Section of Business Law

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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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Inside This Issue

(Continued)

Inside Every Issue

FROM THE CHAIR

Thomas E. Rutledge
Stoll Keenon Ogden PLLC
Louisville, Kentucky

Dear Fellow Committee Members:

<u>The BLS Annual Meeting in Chicago</u>

As you no doubt know, this was the second "annual" BLS meeting. In 2014 attendance, around 1500, was well above projections. Seemingly proving that the annual meeting is a worthwhile proposition for the section's membership, more than 1570 people attended the 2015 BLS Annual Meeting.

The activities of our committee started on Thursday morning with an open committee meeting. The meeting was very well attended, and had an excellent group of first time attendees. How much of that can be ascribed to the fact that the meeting was held in a pub (I can't make this stuff up) I do not know, but as you know I will never complain about anything that increases attendance and Committee membership.

By way of highlights:

1. **Drafting Committee Reports**

(a) *Security Interest in LLC Interests Joint Task Force*

Below is a report from Dan Sheridan as to status of the project thru the meeting in Chicago.

(b) *FLP Agreement*

Johnny Lyle reported that the FLP Agreement is nearly completed. The hope to bring this project to completion by the 2015 LLC Institute appears to be coming to fruition.

(c) *Charging Order book*

As mentioned previously, Jay Adkisson, Carter Bishop and Daniel Kleinberger have undertaken to write a book/practice manual on charging orders. It is hoped that the first draft will be completed sometime in the summer of 2016, with an anticipated publication date in 2017.

(d) *Series LLC Agreement*

While Elisa Erlenbach Maas could not be with us in Chicago, she has reported that:

"The Model Series LLC Agreement subcommittee continues to make progress on the form Agreement. Comments received from within and outside the subcommittee are being considered and have, in large part, been incorporated. Pending the IRS' promulgation of final series classification regulations, the subcommittee aims to have a draft available for review by the Committee in mid-November."

In that the promised regulations are now "late" even as they remain on the IRS priority guidance plan for 2015-16, we are going to have to make a decision as to whether to wait on the final regs or proceed to publish our work product while recognizing that it may need to be supplemented when (if?) the classification regulations are released.

2. **Webinars**

Our webinar program continues to be wildly successful, and has been recognized as such by the BLS Council (see below). That said, ideas for webinars, as well as volunteers to organize them, are needed. Please send any ideas to Ed Wender, to Garth Jacobson or to me.

3. **New Drafting Projects**

As noted above, we are coming up on the completion of the committee's FLP Agreement and Series LLC Agreement. Even as we remain heavily involved in the Security Interest in LLC Interests Project, we should be considering and undertaking additional drafting projects. What would be helpful to you in your practice? One proposal would be the drafting of an operating agreement for a nonprofit LLC. Is that something in which you would like to participate?

4. **LLC Institute**

A full report on the 2015 LLC Institute appears below.

5. **Montréal (April 7-9, 2016)**

See below for more information on the upcoming meeting in Montréal.

6. **Current ALI projects in which the Committee is or should be involved**

Bob Keatinge noted that the ALI is currently working on several projects, including a new restatement of conflicts and a restatement of economic damages, that relate in many respects to the activities of our Committee.

7. **Liason with Real Property, Probate & Trust**

Barry Nekritz, who is the liaison between our Committee and the Section of Real Property, Probate and Trust, pointed out the number of synergies between our Committee and that section and the desire that we continue on working together on joint projects. We have done one joint webinar, and additional topics for joint webinars, as well as other joint projects, are solicited.

8. **Diversity Jurisdiction**

There are two developments in diversity jurisdiction to which everybody should be aware. First, the Third Circuit recently rendered its decision in *Lincoln Benefit Life v. AEI Life LLC*. Therein, the Third Circuit addressed the availability of pleading citizenship "on information and belief" and the sufficiency thereof in response to a facial attack upon jurisdiction. A short review of this decision appears in this issue of the LLC & Partnership Reporter. Second, and as is reproduced later in this issue of the LLC & Partnership Reporter, the ABA House of Delegates earlier this year approved Resolution 103B calling on Congress to amend 28 USC § 1332 to afford unincorporated organizations the same treatment for diversity jurisdiction as is afforded corporations, namely citizenship in the jurisdiction of organization and in the jurisdiction of the principal place of business.

9. **LLCs in Law Schools**

Professors Dan Kleinberger, Anne Tucker, and Dennis Honabach have agreed to lead an effort (its form remains to be determined) to increase training in law schools with respect to LLCs and other unincorporated forms in opposition to the all too common treatment of "business organizations" and the law of business corporations as being synonymous.

10. **Brian Lewis from ULC**

We were joined by Brian Lewis from the Uniform Laws Commission. Brian reported that his portfolio, as a staff member of the ULC, includes all of the Unincorporated Business Entity Acts, and he looks forward to working with us.

11. **Programs in Chicago**

Our first program was chaired by Steve Frost and including Kelley Bender, Chad Buttell, Eric Feldman and Dan Kleinberger and titled "*Corporate-Like Terms: The Dangers and Pitfalls of Using Corporate Concepts in LLC Operating Agreements*." It was standing room only; the room was set up for 120 and there were at least 25 people standing around the margins.

Our second program, this one chaired by Kelley Bender with Bob Keatinge and myself also presenting, was on "*Single-Member LLCs - The Complexities of a Simple Idea*." While slightly less well attended than the morning program, it as well was standing room only.

Thanks for everyone who was in attendance, and I hope you had as enjoyable and interesting a meeting as did I. Even if you were not able to attend the meeting, the CLE materials are available on the ABA website.

<u>The 2015 LLC Institute</u>

The 2015 LLC Institute will be held November 12-13, 2015 at the Waterview Conference Center in Arlington, Virginia.

A copy of the agenda is enclosed. As you can see, we have a great slate of programs being presented by some of the top people in the country. For the first time this year, there will be ethics credits (two hours) available as part of the Institute. Professor Bob Thompson from Georgetown will be presenting the keynote address on Thursday. Also, as a special treat, we will be joined on Thursday morning by Senator Grassley for a few prepared remarks and the opportunity for some back-and-forth as to tax policy. In addition, at the Institute we will present the 2015 Martin I. Lubaroff award to Jim Wheaton.

If you have not registered, please do so right away. Here is a link to the registration page: http://www.americanbar.org/groups/business_law/events_cle/llcs.html If you're having problems with registration, including with respect to hotel rooms (as of right now there are still rooms available in our block, but that information could be well out of date by the time you open this email), contact Mark Page at the ABA (mark.page@americanbar.org).

Professor Bob Hillman had been scheduled to join us. Unfortunately, he had to schedule a medical procedure that will now keep him from attending the Institute. In his place, we will be joined by Susan Saab Fortney, whose credentials most of you already know.

Again, we need to thank both the National Corporate Research, who has been our lead sponsor now for several years, and Lew Kaster, who has as well provided support for this year's and the 2016 LLC Institute. Also, Lexis/Nexis has joined as a sponsor for the 2015 LLC Institute. The Institute is a great value in part because of their generous support.

James "Jim" J. Wheaton to Receive the 2015 Martin I. Lubaroff Award

In connection with the 2015 LLC Institute, we will be presenting the 2015 Martin I. Lubaroff Award to Jim Wheaton. When you register for the Institute, remember you need to as well register for the dinner, and as well pick up any additional tickets for guests.

The BLS Spring Meeting in Montreal

After the LLC Institute, the Committee will next meet in connection with the BLS Spring Meeting in Montreal. The dates for that meeting are April 7-9, 2016.

WE NEED IDEAS FOR PROGRAMS.

The 2016 Annual Meeting of the BLS

The 2016 meeting of the BLS will take place September 8-10, 2016, with the meetings held at the Boston Marriott Copley/Westin Copley complex.

Recognition of our Committee at the Chicago Council Meeting

The first thing that I had to do upon arriving in Chicago was attend the BLS Council meeting. One of the handouts was a compilation of information as to BLS membership, CLE programs, etc. In the middle of the page was a listing of the five most successful webinars in the last year. As Chip Lion, outgoing chair of BLS highlighted to the Council, the top two of the top five programs were sponsored by the Committee on LLCs, Partnerships and Unincorporated Entities. We must be doing something right; let's keep it up.

Kudos to Scott Ludwig

Scott Ludwig has been appointed to the BLS Council Committee on Content Strategy, where he will no doubt continue his work on our behalf in making cutting-edge content available to us as ABA BLS members. In addition, Scott has been appointed to the Committee on Corporate Laws.

The Joint Task Force on Security Interests in LLC and other Unincorporated Entity Interests *(per Dan Sheridan)*

The Joint Task Force on Security Interests in LLC and other Unincorporated Entity Interests had a working meeting on Friday afternoon. A revised version of the draft model security agreement, which incorporates comments from each of the editorial subgroups, has been posted to the task force website. There was an extensive discussion of several key issues that were surfaced through the initial editorial process. First, the model document will include a due diligence checklist (or similar tool) to guide the user through a review and analysis of the operating agreement of the issuing entity. Second, the topic of distributions (pre- and post- default, ordinary and capital) will be addressed in a separate article of the document, rather than nested inside long winded covenants. Finally, the issue of securities laws compliance will be distinguished from the question of whether the interest is "investment property" or a "general intangible." Subject to approval by the sponsoring committees, the task force hopes to sponsor a CLE program in Montreal focused on key issues and concerns in secured transactions involving LLC interest collateral.

