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# THE LLC & PARTNERSHIP REPORTER

(f/k/a The PUBOGRAM)

The Newsletter of the Committee on LLCs, Partnerships and Unincorporated Entities

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Volume XXXIII, No. 1

## FROM THE CHAIR

*Thomas E. Rutledge  
Stoll Keenon Ogden PLLC  
Louisville, Kentucky*

Dear Fellow Committee Members:

### The BLS Annual Meeting in Montréal

We next join together at the BLS spring meeting in Montréal. The committee programs/events are as follows:

#### **Thursday April 7:**

*Anti-Money Laundering  
Subcommittee Meeting  
1:30PM - 2:30PM  
Hotel Bonaventure  
St. Leonard, Convention Floor*

Program: *Key Considerations for  
LLC Interest Collateral  
2:30PM - 4:30PM  
Hotel Bonaventure  
Hampstead, Convention Floor*

*International Use of U.S. Business  
Entities Subcommittee Meeting  
4:30PM - 5:30PM  
Hotel Bonaventure  
St. Pierre, Convention Floor*

#### **Friday April 8:**

Program: *LLC Diversity of  
Citizenship Federal Court Issues  
8:30AM - 10:00AM  
Hotel Bonaventure  
Lachine & Lasalle, Convention  
Floor*

*LLCs, Partnerships and  
Unincorporated Entities  
Committee Meeting  
10:00AM - 12:00PM  
Hotel Bonaventure  
Fountain F, Convention Floor*

Program: *Annual LLC Caselaw  
Update  
2:30PM - 4:30PM  
Hotel Bonaventure  
Lachine & Lasalle, Convention  
Floor*

*Security Interests in LLC and  
Other Unincorporated Entity  
Interests  
Task Force Joint Meeting  
1:00PM - 2:30PM  
Hotel Bonaventure  
Fountain E, Convention Floor*

In addition, we are looking into one of our official informal committee dinners at which we can all catch up with one another or, for those of you new to the group, to make some new connections. That will be on Thursday evening; look to future emails for information.

On March 15 there was presented a webinar *The Intersection Between LLCs and Bankruptcy*. Presenting this webinar will be: Darek S. Bushnaq (Venable LLP, Baltimore, Maryland); Emily L. Pagorski (Stoll Keenon Ogden PLLC, Louisville, Kentucky); and James J. Wheaton (General Counsel, Liberty Tax Service and 2015 Lubaroff Award Winner, Virginia Beach, Virginia). It was well attended and the presentations were outstanding.

Still on the topic of upcoming webinars, likely on June 9 (the date is still being finalized), George Coleman, Susan Saab Fortney and A. J. Singleton will be reprising their program from the 2015 LLC Institute on the ethical maelstrom when a firm is failing. This will be a free CLE ethics program. As always, please feel free to advertise this program to those in your legal community, both within and without your firm. This is a great opportunity for the Committee to capture additional members and, obviously, a great opportunity for each of us to accumulate additional ethics credits.

This issue of the LLC & Partnership Reporter benefits from a number of contributions from Jay Adkisson, Phil Amoa, Peter Mahler, Allen Benson and Stephen Sepinuck. With thanks to them, I have to believe that each of us could provide quick reviews of local cases and statutes that will undoubtedly be of interest to others. Please be thinking of what you can either

write up or forward that would add to the discussion.

This issue of the LLC & Partnership Reporter does not contain a case law review by Professor Beth Miller; rather, Beth is still working on this installment. As those of you who know Beth are already aware, she works as hard as any 2 1/2 people we know, and devotes a significant amount of her "free" time to reviewing and dispassionately summarizing cases for our benefit. When the next installment is available, it will be distributed. In the meantime, I submit that this delay is a good opportunity for all of us to consider how much we benefit from the case law summaries prepared by Beth; for myself, a note of thanks is certainly in order.

In closing, and I know you're sick of hearing it, but this is your Committee - what would be helpful in the way of programs, written materials and webinars in your practice?

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Thomas E. Rutledge - Chair  
Thomas E. Rutledge - Editor  
Peter D. Hutcheon - *Editor Emeritus*

## Vision & Charging Orders

By Jay D. Adkisson  
Riser Adkisson LLP  
Las Vegas, Nevada

Vision Marketing Resources, Inc. ("Vision") sued James L. McMillin and McMillin Group LLC, claiming that Vision has purchased several sets of golf clubs from the latter which were neither delivered or the payment refunded, and that the former used McMillin Group LLC to conduct his personal business.

The defendants failed to respond, and Vision took a default judgment against the two for \$101,500 in compensatory damages and the same amount for punitive damages, for a total judgment of \$203,000 plus some costs and interest. This was in 2011, and the default judgment was entered in the U.S. District Court for the District of Kansas.

Vision requested that the Court enter a Charging Order against the defendants' interest in Buffalo Nickel Trading LLC. Both defendants, and Buffalo Nickel, list Georgia addresses. But the Kansas Court did not grant the request, but instead instructed the Plaintiff to tell the Court:

- (1) How the U.S. District Court in Kansas had jurisdiction over Buffalo Nickel as a Georgia company; and
- (2) Why Kansas law relating to Charging Orders against an LLC did not limit its application to only Kansas LLCs and not foreign (*i.e.*, not Kansas) LLCs.

As to the first part, Vision responded that the Court only needed jurisdiction over the member(s) of a foreign LLC. As to the second, Vision argued that the Kansas LLC statute did not expressly exclude foreign LLCs from the application of its Charging Order provisions.

The U.S. District Judge referred the matter to a U.S. Magistrate Judge to sort out, and the Magistrate Judge entered the Opinion which I shall now relate. To spoil the suspense over that process, the Magistrate Judge's Order was affirmed in all aspects by the U.S. District Judge and became the ruling of the Court, and because of that, I will simply refer to the

Magistrate Judge's Report and Recommendation as the "Opinion", since it was adopted in all respects by the U.S. District Judge.

The Court first addressed the issue of whether it had the jurisdiction to issue a Charging Order in Kansas against a Georgia LLC. A U.S. District Court in post-judgment enforcement proceedings will apply the collection laws of the state in which it sits, unless there is a contrary federal statute as to a particular issue (and no such federal statute controlled here). The Kansas statute provides simply:

On application by a judgment creditor of a member or of a member's assignee, a court having jurisdiction may charge the limited liability company interest of the judgment debtor to satisfy the judgment.

In this case, the Court had personal jurisdiction over the two defendants, but it did not have personal jurisdiction over Buffalo Nickel Trading LLC. Moreover, Buffalo Nickel did not have any presence in Kansas, was not doing business there, and really had no connections at all to the Sunflower State.

Similarly, the Court did not have *in rem* jurisdiction (which is jurisdiction over property as opposed to jurisdiction over a person or entity) over the interests in Buffalo Nickel which were to be charged by the Charging Order. An interest in an LLC is considered to in the nature of intangible property, and intangible property is said to be located where its owner resides, and here the owners of the interests in Buffalo Nickel resided in Georgia.

Vision argued that the *Rockstone Capital* opinion supports its argument that a creditor does not need jurisdiction over the LLC whose interests are charged, but instead just needs personal jurisdiction over the defendants holding those interests -- and, of course, a court that has entered a judgment against those defendants has already determined that hit has such personal jurisdiction (or it could not have entered the judgment).

Although the Court found no Kansas authority on the subject, it did note that *Rockstone Capital* and several other cases, including *Mahalo Investments III, LLC v. First Citizens Bank & Trust Co.* have likewise held that it is not

necessary for the particular court which enters the Charging Order to have jurisdiction over the entity itself. Thus:

the Court agrees with the rationale expressed in them. It therefore concludes that it has the requisite jurisdiction needed to issue a charging order against the LLC member interest of Judgment Debtor James McMillin by its continuing jurisdiction over Plaintiff and Defendants/Judgment Debtors. The Court need not have jurisdiction over the LLC entity itself in order to issue a charging order, when it has jurisdiction over the LLC member because the LLC has no right or direct interest affected by the charging order. Rather it is the judgment debtor's interest in and right to future distributions of the LLC that is being charged. As provided by the Kansas charging order statute, the charging order constitutes a lien on the judgment debtor's LLC interest. It only grants Plaintiff the right to receive any distribution or distributions to which the judgment debtor would otherwise have been entitled with respect to such LLC interest. The statute further provides that no creditor of a member or of a member's assignee shall have any right to obtain possession of, or otherwise exercise legal or equitable remedies with respect to, the property of the LLC. These provisions make it clear that it is the judgment debtor's interest in and rights to the LLC interest that are affected by the charging order.

Thus, the Court decided that because it had jurisdiction over the debtor, the Charging Order could be properly issued against Buffalo Nickel Trading LLC, even though the Court did not have personal jurisdiction over that entity itself.

That left the second issue to be determined by the Court, which was whether the Charging Order provisions of the Kansas Limited Liability Company Act should be applied to a Georgia LLC (a "foreign LLC" in the vernacular of the Act).

Here is the issue:

- The Kansas Limited Liability Company Act defines a "limited liability company" as one formed in Kansas, and a "foreign limited liability company" as one formed in another jurisdiction.
- Foreign LLCs are treated in one part of the Act, but that part does not mention charging orders.
- Charging orders are treated in another part of the Act (K.S.A. 17-76,113) but that part only references LLCs and not foreign LLCs.
- Thus, there is an open question as to whether the Act's charging order provisions relate only to Kansas LLCs, or whether those provisions should control foreign LLCs as well.

Much to my own amazement, this is where I somehow come into the picture as the Court described the issue:

The definition of "member," which specifically includes a person who is admitted to a foreign LLC, suggests that a court having jurisdiction can issue a charging order against a foreign LLC under K.S.A. 17-76,113. However, because the term "limited liability company" appears to be limited to those "formed under the laws of the state of Kansas," this suggests the opposite—that a court does not have authority to issue a charging order against the interests in LLCs formed under another state's laws. One commentator has remarked on this as a foreign LLC "glitch" in the Revised Uniform Limited Liability Company Act ("RULLCA"). Jay D. Adkisson, in his paper, *Charging Orders, The Misunderstood Theory -vs- The Trenches of Litigation*, has described this as a glitch of

statutory drafting resulting from how a “limited liability company” is defined under Section 102 of the RULLCA, the lack of any section authorizing charging orders under Article 8 (applying to foreign LLCs), and because Section 503 (which authorizes charging orders) does not make any reference to a foreign limited liability company.

A strict statutory construction of the Act would lead one to conclude that the charging order provisions only apply to Kansas LLCs, and not to foreign LLCs. Indeed, that is the result that has been reached by two cases: *Fannie Mae v. Heather Apartments LP* and the aforementioned *Rockstone Capital* case. But is that the right result?

The *Heather Apartments* decision has been subject to academic criticism, not the least of which by Professor Carter Bishop of Suffolk University's Law School, who is an expert on this particular topic if anybody is. Here, we finally have a court that makes more than a superficial analysis of the issue, and concludes:

Based upon the inconsistencies in the definitions and absence of any language in K.S.A. 16–76,113 specifically excepting its provisions from applying to a member's interest in a foreign (non-Kansas) LLC, the Court concludes that K.S.A. 16–76,113 is not limited to interests in Kansas LLCs, and a charging order may be issued against an LLC member's interest in a foreign (non-Kansas) LLC. This conclusion is supported by the purpose of a charging order, which is to execute or collect upon a judgment. It is a post-judgment remedy by which the judgment creditor attempts to collect its judgment from future LLC distributions that may flow to the judgment debtor by diverting any such future distributions to the creditor. In the typical case, the debtor remains the owner of the membership interest, with all of the associated rights, except that the creditor is entitled to the member's share of LLC distributions needed to pay the debt if and when the distributions are made. Limiting the issuance of charging orders under K.S.A. 16–76,113 to judgment debtor interests in Kansas-formed LLCs would further significantly hinder a judgment creditor in Kansas from attempting to collect its judgment from a debtor with interests in foreign LLCs. The judgment creditor would be forced to investigate where each LLC was formed and seek a charging order against the debtor's interest in

each of those states. The Court concludes that the Kansas legislature likely did not intend such a result, which could significantly hinder the ability of a judgment creditor to collect its judgments.

