.000775% stake, representing “*one ten-thousandth* of the interest Horne held after the May 2000 [re]purchase.” In response to Sanders’s request for an explanation, Ohmite indicated that additional units had been issued to raise needed capital and that Horne had been given an opportunity, but declined, to purchase additional units to avoid dilution.

Not satisfied with this “terse explanation,” Sanders requested access to Ohmite’s books and records “relating to the dilution of Horne’s (and now his) membership interest” in order “to evaluate the value of [his] ownership interest, the status of the business and financial condition of Ohmite, the performance of Ohmite’s management and the legitimacy of the dilution of [his] interests in Ohmite” Ohmite rejected this request, asserting that “[t]he demand fails to set forth *any* facts” justifying why Sanders needed the requested information, as well as that Sanders “has not asserted that the ‘dilution’ was illegitimate . . . and cannot make such an assertion since he was not a member of the Company at the time of the transaction.” The Company also objected to the scope of the information requested.

Without apparently conceding Sanders’s entitlement to the remainder of the requested documents, Ohmite did provide Sanders with access to certain tax returns and unaudited financial statements in early 2010. Sanders was able to infer from these materials that “Ohmite issued the additional units to an affiliate of its manager” at a “deep discount.” This in turn led Sanders to question whether Ohmite was “being operated exclusively for the benefit of [i]ts principal owners . . . rather than the members as a whole.” This in turn led Sanders to file an action with the Court of Chancery under Section 18-305(a) of the LLC Act seeking access to the remainder of the requested information. The Court, siding with Sanders, granted his motion for summary judgment.

The Court’s Analysis

Vice Chancellor Laster began his analysis by explaining that Section 18-305(a) of the LLC Act gives an LLC member “the right ‘upon reasonable demand for any purpose reasonably related to the member’s interest as a member’ of the LLC” to obtain various books and records of the LLC. This right “is subject to ‘such reasonable standards . . . as may be set forth in a limited liability company agreement or otherwise established by the manager.’”

Turning to Ohmite’s LLC agreement, the Court found no limitation on members’ inspection rights. To the contrary, the agreement provided that “each member’s rights to access books and records are ‘as provided in the [Delaware LLC] Act.’” Ohmite, however, pointed to another provision of its LLC Agreement “providing that ‘an assignee who is not a Member shall not be entitled to . . . receive any information of Company transactions or inspect the Company books.’” Because, Ohmite argued, “Sanders was not a member before February 28, 2007, this provision bars Sanders from obtaining any books and records from before that date.” The Court rejected this argument, concluding that because he was a member of the LLC at the time he made his demand, “the scope of Sanders’s inspections rights is co-extensive with Section 18-305 of the LLC Act,” regardless of how or when Sanders became a member.

The Court next sought to determine whether Sanders had a “proper purpose” to support his demand. In this connection, the Court looked to “cases interpreting similar Delaware statutes concerning corporations and partnerships.” On the basis of this precedent, the Court instructed that an LLC member seeking to inspect books and records “must first establish by a preponderance of the evidence the existence of a ‘proper purpose’ . . . that is ‘reasonably related to such person’s interest’ as a member” Similar to its earlier argument, Ohmite contended that Sanders could not have a proper purpose “because he was not yet a member at the time of the events he seeks to investigate.” The Court also rejected this argument, citing the corporate precedent for the proposition that “[i]f activities that occurred before [the date on which the plaintiff became a stockholder] are ‘reasonably related’ to the stockholder’s interest as a stockholder, then the stockholder should be given access to records necessary to an understanding of those activities.” The Court found no “credible reason grounded in the language, structure, or policy of the LLC Act for a different rule to apply to LLCs.”

Next, the Court concluded that Sanders had established several proper purposes for accessing Ohmite’s books and records. Specifically, Sanders’s desire to value his ownership interest, evaluate “the status of the business and financial condition of Ohmite” and investigate “potential wrong-doing” each was a proper purpose. In the latter case, “Sanders has established ‘a credible basis from which the Court of Chancery can infer there is possible mismanagement that would warrant further investigation.’”²

The final step in the Court’s analysis focused on “whether the requested documents are ‘reasonably required to satisfy the purposes of the demand.’” The Court placed the burden on Sanders to establish that his request satisfied this standard. Consistent with its finding that Sanders did not “have sufficient information available from other sources that merit limiting or denying his inspection rights,” the Court ordered that “Ohmite must provide Sanders with the books and records he has requested.”