This is Your Committee - What Would Help You?

The objective of our Committee is to be your principal resource on the law of unincorporated business organizations both as to the specifics of the various statutory schemes and the interrelationship of these forms to other areas of law such as bankruptcy, federal and state tax, litigation and the Uniform Commercial Code. All of which sounds nice (and it is), but what is most important is the answer to the question **WHAT WOULD BE MOST HELPFUL TO YOU IN YOUR PRACTICE?** It is the answer to that question that will drive the programs we organize, the form documents we draft, etc. Get back to us with the answer to that question, and the Committee will be even more valuable to you.

Please incorporate by reference at this point all of my prior rants with respect to the need for more and new committee members.

James J. Wheaton to Receive the 2015 Martin I. Lubaroff Award

The 2015 recipient of the Martin I. Lubaroff Award is James "Jim" J. Wheaton. Currently Jim serves as General Counsel, Vice President, Legal and Governmental Affairs of Liberty Tax Service, a publicly traded company. Previously he practiced with the firms of Troutman Sanders LLP, and Willcox and Savage, P. C. After graduating from the University of Virginia School of Law, he clerked for the Hon. J. Dickson Phillips, of the United States Court of Appeals for the Fourth Circuit. Prior to attending the University of Virginia School of Law (1982-1985), where Jim was admitted to the Order of the Coif, he studied mathematical economics at Wake Forest University (1978-1982).

Jim's record as a contributor is in no way limited to the bar. For example, he has served as:

- Chairman, Board of Commissioners of the Virginia Public School Authority, 2002-2008;
- Executive Board, Tidewater Council, Boy Scouts of America, 2009 – 2013 (Jim is an Eagle Scout);
- Board of Directors of the Governor's School for the Arts Foundation, 1997-2009;
- Chair, Chesapeake Division, Hampton Roads Chamber of Commerce, 2004; and
- Member, Chesapeake, Virginia School Board, 1991-2000.

With respect to the Virginia Bar, Jim has served as:

- Chair, Business Law Section, Virginia Bar Association, 2009-2011; and
- Chair, Business Law Section, Virginia State Bar, 2003-2005.

Of course, Jim's contributions to the American Bar Association and our own Committee are well known. Jim served as Chair of the Committee from 2007-2010. In addition he has served as:

- Co-chair, Uniform Laws Commission Committee, American Bar Association Business Law Section, 2010-2013;
- ABA Section of Business Law Council, Finance Committee;
- ABA Section of Business Law, Publications Board;
- ABA Business Section Advisor, Uniform Laws Commission Drafting Committees for Series of Unincorporated Business Entities and Harmonization of Business Entities Acts; and
- ABA Commission on Disability Rights.

Jim was as well one of the drafters of the Committee's 1992 Prototype Limited Liability Company Act, a document which to this day has had a far-reaching impact upon the development of LLC law across the country.

From Committee Stalwart and 2014 Lubaroff Award Recipient Lauris Rall:

I first met Jim Wheaton when he was a young lawyer and first time attendee to the (then referred to (fondly)) Partnerships Committee at its meeting in Williamsburg Virginia. We were both wandering around the historic (mostly reproduction) houses looking for the meeting room. I believe Allan Donn "sponsored" his membership as something of an Allan protégé but of course Allen will deny this. Jim has always been a stand up representative of the Committee, willing to speak his mind and to back up his positions with well reasoned analysis and (near and dear to my heart) real world practical examples from representing clients. He has always exhibited a collegial personality and has never hesitated to lend a helping hand on an issue, project or even a personal favor when needed (this is what we are taught at UVA Law School). Added up, he is a "Marty" if there ever was one and that is what this award truly honors and why he is so richly deserving.

From Bill Callison:

Jim Wheaton can be a person of few eloquent words, or he can be elegantly loquacious. He is solid and decent and smart and caring, and he is a very good friend. I will cut quickly to the point – Congratulations Jim, and thank you for helping make our committee the wonderful group of lawyers that it is.

From Beth Miller:

Jim Wheaton is such a deserving recipient of the Lubaroff Award. From his service at a tender age on the drafting committee of the original ABA Prototype LLC Act (1992) to all of the other service he has rendered over the years in this area of practice—educating the bar regarding partnership and LLC law and pursuing improvements of those laws—Jim has exemplified the professional and personal qualities we honor in remembering Marty Lubaroff. Jim's insight, clarity, wisdom, and good humor have gained Jim the respect and affection of all who have had the privilege of working with him. Countless others who have never even met Jim have nevertheless benefited from the contributions he has made through the Virginia bar and the ABA Business Law Section. Jim's personal life is also an example and inspiration to all who have been fortunate enough to get a glimpse of it. Jim is devoted to his family, church, and community, and he is truly one of those people who serve in ways that "make a difference" in the lives of others. Of course Jim does all of this without expecting honors or awards, but I am glad to see him get some of the recognition he so richly deserves.

From Peter Hutcheon:

Jim, Congratulations on your selection (a choice with which I heartily concur) as this year's recipient of The Lubaroff. You add to the stature of the Award, just as your participation in the work of, and contributions to, the Committee have earned the recognition you are receiving.

From Steve Frost:

I have participated in various activities of the ABA Business Section LPUE Committee over many years, first coming to meetings in the late 1990s. Over this 20+ year time frame, I have been fortunate enough to develop friendships with many members of the Committee. As a group, members of our committee often talk about, and even marvel at, how open and welcoming members of the Committee are with newbies. In particular, one trait Lubaroff award winners share is the ability of each to make everyone feel welcome at committee functions; each treats experienced and inexperienced (*e.g.*, young) lawyers alike as peers and equals, immediately making them feel at home and welcome. Jim Wheaton does this better than anyone else. He is one of the most sincere and nicest members of the LPUE Committee. I remember meeting Lori and Jim at an ABA meeting years ago in Orlando. Lori and Jim treated Wendy and me as if we had been closest friends for years. Jim and Lori are peas in a pod. While they are both devoted to their children, they both do so much for others around them. In Jim's case, it is his contributions of time and effort to local schools, the Boy Scouts, worthy Virginia politicians and other passions, all in addition to his contributions to the LPUE Committee. Jim will simply call you to say hi when he is traveling through town, or he will respond immediately with help to questions about restaurants in South Bend, or he will ask about your specific activities and other interests, in my case, school board elections and activities, and he always seems to know what is important to you, even if you have not seen each other or talked in months. In my opinion, Jim is most deserving of this award. He does honor to Marti and his legacy, and he embodies all the characteristics that make Lubaroff award recipients special and deserving.

From Lou Conti:

Jim Wheaton is yet another personification of the Marty Lubaroff embodiment of professionalism, intelligence, courtesy and thoughtfulness.

He adds the southern gentleman's touch and the result is an enormously popular and delightful member of the committee and a good friend to many of us.

It is my great pleasure to join my colleagues in congratulating Jim on a most well deserved receipt of the highest award given to alternative entity lawyers!

From John Maxfield;

I will miss our annual pilgrimage to D.C. or Philadelphia for 20+ years to participate in Bob's LLE seminar. I have lots of wonderful memories with Jim (aka "Wheatie"…compliments of Chris Toll) and others on this email, including Caryl's troll, Susan's legendary "queer the deal" and "Is he good for you?" lines, the Denver blizzard that nearly broke Bob's and my consecutive year speaker streaks, and so many others.

One of the many things that stands out about Jim is his command of the English language. Jim is an amazing communicator. When Jim speaks, there is no theatre, no ego, no wasted words, no pausing to regain thought, no gratuitous usage of big words, no "and umms"….none of that. He just effortlessly, concisely, clearly and always accurately articulates complex topics, one after another, in a fashion that is geared so that everyone in his audience can understand what he is saying. I think he is the best I've ever seen at that. He truly is the Walter Cronkite of the legal profession.

I am fortunate and grateful to have learned so much from Jim and enjoyed his friendship over the years.

From Bob Keatinge:

My many great memories of Jim include his streak of presentations at over 20 successive ALI-

(ABA/CLE) Limited Liability Entities programs, my being mugged (kinda) in San Francisco with Jim and Laurie and others, and Jim's excellent work on the Virginia LLC Act (except with respect to shelf LLCs).

My earliest recollection is Jim's participation in the drafting of the initial Prototype Limited Liability Company Act by WGPLLCASLLCCPUBOSBLABA (Working Group on the Prototype Limited Liability Company Act of the Subcommittee on Limited Liability Companies of the Committee on Partnerships and Unincorporated Business Organizations of the Section of Business Law of the American Bar Association) which was formed at a meeting of the Business Law Section among Jim, myself, Larry Ribstein (reporter), Matt Feeney and Jim Reynolds of Phoenix, Don Hess of Los Angeles, Stuart Levine and Marshall Paul of Baltimore, Dale Schedler of Overland Park Kansas, and Mike Gravelle of Chicago in an era predating E-mail and cell phones. Jim arranged for a call in number from Willcox and Savage and we each contributed to reimburse W&S for the cost of the calls. We spent 2 hours early in the morning (for the Arizona and Los Angeles contingent occasionally before sunrise) talking about the act and share drafts by fax and mail. As I recall, the WG was initiated at the first meeting of the LLC subcommittee at a meeting in Williamsburg (1991) (at which Harry Haynsworth suggested we didn't need LLCs since we had the MBCA Model Close Corporation Supplement and Howard Lefkowitz suggested LLCs would never be of any use unless they had free transferability of interests). Largely as a result of Jim's organization and everyone's hard work, we completed the first Prototype in 1992 drawing on the 12 LLC acts then extant together with the 1969 MBCA, ULPA (1916), UPA (1914 and 1992), RULPA (1976/1985 and Georgia). Jim, in addition to making important substantive comments, often served as the voice of reason when the discussions became heated and lead the process to civilize and pull together the final Prototype.