This result was the recommendation of the Magistrate Judge, which as mentioned above was adopted by the U.S. District Court and became its Order.

## ANALYSIS

As to the question of whether a court must have personal jurisdiction over the entity whose interests are charged to issue a charging order against the debtor's interests in that entity, we are now seeing a growing and fairly consistent body of law develop that reaches the conclusion that such jurisdiction is not needed -- the court need only have personal jurisdiction over the debtor.

Thus, folks who think that if they form an LLC in some faraway place that the creditor will have to go there to get the charging order, as opposed to just getting the charging order in the court that issued the judgment, they are very likely quite wrong.

As to the LLC vs. Foreign LLC issue that comes up in relation to Charging Orders, I strongly agree with Professor Carter Bishop and the U.S. District Court here on that point, and correspondingly believe that *Heather Apartments* and *Rockstone Capital* got the issue wrong.

It is quite likely that in future revisions of the so-called “Harmonized Acts”, i.e., the Uniform Partnership Act, the Uniform Limited Liability Company Act, and the Uniform Limited Liability Company Act, this drafting glitch will be corrected. In the meantime, however, it will probably result in more litigation that pits an arguably superficial statutory construction analysis against practical sense.

***Drafting LLC Agreements for Undesirable Outcomes: Sophisticated investor holds a “put right” but has no basis to challenge valuation on the units that are being “put.”***

By Philip Amoa  
McCarter & English, LLP  
Newark, New Jersey

A Delaware Court of Chancery opinion addresses a dispute arising from two sophisticated investors’ (“Walnut Investors”) challenge of the valuation methodology used in determining the fair market value of the Walnut Investors’ preferred units in PECO Logistics, LLC (“PECO Logistics”).

PECO Logistics is a Delaware LLC managed by a seven-person board. PECO Logistics’ sole asset was its equity interest in PECO Pallet Holdings, Inc., a provider of pallet rental services. PECO Pallet rents pallets to manufacturers who use the pallets to ship grocery products and consumer goods to retailers.

In March 2011, PECO Pallet was acquired. As part of the transaction, certain pre-acquisition stockholders of PECO Pallet, including the Walnut Investors, “rolled over” their existing shares into preferred units of PECO Logistics and became parties to the PECO Logistics, LLC Limited Liability Company Agreement dated as of March 14, 2011 (the “LLC Agreement”).

The LLC Agreement, which was governed by Delaware law, afforded the Walnut Investors a voluntary right to require PECO Logistics to purchase their preferred units (the “Put Units”) during a window of time commencing on the three-year anniversary of the LLC Agreement. Furthermore, the LLC Agreement provided that following written notice of the Put Right, PECO Logistics must engage a nationally recognized valuation firm to determine the fair market value of the Put Units, such determination to be binding on the holder of the Put Right.

The LLC Agreement did not contain any mechanism for judicial, arbitral or any other form of review of the valuation firm’s determination. Neither did it afford the Walnut Investors any right to participate in the selection of the valuation firm or in the valuation process itself after the valuation firm had been selected. (Assuming that both parties had similar

bargaining leverage, it may have been helpful to include language that granted the Walnut Investors the right together with PECO Logistics to appoint by mutual agreement a valuation firm.)

The Court held that the parties to the LLC Agreement unambiguously agreed to be bound by the determination of value that the valuation firm made in response to the Walnut Investors’ exercise of the Put Right, and thus that the Court was not free to second-guess the (admittedly reasonable) judgment calls the valuation firm made in applying the valuation methodology in the LLC Agreement to reach its determination. The Court further stated that the Walnut Investors did not challenge the independence of the valuation firm, nor did they allege any facts demonstrating that PECO Logistics took any action to taint or undermine the valuation process so as to sustain a claim for breach of the implied covenant of good faith and fair dealing.

The rationale for the Court’s ruling is captured in a rhetorical question that then-Chancellor Strine posed: “When parties contractually decide to have a qualified expert with relevant credentials make a determination of value without any indication that the expert’s judgment is subject to judicial review, on what basis would it make sense to infer that the parties intended to have a law-trained judge do a de novo review of the expert’s determination?”<sup>1</sup>

This opinion demonstrates Delaware’s continuing commitment to enforcing unambiguous contracts as written, especially between sophisticated parties.

<sup>1</sup>*Senior Housing Capital, LLC v. SHP Senior Housing Fund, LLC*, 2013 WL 1955012, at \*24 (Del. Ch. May 13, 2013).

**Choose Carefully: Dissolution vs. Dissociation Under RULLCA**

By Peter A. Mahler  
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The Revised Uniform Limited Liability Company Act (2006) or “RULLCA” continues to gain momentum as it spreads across the United States. Currently, fourteen states plus the District of Columbia have adopted RULLCA including California, Florida, and two of New York’s neighbors — New Jersey and Vermont. If and when adopted by Pennsylvania and Connecticut, where RULLCA legislation already has been introduced, New York will be surrounded by RULLCA jurisdictions with the exception of Massachusetts. RULLCA legislation also is pending in Illinois and South Carolina.

Of greatest interest to business divorce lawyers are (1) RULLCA’s relatively expansive grounds for judicial (involuntary) dissolution of LLCs including oppressive conduct by managers and authorizing remedies other than dissolution, i.e, buy-out, and (2) RULLCA’s provision, completely foreign to LLC laws in New York and elsewhere, authorizing judicial dissociation (expulsion) of a member under certain circumstances.

The two provisions have a lot in common. Indeed, there’s substantial overlap between the statutory grounds for dissolution and dissociation under RULLCA. A recent appellate ruling out of the District of Columbia provokes examination of the strategic choice to be made when initiating a business divorce litigation whether to pursue dissolution, dissociation, or both.

**RULLCA’s Dissolution and Dissociation Statutes**

LLC statutes in New York and many other non-RULLCA states provide as the sole ground for judicial dissolution that it “is not reasonably practicable to carry on the business in conformity with the articles of organization or operating agreement” — essentially mimicking the limited partnership law’s counterpart provision.

RULLCA’s drafters took a less cramped approach to judicial dissolution. While

preserving the not-reasonably-practicable standard from partnership law, they also imported as additional grounds for dissolution provisions drawn from statutes governing dissolution of close corporations including oppression and unlawful or fraudulent conduct. Thus RULLCA Section 701(a)(4) defines as an event of dissolution:

(4) on application by a member, the entry by [the appropriate court] of an order dissolving the company on the grounds that:

(A) the conduct of all or substantially all the company’s activities and affairs is unlawful;

(B) it is not reasonably practicable to carry on the company’s activities and affairs in conformity with the certificate of organization and the operating agreement; or

(C) the managers or those members in control of the company:

(i) have acted, are acting, or will act in a manner that is illegal or fraudulent; or

(ii) have acted or are acting in a manner that is oppressive and was, is, or will be directly harmful to the applicant  
. . . .

Importantly, Section 701(a)(5) gives the court the authority to “order a remedy other than dissolution” such as buyout in cases brought under Subsection (a)(4)(C) based on illegality, fraud, or oppression, although the official comment to the provision makes clear that it is a default rule that “can be overridden by the operating agreement” and that “the members may agree to restrict or eliminate a court’s power to craft a lesser remedy, even to the extent of confining the court (and themselves) to the all-or-nothing remedy of dissolution.”

Then there’s judicial dissociation of a member, the authorization for which is found in RULLCA

Section 602(6) providing that a person “is dissociated as a member when”

(6) on application by the limited liability company or a member in a direct action under Section 801, the person is expelled as a member by judicial order because the person:

(A) has engaged or is engaging in wrongful conduct that has affected adversely and materially, or will affect adversely and materially, the company’s activities and affairs;

(B) has committed willfully or persistently, or is committing willfully or persistently, a material breach of the operating agreement or a duty or obligation under Section 409; or

(C) has engaged or is engaging in conduct relating to the company’s activities and affairs which makes it not reasonably practicable to carry on the activities and affairs with the person as a member

Two of my prior posts (here and here) discussed a pair of New Jersey appellate decisions upholding member expulsion rulings under the no-fault standard found in that state’s version of Section 602(6)(C). The official comment to the provision, which is a default rule subject to modification or elimination in the operating agreement, cites other cases in which expulsion was ordered based on the member’s misconduct.

As mentioned above, any of the grounds for dissociation under RULLCA Section 602(6), on the right facts, can be re-shaped as grounds for judicial dissolution under RULLCA Section 701(a)(4) — and vice versa.

### **Reese v. Newman**

In a decision last month by the District of Columbia Court of Appeals in *Reese v. Newman*, No. 14-CV-283 [D.C. Ct. App. Feb. 11, 2016], the court affirmed the lower court’s post-trial order which opted to dissolve the subject

LLC rather than expel one of its two members, even though the jury verdict’s finding supported both remedies.

The case involves a falling out between the two owners of a construction management company, one of whom (Newman) filed an action for judicial dissolution under the D.C. Code’s analog to RULLCA Section 701(a)(4)(C) based on allegations of oppression, breach of fiduciary duty, and fraud. The other member (Reese) opposed dissolution and counterclaimed to expel Newman under the D.C. Code’s analog to RULLCA Section 602(6).

At trial, the jury was asked to make specific findings on the statutory grounds for dissolution based on Reese’s conduct, and for expulsion based on Newman’s conduct. The jury returned findings supporting both judicial dissolution and Newman’s dissociation. The trial judge opted to dissolve the LLC and not to expel Newman.

Reese appealed, arguing that the dissociation statute’s introductory clause (“a person shall be dissociated as a member from a limited liability company when . . .”) removes the trial court’s discretion and required it to expel Newman based on the jury’s findings. Reese also argued that the “compulsory” dissociation remedy trumps dissolution because of the dissolution statute’s provision, based on RULLCA Section 701(a)(5), authorizing the court to order a remedy other than dissolution.

The appellate panel disagreed, pronouncing that Reese’s “interpretation places a command on the trial judge that does not exist.” First, the court held that as a matter of statutory construction, the use of the word “shall” in the dissociation statute’s introductory clause “does not require the judge to expel the member if any of the enumerated conditions are established.” Rather, the statute means that “when a judge has used her discretion to expel a member of an LLC by judicial order, under any of the enumerated circumstances . . ., that member shall be dissociated” (*italics in original*).

Second, the court pointed out a similarly placed use of the word “shall” in the dissolution statute which also includes the provision authorizing alternate remedies based on RULLCA 701(a)(5). Said the court: “If that language does not make the rest of the section mandatory in the dissolution section, and we are persuaded that it

does not, it cannot be said that the 'shall' in the introduction of the dissociation section does the opposite."

Third, the court found solid support for its holding in the official comment to RULLCA Section 602(6), which states that "[w]here grounds exist for both dissociation and dissolution, a court has the discretion to choose between the alternatives." Were it otherwise, the court wrote, "when grounds for both dissolution and dissociation were present, dissolution would never be mandated by a court because dissociation of a member would always necessarily trump it."

Reese is one of the very few available court decisions addressing the interplay between RULLCA's dissolution and dissociation statutes. In that case one member sought dissolution and opposed dissociation; the other sought dissociation and opposed dissolution. But what about situations in RULLCA jurisdictions where one side has the option to proceed under both statutes seeking dissociation as an alternative to dissolution or vice versa?

It's not a far-fetched scenario, particularly in an LLC with two 50% co-managing members. Following Reese's logic, if the petitioning member establishes grounds both for dissolution and dissociation, he or she cannot then insist that the court only grant the petitioner's first-choice remedy. Petitioner's counsel clearly must give forethought to these vital strategic implications of the choice of remedy. The petitioner's strategic calculus arguably is made even more complex by the possibility under RULLCA that dissociation can be ordered as an "other remedy" available to the trial judge under Section 701(a)(5), also keeping in mind that the effect of dissociation under RULLCA Section 603 is not buy-out but to demote the dissociated member to non-voting, non-managing holder of an economic interest in the LLC.

