

When are LLC Interests a Security

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1. Introduction

Since the adoption of Oregon's Limited Liability Company Act (ORS Chapter 63) in 1993, limited liabilities companies ("LLC") have become a popular form of doing business. Lawyers assisting in the formation of LLCs should give careful consideration to the applicability of the securities laws.

Since LLCs are a recent development, as yet there are no reported Oregon cases on whether an LLC interest is a security and are few cases nationally.

While the definition of a "security" in the Oregon and federal securities laws do not include LLCs, some of the terms contained in that definition may be broad enough to encompass LLC interests. ORS 59.015(19)(a). In the event that an LLC interest falls

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within the scope of "security" definition (i) the sale of the interest will need to be registered, unless exempt, (ii) the person selling the LLC interest will need to be licensed, unless exempt, and (iii) the disclosure provisions of the securities law will apply regardless of whether or not the transaction is registerable or exempt.

2. Overview of the Definition of a Security

Each of the various state and federal securities statutes contains a definition of the term "security." These definitions tend to be quite similar. The present definition of a "security" in the Oregon securities law is contained in ORS 59.015:

As used in the Oregon securities law, unless the context otherwise requires:

(17)(a) "Security" means a note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in a pension plan or profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, certificate of interest or participation in an oil, gas, or mining title or lease or in payments out of production under such title or lease, real estate paper sold by a mortgage broker or a person described in paragraph (b) of subsection (1) of this section to persons other than persons enumerated in ORS 59.035(4), or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificates for, receipt for, guarantee of, or warrant or right to subscribe to or purchase any of the foregoing.

Court interpretations of the term "security" are much more important than is a plain reading of the definition itself. Although there has been some movement to narrow earlier case law, traditionally, the courts have liberally construed the definition of a security in order to effectuate the purposes of the securities law.

In the 60 years following the passage of the first securities law, the focus of the courts with respect to the definition of a security was on more exotic investment transactions, rather than on traditional instruments such as stock and bonds. On the whole, the courts focused on one of the terms in particular which appeared in the securities definition: the term "investment contract" (a term appearing in the definition section of the federal, Oregon and most state securities laws).

The courts are likely to analyze LLC interests under the tests developed for "investment contract" securities.

3. The Investment Contract Test

The principal investment contract test has its origins in *SEC v. WJ Howey Co.*, 328 US 293 (1946). In that case, the SEC sought to enjoin a Florida company which was selling small citrus grove tracts, each coupled with a long-term service contract, to persons living throughout the United States. The service contract specified that, for a fee, the company would maintain, harvest and sell the orange crop and then forward the profit to the "owner". Given the size of each plot and the distance separating that plot from its owner, it was uneconomical to purchase a plot and its orange trees without also purchasing a service contract.

In determining whether the transaction involved a security, the *Howey* Court held that form should be disregarded for substance and emphasized that the economic realities of the transaction were paramount. The U. S Supreme Court adopted as its approach in defining a security an older state law approach, one which "embodies a flexible rather than a static principle, one that is capable of adoption to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." *Id.*, at 299. The Court held that this transaction contained all of the elements usually associated with a security: *i.e.*, the investor provided the capital and shared in the profits while the promoters managed, controlled and operated the enterprise. The Court then adopted a test which, with some later modification, remains today the cornerstone of securities law:

The test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others. *Id.*, at 300, 301.

The most significant modification of the *Howey* test first appeared in *SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F2d 476 (9th Cir), *cert denied*, 414 US 821 (1973). In that case, the Ninth Circuit (in a case arising out of Oregon) analyzed a

transaction which amounted to a "gigantic and successful fraud" which, but for the minimal effort required of the investors in order for them to receive a profit, would otherwise have met the *Howey* test. Recognizing that Congress intended that a flexible approach be employed, the Court held that an investment contract existed when "the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprises." *Id.*, at 482. This modification, which effectively eliminated the word "solely" from the *Howey* test, is generally applied in all jurisdictions today.

The principal investment contract test used in Oregon, equivalent to the federal *Howey* test, is set out in *Pratt v. Kross*:

- (1) an investment of money (or money's worth),
- (2) in a common enterprise,
- (3) with the expectation of profit,
- (4) to be made through the management and control of others. *Pratt v. Kross*, 276 Or 483, 498, 555 P2d 765 (1976).

Most LLC interests easily fall within the first three prongs of this four prong test. Whether or not a particular LLC has sufficient "management and control" by "others" will likely determine whether the securities laws will apply.

4. Limited partnership interests

In the 1970s and early 1980s, limited partnerships were popular vehicles for investments. A significant number of lawsuits were filed, claiming the sale of a limited partnership interest fell within the scope of the securities laws.