From Warren Kean:

I was pleased the hear Jim would be the recipient of this year's Lubaroff Award, embodying the qualities of Marty Lubaroff in whose honor the award is made: long and consistent leadership, scholarship and service to the bar with respect to LLCs and alternative entities. Jim has a long history of contributing his valuable time and expertise to the rapid development of one of the most important, if not the most important, areas of US business law in the last 50 years. He often pulled double duty in serving in leadership roles for the Bar at both the national and state level. Jim was instrumental in the drafting the Virginia LLC Act, an important resource to me and the other members of the North Carolina Bar Association tasked with modernizing the North Carolina LLC Act in 2014. Mostly though, I reflect on the other, human qualities shared by Jim and the past recipients of the Lubaroff Award, men and women of the highest character and graciousness towards their colleagues. I particularly remember Amy and I sitting across for Jim and Lauroie, returning to our Chicago hotel after a wonderful evening listening to the Chicago Symphony Orchestra at an outdoor concert, one of the many special events arranged and made available to committee member by other members of this committee (for that event it was Steve Frost). During the ride back we discussed a number of things, but what struck Amy and me in getting to know Jim and Lauroie is what a proud and good father Jim is and what I remarkable job Jim has done in maintaining a balance of excellence in his life. Well deserved congratulations Jim.

From Dale G. Schedler, another drafter of the 1992 Prototype LLC Act:

My recollections of Jim and his contributions to the prototype LLC working group (Bob, the impressive acronym was way, way beyond my intentional typing ability) - he was visionary enough to see that LLCs were the "better mousetrap," he had a great "business sense" approach to cutting through the superfluous, and he could find common ground between different countries of thought.

Jim, congrats - well deserved.

From Allan Donn:

Jim and I were partners for more than 10 years. More recently, I enjoyed working with Jim on an expert legal opinion on issues under the Virginia Limited Liability Company Act submitted to an arbitration panel in Geneva. I was again reminded of the depth of his knowledge of the law of business entities. For a number of years he taught a course on business entities at the University of Virginia Law School.

Jim was the second Chairman of the Virginia Bar Association Committee on LLCs. His extended service in that position enabled him to correct a number of the missteps of his predecessor.

Although most of us are content merely to practice law, Jim has performed considerable public service as well, serving on the School Board of

Chesapeake, Virginia and as Chairman of the Board of the Virginia Public School Authority.

Last, from Caryl Welborn:

I can't say it better than John [Maxfield], but I'll add my support to his comments. I admired the way Jim seemed to so effortlessly present in not just perfect sentences but perfect paragraphs: orderly, concise and understandable. His subject knowledge was expansive and his recall of details terrific. What was even more impressive was that he seemed to prepare the LLE Program presentations in the 'make-up hour' beforehand, as he quite furiously wrote out notecards covering a large number of cases. And then Jim managed his comments to fit the time permitted, never being flustered by the fact that this was not the time ORIGINALLY allotted. In general, his equanimity was exemplary (and helpful to me, for sure). As John notes, Jim couldn't be prompted to overreact to crazy ideas.

I always enjoyed the socializing periods and hearing of Jim's interests, some of which we shared: among them, happily, youth sports and the wine list. Did I ever see him when he wasn't smiling?

Quite a gentleman.

Congratulations to Jim on the award, and best to all.

LLCs, Partnerships and Unincorporated Entities Committee
2015 LLC Institute
November 12 – 13, 2015
Agenda

Thursday, November 12, 2015

7:20 a.m. - 8:00 a.m.	Breakfast (included in registration)
8:00 a.m. – 8:05 a.m.	Welcome; Housekeeping
8:05 a.m. – 8:45 a.m.	**Prepared remarks from and Q&A with Senator Grassley** *(Iowa, senior member of the Committee on Finance and member of the Joint Committee on Taxation)*
8:45 a.m. - 10:45 a.m.	**Program (2 hrs.) Case Law Review** *This panel will discuss recent LLC and partnership cases on various topics of significance, including cases dealing with fiduciary duties and veil piercing and cases illustrating pitfalls in drafting operating agreements.* Chair: Prof. Elizabeth "Beth" Miller, Prof. of Law, Baylor Law School Presenters: Lou Hering, Partner, Morris, Nichols, Arsht & Tunnell LLP; Christina Houston, Partner, DLA Piper
10:45 a.m. - 11:00 a.m.	Break
11:00 a.m. - 12:30 p.m.	**Program (1.5 hrs.) Legal Opinions Not In Delaware** *Transaction docs most often are governed by laws other than Delaware, so that was why I made that change. Otherwise, you da best.* *Opinion letter practice is typically focused upon Delaware entities. Notwithstanding the view that Delaware is the "dominant" jurisdiction, it is a simple fact that most LLCs nationwide are not organized in Delaware. Join us as we review both similarities and pitfalls in rendering opinions on LLC's and other unincorporated entities organized outside of Delaware.* Chair: Christina Houston, DLA Piper LLP Presenters: Anna Mills, The Van Winkle Law Firm; Bill Callison, Faegre Baker Daniels LLP; Johnny Lyle, Adams and Reese LLP; Cristin Keane, Carlton Fields, P.A.

12:30 p.m. - 1:45 p.m.	**Luncheon with Keynote Speaker Prof. Robert Thompson** (Georgetown Law Center)
2:00 p.m. - 3:30 p.m.	**Program (1.5 hrs.) The Legal Death of a LLC: A Nationwide Hodgepodge of Rules and Practices** *This panel focuses on LLC dissolution, wind-up, and termination. The presentations and discussion are designed to address, among other things, the statutory differences in dissolution schemes as among various states, the policy reasons underlying these differences, and how the differences work in theory and practice.* Chair: Prof. Joan Heminway, The University of Tennessee College of Law Presenters: Prof. Carter Bishop, Suffolk University Law School; Prof. Doug Moll, University of Houston Law Center
3:30 p.m. - 3:45 p.m.	Break
3:45 p.m. - 5:15 p.m.	**Program (1.5 hrs.) What Is An Operating Agreement and Why Do We Care?** *Like Shimmer Floor Wax, which was both a floor wax and dessert topping (N.B. http://www.nbc.com/saturday-night-live/video/shimmer-floor-wax/n8625), one of the many questions about the operating agreement is whether it is a contract, the organic formation constitution of a business organization, or something else (like a business plan or statement of intention). Of course in some cases it is all of these and in others of more limited effect. But in any case it is critically important in understanding the tax and business relationship that is an LLC. This panel will consider some of the important questions of what the operating agreement is (or are in the case of multiple components), how it comes into being, what its function is in various contexts (among the members, with the LLC, and under different legal regimes such as tax and bankruptcy), and how we go about determining its contents and explaining what it is an how it works to others.* Chair: Robert Keatinge, Holland & Hart LLP Presenters: Kelley Bender, Chapman & Cutler; Prof. Ann Conaway, Widener University School of Law; Elizabeth S. Fenton, Saul Ewing; Prof. Joan Heminway, University of Tennessee College of Law; Jessica Liou,Weil, Gotshal & Manges LLP
6:30 p.m. - 7:30 p.m.	**Cocktail Hour – Cash Bar**
7:30 p.m. - 10:00 p.m.	**Lubaroff Award Dinner -** (this event is a separately ticketed event--$125.00 - obtain through the registration process)

Friday, November 13, 2015

7:30 a.m. - 8:30 a.m.	Breakfast (included in registration)
8:30 a.m. - 10:30 a.m.	**Program (2 hrs.) Navigating the Ethical Maelstroms When the Law Firm Ship is Going Down**

The profession has seen a number of law firms dissolve in the last few decades. When law firms fail, a number of ethical and risk management issues surface that require careful and conscious planning to successfully navigate. These issues relate to everything from client property and client files, to conflicts of interest, client confidentiality, billing and collection of legal fees, and migration of lawyers and staff. This program will address many of these issues by reviewing hypotheticals to pose rules-based and practical solutions to ethical issues."

Chair: George Coleman, Bell Nunnally & Martin LLP
Co-Presenters: Prof. Susan S. Fortney, Texas A&M University School of Law; A.J. Singleton, Stoll Keenon Ogden PLLC

10:30 a.m. - 10:45 a.m.	Break
10:45 a.m. – 12:15 a.m.	**Program (1.5 hrs.) Unfinished Business Doctrine**

Drawing upon the experience of some large law firm bankruptcies and other recent decisions, this presentation will discuss claims by creditors and former partners seeking repayment of prior distributions or for profits earned by other firms after the dissociation of the attorneys handling the matter from, or dissolution of, the firm and will focus on potential liability issues and the pertinent ethical issues presented by such claims.