### Pending Legislation

As many of you are already aware, there has been introduced to the legislature of the Cayman Islands a proposed LLC Act. This statute is unabashedly based upon the Delaware LLC Act. Be looking for its passage.

Still on the topic of our legislative proposals:

- Connecticut, Illinois, Pennsylvania and South Carolina have all introduced new LLC Acts into their legislatures. It is my understanding each of these statutes is based upon RULLCA. I am also told, but have not independently investigated, that the Connecticut proposal departs from RULLCA in that it does not provide for dissenter rights.
- ULPA has been introduced in Pennsylvania.
- RUPA, after a long drought of introductions, has been introduced in both Wisconsin and Pennsylvania.

Indiana has passed amendments to its LLC Act (officially the Indiana Business Flexibility Act) allowing for series. An LLC capable of creating series is referred to as a "Master LLC." The statute's effective date is January 1, 2017.

## **Textron & Charging Orders**

By Jay D. Adkisson  
Riser Adkisson LLP  
Las Vegas, Nevada

Textron Financial Corporation sued New Mexico resident Michael S. Gallegos in the U.S. District Court for Rhode Island for a loan made on a hotel deal gone bad. Textron was awarded a nearly \$22 million verdict, but apparently was only able to collect a little more than \$10,000.

Textron then assigned the judgments to SPE LO Holdings, and that company did some snooping around for Gallegos' assets, eventually obtaining documents from the California Secretary of State's office which indicated that Gallegos was at least the manager (it was unclear whether he was also a member) of two California entities: Pacific Pearls Hotel LLC and Pacific Pearl Management LLC.

SPE then filed a Motion for Charging Order in the U.S. District Court for the Central District of California against any interest that Gallegos had in the two LLCs. For those who don't know what a Charging Order is, the Court gave a nice, short summary as follows:

When there's a money judgment against an LLC member personally, but not against the LLC, the member's interest may be reached by a charging order. [] A charging order is a lien on the member's distributional interest. [] It only allows the judgment creditor to receive distributions to which the member would otherwise be entitled; it doesn't entitle the creditor to participate in the LLC's management or exercise the rights of a member. [] It thereby protects other members of an LLC from being forced to involuntarily share governance responsibilities with someone they did not choose, or from being forced to accept a creditor of another member as a co-manager. [internal citations and quotations omitted]

Here, SPE did not hire a process server to deliver a copy of the Motion to the two LLCs, but instead simply dropped a copy of the Motion in the mail.

For his part, Gallegos (but not the companies) opposed the Motion for Charging Order, and asserting basically three arguments:

(1) The California Secretary of State documents were not admissible;

(2) Personal service by a process server of the Motion for Charging Order was not made on the LLCs and therefore they were not a party to the Motion; and

(3) There is no proof that Gallegos was a member of the LLCs such that he had an interest that could be charged.

As the Court put it:

He doesn't contend that the Secretary of State records are inaccurate. Nor does he deny that he's a member of the LLCs. He just argues that SPE LO hasn't proved it.

Gallegos lost on his first argument, that the California Secretary of State documents were not admissible, largely because no witness from the Secretary of State's office authenticated them (i.e., they were "hearsay"). The Court rejected this argument, since as public records the Court could take judicial notice of the documents, and did.

Gallegos also lost on his second argument as well, which is that the notice of the Motion given to the two LLCs by mail was insufficient. The Court noted that personal service by a process server is not required, but notice by mail of the Motion was adequate to satisfy the requirements of California law. It was also wholly unnecessary to make the LLCs a party to the Motion for Charging Order.

This brings us to Gallegos last argument, which is that there was no proof that he was a member of the two LLCs.

On this point, the Court noted that prior California state court opinions require that a creditor present "substantial evidence" that the debtor has an interest in the LLC (or partnership) to be charged. But since the California Secretary of State documents only showed that Gallegos was a "manager" without

also clearly showing that he was a “member”, SPE failed on its burden of proof, and therefore its Motion would be denied.

However, “[t]o avoid the possibility that Gallegos has avoided entry of a charging order by playing coy”, the Court would allow SPE to conduct discovery on the issue and re-submit the Motion if it found that Gallegos also had a membership interest in the two LLCs in addition to being a manager.

## ANALYSIS

As to the last point, I think the Court made a reasonable decision based on the case law. However, I also think that this decision -- and the opinions which support it -- are wrong. Let me explain why.

In the post-judgment enforcement world, liens are commonly available to freeze a debtor's assets so that the debtor cannot dispose of those assets prior to collection (or, if the debtor does dispose of the asset, the transferee takes subject to the lien). Thus, post-judgment liens are almost always “blanket liens” -- liens which cover all the debtor's assets whether identified or not -- since the creditor usually doesn't know, at least initially, what assets the debtor has.

Thus, an Abstract of Title creates a lien on all the debtor's real property in the county, whether the debtor owns any property the county or not - it is not necessary for the creditor to list the properties subject to the abstract.

Similarly, in California the filing of a Form JL-1 (short for “judgment lien”) with the California Secretary of State's office has the effect of creating a lien on all the debtor's personal assets in California, whether the debtor has any personal assets in California or not (and other states have similar forms which have the same effect).

The service on the debtor of an Order to Appear for Examination (called an “OEX”) likewise creates a lien on all the debtor's personal assets wherever located, and this lien is at least binding on the debtor whether the debtor has any personal assets or not.

There is no good reason why the lien created by a Charging Order should not work the same way, i.e., it should operate to put a lien on the

debtor's interest in a partnership or LLC, whether that particular has been identified as being owned by the debtor or not.

Another way to look at this is that if the Charging Order is issued against an interest though (but not proven) to be owned by the debtor, but the debtor doesn't actually have such an interest, then the lien would not attach and it is a “no harm, no foul” result. A partnership or LLC that receives a Charging Order could safely ignore it if the debtor did not hold an interest in the entity -- just like any other post-judgment lien where a party holds no property of the debtor.

Indeed, there would seem to be nothing wrong with a Court entering a generic Charging Order which said something like “All interests of the debtor in any partnership or LLC are hereby charged with payment of the judgment,” and if that Charging Order picks up such an interest then great, but if not then against it is a “no harm, no foul” result.

Of course, the partnership or LLC has its own significant concerns, which is making distributions to the right party (i.e., the debtor/member or the creditor) without fear of being held in contempt. Thus, the way the law works now, a lien created by a Charging Order is not said to be perfected until service of the Charging Order is made upon the entity.

What you don't want to happen is for some creditor to simply bomb-out a gazillion copies of a Charging Order to every LLC and partnership out there, hoping that a net the size of an ocean will catch at least a minnow. We don't have to have every LLC and partnership in a given jurisdiction be burdened with checking their books to see if debtors have an interest in their companies, when there is utterly no reason to believe that they might, other than the insufficient believe of every creditor that a debtor must have assets *somewhere*.

Thus, as a practical matter, there has to be some standard of proof for a creditor seeking a Charging Order that a particular LLC or partnership does, in fact, have some connection to the debtor.

But I disagree that “substantial evidence” is the correct standard; probably “reasonable suspicion” is a much better standard for this purpose. Using a “reasonable suspicion”

standard would allow a creditor to target specific LLCs and partnerships in which the debtor *might* have an interest, without allow the debtor to dodge the Charging Order because the ownership was not proven from the start.

Applied to this case, that Gallegos was the manager of the two LLCs would lend itself to the reasonable suspicion that he was also a member, and thus would have allowed the Charging Order to be entered against any interests that he had in those two LLCs (and if he did not have an interest, then, again, it is a “no harm, no foul” situation).

Keep in mind that only the debtor knows what interests he holds, debtors frequently lie about their holdings, and it is extremely difficult because of privacy and other laws to determine the identity of members of an LLC or partnership. Allowing Charging Orders based on *reasonable suspicion* as opposed to *substantial evidence* would ultimately save both the creditor and target LLCs and partnership from the costs of formally propounding or responding to discovery regarding a debtor's possible interests in the latter.

This leads me to my next point, which relates to the correct party to a Motion for Charging Order and what defenses can be appropriately asserted by whom.

I've never been convinced that a debtor should have much more to say about a Motion for Charging Order, other than:

- (1) To contest the validity of the judgment, which will a total non-issue in 99.9% of such motions; and

- (2) To claim an applicable exemption under state law (for instance, to claim a “wildcard exemption” for \$10,000 or some amount which exists under some state's laws, or to claim that the distributions are really compensation subject to the 25% federal limitation on wage garnishment).

These are legitimate challenges that debtors should assert if they are entitled to them. But debtors will inevitably come in and complain

about everything under the sun to try to bamboozle the Court, even though most of their arguments are really those of the affected LLC or partnership. This wastes the time of the creditor and the courts, and while the courts are usually good at seeing through this nonsense, it would be better if they started putting their foot down to end such challenges.

Yes, it is the debtor who loses a revenue stream, but the debtor should have thought about that before he engaged in the conduct that gave rise to the judgment in the first place -- the civil version of *if you don't want to do the time, don't do the crime*. It is the LLC or partnership, however, which faces the practical challenges of complying with the Charging Order.

Note that the LLC or partnership does not have an iron in the fight; it has utterly no good reason to care who receives the distributions made to the debtor's interests. The only concern of the LLC or partnership is that it receive timely notice of the Charging Order so that the entity can direct distributions to the right place.

As a considerable number of courts have now held, it is not necessary that the LLC or partnership be made a party to the case in which a Charging Order is issued. Instead, it is only necessary for the LLC or partnership to be put on notice of the Motion, as in some states (such as California where this case arose), the mere filing of the Motion and service on the LLC or partnership (or its members) creates a temporary lien on the debtor's economic interest, *i.e.*, right to distributions. The subsequent granting of the Motion, and notice to the LLC or partnership that the Charging Order has been entered, makes that lien permanent until the judgment is satisfied.

Because the LLC or partnership only needs have notice of the Charging Order and its terms, delivery upon the LLC or partnership by mail is as good as any, and there is no technical requirement that a process server need be involved. However, I have always gone to the extra expense of having a process server deliver the Charging Order so that it is accomplished the same day, and to make it easier to get a contempt charge should the LLC or partnership fail to comply (as they sometimes do when controlled by the debtor).

It is worth noting here that a Charging Order is also binding upon the *debtor* as well as the LLC or partnership. Thus, if an LLC or partnership that is subject to a Charging Order makes a distribution to the debtor, then the debtor can be held in contempt of the Charging Order for failing to turn the proceeds over to the creditor. This can be important in situations where the debtor has a membership interest in a foreign LLC or partnership that is not subject to the contempt powers of a U.S. court, since the creditor can still effectively block distributions to the debtor by making the debtor turn over any such distributions to the creditor, or go sit in jail until he has done so.

Note that most Charging Orders usually have elaborate provisions to prevent a debtor from getting money out through the backdoor, by way of loans or management fees. Creditors may also chase distributions on what amounts to an "imputed income" theory, which keeps a debtor from having the LLC or partnership make an oversized distribution to his non-debtor spouse - this would also be a fraudulent transfer.

Finally, it is my own opinion that the procedure for the issuance of Charging Orders is deeply flawed. Most post-judgment orders do not require Court intervention, but instead the court clerk issues the Order and then the defendant or other affected person (such as an employer receiving a garnishment summons) has a short period of time to lodge objection upon receiving the Order.

There really is no compelling reason why this should not be the procedure for Charging Orders too. In the vast majority of cases, having a Motion for Charging Order unnecessarily increases the cost for the creditor, wastes the creditor's time, and squanders the limited resources of the Court. Most of the time, the LLC or partnership doesn't care, so the hearing on the Motion is limited to the debtor showing up and whining about how unfair it all is that he has to pay on his judgment.