Conclusion

The Court’s ruling in *Sanders* demonstrates that the importance attributed by the Court of Chancery to the right of stockholders to inspect corporate books and records will be extended to the LLC context, at least where the governing LLC agreement does not limit those rights. Thus, the Court was not willing to impose temporal restrictions not recognized in the corporate context. Moreover, while LLC members bear the burden of establishing a proper purpose for their requests for access to LLC books and records, as well as the reasonableness of the scope of such requests, the Court will review the propriety of any such request under the relatively permissive regime applicable to corporations and their stockholders. Of course, inasmuch as LLCs, unlike corporations, are largely creatures of contract rather than of statute, LLC members can limit their respective inspection rights in the governing LLC instrument if that is believed to better serve their purposes.

² From the Court’s point of view, proof “that misconduct has actually happened” is not required. Rather, it is sufficient that “the dilutive issuance suggests a possible breach of the duty of loyalty.”

Please feel free to discuss any aspect of this Client Alert with your regular Milbank contacts or with any of the members of our Corporate Governance Group, whose names and contact information are provided below.

Beijing

Units 05-06, 15th Floor, Tower 2
China Central Place, 79 Jianguo Road, Chaoyang District
Beijing 100025, China

| | | |
|--------------|------------------|-------------------|
| Anthony Root | +86-10-5969-2777 | aroot@milbank.com |
| Edward Sun | +86-10-5969-2772 | esun@milbank.com |

Frankfurt

Taunusanlage 15
60325 Frankfurt am Main, Germany

| | | |
|----------------|-------------------|---------------------|
| Norbert Rieger | +49-89-25559-3620 | nrieger@milbank.com |
|----------------|-------------------|---------------------|

Hong Kong

3007 Alexandra House, 18 Chater Road
Central, Hong Kong

| | | |
|------------------|----------------|------------------------|
| Anthony Root | +852-2971-4842 | aroot@milbank.com |
| Joshua Zimmerman | +852-2971-4811 | jzimmerman@milbank.com |

London

10 Gresham Street
London EC2V 7JD, England

| | | |
|---------------|------------------|---------------------|
| Stuart Harray | +44-20-7615-3083 | sharray@milbank.com |
|---------------|------------------|---------------------|

Los Angeles

601 South Figueroa Street, 30th Floor
Los Angeles, CA 90017

| | | |
|---------------|-----------------|-----------------------|
| Ken Baronsky | +1-213-892-4333 | kbaronsky@milbank.com |
| Neil Wertlieb | +1-213-892-4410 | nwertlieb@milbank.com |

Munich

Maximilianstrasse 15 (Maximilianhöfe)
80539 Munich, Germany

| | | |
|----------------|-------------------|-----------------------|
| Peter Nussbaum | +49-89-25559-3430 | pnussbaum@milbank.com |
|----------------|-------------------|-----------------------|

New York

One Chase Manhattan Plaza
New York, NY 10005

| | | |
|----------------|-----------------|----------------------|
| Scott Edelman | +1-212-530-5149 | sedelman@milbank.com |
| Roland Hlawaty | +1-212-530-5735 | rhlawaty@milbank.com |
| Thomas Janson | +1-212-530-5921 | tjanson@milbank.com |
| Joel Krasnow | +1-212-530-5681 | jkrasnow@milbank.com |
| Alan Stone | +1-212-530-5285 | astone@milbank.com |
| Douglas Tanner | +1-212-530-5505 | dtanner@milbank.com |
| Paul Wessel | +1-212-530-5077 | pwessel@milbank.com |

São Paulo

Rua Colombia, 325
Jardim América
São Paulo, SP
01438-000

| | | |
|----------------|------------------|----------------------|
| Andrew Janszky | +55-11-3927 7701 | ajanszky@milbank.com |
|----------------|------------------|----------------------|

Singapore

30 Raffles Place, #14-00 Chevron House
Singapore 048622

| | | |
|----------------|---------------|-----------------------|
| David Zemans | +65-6428-2555 | dzemans@milbank.com |
| Naomi Ishikawa | +65-6428-2525 | nishikawa@milbank.com |

Tokyo

21F Midtown Tower, 9-7-1 Akasaka, Minato-ku
Tokyo 107-6221 Japan

| | | |
|--------------|----------------|----------------------|
| Gary Wigmore | +813-5410-2840 | gwigmore@milbank.com |
|--------------|----------------|----------------------|

Washington, DC

International Square Building, 1850 K Street, NW
Suite 1100

| | | |
|----------------------|-----------------|----------------------|
| Washington, DC 20006 | | |
| Glenn Gerstell | +1-202-835-7585 | gerstell@milbank.com |