Chair: Robert Keatinge, Holland & hart LLP
Presenters: Christopher Murray, Diamond McCarthy LLP; Barbra Parlin, Holland & Knight LLP

12:15 p.m. - 1:00 p.m.	**Luncheon**: Working Committee Discussion (this event is a separately ticketed event - $35.00 - obtain through the registration process)
1:00 p.m. - 1:15 p.m.	Break
1:15 p.m. - 3:15 p.m.	**Program (2 hrs.) S-Corp LLCs**

It is increasingly common for limited liability companies to elect taxation as subchapter S corporations. Traditionally, LLC operating agreements have been drafted on the assumption that the entity will be taxed as a partnership under subchapter K, or, in the case of single member LLCs, as a disregarded entity. While pass-through taxation is a common attribute of both partnerships and subchapter S corporations, there are significant differences between these two tax *regimes. This panel will discuss issues associated with the de-coupling of the form of an entity from its taxation and associated planning considerations in the context of LLCs that elect to be taxed as S corporations or as qualified subchapter S subsidiaries. Among other topics, it will address the characteristics of subchapter S corporations, factors influencing the choice of S corporation tax status, operating agreement provisions tailored to the subchapter S tax regime, the implications of "disregarded" entity status (and loss of that status), fundamental differences between qualified subchapter S subsidiaries and LLCs that are disregarded under the check-the-box regulations, and implications for acquisitions, dispositions and succession planning.*

Chair: Dan Sheridan, Stark & Stark
Presenters: Prof. Martin J. McMahon, Jr., Fredric G. Levin College of Law, University of Florida; Warren P. Kean, Shumaker, Loop & Kendrick, LLP

3:15 p.m. - 3:30 p.m. Break

3:30 p.m. - 5:00 p.m. **Program (1.5 hrs.) Did you really mean what you wrote in that IRR distribution waterfall?**

This panel will discuss the prevalent use of internal rate of return (IRR) in distribution waterfalls and how it compares to more traditional "preferred return" waterfalls. The speakers will explain the economic and tax considerations, including concepts of compounding, time value of money, use of Excel references, benefits of IRR waterfall provisions, and common drafting errors. The speakers will compare and contrast many sample waterfalls and determine if there really is a difference in the current varied definitions of IRR in documents.

Chair: Prof. Brad Borden, Brooklyn Law School
Presenters: Steve Schneider, Goulston & Storrs; Thomas Kaufman, Goulston & Storrs (invited); John Grumbacher, Goulston & Storrs (invited)

5:00 p.m. - 5:15 p.m. **Wrap-Up**

Delaware Chancery Court Endorses Equitable Dissolution of LLC

By Peter Mahler
Posted originally on his blog *New York Business Divorce*
May 4th, 2015

Viewing the arc of Delaware Chancery Court jurisprudence over the last two decades implementing that state's Limited Liability Company Act, and witnessing the Delaware legislature's frequent amendments to the statute in reaction to judicial developments, you can't help but detect a pattern of maintaining the unique attributes of the Delaware LLC, as compared to other forms of business entity, by:

- rigorously promoting freedom of contract (in the form of the LLC agreement) and its corollary, "you made your bed now lie in it";
- deciding internal governance disputes within the bounds of the interplay of the Delaware LLC Act's default rules and the LLC agreement; and
- strongly disfavoring judicial intervention based on open-ended notions of fairness (the main exception being when managers take on fiduciary duties by agreement or by default under the statute).

Stated simply, in Delaware certainty trumps indeterminacy.

Well, not always, as seen in a first-impression ruling last week by Vice Chancellor J. Travis Laster in *In re Carlisle Etcetera LLC*, C.A. No. 10280-VCL,[1] in which the court held that the assignee of an LLC membership interest, who as a non-member and non-manager lacked standing to seek involuntary dissolution under Section 18-802 of the Delaware LLC Act, nonetheless had standing to seek equitable dissolution under the Chancery Court's common-law authority as a court of equity.

Background

The case involves the Tom James Company ("TJC"), known throughout the U.S. and overseas as a manufacturer and retailer of custom clothing with an unusual business model in which tailors come directly to customers' homes or offices. In 2012, TJC and a Hong Kong-based premium apparel supplier known as the Royal Spirit Group ("Royal") formed a Delaware LLC known as Carlisle Etcetera ("Carlisle") as a joint venture in which Royal owned its 50% interest through its affiliate, Well Union Capital Ltd. ("WU Parent").

At inception TJC and WU Parent executed a simple form of operating agreement in which they committed to work promptly on a more detailed operating agreement to replace the original one, but never did so. The simple agreement, which created an evenly-divided, four-person Board as sole manager, was silent on the assignment of membership interests.

Meanwhile, shortly after Carlisle's formation, WU Parent assigned its 50% membership interest to a wholly owned subsidiary ("WU Sub"). TJC was told of the transfer, did not object, and treated WU Sub as a member from that point on, as evidenced by tax filings identifying WU Sub as "member" and subsequent draft agreements doing the same. (Although not mentioned in the court's opinion, the transcript of the oral argument indicates that at some point TJC may have assigned its membership interest to a subsidiary or affiliated entity without the formal approval of WU Parent or Sub which, in light of the court's ruling described below, raises the possibility of an LLC with no members!)

Serious disagreements and deadlock between the two owners arose within a year. The Board deadlock effectively gave company control to TJC whose CFO served as Carlisle's CEO. In early 2014, TJC told Royal that it no longer wished to continue the joint venture. Subsequent buy-out negotiations failed.

No Standing to Seek Statutory Dissolution

In October 2014, WU Sub filed a petition seeking judicial dissolution of Carlisle under Delaware LLC Act § 18-802 based on deadlock at the member and manager levels. TJC moved to dismiss for lack of standing, contending that under the applicable default rules in § 18-702 of the LLC Act, (a) WU Parent was no longer a member of Carlisle upon the assignment of its membership interest to WU Sub, and (b) WU Sub as assignee had no membership interest because TJC never formally consented to its admission as a member. WU Sub countered that it was a de facto member by consent of the members as "reflected in the records" of the LLC, i.e., the tax returns and draft agreements, under § 18-301(b)(1) of the LLC Act.

Vice Chancellor Laster agreed with TJC's position, holding that notwithstanding TJC's treatment of WU Sub as a member, the absence of TJC's formal

[1] 2015 WL 1947027 (Del. Ch. April 30, 2015).

consent to WU Sub's admission as member as required by the Delaware LLC Act deprived it of standing to seek judicial dissolution under § 18-802, which confers the right to petition on members and managers, not assignees.

Equitable Standing to Seek Dissolution

"In my view, [TJC] errs in contending that Section 18-802 is the exclusive extra-contractual means of obtaining dissolution of an LLC. Under the facts of this case, WU Sub has standing to seek dissolution in equity."

So begins Vice Chancellor Laster's fascinating discussion of equitable dissolution at pages 15-27 of his opinion. The opinion cites, among other authorities, Justice Story's and Pomeroy's ancient treatises on equity jurisprudence in support of the Chancery Court's "traditional equitable jurisdiction" over partnership disputes. The statutory dissolution provision for LLCs, § 18-802, "does not state that it establishes an exclusive means to obtain dissolution," Vice Chancellor Laster wrote, "nor does it contain language overriding this court's equitable authority." Had it done so, he continued, the statute's validity "would raise serious constitutional questions" under the state constitution's article generally giving the Court of Chancery all the equity jurisdiction of the English chancery courts as it existed prior to American independence. To those who ask, What knickers-wearing, tricorn-topped American colonists possibly could have imagined LLCs back in the 1700's?, Vice Chancellor Laster answered:

> I cannot accept the contention that because the nascent practice of entity law as it existed at the time of the colonies' separation had not yet envisioned LLCs, they fall outside the domain of equity. Decisions addressing the dissolution of LLCs have recognized the continuing role of equity.

Perhaps anticipating the reaction of creative drafters of LLC agreements, Vice Chancellor Laster's opinion noted that "the ability to waive dissolution under Section 18-802″ — as has been upheld in prior Chancery Court rulings including the R&R Capital and Huatuco cases — "does not extend to a party's standing to seek dissolution in equity." In that same vein the opinion also poked at the "purely contractarian view" of LLCs, stating what perhaps is the core theoretical justification for the court's decision:

> To my mind, when a sovereign makes available an entity with attributes [such as limited liability] that contracting parties cannot grant themselves by agreement, the entity is not purely contractual. Because the entity has taken advantage of benefits that the sovereign has provided, the sovereign retains an interest in that entity. That interest in turn calls for preserving the ability of the sovereign's courts to oversee and, if necessary, dissolve the entity. Put more directly, an LLC agreement is not an exclusively private contract among its members precisely because the LLC has powers that only the State of Delaware can confer.

Turning to the facts of the Carlisle case, Vice Chancellor Laster found adequate grounds for equity to intervene, namely, absent dissolution "the Company will continue, with [Royal] locked-in as a silent and powerless passive investor," in a "situation . . . contrary to the bargain the parties struck," where "both sides recognized the need to go their separate ways," and with a non-functioning Board designated as the sole manager, leaving Carlisle:

> operating contrary to the governance structure set forth in its constitutive agreement. [¶] When considering whether holders of equity in other entities can pursue equitable causes of action, despite their lack of formal ownership status, this court has relied on the substance of the relationship and permitted the suits to proceed. . . . Consequently, I believe that WU Sub has standing in equity, as an assignee, to seek dissolution of the Company under the facts alleged in the petition.