Nobody needs that grief. Somebody please simplify the Charging Order procedure.

### **Charging Order Practice Manual**

At its February meeting, the BLS Publications Board approved going forward with the Charging Order Practice Manual that is to be co-authored by Jay Adkisson, Carter Bishop and Dan Kleinberger.

We already know that Jay, Carter and Dan are each themselves gurus as to the oft confusing charging order; combining them together in the crafting of this work will undoubtedly yield a cutting edge product.

## ***Less Drastic Measures: Maryland Case Highlights Non-Dissolution Remedies for Oppressed Minority Shareholders***

By Peter A. Mahler  
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“Capital punishment for the corporation.” That’s how the Maryland Court of Appeals — that state’s highest court — in *Bontempo v. Lares*, 444 Md. 344 [2015], recently referred to the remedy of judicial dissolution made available by statute in most states, including New York, to oppressed minority shareholders of closely held corporations.

I would not go so far as to suggest that our corporate jurisprudence is experiencing something akin to the growing anti-death penalty movement in our criminal jurisprudence, but the thoughtful majority opinion for the Maryland high court in *Bontempo* marks a heightened regard for the diverse interests at stake when considering an appropriate remedy for oppressive conduct by those in control of the corporation, and highlights the breadth of less drastic, alternative remedies available to trial courts.

*Bontempo* also merits attention at a more granular level for its discussion of the interplay and distinction between remedies available to an oppressed minority shareholder qua shareholder versus qua fired employee.

### **Background**

The case involves a Maryland corporation named Quotient, Inc. formed in 1999 by respondents Clark Lare and his wife Jodi to recruit information technology professionals for placement as consultants at government agencies and private employers. The following year, the petitioner David Bontempo joined the business in a “handshake deal” as a 45% shareholder responsible for sales and business development. Bontempo was made an officer and director but had no employment agreement.

In 2001, Bontempo formally subscribed to a pre-existing Stockholders Agreement between the Lares which included a provision requiring any shareholder whose employment was terminated “for good cause” to sell his or her shares to the corporation or to the remaining shareholders.

The same provision was included in a 2004 Amended and Restated Stockholders Agreement.

Quotient’s business grew and prospered due in large part to its success in obtaining federal government contracts. However, over a period of years the relationship between Bontempo and Clark Lare soured over money, hiring, and other issues, leading Lare to cut Bontempo’s salary in 2009. In March 2010, after failing to reach terms on a negotiated buyout of Bontempo’s shares, Lare fired Bontempo, later claiming that he did so for cause based on Bontempo’s poor job performance.

### **The Lower Court Proceedings**

Bontempo filed suit soon afterward under Maryland Code, Corporations & Associations § 3-413 which, like § 1104-a of New York’s Business Corporation Law, authorizes a minority shareholder of a close corporation to petition for judicial dissolution on grounds of “illegal, oppressive, or fraudulent” acts by the directors or those in control of the corporation. Bontempo’s complaint also asserted a direct claim against Quotient seeking damages for unpaid salary and distributions based on his status as both an employee and a shareholder. His complaint also asserted derivative claims against the Lares for breach of fiduciary duty and diversion of corporate funds for personal purposes. The Lares counterclaimed for a judgment declaring that Bontempo had been fired for good cause and thus was required to sell his stock to the company.

After a nine-day bench trial the trial judge ruled in Bontempo’s favor on his oppression claim, finding that he had a reasonable expectation of employment and participating in profit distributions and that he would not be terminated for subjective reasons. The trial court specifically found that Lare oppressed Bontempo by firing him for refusing to sell his shares.

The court nonetheless declined to order the drastic remedy of dissolution or to reinstate Bontempo’s employment, noting that the company’s business was “thriving” and that a lesser, more appropriate remedy was to order an accounting of the Lares’ personal use of Quotient funds for non-business purposes, together with an award of a portion of Bontempo’s legal fees and \$118,000 in unpaid

distributions. The court also denied Bontempo relief on his claim for unpaid salary, finding that at all times he was an at-will employee of the corporation. Finally, the trial court dismissed the Lares' counterclaim seeking to compel a stock sale, finding unsupported their contention that Bontempo had been fired for good cause.

Both sides appealed to the Maryland intermediate appellate court which affirmed all but one of the trial court's challenged rulings.

### **The Court of Appeals' Ruling**

The primary issue raised by Bontempo in his subsequent appeal to the Maryland high court was whether the lower courts erred by failing to order employment-related relief — e.g., reinstatement with an award of back pay and a salary into the future — as part of the relief for Lares' oppressive conduct. In affirming the lower courts' rulings, the Court of Appeals therefore discussed not only the at-will employment doctrine under Maryland law, but also the basis for finding oppression and the appropriate remedy once oppression is established.

Under Maryland common law, as in New York, there is a strong presumption that an employment relationship is at-will unless the parties contract otherwise by specifying a clear duration of employment or by spelling out reasons for termination, such as just cause. The Court of Appeals rejected Bontempo's argument that, as the court put it, essentially "leverage[d] the court's assessment of his expectations [of continued employment] for purposes of the dissolution remedy into an employment-related remedy for a non-existent employment contract." As the court further explained:

A "reasonable expectation" for purposes of the corporate dissolution statute is simply a way of detecting oppression, but it does not dictate the relief that an equity court is to grant. While Mr. Bontempo may have had a reasonable expectation of a future relationship with Quotient that included a connection to the corporation as an employee, officer, director, and shareholder, that is a far cry from an employment agreement

that entitles him to a specific employment-related relief — i.e., a specific position within the company with specific duties, pay, and conditions of employment. One might envision a situation in which a minority shareholder reasonably believed, upon committing capital to an entity, that one day he would advance to an executive position with the enterprise and in which, as a result of oppressive conduct of the majority shareholder, the minority shareholder has never been considered for any management position. A court acting under the authority of the corporate dissolution statute would be venturing far afield to order the company to hire the shareholder into a particular position with particular duties at a specified salary.

The high court also rejected Bontempo's argument that employment-related relief would be "equitable" because the Stockholders Agreement required a shareholder-employee terminated for good cause to sell his or her shares back to the company. Here's what the court said in that regard:

[T]he reference to a "for cause" termination in a forced sale provision of the [Stockholders Agreement] is quite different from an employment agreement. When an owner-employee's job with the company is terminated for cause, it indicates such a rift among those in control of the company that a forced buy-out would likely be necessary to oust the terminated employee of his shares and preserve the ability of the corporation to operate. The fact that a buy-out is mandated when one of the owner-employees is terminated for cause does not imply that an owner-employee may only be terminated for cause. It does

mean that the forced buy-out is not triggered if the owner-employee is not terminated for cause. In this case, in ruling on Quotient's counterclaim, the Circuit Court found that he was not terminated for cause and, accordingly, he was not required to sell his shares.

Were the lesser, monetary remedies for oppression granted Bontempo adequate? The two dissenting judges thought not, among other reasons, because they did not provide Bontempo protection going forward against the Lares' "continuing to funnel corporate earnings to their personal benefit."

Bontempo's seemingly single-minded pursuit of employment-related remedies including reinstatement, and his opposition to a compelled buy-out under the Stockholders Agreement, may have dissuaded him from seeking an all-out dissolution remedy as well as the more typical alternative remedy to dissolution, namely, a mandatory buy-out of the petitioner's shares for fair value. The Court of Appeals' opinion saw fit nonetheless to comment on the range of interests — not just those of the oppressed shareholder — to be taken into account when devising an equitable remedy:

A court acting under [the oppressed shareholder statute] to fashion a remedy less drastic than dissolution is not required to match its remedy to an expectation of the minority shareholder. (Indeed, the default remedy — dissolution — may bear no correlation to any expectation of a shareholder.) In particular, a court should take into account not only the reasonable expectations of the oppressed minority shareholder, but also the expectations and interests of others associated with the company. Inherent in the notion that a court of equity may devise a remedy other than the statutory remedy invoked by the minority shareholder is that there are other interests at stake besides those of the oppressed

or disaffected shareholder. The existence and operation of the corporation — an entity that is legally distinct from any of its owners — affects not only the complaining and controlling shareholders, but also many others who may be associated with or depend on the company — other shareholders, its management, employees, and customers. Dissolution — capital punishment for the corporation — affects those parties as well.

Finally, any discussion of Bontempo would be incomplete without mentioning the "non-exhaustive" list of "alternatives to dissolution that might be appropriate in a particular case" — including a buy-out for fair value — drawn from a 1973 decision by the Oregon Supreme Court in *Baker v. Commercial Body Builders, Inc.*:

(a) The entry of an order requiring dissolution of the corporation at a specified future date, to become effective only in the event that the stockholders fail to resolve their differences prior to that date;

(b) The appointment of a receiver, not for the purposes of dissolution, but to continue the operation of the corporation for the benefit of all the stockholders, both majority and minority, until differences are resolved or "oppressive" conduct ceases;

(c) The appointment of a "special fiscal agent" to report to the court relating to the continued operation of the corporation, as a protection to its minority stockholders, and the retention of jurisdiction of the case by the court for that purpose;

(d) The retention of jurisdiction of the case by the court for the protection of the minority stockholders without

appointment of a receiver or “special fiscal agent”;

(e) The ordering of an accounting by the majority in control of the corporation for funds alleged to have been misappropriated;

(f) The issuance of an injunction to prohibit continuing acts of “oppressive” conduct and which may include the reduction of salaries or bonus payments found to be unjustified or excessive;

(g) The ordering of affirmative relief by the required declaration of a dividend or a reduction and distribution of capital;

(h) The ordering of affirmative relief by the entry of an order requiring the corporation or a majority of its stockholders to purchase the stock of the minority stockholders at a price to be determined according to a specified formula or at a price determined by the court to be a fair and reasonable price;

(i) The ordering of affirmative relief by the entry of an order permitting minority stockholders to purchase additional stock under conditions specified by the court;

(j) An award of damages to minority stockholders as compensation for any injury suffered by them as the result of “oppressive” conduct by the majority in control of the corporation.

## **Spates**

By Jay D. Adkisson  
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Christopher Spates owed \$82,730.64 on his child support obligations to three different mothers, and the Child Support Division of the Texas Office of the Attorney General ("OAG") was trying to collect.

Spates was the sole owner and member of Prodigy Services, LLC. That company got into a dispute with another business, Eni U.S. Operating Company, and Prodigy ended up suing Eni in Harris County, Texas (where Houston is located).

The OAG got wind of the lawsuit, and filed liens in the Prodigy vs. Eni lawsuit to capture any proceeds that Prodigy might win. A week later, Prodigy and Eni settled, under the terms of which Eni was required to pay Prodigy \$257,500. Apparently worried about the OAG's liens, Eni asked the trial court to enter an order, which it did, allowing Eni to pay the \$257,500 into the court's registry.

The OAG then filed a request for a Charging Order against Spates's interest in Prodigy Services LLC, and requested that the Court disburse \$82,730.64 to the OAG to satisfy Spates's child support judgments. Over Prodigy's objections, the Court granted the OAG's request.

Prodigy then filed a Writ of Mandamus with the Texas Court of Appeals, seeking to have that court order the District Court to distribute all of the Eni settlement to Prodigy instead. The Court of Appeals agreed, and the District Court then ordered the \$257,500 paid to Prodigy.

But the very next day, the District Court entered the Charging Order requested by the OAG, in the amount \$94,376.54 (the amount to which Spates's child support obligation had grown in the interim), and directed that any funds that Prodigy distributed to Spates were to instead go to the OAG and the three mothers until the obligation was paid down.

Spates and Prodigy both appealed the Charging Order, contending that the District Court did not have jurisdiction to enter the Charging Order

(recalling that the case before the District Court was the Eni litigation, and Spates personally was not a party to that case). They also contended that the OAG was not entitled to a Charging Order because it did not serve Spates as the debtor with a notice of the request for Charging Order.