Although the term "limited partnership interest" does not appear in the definition of a security under the federal, Oregon and most other state securities statutes, courts almost universally held that the sale of a limited partnership interest were "investment contract" securities. *See, for example: Pratt v. Kross*, 276 Or 483, 555 P2d 765 (1976); *Reeves v. Teuscher*, 881 F2d 1495 (9th Cir 1989); *In re Longhorn Securities Litigation*,

573 F Supp 255 (WD Okla 1983).

Courts so held because most limited partnership interests meet all four prongs of the investment contract *Howey* test. When an investor purchases a limited partnership interest, there is: (1) an investment of money, (2) in a common enterprise, (3) with the expectation of profit, (4) to be made through the management and control of others.

The key element in the analysis of a limited partnership interest is "management and control." Under the Uniform Limited Partnership Act, a limited partner, unlike a general partner, has no significant input into the management and control of the limited partnership.

But not all limited partnership interests are securities. Courts have held limited partnership interests are not securities when the limited partner has control over the management of the partnership, such as when the limited partnership interest is owned by a general partner, a director of a general partner, or a parent corporation of a corporate general partner. *See, for example: Bamco v. Reeves*, 675 F Supp 826 (SD NY 1987); *Darrah v. Garrett*, [1984 Transfer Binder] FED SEC L REP (CCH) ¶ 91,472 (ND Ohio 1984); *Bank of America National Trust & Savings Association v. Hotel Rittenhouse Associates*, 595 F Supp 800 (ED Pa 1984).

5. General partnership interests

The term "general partnership interest" likewise does not appear in the definition of a "security" in the federal and state law securities statutes. In some cases, investors argued that a general partnership interest was an "investment contract". This argument usually was not a successful one.

Unlike a limited partner, general partners are usually not prohibited from participating in the management of the partnership. As a consequence, there is a strong presumption that an interest in a general partnership is **not** a security. *Odom v. Slavik*, 703 F2d 212 (6th Cir 1983).

But some general partnership interests can be securities. The test for determining whether or not a general partnership interest is a security was first set out in *Williamson v. Tucker*, 645 F2d 404 (5th Cir), *cert denied*, 454 US 897 (1981). The test is commonly

referred to as the *Williamson* test.

[A]n investor who claims his general partnership or joint venture interest is an investment contract has a difficult burden to overcome. On the face of a partnership agreement, the investor retains substantial control over his investment and an ability to protect himself from the managing partner or hired manager. Such an investor must demonstrate that, in spite of that partnership form which the investment took, he was so dependent on the promoter or a third party that he was in fact unable to exercise meaningful partnership powers. A general partnership or joint venture interest can be designated a security if the investor can establish, for example, that (1) an agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership; or (2) the partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or (3) the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers. (footnotes omitted) *Id.* at 424.

Under this test, a general partnership interest is not a security unless the investor can establish (1) that operating agreement excludes the investor from effecting the management of the partnership, (2) that he is particularly unknowledgeable in business affairs, or (3) the managing partner's expertise is unique.

The *Williamson* test is applied by nearly all courts analyzing whether a general partnership interest is a security.

6. LLC Interests as Securities

LLC interests do not appear in the definition of the federal securities laws, nor the securities laws of Oregon and most other states.

NOTE: Some states have amended their statutory definition of a security to include membership interests in limited liability companies. *See, for example:* Section 421-B:2XX(a) of the New Hampshire statutes. Kansas has included references to LLCs to its securities statutes. KAN STAT § 17-1262(l) (adding LLC interests to list of securities exempt in certain limited offerings). Section 25019 of the California statutes provides:

"Security" means any note; stock; treasury stock; membership in an incorporated or unincorporated association; bond; debenture; evidence of indebtedness; certificate of interest or participation in any profit-sharing agreement; collateral trust certificate; preorganization certificate or subscription; transferable share; investment contract; viatical settlement contract or a fractionalized or pooled interest therein; life settlement contract or a fractionalized or pooled interest therein; voting trust certificate; certificate of deposit for a security; **interest in a limited liability company and any class or series of those interests (including any fractional or other interest in that interest), except a membership interest in a limited liability company in which the person claiming this exception can prove that all of the members are actively engaged in the management of the limited liability company; provided that evidence that members vote or have the right to vote, or the right to information concerning the business and affairs of the limited liability company, or the right to participate in management, shall not establish, without more, that all members are actively engaged in the management of the limited liability company;**

Oregon's definition of a securities does not specifically mention limited liability interests. ORS 50.015(19)(a).