Vice Chancellor Laster issued his Carlisle opinion on April 30, 2015. Two business days later, on May 1st, he issued an Order granting WU Sub's motion for summary judgment on its petition to dissolve the LLC. The Order applies the standard for dissolution developed under Section 18-802 and cites deadlock, the parties' acknowledgement of the need to separate, and the lack of an exit mechanism as warranting dissolution and the appointment of a custodian.

I suppose you could analogize Carlisle's recognition of equitable LLC dissolution to New York's recognition of common-law dissolution for closely held corporations, which generally comes into play when oppressed minority shareholders lack the minimum 20% stock interest required by the dissolution statute, BCL § 1104-a. Standing under LLC Law § 702, New York's statute authorizing judicial dissolution of LLCs, is even narrower than Delaware's statute, limiting the right to petition to members, i.e., excluding both managers and assignees. I know of no New York case addressing a non-member's equitable standing to seek common-law dissolution of an LLC.

Hat tip to Kurt Heyman of Proctor Heyman Enerio LLP for alerting me to the Carlisle case in which Kurt represents the petitioner.

The Sixth Circuit Holds a Limited Liability Company is a "Person" Under the FDCPA

By Jeana R. Long
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Recently, the Sixth Circuit held a limited liability company is a "person," with standing to sue under the Fair Debt Collection Practices Act ("FDCPA"). *Anarion Investments, LLC v. Carrington Mortgage Services, LLC*, 794 F.3d 568, 2015 U.S. App. LEXIS 12670 (6th Cir. Tenn. 2015). This decision could lead to suits brought by LLC's and other legal entities, seeking to expand the holding in Anarion.

After a series of transfers from the original borrower and owner of residential real property, Anarion, a limited liability company, held a lease with an option to buy the property. When the original borrower defaulted on his loan, the property went into foreclosure and Anarion sued the defendant mortgage servicer, claiming it made certain misrepresentations in foreclosure notices. The only issue on appeal was whether a limited liability company, with an interest in the subject property, was a "person" under section 1692 of the FDCPA. Section 1692k, provides that "any debt collector who fails to comply with any provision of this subchapter with respect to any person is liable to such person."

In its analysis, the court first turned to the Federal Dictionary Act, which provides that the word "person" includes entities unless "the context indicates otherwise." Next, the court focused on other provisions of the FDCPA wherein Congress specifically limited its application to "natural persons." The court reasoned that since §1692k makes no such express limitation, "person" includes entities.

The court dismissed concerns that its holding would open the door for other legal entities to file suit under the FDCPA stating, "[t]his case is unusual because Anarion brought suit based on an attempt to collect [a] personal debt" from the original borrower.

The dissenting opinion described the majority opinion as "cavalier" and argued the "stated purpose and history" of the FDCPA is to protect natural persons from "abusive debt collection" of consumer debt. The FDCPA defines "consumer" as "any natural person obligated or allegedly obligated to pay any debt." 15 U.S.C. §1692a(3).

The dissent expressed concern that the majority opinion "opens the door to a new class of plaintiffs under the FDCPA" with an utter lack of authority for its holding, stating "[d]espite the thousands of claims that have been brought in federal court since the passage of the FDCPA in 1977, neither the majority nor the parties cite a single instance in which a legal entity has sued as a 'person' entitled to relief under the Act."

Is the majority correct in dismissing these concerns based on the special facts in Anarion? Or is the dissent correct that this decision will open the proverbial flood gates and allow other legal entities to file claims under the FDCPA "enabled by an unprecedented holding that legal entities are 'persons'... ?" Only time, and further judicial interpretation, will tell.

IRS 2015-2016 Priority Guidance Plan

On July 31, 2015, the IRS released its 2015-2016 Priority Guidance Plan. Without meaning to suggest that you should not scrutinize the plan generally to see what may be forthcoming of interest to your practice, it is worth noting that it lists:

- Guidance on the application of § 1402(a)(13) to limited liability companies.
- Final regulations under §§ 108 and 7701 concerning the bankruptcy and insolvency rules and disregarded entities. Proposed regulations were published on April 13, 2011.
- Final regulations under § 7701 regarding series LLCs and cell companies. Proposed regulations were published on September 14, 2010.
- Final regulations under § 1.337(d)-3 relating to partnership transactions involving a corporate partner's stock or other equity interests. Final and temporary, and proposed regulations were published on June 12, 2015.
- Final regulations under § 469(h)(2) concerning limited partners and material participation. Proposed regulations were published on November 28, 2011.
- Regulations concerning the fractions rule under § 514(c)(9).
- Guidance on targeted capital accounts under § 704(b).
- Regulations to update the securities partnership aggregation rules under § 704(c).
- Guidance under §§ 704, 707, and 721 on management fee waivers.
- Final regulations under §§ 704, 734, 743, and 755 arising from the American Jobs Creation Act of 2004, regarding the disallowance of certain partnership loss transfers and no reduction of basis in stock held by a partnership in a corporate partner. Proposed regulations were published on January 16, 2014.
- Final regulations under § 706(d) regarding the determination of a distributive share when a partner's interest changes. Proposed regulations were published on April 14, 2009.
- Regulations under § 706(d) regarding the determination of a distributive share of any allocable cash basis items and certain other items when a partner's interest changes.
- Regulations under § 707 relating to disguised sales of property and regulations under § 752 regarding a partner's share of liabilities. Proposed regulations were published on January 30, 2014.
- Final regulations under § 732(f) regarding aggregation of basis for partnership distributions involving equity interests of a partner. Proposed regulations were published on June 12, 2015.
- Final regulations under § 751(b) on unrealized receivables and inventory. Proposed regulations were published on November 3, 2014.
- Final regulations under § 752 regarding related

person rules. Proposed regulations were published on December 16, 2013.

- Final regulations under §§ 761 and 1234 on the tax treatment of noncompensatory partnership options. Proposed regulations were published on February 5, 2013.
- Final regulations under § 7704(d)(1)(E) regarding qualifying income for publicly traded partnerships. Proposed regulations were published on May 6, 2015.
- Guidance under § 6063 on signing partnership returns.
- Procedural guidance for TEFRA partnerships.

Finding Purpose Outside the LLC Agreement

By Peter Mahler
Posted originally on his blog *New York Business Divorce*
June 8th, 2015

Judicial dissolution statutes for limited liability companies in New York, Delaware, and many other states use the contract-centric language drawn from limited partnership law, namely, whether it is reasonably practicable to carry on the business in conformity with the articles of organization and operating agreement.

Court decisions in both Delaware and New York have construed their respective LLC statutes as authorizing judicial dissolution when the purpose of the entity, as defined in the operating agreement, can no longer be achieved. For instance, former Vice Chancellor Chandler of the Delaware Chancery Court in his 2008 Seneca Investments decision, and then-Vice Chancellor Strine in his 2009 Arrow Investment Advisors decision, both used language suggestive of the LLC agreement as the sole source to which a court should look in determining the LLC's purpose. In New York, Justice Austin, writing for the Appellate Division, Second Department, in the seminal 1545 Ocean Avenue decision, similarly crafted a dissolution standard keyed to the frustration of the LLC's "stated purpose" in the context of its operating agreement.

Does that mean courts never look outside the LLC agreement when determining if its purpose no longer is achievable? And how should a court determine purpose when the LLC has no written agreement? Recent decisions from Delaware and New York provide some clues to the answers.

Delaware Court Looks "Beyond the Purpose Clause"

Just last week, in Meyer Natural Foods LLC v Duff, C.A. No. 9703-VCN [Del. Ch. June 4, 2015], Vice Chancellor Noble summarily dissolved a Delaware LLC at the behest of its 51% managing member, notwithstanding the absence of operational deadlock or any genuine dispute that the LLC's business could carry on profitably in conformity with the LLC agreement's broadly defined purpose to engage in the business of marketing, distributing, and selling natural beef products.

So why dissolution? Because the business effectively was formed to operate as a joint venture with a beef products supplier owned and operated by the LLC's 49% owners, who later terminated an exclusive supply agreement entered into by the supplier and the LLC concurrently with the LLC agreement. Prior to the dissolution proceeding, in separate litigation, the minority owners obtained a court order upholding their contention that, upon termination of the supply agreement, they were contractually free to compete against the LLC. Although the LLC agreement made no mention of the supply agreement and contained an integration clause, the supply agreement stated that it was a "condition to" the LLC agreement, and the LLC agreement referenced non-compete covenants that, as Vice Chancellor Noble found, "underscored the importance of the parties' supply arrangement" which no longer existed.

The court's opinion noted, on the one hand, the minority owners' argument for a "broad characterization" of the LLC's purpose consistent with the "plain language" of the LLC agreement's purpose clause and, on the other hand, the petitioner's "contextual interpretation" of the purpose clause "based on the various non-compete and mutual obligations" in the several agreements entered into when the venture was organized.