But the procedural sword cuts both ways, and since Spates was not a party to the underlying Eni litigation, he also lacked standing to appeal the District Court's order, and his appeal was dismissed on this ground at the outset. But Prodigy could still appeal, and the Court of Appeals took up its arguments.

First, the Court of Appeals had to address whether the Charging Order was even appealable as a final Order, holding that it was because it did finally resolve the rights of the OAG to Spates's distributions from Prodigy.

Prodigy argued that the District Court lacked personal jurisdiction over Spates, since he was not a party to the lawsuit, and subject matter jurisdiction since, the Eni litigation did not involve the OAG. In other words, Prodigy contended that the OAG should have sought the charging order in the family law court that was hearing the child support matter, not in the Eni litigation.

However, a Charging Order creates a lien on the debtor's interest in an LLC, and the OAG is empowered by Texas law to create liens on a debtor's assets to collect on a child support order. The only way to create such a child support lien on Spates's interest in Prodigy was by a Charging Order, and Texas law further allows the OAG to create liens (but not specifically Charging Order liens) in any court case where the debtor has any right to payment. Thus, it was appropriate that the District Court could enter the Charging Order against Spates's interest in Prodigy in the Eni litigation.

That left the issue of the District Court entering the Charging Order, even though Spates was not a party to the Eni litigation. But, it was not necessary that Spates be made a party for the trial court to have jurisdiction to enter the charging order. The Business Organizations Code does not require that the judgment debtor be made a party to an action in which a judgment creditor files an application for a charging order against the debtor's membership

interest in the limited liability company. Additionally, the charging order in this case is not directed to Spates and it imposes no obligations on him. Likewise, the charging order does not entitle the OAG to reach the proceeds of Prodigy's settlement with Eni or Prodigy's property to satisfy the OAG's three money judgments against Spates.

In other words, the Charging Order merely created a lien on Spates's distributional interest for an existing judgment, and so it was wholly unnecessary that he be joined as a party in the Eni litigation. This same reasoning also took care of Prodigy's procedural arguments, and the Court of Appeals thus affirmed the District Court.

## **ANALYSIS**

The curious question not answered by this case is why the OAG didn't get a Charging Order against Prodigy in the family law court, instead of the court that was hearing the Eni litigation. It sort of tortures logic to say that because Prodigy was getting a payment from Eni, that the OAG should be able to lien Spates's interest in that particular litigation.

Reading between the lines, always a dangerous thing to do, it seems that the Court was looking at Prodigy as essentially being Spates, since he was the sole owner of Prodigy, and then extrapolating that to allowing the OAG to assert its lien in the Eni litigation.

One can only wonder what would have been the result if, say, Spates had owned only a 1% in some investment hedge fund that was receiving settlement proceeds, i.e., he didn't own anything like a majority in the LLC nor control it.

Otherwise, this opinion once again emphasizes the lien nature of a Charging Order, and how lien law (in this case, family law liens) so closely interrelates with Charging Orders. If you are going to deal with Charging Orders, then you'd better understand liens pretty well generally, and if you are going to litigate Charging Orders, then you'd better understand the ramification of liens in a particular case.

Because with a Charging Order, that's what you end up with: A lien. Too many practitioners keep overlooking this very fundamental fact.

***Connecticut Court Applies the Law of a Purported Agent on Behalf of an Undisclosed Principal; the Agent is Liable on the Debt***

By Thomas E. Rutledge  
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In a recent decision from an appellate court in Connecticut, it applied the law of agency with respect to undisclosed principals and, finding there not been complete disclosure as to the principal, held the agent liable in the debt created. *Pelletier Mechanical Services, LLC v. G&W Management, Inc.*, No. 36993, 162 Conn. App. 294 (Jan. 12, 2016).

G&W Management, Inc., a property manager, had entered into contracts with Pelletier Mechanical Services, LLC with respect to repairs at various properties it managed, including responding to emergencies. Ultimately Pelletier would issue invoices to G&W for more than \$16,000. G&W asserted, in defense to liability of those invoices, that it was acting merely as an agent for the property owners, and in consequence that it had no liability on those debts.

Under the law of agency, when an agent acts on behalf of the principal, the agent is not liable on obligations to the third party. The condition for the application of this rule is that the agent disclose not only that there is a principal, but who is that principal. It is only with the knowledge of who is the principal that the third party is able to assess whether they are willing to extend credit with respect to the work performed.

G&W defended on the basis that it was known that it was a property management company. Ultimately, that was not sufficient. The Court of Appeals held, inter alia, that even if it was known by Pelletier that G&W was a property management company acting on behalf of the property managers, G&W had never disclosed who are the principals. Applying settled Connecticut law as well as comment (b) to section 6.02 of the Restatement (Third) of Agency, the court had little difficulty in finding G&W liable. Also, the Court reiterated the rule that it is the obligation of the agent to effect full disclosure to the third party; the third party does not have a duty of inquiry with respect to whether there is and who is the principal.

***Differential Under New York Law on Liability for Unpaid Wages***

The New York statute governing corporations has a well-known provision, Section 630, which imposes liability for unpaid wages, which can include for example vacation pay and unpaid employee trust fund taxes, upon the 10 largest shareholders of a New York corporation. The New York LLC Act, at Section 609, a provision approved at the very end of 2014, likewise provides for personal liability for unpaid wages upon the 10 largest members of a New York LLC.

Historically, in response to the application of Section 630 of the Business Corporation Code, it has been common for those organizing businesses that will have New York employees to organize in another jurisdiction such as Delaware. Such a foreign corporation would not, by its terms, be subject to Section 630. In response to this arbitrage, last year Section 630 was amended to apply to foreign corporations with employees in New York. In consequence, organization of a corporation that will have New York employees outside of New York no longer provides a shield from liability for unpaid wages.

There continues to exist, however, a differential with respect to LLCs. Section 609 of the New York LLC Act does not apply to LLCs organized outside of New York. A proposal considered in 2015 to extend Section 609 of the LLC Act to foreign LLCs has not (to date) been approved.

## ***Dissociated LLC Member Faces “Equitable” Forced Buy-Out***

By Peter A. Mahler  
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When it comes to LLC jurisprudence, equity’s on a roll.

A few major examples come to mind: the recent Carlisle case in which the Delaware Court of Chancery enforced “equitable dissolution” of an LLC upon the petition of the assignee of a membership interest who lacked standing under the dissolution statute; the Mizrahi case in which a New York appellate panel ordered an “equitable buy-out” of a 50% LLC member upon petition by the other 50% member in the absence of a statutory buy-out remedy; the Gottlieb decision in which another New York appellate panel gave birth to common-law “equitable accounting” claims.

Add to the growing list of equity-driven rulings for these contract-centric creatures of statute an unpublished decision last week by a New Jersey intermediate appellate court in *All Saints University of Medicine Aruba v. Chilana*, No. A-2425-13T1 [N.J. Super. Ct. App. Div. Oct. 27, 2015], directing the lower court on remand to consider ordering a forced sale of a dissociated LLC member’s interest as a “common law equitable remedy” for “common law breaches of duty” notwithstanding the appellate court’s recognition that neither the applicable dissociation statute nor the LLC’s operating agreement authorized a compulsory sale.

This is All Saints’ second round-trip to the Appellate Division. I wrote about the first appeal in a post entitled “But I Did Nothing Wrong!” No Defense to Involuntary Dissociation of LLC Member in which I told the woeful tale of a start-up Caribbean medical school organized as a New Jersey LLC on the fringes of financial failure due to dissension between two 53% and 47% membership factions laboring under an operating agreement that required unanimous approval of all management decisions. The appellate court on that occasion upheld the trial court’s decision dissociating the 53% faction under the statute’s provision authorizing dissociation when a member engages in conduct “which makes it not reasonably

practicable to carry on the business with the member as a member of the limited liability company.”

The underlying reason for dissociation was the member’s refusal to contribute cash to keep the financially troubled school afloat, requiring the 47% member to bail it out with a \$350,000 loan. The trial court also found that the dissociated member “acted recklessly and purposefully to undermine the interests of the LLC, and the medical school” by various acts including “causing and perpetuating its financial deadlock.”

Due to uncertainty whether the parties had previously stipulated to a buy-out in the event of dissociation from the LLC (which the trial court also determined had a zero fair value), the appellate court remanded the case for further proceedings to determine whether the dissociated member wished to have the court consider whether he could withdraw from the stipulation and retain his non-managing, non-voting, economic interest.

In my prior post, I noted that the outcome was not

an entirely happy outcome for the prevailing 47% faction which, if the dissociated member chooses [to remain a passive investor], may be hobbled in any future efforts to raise capital or obtain debt financing for the school’s operations and growth, and whose strategic business plan may be influenced by the built-in disincentive provided by the ongoing economic interest of the dissociated member.

Apparently the 47% faction saw it the same way, because on remand they fought to enforce the stipulation and the zero-dollar buy-out. The trial judge, however, found the stipulation inoperative and also concluded that the 47% faction’s alternative argument — that the court should order a forced buy-out as an equitable remedy for the dissociated member’s breach of his common law duties as previously found by the court — was outside the appellate court’s

remand mandate. This time, the 47% members appealed.

Successfully, as it turned out. In its ruling last week, the appellate court explained that “[n]ow that it is established that the parties did not stipulate to a buyout on dissociation, the case must be remanded to allow the judge to consider the question of remedy anew,” adding,

To do otherwise would prevent the trial court from considering a remedy for the breaches of [the dissociated member’s] fiduciary duties and duty of loyalty, thus running afoul of “the maxim lying at the foundation of equitable jurisprudence, that equity ‘will not suffer a wrong without a remedy.’” [Citation omitted.]

In reaching its conclusion, the court rejected the dissociated member’s arguments that the LLC’s operating agreement prohibited a forced sale. It also reasoned that, while the dissociation statute “does not compel the sale of the shares of a dissociated member,” at the same time “we see no reason to conclude that it precluded such a remedy for a member’s breach of his fiduciary duties and duty of loyalty as occurred here.” Absent a compulsory buy-out remedy, the court further observed, the prevailing 47% members likely “would have preferred [a judicial dissolution] remedy to the one entered on remand, which removed the [dissociated member] from management in [the LLC] but left him the ongoing economic benefit of his interest.” Summing up, the court wrote:

Given the circumstances of this case, namely that [the prevailing members] infused in excess of \$350,000 during the pendency of the litigation without which [the medical school] would not have survived, that the trial court found, and we affirmed, that there was no proven value of [the LLC] as of the valuation date and that it would require an infusion of an additional \$550,000 to sustain [the medical

school] before it would realize a profit, equity demands that the trial court not be precluded from considering a non-statutory remedy that terminates [the dissociated member’s] interest on dissociation in addition to removing him from management. . . .

Accordingly, we remand for the limited purpose of allowing the trial court to consider anew the remedy for [the dissociated member’s] breaches of his fiduciary duties and duty of loyalty, including leave to consider whether [his] wrongful conduct warrants a forced buyout, an issue on which we express no opinion.

Anyone want to lay odds that, after the next decision by the trial court on the second remand, we’ll see a third trip to the Appellate Division?

The dissociation statute at issue in All Saints predates New Jersey’s recent adoption of the Revised Uniform LLC Act. The new Act also contains provision for judicial dissociation, now augmented by express authorization to “order the sale of the interests held by such person immediately before dissociation to either the company or to any other persons who are parties to the action if the court determines, in its discretion, that such an order . . . would be fair and equitable to all parties under all of the circumstances of the case.”

Interestingly, the forced-sale remedy now embedded in the New Jersey statute is not found in the Revised Uniform LLC Act (2006) as promulgated by the National Conference of Commissioners on Uniform State Laws. In many if not most states, New York included, the LLC laws omit any judicial dissociation remedy, much less the double-barreled remedy of dissociation and forced sale, thereby making such outcomes dependent on their presence or omission in the operating agreement or perhaps, for argument’s sake, unless a judge decides that equity requires otherwise.