Most, but not all, commentators and courts which have analyzed whether limited liability interests are securities have applied the *Williamson* test (originally applied to general partnership interests) to determine whether the limited liability interest is an "investment contract" security. *Williamson v. Tucker*, 645 F2d 404 (5th Cir), *cert denied*, 454 US 897 (1981).

NOTE: At least one law review article, Steinberg & Conway, *The Limited Liability Company as a Security*, 19 Pepperdine L Rev 1105 (1992), proposed that LLC interests should be analyzed under the "stock" tests discussed in *United Housing Foundation v. Forman*, 421 US 837 (1975) and *Landreth Timber Co. v. Landreth*, 471 US 681 (1985). This view has not gain much support. Some courts have analyzed an LLC interest under both the "investment contract" test and the "stock" test before concluding that the LLC interests in question were **not** a security. *Robinson v. Glynn*, 349 F3d 166 (4th Cir 2003); *Great Lakes Chemical Corp. v. Monsanto Co.*, 96 F Supp 2d 376 (D Del 2000).

Applying the Williamson test for whether an interest is an “investment contract” securities, most commentators believe most manager-managed LLCs are securities; while most member-managed LLCs are not securities. This is because member-managed LLCs generally do not meet the 4th prong of the Howey test – profits to be “made through the management and control of others.” Members of manager-managed LLCs, however, are not relying on their own management, but rather, on the management of the manager.

Members of a manager-managed LLC are more likely to be passive investors in need of the protections afforded by the federal securities laws. By the same token, members of member-managed LLCs who are able to actively participate in the management affairs of the entity are less likely to need such protections. But even these characteristics may differ based on the economic realities and facts of each case, making it difficult to establish bright line rules in this area. *Conde v. SLS West, LLC*, 2005 WL 1661747 (SD Ind 2005).

The specific circumstances of particular LLCs has resulted in case law which does not neatly follow dictates of the manager-managed/member-managed theory.

Three of the earliest cases involved the wireless cable scam perpetrated in the 1990s. These programs raised funds from hundreds of unsophisticated retired folk – often spread over many states – through the sale of interests in member-managed LLCs. Despite the fact that these LLCs were member-managed, the courts held these interests to be securities. *See: SEC v. Shreveport Wireless*, [1998 Transfer Binder] FED SEC L RPTR (CCH) ¶ 90,322, 1998 WL 892948 (D DC 1998) (sales to 2000 geographically diverse investors); *Nutek Information Systems v. Arizona Corporation Commission*, 977 P2d 826 (Ariz App 1998) (sales to 920 investors); and *SEC v. Parkersburg Wireless LLC*, 991 F Supp 6 (D DC 1997) (sales to 700 investors).

On the other hand, manager-managed LLCs may not be securities if the non-managing member has sufficient financial strength and sophistication.

Great Lakes Chemical Corp. v. Monsanto Co., 96 F Supp 2d 376 (D Del 2000) is an interesting case in that the plaintiff purchased 100% of the LLC interests from the managing and non-managing members of an LLC. The managing member had contributed \$162.9 million for a 81.5% interest; the non-managing member contributed

\$37.1 million for a 18.5% interest. Plaintiff claimed these interests were securities. The court disagreed, finding that the 18.5% owner had the power to vote to remove the manager (albeit, with only an 18.5% interest, a power which needed the vote of the manager to prevail).

Likewise in *Robinson v. Glynn*, 349 F3d 166 (4th Cir 2003), Robinson membership interest in a manager-managed LLC was held not to be a security because Robinson was “an active and knowledgeable executive” with the LLC who had the power to appoint 2 of the 7 managers of the LLC.

In *Endico v. Fonte*, 485 F Supp 2d 411, (SD NY 2007), plaintiff was induced to contribute a building he owned to an LLC in exchange for an interest in the LLC. Defendants were the “managing members.” In holding that the LLC interest was not a security, the court held that plaintiff was not a passive investor under the investment contract test in that he was the sole signatory on the LLC’s bank account – thus controlling the LLC’s purse-strings – and that the Operating Agreement required unanimous consent of the members was required to sell or mortgage the property.

NOTE: Other courts have noted that the mere fact that the investor has some nominal involvement in the operation of the business is not enough, “the focus is on the dependency of the investor on the entrepreneurial or managerial skills of the promoter or other party.” *SEC v. Merchant Capital, LLC*, 483 F3d 747, 755 (11th Cir 2007).

Some cases do follow the general rule. In *Keith v. Black Diamond Advisors, Inc.*, 48 F Supp 2d 326 (SDNY 1999), the court held that a LLC interest was not a security in a member-managed LLC because the plaintiff had the right under the operating agreement to actively participate in the management of the LLC, even though in practice, his role was more passive.