After noting that the Arrow and Seneca decisions seemingly confine the analysis to the language of the purpose clause, Vice Chancellor Noble nonetheless found more "persuasive" the petitioner's contextual interpretation that looked "beyond the purpose clause of the LLC Agreement," explaining as follows:

> Despite the integration clause in the LLC Agreement, the entirety of the parties' agreement . . . demonstrated that [the LLC] was not intended to be a business where [the petitioner] ran all of the operations and

> distributed profits to Respondents as passive members with an incidental supply contract. . . . Limiting the analysis to the purpose clause of the LLC Agreement would resolve the dispute on a technicality. . . . Fundamentally, the Court looks to the match between the company's purpose and its reasonable current and future activities. . . . Given that the purpose of [the LLC] was to market and sell natural beef supplied by [the Respondents] according to [petitioner's] specifications, the Court concludes that it is no longer reasonably practicable to operate [the LLC] in line with this vision. . . . [The LLC] cannot achieve its purpose when Respondents do not believe restrictive covenants apply to them and the Output and Supply Agreement has been terminated. The Court has determined that the purpose of [the LLC] was to operate a "joint venture business" based on a supply and distribution arrangement, but Respondents' entities no longer provide [the LLC] with cattle.

In case you're wondering why the 51% managing member had to seek judicial and not voluntary dissolution of the LLC, the LLC agreement expressly provided that the managing member could not cause the LLC "to undertake or engage in . . . the dissolution of the Company." Another section of the agreement provided that dissolution is mandatory upon "the entry of a decree of judicial dissolution" under the LLC Act. The respondents in Meyer argued that the former provision trumped the latter, but the court disagreed, eschewing what it described as a "strict interpretation of an LLC agreement where the result would be inequitable."

New York Cases

A pair of New York cases merits attention on the subject of ascertaining the LLC's purpose.

One of the them, *Vella v JP&F Realty Holding, LLC*, Short Form Order, Index No. 5545/12 (Sup Ct Nassau County Sept. 28, 2012), which I previously highlighted here, involved an LLC whose operating agreement contained a narrow purpose clause expressly for the acquisition of a specific parcel of realty to house the members' separate business. The contemplated purchase of the specified realty fell through, after which the LLC acquired a different property to house the separate business without any amendment of the LLC agreement. In the subsequent dissolution proceeding, the petitioner alleged that the stated purpose of the LLC could not be achieved, in response to which the respondents offered a series of documents allegedly authorized by the petitioner in furtherance of the acquisition of the replacement property. The court concluded that discovery and a hearing were required to determine whether it was reasonably practicable to carry on the LLC's business in conformity with its purpose, i.e., the court did not confine itself to the express terms of the operating agreement's purpose clause.

The second case, *Matter of Natanel*, 43 Misc 3d 1217(A) [Sup Ct Kings County 2014], is one I litigated on behalf of a 50% member who petitioned for dissolution of an LLC that, like the one in Vella, was formed by its two members to acquire a building to house their separate operating business. Unlike Vella, the realty LLC had no written operating agreement. After the members' separate business closed shop, my client petitioned for dissolution of the realty LLC on the ground, among others, that it was no longer serving its specifically intended purpose to house the operating business. The other member contended the realty was acquired not for that specific purpose, but as an investment. Justice Carolyn Demarest's post-trial decision credited my client's testimony as to the LLC's limited purpose and granted dissolution, explaining:

> Respondent relies upon his contention that the purpose of [the LLC] was to provide a vehicle for real estate investment. The statute mandates an examination of the operating agreement or the articles of organization defining

> the purposes of the LLC to determine whether it is reasonably practicable to continue the business. As noted, however, no operating agreement was ever signed here and the articles of organization fail to recite the purpose of the LLC. While generally, under such circumstances, the LLCL will prescribe the default rules, the statute cannot define the purely contractual basis for forming the LLC so as to permit a determination of whether its purpose is being thwarted by the conflict between the members.
>
> . . . [T]he controlling statute provides for dissolution of the LLC, in the discretion of the court, where the purpose of the LLC can no longer be achieved. The credible, competent evidence is that petitioner and respondent formed [the LLC] exclusively in order to continue to house [the separate operating business]. There is no dispute that [the separate operating business] no longer functions as a business and, indeed, both partners have formed separate businesses in competition with . . . each other. In such circumstances, [the LLC's] purpose no longer exists and dissolution is appropriate.

There is no single rule to govern the myriad fact patterns in cases such as *Meyer*, *Vella*, and *Natanel* where no operating agreement exists or where post-formation events either bring about a material change in the adverse members' business relationship or materially deviate from the LLC agreement's stated purpose. In other words, determining the LLC's purpose for dissolution purposes, whether stated broadly or narrowly in the LLC agreement or not at all, is highly fact specific, and ultimately the question of dissolution based on inability to achieve the LLC's purpose is vested in the sound discretion of the court exercising its equitable powers.

Diversity Jurisdiction and Jurisdictional Discovery: The Third Circuit Holds That "Hiding The Ball" Will Not Work

By Thomas E. Rutledge
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Federal diversity jurisdiction, 28 U.S.C. § 1332, requires that the dispute both involve more than $75,000 and that there be complete diversity, *i.e.*, that no defendant be a citizen of any state of which a plaintiff is a citizen. While corporations, consequent to specific legislative designation, are deemed to be citizens of the jurisdiction of incorporation and the jurisdiction in which is located the corporation's principal place of business, an unincorporated association such as a partnership, limited partnership or LLC is deemed to be a citizen in which any of its partners/members are citizens to the effect that, for example, if a member of an LLC is itself another LLC or a partnership, citizenship must be tracked through all layers until there are reached either natural persons or corporations. A plaintiff bringing an action in federal court, or a defendant seeking to remove an action to federal court, is required to plead facts demonstrating that diversity exists. This obligation can be at best difficult to satisfy when one considers that the membership of partnerships and LLCs is almost never of public record. How then, can either the plaintiff or the defendant seeking to enlist diversity jurisdiction adequately plead its existence?

This dilemma was recently faced and addressed by the Third Circuit Court of Appeals. In this case, the plaintiff brought an action in federal court against defendants including LLCs. Those defendants moved to dismiss the action on the basis that diversity jurisdiction had not been adequately pled. Of course, the information as to the membership of those defendant LLCs was uniquely within their control. As such, the plaintiff had pled diversity jurisdiction on the basis of "information and belief." Ultimately, the Third Circuit would confirm that "information and belief" pleading is at least initially sufficient.[1]

Lincoln Benefit brought suit in order to have declared void two life insurance policies, alleging they were procured by fraud or for the benefit of third-party investors (*i.e.*, "Stranger Originated Life Insurance" or "STOLI"). AEI Life, LLC and ALS Capital Ventures, LLC were identified as the record owners and beneficiaries of those two policies. In its Complaint, originally filed in New Jersey, Lincoln Benefit alleged that it is a citizen of Nebraska based upon its organization and principal place of business. It alleged, "upon information and belief," that AEI Life, LLC and ALS Capital Ventures, LLC were citizens of, respectively, New York and Delaware. In response:

> The defendants filed motions to dismiss for, among other things, lack of subject-matter jurisdiction. Their primary argument was that Lincoln Benefit failed to adequately plead diversity jurisdiction: an LLC's citizenship is determined by the citizenship of its members, and Lincoln Benefit had not alleged the citizenship of the members of the LLC defendants.

Lincoln Benefit, in response, pointed out that none of the defendants had asserted that it was a citizen of Nebraska and further that, as information as to the membership of an LLC is not publicly available, it should be allowed to proceed on a "information and belief" basis or, in the alternative, it should be afforded the opportunity to undertake limited discovery for the purposes of confirming that diversity did exist. The trial court held against Lincoln Benefit, holding (a) that pleading diversity on the basis of information and belief is insufficient and (b) that allowing jurisdictional discovery would be inappropriate when it was not clear that the federal court did not already have jurisdiction. It was from these determinations that Lincoln Benefit appealed to the Third Circuit Court of Appeals.

The Third Circuit, after providing a brief review of the rules of diversity jurisdiction, noted that there are two bases for challenging jurisdiction. First, there is a "facial attack," which, as was done in this case, alleges a deficiency in the pleadings.

[1] *Lincoln Benefit Life Company v. AEI Life, LLC*, No. 14-2660, 2015 WL 5131423, ___ F.3d__ (3rd Cir. Sept. 2, 2015).