## **Metzner**

By Jay D. Adkisson  
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Dad was a debtor and owned 49% LLC (Mom owned 49%, and Son owned the other 2%). Creditor first moved to reverse veil-pierce the LLC, and the Court denied this request.

Creditor then obtained a Charging Order against Dad's 49% interest in the LLC. Then, Dad dies.

Creditor claimed that when Dad died, the LLC dissolved and the 49% of the assets should have been distributed to Creditor as holder of the Charging Order. A dispute ensued as to whether LLC dissolved, and whether an election to keep the LLC alive was made timely, or was backdated.

To short-circuit the case and avoid the backdating issue, Dad's Estate, Mom, Son and the LLC all moved for summary judgment, claiming that in the interim the judgment had expired, and had not been revived by the Creditor.

In opposition, the Creditor argued something to the effect that since the Charging Order was put in place before the judgment expired, the Charging Order is still valid. This argument was based on a peculiarity of Delaware law, which basically says that a creditor cannot enforce a judgment after five years of its issuance, unless the creditors goes to court and obtains permission to enforce that judgment through what is known as a Writ of Scire Facias (what would be known in many states as a Motion to Show Cause). But that is different from the judgment expiring, and in Delaware judgments do not expire, they are just presumed to have been paid after 20 years, and of course a creditor can rebut that presumption.

The Master appointed by the Court of Chancery ruled that the Charging Order was still valid because it was issued within five years of the Judgment, and Summary Judgment was denied on that issue. The Master then instructed the parties to get on with discovery of the alleged backdating issue.

## **ANALYSIS**

While this opinion does not get to this issue, it does bring up the novel question of whether a Charging Order would survive an expired judgment. The so-called Harmonized Acts (the Uniform Partnership Act, the Uniform Limited Partnership Act, and the Uniform Limited Liability Company Act, and all their revisions) do not speak to the issue, and thus we are left to look to local Enforcement of Judgment Laws (EJLs) for guidance. This of course means that the outcome may vary from state-to-state.

In general, a Charging Order effectuates a lien on the debtor's economic rights a/k/a right to distributions. A Charging Order lien should probably be considered in the nature of a "judgment lien", and judgment liens typically evaporate when the underlying judgment expires. *U.S. Mortgage v. Laubach*, 73 P.3d 887 (Okla., 2003). Thus, if a Creditor allows the judgment to expire, the Charging Order lien will presumably expire with it.

The point is that a creditor seeking to collect against a debtor's interest must keep the underlying judgment from expiring, and not simply rely upon the Charging Order lien to collect.

Note that such is not what happened in this case, since under Delaware law a judgment never expires, but many states do have 5- or 10-year periods within which a judgment must be renewed or it forever expires.

## POTENTIAL PROBLEMS WITH THE LLP STRUCTURE FOR PROFESSIONAL FIRMS

Thomas E. Rutledge  
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There is a case currently pending before the New Jersey Supreme Court, that, in concert with some earlier decisions, identifies particular problems with using the LLP format for professional firms. Knowing that many of your respective firms are organized as LLPs, I wanted to pass this information along to you.

By way of background, an LLP is first a general partnership that makes a special election for LLP status, thereby achieving limited liability for the partners. Many states, including New Jersey and Kentucky, require that, in order for a law firm to elect LLP status, they must have in place malpractice insurance or similar protections for clients.<sup>1</sup> Most if not all states have similar requirements. The rules as to the maintenance of malpractice insurance are, however, generally silent as to the consequences when that requirement is not satisfied.

Currently pending before the New Jersey Supreme Court is *Mortgage Grader Inc. v. Ward & Olivo*, a case squarely presenting the question of what happens when malpractice insurance is not maintained. Oral argument was held on February 1.

This dispute involves an allegation of malpractice by Mortgage Grader arising out of allegedly deficient advice delivered by Olivo; there is no allegation that Ward had any involvement with the file. After the (allegedly) deficient advice was rendered: (a) Ward withdrew from the firm; (b) the firm proceeded to wind-up its affairs; and (c) the firm allowed its malpractice coverage to lapse. That process commenced in June 2011; the malpractice insurance lapsed in August, 2011.<sup>2</sup> It was not

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<sup>1</sup> In New Jersey, that is Rule 1:21-1C, *Limited Liability Partnerships for the Practice of Law*. The Kentucky rule is set forth at SCR 3.022, *Forms of Practice of Law*, and SCR 3.024, *Requirements of Practicing Law in Limited Liability Entities*.

<sup>2</sup> See *Mortgage Grader, Inc. v. Ward & Olivo, LLP*, 438 N.J. Super. 202, 206; 102 A.3d 1226, 1228 (N.J. Super. Ct. 2014).

until October, 2012 that Mortgage Grader filed its complaint.<sup>3</sup>

Ward, in addition to defending on a procedural basis, sought dismissal on the basis that he was a partner in an LLP and thereby shielded from personal exposure on partnership obligations.<sup>4</sup> The trial court rejected that assertion, finding that Ward & Olivo had continued collecting fees even as it allowed its malpractice coverage to lapse. From there, applying Rule 1:21-1C(a)(3), the trial court observed that “[t]he condition precedent to attorneys operating as an LLP is [maintaining] malpractice insurance.”<sup>5</sup> The firm having been still operating as it collected fees but allowing its malpractice coverage to lapse, the trial court held that Ward & Olivo reverted to a general partnership and that Ward lost the benefit of an LLP election.

The Appellate Division would reverse that determination, finding, (a) the N.J. Partnership Act did not impose the loss of limited liability as a consequence of the failure to have insurance; and (b) likewise the New Jersey Supreme Court, in adopting Rule 1:21-C(a)(3), did not impose a similar consequence. As to the first point:

The Legislature has been aware of Rule 1:21-1C since 1996. The Legislature has decided not to amend the UPA to require an LLP to revert to GP status as a sanction for failing to purchase a tail insurance policy when attorneys practice as an LLP. Therefore, our interpretation of the available sanctions is supported by a long period of legislative acquiescence by failing to amend the UPA.

Thus, if attorneys practice as an LLP, and the LLP fails to maintain malpractice insurance as required by the court rules, then the Supreme Court may terminate or suspend the LLP’s right to practice law or otherwise

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<sup>3</sup> *Id.*

<sup>4</sup> 438 N.J. Super. at 207; 102 A.3d at 1228.

<sup>5</sup> 438 N.J. Super. at 208; 102 A.3d at 1229.

discipline it. As currently written, however, the court rules do not authorize a trial court to sanction a partner of an LLP for practicing law as an LLP without the required professional liability insurance by converting an otherwise properly organized LLP into a GP.<sup>6</sup>

As to the second point:

Our Supreme Court has chosen to discipline attorneys without malpractice insurance that are organized as professional corporations, rather than dissolve their corporate structure. See, e.g., *In re Aponte*, 215 N.J. 298, 298–99, 72 A.3d 243 (2013) (censuring an attorney for failing to maintain liability insurance while practicing as a professional corporation in violation of R. 1:21–1A(a)(3)); *In re Muldoon*, 213 N.J. 79, 61 A.3d 145 (2013) (same); see also *In re Tiffany*, 217 N.J. 519, 520, 90 A.3d 1254 (2014) (disbarring an attorney for, among other things, violating the rule requiring professional corporations to file a certificate of insurance with the Clerk of the Supreme Court).<sup>7</sup>

From there this appeal to the New Jersey Supreme Court was filed. Based upon published summaries of the oral argument, counsel for Ward argued that the LLP had insurance in place while it was practicing law (and not merely collecting accounts receivable), and that a change in the law requiring tail coverage could be applied only prospectively. Counsel for Mortgage Grader asserted that failure to have insurance in place effects the loss of the benefits of LLP statutes.

One potentially disturbing aspect of the language used by the Appellate Division and in

<sup>6</sup> 438 N.J. Super. at 211-12; 102 A.3d at 1231 (citation omitted).

<sup>7</sup> 438 N.J. Super. at 212; 102 A.3d at 1231.

the oral argument is the notion that the loss of LLP status and the treatment of the firm as a general partnership is some sort of “conversion”. That characterization is at least a misnomer. An LLP is a general partnership that has elected into a special status – it is still a general partnership but for the rule of partner limited liability.<sup>8</sup>

This decision follows on at least three other cases where courts have had to consider the effect of no longer being an LLP.

In *Apcar Inv. Partners VI, Ltd. v. Gaus*,<sup>9</sup> a partner was held personally liable on a lease executed by the partnership in its LLP name three years after failure to renew its initial LLP registration. The court rejected a “substantial compliance” argument based on the clear language of the LLP statute.

*Evanston Ins. Co. v. Dillard Dep’t Stores, Inc.*,<sup>10</sup> involved a claim of trademark infringement by a law firm that had been an LLP. After the firm dissolved and allowed its LLP election to terminate, the judgment against the firm was entered. In response to the argument that the operative conduct took place while the firm was an LLP, and therefore that limited liability should apply, the court would rule that the debt was not incurred until the judgment against the partnership was entered, at which time the LLP registration had expired, and the partners thus were not protected from liability.<sup>11</sup> While certain states including Delaware,<sup>12</sup> Kentucky<sup>13</sup> and Texas<sup>14</sup> have amended their respective statutes in order to at least minimize

<sup>8</sup> See, e.g., RUPA § 201(b), 6 (pt. 1) U.L.A. 91 (2001).

<sup>9</sup> 161 S.W.3d 137 (Tex. App.-Eastland 2005, no pet.).

<sup>10</sup> 602 F.3d 610, 616 (5th Cir. 2010).

<sup>11</sup> See also generally Elizabeth S. Miller, *The Perils and Pitfalls of Practicing Law in a Texas Limited Liability Partnership*, 42 TEXAS TECH. L. REV. 570, 571-75 (2011).

<sup>12</sup> DEL. CODE ANN. § 15-306(c).

<sup>13</sup> KY. REV. STAT. ANN. § 362.1-306(3) was in 2012 amended to read as follows:

(3) An obligation of a partnership **arising out of or related to circumstances or events occurring or** incurred while the partnership is a limited liability partnership, **whether arising in contract, tort, or otherwise, is solely the obligation of the partnership.** ....

<sup>14</sup> TEXAS BUS. ORG. CODE § 152.801(c).

the impact of the *Evanston* decision by defining when a liability is deemed to have accrued,<sup>15</sup> it must be assumed that facts will arise in the future that will not be addressed by those amendments. Further, if a particular LLP is not organized in a state that has made a similar amendment, the *Evanston* rule could be applied.

In *Edward B. Elmer, M.D., P.A. v. Santa Fe Properties, Inc.*,<sup>16</sup> the court concluded that an LLP's failure to carry the required insurance rendered the liability shield ineffective even though the liability in issue stemmed from breach of a lease and thus was not the type of liability that would have been covered by the insurance. The plaintiff sued the partnership and its two partners for breach of a commercial lease. The plaintiff obtained a judgment against the partnership, and that judgment was severed and became final. After the plaintiff was not able to collect the judgment from the partnership, the plaintiff obtained a summary judgment against one of the partners. The partner appealed arguing that the plaintiff's suit against the partner was barred because the plaintiff initially obtained judgment against the partnership alleging it was an LLP. The court held that the partner was not protected from individual liability because the partnership was not a properly registered limited liability partnership under the Texas Revised Partnership Act at the time it incurred the lease obligations. The Texas LLP provisions required that an LLP carry insurance or meet certain financial responsibility requirements. The court noted that, unlike the limited partnership statute, the LLP provisions contain no substantial compliance language. Therefore, the court concluded that strict compliance with the statute is required. Although the partner itself carried errors and omissions insurance, the court pointed out that the policy did not appear to cover the partnership or the other partner. Because the partnership did not have the required insurance or other forms of financial responsibility designated by the statute, it was not a properly registered LLP,<sup>17</sup> and the partner was not protected from liability.