On the other hand, an interest in a manager-managed LLC may be a security where the member’s ability to exercise any management control is effectively non-existent. *KFC Ventures, L.L.C. v. Metaire Medical Equipment Leasing Corp.*, 2000 WL 726877 (ED La 2000).

NOTE: Two courts have held that the Williamson analysis should also be applied to interests in limited liability partnerships (“LLPs”). *SEC v. Merchant Capital, LLC*, 483 F3d 747 (11th Cir 2007); *Toothman v. Freeborn & Peters*, 80 P3d 804 (Colo App 2002).

Under the Oregon law, the business and affairs of an LLC are managed by its members "unless the articles of organization provide otherwise." ORS 63.130. At least in the Ninth Circuit, inquiry on whether or not a general partnership interest is a security focuses on the structure of the partnership at the time that the partnership interest is acquired, not on how the entity functions in practice during its existence. *Holden v. Hagopian*, 978 F2d 1115 (9th Cir 1992). *See also: KFC Ventures, L.L.C. v. Metaire Medical Equipment Leasing Corp.*, 2000 WL 726877 (ED La 2000); *Keith v. Black Diamond Advisors, Inc.*, 48 F Supp 2d 326 (SDNY 1999).

7. Applying *Williamson* to LLCs

Under *Williamson*, a general partnership interest may be a security if:

(1) an agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership. *Williamson, supra* at 424.

A partner does not need to have the ability to prevail on partnership votes. *See: Robinson v. Glynn*, 349 F3d 166 (4th Cir 2003); *Great Lakes Chemical Corp. v. Monsanto Co.*, 96 F Supp 2d 376 (D Del 2000). Minority general partners and the majority partners can both influence management decisions. Neither minority nor majority general partnership interests usually fall within the securities laws.

In *SEC v. Merchant Capital, LLC*, 483 F3d 747 (11th Cir 2007), the SEC brought an action against the promoters who sold interests in limited liability partnerships to 485 geographically dispersed investors. The agreement provided for the election of a managing general partner, but the partners only had the opportunity to vote for one candidate (the promoter) at the time of the investment, before the partners knew the identity of the other partners. Removal of the managing general partner could only occur “for cause” and by unanimous vote of the partners. Thus, the court concluded that the

entity distributed power as would a limited partnership.

7.1 Inexperienced member

The second prong of the *Williamson* test looks to the inexperience of the partner or some other factor which renders the partner unable to meaningfully exercise his partnership powers.

(2) the partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers. *Williamson, supra* at 424.

With respect to the second prong of *Williamson*, the Ninth Circuit has held that "[t]he proper inquiry is whether the partners are inexperienced or unknowledgeable 'in business affairs' generally, not whether they are experienced and sophisticated in the particular industry or area in which the partnership engages and they have invested." *Holden v. Hagopian*, 978 F2d 1115 (9th Cir 1992). *See also: Keith v. Black Diamond Advisors, Inc.*, 48 F Supp 2d 326 (SDNY 1999). If this analysis is applied to an LLC, the sophistication of an LLC's members will be an important factor in determining whether the securities laws apply.

More recently, the Eleventh Circuit rejected this argument and held that Howey required it to look to whether the investors were inexperienced in that particular business. *SEC v. Merchant Capital, LLC*, 483 F3d 747, 762 (11th Cir 2007).

7.2 Unique promoter

The third prong of the *Williamson* test looks to whether the promoters have some unique management ability such that they cannot be replaced as manager.

(3) the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers. *Williamson, supra* at 424.

The Ninth Circuit has held that the promoter/manager must possess some "non-replaceable expertise" which is necessary to the successful management of the partnership. *Holden v. Hagopian*, 978 F2d 1115 (9th Cir 1992). It is not important that the individual partners can not themselves step into the shoes of the manager. The

manager's skill must be such that the manager is not be replaceable by **anyone**.

The Ninth Circuit has indicated, however, that a manager might be deemed non-replaceable in situations where the economic realities of the arrangement makes replacement of the manager unfeasible. *Hocking v. DuBois*, 885 F2d 1449 (9th Cir 1989), *cert denied*, 494 US 1078 (1990) (Nevada resident purchased single Hawaiian condo unit contributed to larger rental pool); *Koch v. Hawkins*, 928 F2d 1471 (9th Cir 1991) (35 separate general partnerships each owned small, separate parcels of a much larger jajoba plantation and the smaller parcels alone could not be operated economically).

The Eleventh Circuit has also held that a manager of 28 separate limited liability partnerships may be deemed irreplaceable where the assets of those LLPs were tied up in a common pool. *SEC v. Merchant Capital, LLC*, 483 F3d 747, 763-4 (11th Cir 2007).