There is as well a "factual attack," which challenges whether the alleged facts justify jurisdiction. Distinguishing, in the setting of this dispute, a facial from a factual attack, the Court, wrote:

> If the defendants here had challenged the factual existence of jurisdiction, Lincoln Benefit would have been required to prove by a preponderance of the evidence, after discovery, that it was diverse from every member of both defendant LLCs. Instead, however, the defendants mounted a facial challenge to the adequacy of the jurisdictional allegations in Lincoln Benefit's complaint. [2]

In reliance, at least in part, on the decision rendered in *Lewis v. Rego, Co.*[3] and as well limiting *Chem. Leaman Tank Lines, Inc. v. Aetna Cas. & Sur. Co.*[4] for the proposition that "rather than affirmatively alleging the citizenship of the defendant, a plaintiff may allege that the defendant is *not* a citizen of the plaintiff's state of citizenship." To the effect that:

> A State X plaintiff may therefore survive a facial challenge by alleging that none of the defendant association's members are citizens of States X.[5]

provided that the plaintiff has undertaken reasonable inquiry in support thereof. To that end:

> [B]efore alleging that none of an unincorporated association's members are citizens of a particular state, a plaintiff should consult the sources at its disposal, including court filings and other public records. If, after this inquiry, the plaintiff has no reason to believe that any of the Association's members share its state of citizenship, it may allege complete diversity in good faith. The unincorporated association, which is in the best position to ascertain its own membership, may then mount a factual challenge by identifying any member who destroys diversity.[6]

Explaining the rationale for its holding, the Court wrote:

> We believe that allowing this method of pleading strikes the appropriate balance between facilitating access to the courts and managing the burdens of discovery. District courts have the authority to allow discovery in order to determine whether subject-matter jurisdiction exists. Rule 8(a)(1), however, serves a screening function: only those plaintiffs who have provided some basis to believe jurisdiction exists are entitled to discovery on that issue. The corollary of this principle is that a plaintiff need not allege an airtight case before obtaining discovery.
>
> Depriving a party of a federal forum simply because it cannot identify all of the members of an unincorporated association is not a rational screening mechanism. The membership of an LLC is often not a matter of public record. Thus, a rule requiring the citizenship of each member of each LLC to be alleged affirmatively before jurisdictional discovery would effectively shield many LLCs from being sued in federal court without their consent. This is surely not what the drafters of the Federal Rules intended.
>
> Moreover, the benefits of such a stringent rule would be modest. Jurisdictional discovery will usually be less burdensome than merits discovery, given the more limited scope of jurisdictional inquiries. It seems to us that in determining the membership of an LLC or other unincorporated association, a few

[2] 2015 WL 5131423,* 3.

[3] 757 F.2d 66 (3rd Cir. 1985).

[4] 177 F.3d 210, 222 n. 13 (3rd Cir., 1999).

[5] *Id.* at *4.

[6] *Id.*

> responses to interrogatories will often suffice. So long as discovery is narrowly tailored to the issue of diversity jurisdiction and parties are sanctioned for making truly frivolous allegations of diversity, the costs of this system will be manageable.[7]

This opinion was followed by a concurrence written by Judge Ambro that, while not specifically commenting upon this dispute, urged the U.S. Supreme Court to in effect abandon the rule of *Carden v. Arkoma Associates*[8] and allow at least limited liability companies, notwithstanding the fact that they are unincorporated, to proceed under the rules for determining citizenship that are applicable to corporations.

Assuming the reasoning employed in the *Lincoln Benefit* decision is followed by the other circuits, this could be a most important decision. First, it significantly undercuts the large number of decisions that, to date, have held that citizenship must be pled specifically and not on information and belief.[9] Further, it stands in direct challenges to those decisions that have held that citizenship must be affirmatively pled and that negative statements as to citizenship are insufficient.[10] While it may do nothing to address the fact that diversity jurisdiction may be unavailable consequent to de minimis indirect ownership,[11] it does limit the ability of a defendant to "hide the ball" as to its citizenship while objecting that the other side has not adequately pled citizenship and therefore diversity.

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[7] *Id.* at * 5.

[8] 494 U.S. 185 (1990).

[9] *See*, *e.g.*, *Principle Solutions LLC v. Feed.Ing BV*, Case No. 13-C-223 (E.D. Wisc. June 5, 2013) ("It is well-settled that a plaintiff claiming diversity jurisdiction may not do so on the basis of information and belief, only personal knowledge is sufficient."); *Pharmerica Corp. v. Crestwood Care, LLC*, No. 13C 1422, 2015 WL 1006683 (E.D. Ill. March 2, 2015) ("[I]t is not sufficient to assert jurisdiction based on information and belief."); *MCP Trucking, LLC v. Speedy Heavy Hauling, Inc.*, 2014 WL 5002116 (D. Colo. Oct. 6, 2014) (denying jurisdictional discovery and remanding action to state court even as it acknowledged that further discovery in that forum could demonstrate that diversity exists, leading to subsequent removal); *Lake v. Hezebicks*, 2014 WL 1874853 (N. D. Ind. May 9, 2014) (allegations of subject matter jurisdiction must be based on personal knowledge and may not be based upon information and belief and collecting cases to that effect).

[10] *See*, *e.g.*, *D.B. Zwirn Special Opportunities Fund, LP v. Mehrotra*, 661 F.3d. 124 (1st Cir. 2011), citing *Cameron v. Hodges*, 127 U.S. 322 (1888).

[11] *See*, *e.g.*, *Fadal Machining Centers, LLC v. Mid-Atlantic CNC, Inc.*, 2012 WL 8669, 2012 U.S. App. LEXIS 48 (Jan. 3, 2012); *Alphonse v. Arch Bay Holdings, L.L.C.*, 2015 WL 4187585 (5th Cir. July 13, 2015).

Can LLC Agreement Be Enforced Against Member Who Doesn't Sign It?

By Peter Mahler
Posted originally on his blog *New York Business Divorce*
September 8th, 2015

It just got more dangerous to become a minority member of a New York limited liability company without a written operating agreement.

In a case of first impression decided last month, a Manhattan judge ruled that the majority members of an LLC that had no operating agreement at the time of its formation were authorized by statute to later adopt and enforce against a non-signatory minority member an operating agreement that, among other things, authorizes additional capital calls and potentially dilutes the membership interest of a member who fails to contribute.

The facts in *Shapiro v Ettenson*, 2015 NY Slip Op 31670(U) [Sup Ct NY County Aug. 16, 2015], are fairly simple. In January 2012, three individuals — plaintiff Shapiro and defendants Ettenson and Newman — filed articles of organization for ENS Health, LLC as a member-managed LLC with each member holding a one-third membership interest. From its formation until December 2013, ENS had no written operating agreement. Between September and December 2013, the members negotiated and exchanged draft agreements but none was executed.

In December 2013, Ettenson and Newman, acting under authority of written consent signed by the two of them in lieu of meeting, filed amended articles of organization designating the LLC as manager-managed. They also executed an operating agreement without Shapiro's consent or signature.

The operating agreement (read here) designated the three members as co-managers. It provided that any action requiring manager approval shall be approved by a majority of the managers, and likewise that any action requiring member approval shall be approved by those holding a majority of the membership interests.

The operating agreement also authorized the members to approve, by majority interest vote, requests to members for additional capital contributions and provided for the adjustment of the members' percentage interests in the LLC should a member fail to make a requested contribution which is then made up for by the other members.

At a meeting in October 2014, Ettenson and Newman approved resolutions eliminating Shapiro's $50,000 salary and requesting an additional capital contribution of $10,000 from each member. They also sent Shapiro a capital call notice advising Shapiro that his membership interest was subject to reduction if he failed to make the contribution, should the other members make up the deficit. Shapiro objected to both actions and filed suit the following month.

Shapiro's Lawsuit

Shapiro's complaint alleged that the three members orally agreed at its inception to maintain the LLC as a member-managed company; that all decisions would be by unanimous member vote; and that no member's interest would be diluted in the event of inability or failure to make an authorized capital call. The complaint primarily sought a judgment declaring the operating agreement invalid since it lacked the signature of all three members; declaring invalid the amended articles of organization; declaring invalid the capital call; and declaring invalid the defendants' vote to eliminate Shapiro's salary.

In their answer, Ettenson and Newman counterclaimed for reverse relief declaring valid the operating agreement, the amended articles of organization, the capital call, and the vote to eliminate Shapiro's salary. The counterclaim also sought in the alternative a judgment declaring those actions valid even assuming the operating agreement's invalidity, i.e., that they were permitted under the LLC Law's default rules.

The Summary Judgment Motions

The two sides subsequently filed dueling motions for summary judgment. The defendants argued:

• Plaintiff's alleged oral agreement made at the LLC's inception, requiring unanimous member consent for all decisions and precluding involuntary dilution of a member's interest, is unenforceable under LLC Law §§ 102(u) and 417(a) requiring the adoption of a written operating agreement and under case law holding that, absent a written operating agreement, the LLC Law's default rules function as the statutory operating agreement. In other words, under New York law there is no such thing as an oral operating agreement.

• The written operating agreement executed by defendants without plaintiff's consent, and the amendment of the LLC's articles of organization changing it to a manager-managed LLC, are both valid under LLC Law § 402(c)(3) stating in pertinent part, "Except as provided in the operating agreement, . . . the vote of a majority in interest of the members entitled to vote thereon shall be required to . . . adopt, amend, restate or revoke the articles of organization or operating agreement . . .."

• Under the default rules contained in LLC Law §§ 402(f) and 408(b), even were the operating agreement adopted by defendants invalid, defendants lawfully exercised their majority voting power as members and managers in regard to the amendment of the LLC's articles, the capital call, and the elimination of plaintiff's salary.

The plaintiff argued:

• The term "members" as used in LLC Law § 102(u) ("'Operating agreement'" means any written agreement of the members concerning the business of a limited liability company and the conduct of its affairs and complying with [§ 417] of this chapter") and § 417(a) ("the members of a limited liability company shall adopt a written operating agreement") must be interpreted to mean all the members.

• An LLC operating agreement is a contract and therefore cannot bind a non-signatory member.

• Under LLC Law § 417(c), which provides that an operating agreement "may be entered into before, at the time of or within ninety days after the filing of the articles of organization," the operating agreement entered into by the two defendants almost one year after the LLC's formation is invalid.