<sup>15</sup> It is quite possible that other states have made amendments with a similar aim; I have not undertaken a review of all of the state acts as to this point.

<sup>16</sup> 2006 WL 3612359 (Tex. App.—San Antonio 2006, no pet.).

<sup>17</sup> This summary is taken from Elizabeth S. Miller, *Owner Liability Protection and Piercing the Veil of Texas Business Entities*, Nov. 5, 2012 at 33, available at [http://www.baylor.edu/content/services/document.php/18792\\_2.pdf](http://www.baylor.edu/content/services/document.php/18792_2.pdf)

The Mortgage Grader case seems tailor-made by a malicious law professor. Initially, it requires either reconciliation or ranking of business organization and professional regulation law. Are they to be treated, particularly in the context of law firms, as being equal magisterium entitled to equal deference or, in the alternative, must (presumably) professional regulation control over generally applicable entity law.

At the same time, there must be considered the legitimate concerns of both those who are leaving a firm (irrespective of whether it is continuing or not) and of clients. An attorney leaving a firm, particularly one that is continuing, has little bargaining position with respect to its ongoing operations including the maintenance of a valid LLP election and the maintenance of required insurance. Depriving those partners, ex post departure, of the benefits of the LLP election has every appearance of unfairness. Altering the facts slightly, in the context of a firm that is dissolving, all of the partners have an incentive to ensure that they remain protected from liability with respect to actions undertaken during the partnership's active existence. This differential may justify a differential in treatment of a withdrawing partner (or partners) from a firm otherwise continuing versus a firm that is dissolving.

There must as well be considered the claims of clients who have meritorious complaints for malpractice. The professional regulatory rules that impose the malpractice insurance requirement as a condition precedent to LLP election are intended to preclude attorneys from practicing through an entity shell that would in effect be abandoned in the case of a malpractice claim, leaving the client with only its few assets and a judgment against the attorney who was directly engaged in the malpractice. Where that outcome does come to pass, a policy argument may be made that the benefits of the LLP election should be lost. To those who would assert that professional discipline delivered by a state Supreme Court, and not the loss of limited liability, should be the remedy when the required malpractice insurance is not maintained, at least two questions arise. First, what would be the effective discipline other than the Supreme Court directing that the liability shield be waived; a public reprimand to the attorney or attorneys

who failed to maintain the malpractice coverage does nothing to benefit the client who bears the consequence of attorney malpractice. This futility is even more obvious when, as is the case of Ward & Olivo, the firm has dissolved.

The maintenance of insurance coverage can be expensive, and there is a legitimate question as to how long any firm should have to bear that burden. While, with respect to a personal injury firm that cycles its clients in and out relatively quickly, and there is a short statute of limitations/statute of repose with respect to the bringing of the malpractice claim, tail coverage may be affordable. But what about a law firm that engages in sophisticated estate planning? The problems with the documents they create may not be discovered for decades until, as they say, the will matures. Can, and more, importantly should the rules with respect to the maintenance of malpractice coverage apply conceivably 20 or 30 years after the dissolution of the firm at which the lawyer who drafted that will was practicing?

At this juncture I am only seeking to identify competing issues and interests. The ultimate determination as to which shall prevail is well above my pay grade.

There are at least two “take aways” from these cases, namely:

- ▶ the “contingent” nature of the limited liability shield provided by the LLP election should be a factor in the choice of entity calculus; and

- ▶ persons departing a professional firm organized as an LLP need to consider the potential lingering exposure should the firm either:

- (i) continue but fail to maintain both a valid LLP election and required insurance; or

- (ii) dissolve and not maintain in place both an LLP election and tail insurance for a period sufficient to address potential claims that arguably accrued during their tenure at the firm.

## Restricting Amendment of a Debtor's LLC Operating Agreement

By Allen Benson & Stephen L. Sepinuck

The 2013 amendments to the Revised Uniform Limited Liability Company Act ("RULLCA") added a provision that transactional attorneys for secured lenders might wish to exploit. Specifically, § 107(a) now provides:

An operating agreement may specify that its amendment requires the approval of a person that is not a party to the agreement . . . . An amendment is ineffective if its adoption does not include the required approval.

At least a dozen jurisdictions have enacted this rule and Delaware has something similar.<sup>1</sup>

Using this provision, a prospective lender might require the members of a limited liability company that seeks to borrow funds to amend the operating agreement to: (i) prohibit acts that might interfere with the perfection or priority of the lender's security interest; and (ii) require the lender's consent to any future amendment of these provisions of the operating agreement.

Unfortunately, the efficacy of this tactic is subject to some question. The remainder of this article explores whether this tactic works by focusing on three different restrictions:

- a prohibition on a name change;
- a prohibition on a relocation or merger;
- a prohibition on the grant of a security interest to anyone else.<sup>2</sup>

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<sup>1</sup> See, e.g., Cal. Corp. Code § 17701.12(a); Del. Code Ann. Tit. 6, § 18-302(e); D.C. Code § 29-801.09(a); Fla. Stat. § 605.0107(1); Idaho Code § 30-25-107(a); Iowa Code § 489.112(1); Minn. Stat. § 322C.0112(1); Neb. Rev. St. § 21-112(a); N.J. Stat. § 42:2C-13(a); N.D. Cent. Code § 10-32.1-15(1); Utah Code § 48-3a-114(1); Vt. Stat. tit. 11, § 4003(k); Wyo. Stat. § 17-29-112(a).

<sup>2</sup> The authority granted by § 107(a) might also be useful in other ways, such as preventing a significant change in the company's business. *E.g.*, *Overhoff v. Scarp, Inc.*, 812 N.Y.S.2d 809 (N.Y. Sup. Ct. 2005) (the company's sale of assets and termination of employees was null and void because the action was not, as the operating agreement required, approved by all members).

## Prohibition on Name Change

Section 9-507(c) of the Uniform Commercial Code provides that a filed financing statement which becomes seriously misleading as a result of a change in the debtor's name is not effective to perfect a security interest in collateral acquired more than four months after the name change.<sup>3</sup> As a result, lenders with a security interest in collateral that turns over frequently – such as inventory or accounts – must regularly check to see if the debtor's name has changed. If so, the lender must file an amendment to the financing statement.

At first glance, RULLCA § 107(a) appears to offer lenders a way to avoid the hassle and cost of monitoring the debtor's name by making the creditor's consent necessary for a change in the debtor's name. However, it is unlikely that a term in an LLC operating agreement requiring the lender's consent to a name change would be effective.

Under Article 9, the name of a registered organization, such as an LLC, is the name "stated to be the registered organization's name on the public organic record" most recently filed with or issued by the registered organization's jurisdiction of organization.<sup>4</sup> Article 9 then defines "public organic record" as a record available to the public for inspection and "filed with or issued by a State . . . to form or organize an organization . . . [or] amend[] or restate[] the initial record."<sup>5</sup> An operating agreement neither forms the LLC nor is it generally filed with the state. In most states, a certificate of formation or an amended certificate of formation, is the public organic record for an LLC.

Thus, § 107(a), which deals with amendments to the operating agreement, would not seem relevant to a change in a company's name. This should be so even if the company's operating agreement specifies the company's name and purports to require the lender's consent to any change of that name. Put simply, for the purposes of Article 9, if an

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<sup>3</sup> U.C.C. § 9-507(c). This rule would not apply if the new collateral were proceeds of other collateral in which the security was perfected. See U.C.C. § 9-315(c), (d).

<sup>4</sup> U.C.C. § 9-503(a)(1).

<sup>5</sup> U.C.C. § 9-102(a)(68)(A).

authorized representative files an amended certificate of formation changing the company's name, the name is changed regardless of what the operating agreement states; the absence of the lender's consent to the change would not and could not prevent the change from occurring.<sup>6</sup>

### ***Prohibition on a Relocation or Merger***

To perfect a security interest in most types of collateral, Article 9 requires that a financing statement be filed in the jurisdiction where the debtor is located.<sup>7</sup> If the debtor later moves to a different jurisdiction, a secured party generally has four months to file in the new jurisdiction in order for its security interest to remain perfected.<sup>8</sup>

Until recently, it was difficult for an LLC or other registered organization to move to a different state. That was because, for the purposes of Article 9, a registered organization is deemed to be located in the state under whose law it is organized.<sup>9</sup> It does not matter where the company's business is conducted, where its chief executive office is located, or where its members are located. For the purposes of perfection of a security interest, a limited liability company or other registered organization is located in the jurisdiction under whose law it is organized. While a limited liability company or other registered organization could "reincorporate" in a different state – that is, the members could form a new entity in a different state and cause the two entities to merge, with the new entity as the survivor – the law generally, and Article 9 in particular, treated such a merger not as a relocation, but as a transfer of assets from the original debtor to a new debtor.<sup>10</sup>

RULLCA, however, permits a limited liability company organized in one state to "domesticate" into a different state, and treats

the surviving entity as the original entity, not as a transferee.<sup>11</sup> It also permits the merger of domestic and foreign limited liability companies, and seems to treat the survivor as a continuation of the merged companies.<sup>12</sup> As a result, a secured lender to a limited liability company must either periodically check to see if the debtor has relocated or accept the risk that its security interest might become unperfected. A lender that could effectively prevent the debtor from relocating to a new jurisdiction could avoid this burden and risk.<sup>13</sup>

An operating agreement that prohibited domestication or interstate merger without the lender's prior written consent would seem to prevent the domestication or merger from occurring, and thus allow the lender not to have to monitor for such actions. However, it is not clear that a domestication or merger constitutes or requires an amendment to the operating agreement, so it is not clear that § 107(a) would be applicable at all.<sup>14</sup> Even if § 107(a) does apply, another provision of RULLCA makes it even less certain that the lender's refusal to consent would prevent the domestication or merger from occurring.

Section § 107(d), adopted in most of the states that have enacted § 107(a),<sup>15</sup> provides:

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<sup>11</sup> See RULLCA § 1056(a)(1)(B), (2) (the domesticated entity is the same as the domesticating entity and "all property of the domesticating entity continues to be vested in the domesticated entity without transfer, reversion, or impairment"). See also Del. Code. tit 6, § 18-214(f), (g).

<sup>12</sup> See RULLCA § 1026(a)(3) ("all property of each merging entity vests in the surviving entity without transfer, reversion, or impairment"). RULLCA also permits a corporation organized under one state's law to convert to a limited liability company organized under a different state's law, and treats the surviving entity as the original entity. See § 1046(a)(2) ("all property of the converting entity continues to be vested in the converted entity without transfer, reversion, or impairment").

<sup>13</sup> If the survivor of a domestication or an interstate merger or conversion is treated as a transferee, a secured party perfected by filing would have one year to file a financing statement in the new state with respect to collateral owned by the original debtor prior to the move, see U.C.C. § 9-316(a)(3), and four months to file in the new state with respect to collateral acquired by the new debtor after the merger, see U.C.C. § 9-316(i). Consequently, the monitoring burden would be about the same.

<sup>14</sup> Moreover, the rules on domestication and merger contain no cross-reference to § 107 or other suggestion that the consent of anyone other than the members is needed. See §§ 1023, 1053.

<sup>15</sup> See, e.g., Cal. Corp. Code § 17701.12(d); D.C. Code § 29-801.09(d); Fla. Stat. § 605.0107(4); Idaho Code § 30-25-

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<sup>6</sup> Section 302 of RULLCA, drawn from § 303 of the Revised Uniform Partnership Act (1997), allows an LLC to file a statement limiting the authority of specified persons or company office holders. However, this provision is principally concerned with real estate records, and would, in any event, not prevent someone from filing – or the filing office from accepting – an amended certificate of formation. See RULLCA § 302, cmt.

<sup>7</sup> See U.C.C. §§ 9-301(1), 9-310(a).

<sup>8</sup> U.C.C. § 9-316(a)(2), (h).