7.3 An LLC interest might constitute "stock" for purposes of securities laws

As discussed above, the various securities laws contain definitions of a security which list a couple of dozen instruments as securities. Most analysis has focused on of these instruments, "investment contracts," an applied the test for an investment contract to determine whether a particular LLC interest is a security. A few persons have argued that LLC interests are equivalent to "stock," another instrument which appears in the various securities law definitions.

For instance, in one law review article, Steinberg & Conway, *The Limited Liability Company as a Security*, 19 Pepperdine L Rev 1105 (1992), the authors analyzed LLC interests under the "stock" test discussed in *United Housing Foundation v. Forman*, 421 US 837 (1975) and *Landreth Timber Co. v. Landreth*, 471 US 681 (1985). Their point is that even though LLC interests are not called "stock" in the LLC statute, the "stock" test is appropriate since LLC interests have most of the characteristics of "stock" set out in *Forman*:

- (a) the right to receive dividends contingent upon the apportionment of profits;
- (b) negotiability;
- (c) the ability to be pledged or hypothecated;

- (d) voting rights in proportion to the number of interests owned; and
- (e) the ability to appreciate in value.

See: Forman, supra at 851.

Another law review article disagrees. Sargent, *Are Limited Liability Company Interests Securities?*, 19 Pepperdine L Rev 1069 (1992).

8. Other factors

In analyzing other instruments under the securities laws, the courts have given weight to the expectations of the parties themselves. *SEC v. R. G. Reynolds Enterprises, Inc.*, [1991-92 Transfer Binder] FED SEC L REP (CCH) ¶ 96,464 (9th Cir 1991). If the parties refer to the transaction as an "investment," the courts are more likely to apply the investment laws. The courts also give weight to the plan of distribution. *Id.*; *Reves v. Ernst & Young*, 494 US 56 (1990). Mass marketing and high attendance investment meetings increase the chance that the securities laws are applicable.

9. Different classification based upon role of owner and method of acquisition

It is possible that some LLC interests in a particular LLC will be securities and other LLC interests in the same LLC will not. A few courts have held an limited partnership interest not to be security in circumstances where the limited partner has substantial control over the management of the partnership, such as when the limited partnership interest is owned by a general partner, a director of a general partner, or a parent corporation of a corporate general partner. *See, for example: Bamco v. Reeves*, 675 F Supp 826 (SD NY 1987); *Darrah v. Garrett*, [1984 Transfer Binder] FED SEC L REP (CCH) ¶ 91,472 (ND Ohio 1984); *Bank of America National Trust & Savings Association v. Hotel Rittenhouse Associates*, 595 F Supp 800 (ED Pa 1984). Applying the same reasoning, an LLC interest held by one of the centralized managers of an LLC with centralized management would likely not be a security while an LLC interest in the same LLC held by a passive member may well be a security.

Even if an LLC interest is not a security, the assignment of that interest may well be. ORS 63.249(2) provides that the assignment of an LLC interest does not entitle the assignee to participate in management. The resale of an instrument can fall within the securities laws even though the original issuance of that instrument did not fall within the

securities laws. See: *Banco Espanol de Credito v. Security Pacific National Bank*, 973 F2d 51 (2nd Cir 1992), *cert den*, 61 USLW 3851 (1993); *Commercial Discount Corp. v. Lincoln First Commercial Corp.*, 445 F Supp 1263 (SD NY 1978) (both cases involving the resale of promissory notes). With respect to the assignment of an LLC interest, the resale of the right to share in profits without the transfer of the right to participate in management could well mean that the assignment falls within the securities law even though the original sale of the LLC interest did not.

10. Summary

In summary, if the courts apply existing case law regarding general partnership interests to LLC interests, most LLC interests will not fall within the securities laws. Factors which may indicate a contrary result include centralized management, unsophisticated members, promoters with unique skills, members living a great distance from the site of the LLC's business, frequent use of the term "investment" in communications between the members and the LLC, mass marketing of the LLC interests, and a high number of LLC members. While some of these factors alone may not be enough to cause the securities laws to apply, a combination of such factors could be worrisome.

Of these factors, centralized management is likely the most important factor. It may be present in situations where the LLC makes an ORS 63.130 election in its organizational documents. It may also be present where the LLC delegates important management duties to promoters or third parties by contract or otherwise and where the termination of that delegation is made difficult by the imposition of supermajority voting requirements, penalties for exercise of that termination power, or contractual impediments to prompt termination (*e.g.*, a 3-year no-cancel clause, a 6-month notice requirement, etc.).