<sup>9</sup> U.C.C. § 9-307(e).

<sup>10</sup> See U.C.C. § 9-316 cmt. 2, ex. 4.

if a record delivered by a limited liability company to the [Secretary of State] for filing becomes effective and conflicts with a provision of the operating agreement:

(1) the agreement prevails as to members, persons dissociated as members, transferees, and managers; and

(2) the record prevails as to other persons to the extent they reasonably rely on the record.

This provision suggests that a domestication or merger for which the lender's consent was required but not given might nevertheless be effective against other persons who reasonably rely on the public record. Whether it would or would not depends on whether the filed record relating to the merger "becomes effective" and whether and how this provision, which apparently speaks only to records filed within the state that enacted the provision, applies in a multi-state transaction.<sup>16</sup> There are no known cases dealing with these issues, so transactional lawyers should counsel their lender clients not to rely too heavily on an operating agreement that requires the lender's consent to a relocation by domestication or merger.

### ***Prohibition on the Grant of a Security Interest***

Even a lender with a properly perfected security interest must occasionally be concerned about losing priority to a subsequent secured party. For example, a seller or lender who later acquires and perfects a purchase-money security interest can obtain priority over the earlier lender with respect to the purchase-money collateral.<sup>17</sup> A lender to an LLC could

avoid this risk if the debtor's operating agreement prohibited the debtor from creating or granting a security interest without the lender's consent and that prohibition were effective.

Indeed, such term in the operating agreement is likely to be effective. An operating agreement that prohibits the creation of a security interest without a lender's consent would undoubtedly be effective among the members and would no doubt deny the manager and members actual authority to bind the company to a security agreement. Consequently, the only ways the company could grant a security interest in some of its property, would be if: (i) the lender consented; or (ii) under traditional principles of agency law, the manager or member acting for the company could nevertheless bind the company. The first is obviously within the control of the lender, and thus should not be of great concern. The second is also a minimal risk. The operating agreement would, by its terms, deny the member or manager *actual* authority to bind the company to a security agreement to which the lender did not consent. Moreover, while a prospective secured party can in some cases rely on an agent's *apparent* authority, such authority must come from the actions of the principal, not the agent.<sup>18</sup> In most cases, there would be no such actions by the limited liability company itself. Even in the rare cases where there might be,<sup>19</sup> the new secured party would be able to benefit from this rule only to the extent that it acted reasonably in not reviewing the operating agreement. Thus, a seller of an isolated piece of equipment who retains a purchase-money security interest in the equipment sold might benefit from the doctrine

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107(d); Iowa Code § 489.112(4); Minn. Stat. § 322C.0112(4); Neb. Rev. St. § 21-112(d); N.J. Stat. § 42:2C-13(d); N.D. Cent. Code § 10-32.1-15(4); Utah Code § 48-3a-114(4); Vt. Stat. tit. 11, § 4003(n); Wyo. Stat. § 17-29-112(d).

<sup>16</sup> In other words, for the lender's consent to matter, § 107(a) of RULLCA needs to be enacted in the state under whose law the original limited liability company was formed. For the limiting effect of § 107(d) to apply, it is unclear whether it must be enacted in that state, the state in which the new limited liability company is formed, or both.

<sup>17</sup> See U.C.C. § 9-324.

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<sup>18</sup> See RESTATEMENT (THIRD) OF AGENCY § 3.03, cmt. b (2006) ("Apparent authority is present only when a third party's belief is traceable to manifestations of the principal"); Hepp v. Ultra Green Energy Services, LLC, 2015 WL 1952685 (N.D. Ill. 2015) (the managing member of an LLC did not have actual authority to bind the LLC to a note and security agreement and might not have had apparent authority, which requires conduct by the principal that causes a third party to believe that the agent is authorized).

<sup>19</sup> See United Bank v. Expressway Auto Parts, Ltd., 2015 WL 6697469 (Ohio Ct. App. 2015) (even if the individual who signed the security agreement on behalf of the debtor, a limited liability company of which he identified himself as a member, was neither a member nor a manager of the LLC, and thus lacked actual authority to bind the LLC, he had apparent authority and the LLC ratified his action by reporting the secured obligation as a liability on its federal income tax returns and making monthly payments for eight years).

of apparently authority; a bank or other sophisticated lender providing working capital financing – which would normally be expected to review the operating agreement as part of its due diligence – could not.

Nothing in RULLCA alters this analysis or result. Specifically, § 107(d) would not be relevant to the issue. Even if the company delivered a financing statement identifying the new secured party to the Secretary of State for filing,<sup>20</sup> § 107(d) would, at most, make the *financing statement* effective. It would do nothing to make the *security agreement*, which is not filed with the Secretary of State, effective.

Similarly, U.C.C. § 9-406 and § 9-408 would not override the restriction in the operating agreement. Those sections trump the terms in an agreement between the debtor and an account debtor that purport to prevent the debtor from granting a security interest or that require the account debtor's consent to the creation of a security interest.<sup>21</sup> However, the lender is not an "account debtor,"<sup>22</sup> and a limited liability company's operating agreement is not an agreement between the company and an account debtor. Indeed, the company is usually not a party to its own operating agreement; the agreement is one among the members. As a result, the anti-assignment rules of § 9-406 and § 9-408 would simply not apply. If this seems like a hyper-technical reading of those sections, it is one supported by a draft commentary by the Permanent Editorial Board of the UCC.<sup>23</sup>

### **Conclusion**

Section 107(a) of RULLCA appears to provide secured lenders to limited liability companies with an opportunity to protect their interests by restricting the company's powers. However, it probably does little in this regard. Section 107(a) probably cannot eliminate or alleviate the need to monitor for a change in the company's name. It is questionable whether it

can reduce the risk of a relocation to a different jurisdiction. Finally, while restrictions in an operating agreement might prevent the company from granting a security interest to a competing lender, nothing in § 107(a) speaks to this. Perhaps more to the point, if the operating agreement can prevent the grant of a security interest, all secured lenders should be examining it as part of their due diligence.

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<sup>20</sup> This assumes that the office listed in the state's enactment of § 107(d) is the same office in which financing statements are filed. That might not be true. Moreover, normally the secured party, not the debtor, files the financing statement.

<sup>21</sup> See U.C.C. §§ 9-406(f), 9-408(d).

<sup>22</sup> See U.C.C. § 9-102(a)(3) (defining "account debtor").

<sup>23</sup> See PEB, Draft Commentary on the Application of UCC Sections 9-406 and 9-408 to Transfers of Security Interests in Unincorporated Business Organizations (Feb. 1, 2012).

### ***No Change (Yet?) For Texas LLCs and Statutory Liability for Attorney's Fees***

Texas has a curious statute which provides that in any breach of contract action against a person or a corporation, the prevailing party may recover their attorney's fees. This rule is set forth in Section 38.001 of the Texas Civil Practice and Remedies Code. Specifically, with respect to claims arising in certain categories, "[a] person may recover reasonable attorney's fees from an individual or corporation, in addition to the amount of a valid claim and cost." In *Hoffmen v. L & M Arts*, Civ. Act No. 3:10-CV-0953-D, 2015 WL 1000838 (N.D. Texas March 6, 2015), the court was called upon to assess who is potentially liable under this provision.

While Section 38.001 allows recovery to a "person", which is itself a defined term (see Tex. Gov't Code Ann. § 311.005(2)), that term is not utilized as defining who was potentially subject to liability. Rather, that is restricted to "an individual or corporation.", and neither of those terms is defined. As this suit involved a claim against an LLC, the court was faced with the conundrum that:

Thus while it is apparent from the text of § 38.001 that the universe of those who may recover attorney's fees is broader than those from whom such fees may be recovered, the court must decide whether an LLC falls within the scope of "an individual." 2015 WL 1000838, \*5.

The court easily disposed of the suggestion that an LLC constitutes an "individual," finding rather that the term is restricted to natural persons. The court likewise dismissed the suggestion that "corporation" encompasses LLCs, noting that they are organized under different statutes and that corporation as a defined term under the Business Association Act does not include LLCs.

There has been submitted to the Texas legislature a proposal to expand § 38.001 to include claims against LLCs and other organizational forms in addition to corporations. See 2015 HB 230. To date, however, that legislation has not passed.

***Hurry Up and Wait Some More***

It had been anticipated that the final version draft of the Uniform Series LLC Act would be read and (possibly) approved by the Uniform Laws Commission at its 2016 annual meeting. That is not to be the case.

Rather, in order to ensure that the act comprehensively addresses the many challenging issues presented, and the questions newly identified as the drafting effort proceeds, the ULC has granted the project another year. While there will be a partial reading of the act at the 2016 ULC meeting, it will not there be put to a vote. Rather, that is now scheduled for the ULC annual meeting in 2017.

A salutary benefit of this additional time will be that Dan Kleinberger, the reporter on the project, may be able to preserve what little sanity he has left.

***The 2016 LLC Institute***

The 2016 LLC Institute will take place October 20/21, 2016 at our usual location in Arlington Virginia. Information as to registration and hotels will be distributed later. In the meantime, please block out these dates on your calendar.

## WORTH READING

James M. Peaslee, *Disregarded Entities and Debt Modifications*, TAX NOTES TODAY (March 8, 2016), 2016 TNT 54-14.

Stuart L. Pachman, *Jurisdiction and Choice of Law In Minority Oppression Cases*, NEW JERSEY LAWYER 58 (Dec. 2015).

Mark Opper and Dustin Janes, *What Actions Under State Law Create a New Eligible Entity Under the Check-the-Box Regulations?* 18 J. PASSTHROUGH ENTITIES 7 (Nov./Dec. 2015).

J. William Callison, *Indemnification vs. Advancement, and Drafting Considerations*, 18 J. PASSTHROUGH ENTITIES 51 (Nov./Dec. 2015).

Suren Gomtsian, *The Governance of Publicly Traded Limited Liability Companies*, 40 DEL. J. CORP. LAW 207 (2015).

Herrick K. Lidstone, Jr. and Allen Sparkman, *Pick Your Partner Versus United States Bankruptcy Code*, TEXAS J. BUS. L. (forthcoming), available on SSRN.

Allen Sparkman, *Charging Orders - A Reconsideration*, available on SSRN.

Peter Molk and Verity Winship, *LLCs and the Private Ordering of Dispute Resolution*, 41. J. CORP. LAW (forthcoming), available on SSRN.

Suren Gomtsian, *Contractual Mechanisms of Investor Protection In Non-Listed Limited Liability Companies*, 60 VILLANOVA L. REV. 955 (2015).

Peter Molk, *How Do LLC Owners Contract Around Default Statutory Protections*, 42. J. CORP. LAW (forthcoming), available on SSRN.

Bradley T. Borden, *Code Section 1031, Swaps-and-Drops 30 Years After Magneson*, 19 J. PASSTHROUGH ENTITIES 11 (Jan./Feb. 2016).

Thomas E. Rutledge, *As Amended From Time To Time*, 19 J. PASSTHROUGH ENTITIES 35 (March/April, 2016).

## PLANNING AHEAD

The Committee on LLCs, Partnerships and Unincorporated Entities will meet three times in 2016: at the Spring Meeting of the Section on Business Law, at the Annual Meeting of the Section of Business Law, and at the 2016 LLC Institute. Looking forward:

|   |                       |
|---|-----------------------|
| 2016 ABA BLS Annual Meeting<br>Boston, Massachusetts  | September 8-10, 2016  |
| 2016 LLC Institute<br>Arlington, Virginia             | October 20-21, 2016   |
| 2017 ABA BLS Spring Meeting<br>New Orleans, Louisiana | April 6-8, 2017       |
| 2017 ABA BLS Annual Meeting<br>Chicago, Illinois      | September 14-16, 2017 |
| 2017 LLC Institute                                    | TBD                   |

The detailed schedules for Committee meetings and programs at these meetings will be announced in future issues of the [LLC & Partnership Reporter](#).

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