• Under the default rule in LLC Law § 502(c), absent authorization in the operating agreement a member's interest in the LLC may not be reduced, terminated, or otherwise adversely affected by his or her failure to make an additional capital contribution.

• Under the default rule in LLC Law § 417(b), no amendment of the operating agreement or articles is permitted without the written consent of any adversely affected member, inter alia, concerning the obligation to make contributions or entitlement to distributions and allocation of profit and loss.

For those who wish to dig deeper, read here and here the defendants' opening and reply briefs, and here and here plaintiff's opening and reply briefs.

The Court's Decision

The decision by Manhattan Supreme Court Justice Kelly A. O'Neill Levy begins its analysis by reviewing the various sections of the LLC Law cited by the parties, leading to her agreement with the defendants' position that LLC Law § 402 authorized them to adopt the LLC's operating agreement by majority vote and without plaintiff's consent. Here's what she wrote:

> Under section 402 (a), (c) (3), and (f), Shapiro, Ettenson, and Newman were each entitled to vote in proportion to their one-third ownership interests in order to "adopt, amend, restate or revoke the articles of organization or operating agreement." Together, Ettenson and Newman owned two-thirds of [the LLC], clearly constituting a majority sufficient, under the LLC Law, to adopt the

> Operating Agreement and amend the articles of organization. Therefore, Ettenson and Newman have made a prima facie showing that they were authorized to approve and adopt the Operating Agreement and to amend the articles of organization, and that these documents are valid and enforceable.

Justice O'Neill Levy was not persuaded by plaintiff's reliance on LLC Law § 417, finding that the section neither requires the adoption of an operating agreement by unanimous consent of the members nor prohibits adoption by less than unanimous consent. "In short," the judge wrote, "Shapiro's argument is not supported by the plain language of the LLC Law."

Justice O'Neill Levy also found that the defendants' capital call did not "trigger," much less run afoul of, LLC Law § 502 because the contribution was merely "requested" and not obligatory, and because the consequences of failing to make a requested contribution were contained in the operating agreement adopted by defendants as authorized by § 502(c). She also rejected each of plaintiff's arguments challenging the defendants' action taken as majority managers to eliminate plaintiff's salary.

At page 11 of the decision, Justice O'Neill Levy broadly concluded that the actions taken by defendants were lawful even if the operating agreement were deemed invalid, writing:

> The court notes that, even assuming for the moment that the Operating Agreement was invalid and there was no written operating agreement, the default provisions of the LLC Law would apply. Under the default provisions, section 401 vested [the LLC's] management in its three members. Under section 402, Ettenson and Newman held a combined majority interest, thereby permitting them to reduce Shapiro's salary and issue the capital call. Therefore, defendants' actions were valid even in the absence of an operating agreement. [Citation omitted.]

The decision accordingly grants summary judgment in favor of the defendants on their counterclaims and dismisses each of the plaintiff's claims, and includes decretal provisions declaring valid and binding on all the members the operating agreement, the amended articles of organization, the notice of capital call, and the elimination of plaintiff's salary.

A Few Observations

• For many reasons, whether it's a family-owned business, a small start-up among unrelated business partners, or even a larger enterprise with persons operating on trust and a handshake — and often without legal counsel — it's not at all unusual for the prospective co-members to file the minimal articles of organization for an LLC without having first negotiated and signed a written operating agreement. The Shapiro decision, if affirmed on appeal (assuming the plaintiff files an appeal which, so far, he hasn't) or followed by other trial judges could become a highly dangerous trap for unwary minority members of New York LLCs who, like Mr. Shapiro, could find themselves bound by a subsequently adopted operating agreement they never knew about, much less approved, containing all sorts of potentially prejudicial governance provisions for capital contributions, member expulsion, elimination of management rights, etc. Practitioners must strongly caution any client who wants to become a minority member of a New York LLC to have in place a satisfactory written operating agreement before proceeding. The agreement also should provide for unanimous member approval of any amendments to the operating agreement and articles of organization.

• From what I can tell, the plaintiff in Shapiro did not make an explicit statute of frauds argument, though, as noted above, he did contend that he could not be bound by a "contract" that he never signed. In Delaware, the Chancery and Supreme Courts held in the Olson v. Halvorsen case that, notwithstanding the Delaware LLC Act's section permitting oral operating agreements, the state's general statute of frauds applies to LLC agreements, that is, until the Delaware legislature subsequently overruled that case by amendment to the Delaware LLC Act. I'm not aware of any New York cases addressing the issue.

• Speaking of Delaware Chancery Court, last year in *Seaport Village Ltd. v. Seaport Village Operating Co. LLC*, Vice Chancellor Laster ruled that an LLC agreement binds the LLC even if not executed on the LLC's behalf, in accordance with a 2002 amendment to § 18-101(7) of the Delaware LLC Act explicitly providing that an LLC "is bound by its limited liability company agreement whether or not the limited liability company executes the limited liability company agreement." The decision notes in passing that "[i]n 2005, the General Assembly added nearly identical language to the LLC Act to clarify that members also are bound by the LLC's operating agreement, regardless of whether they execute the agreement." Obviously New York's LLC Law lacks similar provisions.

• The *Shapiro* decision, in the passage that assumes arguendo there's no written operating agreement and nonetheless upholds under the LLC Law's default rules the capital call and potentially adverse consequences to a member who doesn't contribute, appears to gloss over the impact of LLC Law § 502(c) which, as New York courts have held (read here), authorizes such consequences only if embodied in a written operating agreement.

State Issues Guidance on Nexus For Foreign Corporate Member of Disregarded LLC Investment Company

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The New York State Tax Department has issued important guidance regarding the scope of the exemption from Article 9-A for non-U.S. corporations that use limited liability companies to engage in qualifying investment activities in New York. Advisory Opinion, TSB-A-15(5)C (N.Y.S. Dep't of Taxation & Fin., July 10, 2015).

The facts presented are straightforward. A Swiss holding company is the sole member of a Delaware limited liability company ("LLC") that is treated as a disregarded entity for federal and state income tax purposes. The LLC is solely engaged in investing in securities in private equity funds, hedge funds and operating-companies for its own account. The LLC has an office in New Jersey, and has never owned or leased real property in New York. The Swiss holding company is not otherwise engaged in the conduct of a U.S. trade or business for federal income tax purposes, and thus does not have effectively connected income under IRC § 882.

Generally, under IRC § 864(b)(2), trading in securities or commodities by a non-dealer is not considered a trade or business within the United States for federal income tax purposes. Therefore, a foreign corporation engaged in those activities in the United States does not have effectively connected income.

The question presented was whether the Swiss holding company will become subject to Article 9-A if the LLC were to relocate its office from New Jersey to New York City. The Department ruled that so long as the LLC continues to engage solely in qualifying activities in New York within the meaning of IRC § 864(b)(2), and the Swiss holding company continues not to have effectively connected income, the holding company will not be subject to Article 9-A. This is based on the language of Tax Law § 209(2-a), which provides that an alien (i.e., non U.S.) corporation that is not treated as a "domestic corporation" for federal purposes and that has no effectively connected income is not subject to Article 9-A. Under corporate tax reform, alien corporations no longer have an annual franchise tax filing requirement.

In response to the question regarding what may be required to substantiate entitlement to the exemption, the Department would say only that it may be necessary to produce the alien corporation's books and records to confirm, for example, that the corporation's New York activities are limited to the investment or trading activities described in IRC § 864(b)(2).

Additional Insights

The Advisory Opinion specifies that it applies only to situations where the LLC's in-State activities are limited solely to investment activities prescribed under IRC § 864(b)(2). It does not address the consequences if the Swiss holding company has effectively connected income from some other activity conducted wholly outside the State. It also does not discuss the result if the holding company has other affiliates that do have effectively connected income in the United States. It should be noted that alien corporations that are not treated as "domestic corporations" and that do not have effectively connected income cannot be included in a New York combined return.

The Department provided this guidance as an Advisory Opinion, even though it has informally indicated that it would generally address interpretations under corporate tax reform through regulations and Corporate Tax Reform FAQs posted on its website, rather than through Advisory Opinions.

Louisiana Fourth Circuit Holds Public Bid Invalid Absent Written Evidence of Authority to Sign Bid

By Mark Frilot
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Contractors that bid public projects in Louisiana are familiar with the Public Bid Law's requirement that "[w]ritten evidence of authority of the person signing the bid for public works shall be submitted at the time of bidding." The Public Bid Law further provides that, for bidders that are limited liability companies, a signatory's authority is deemed sufficient if the signatory is a member of the limited liability company and is listed as a member in the most current business records on file with the Secretary of State. The Louisiana Fourth Circuit, in *Dynamic Constructors, L.L.C. v. Plaquemines Parish Government*, was recently called upon to decide whether, under Section 2212B(5)(a) and specific bid instructions, an L.L.C. bidder was required to furnish with its bid written evidence of the individual signatory's authority to bind the L.L.C., even when the signatory was an L.L.C. member who was listed in the Secretary of State's most current business records. The court held that, under the facts before it, the low bidder, who had not furnished written evidence of authority of the person signing the bid, did not comply with the Public Bid Law, rendering its bid non-responsive and requiring the public owner to award the project to another bidder.

In Dynamic, the public owner, Plaquemines Parish Government (PPG), determined that Dynamic Constructors, L.L.C. (Dynamic) was the lowest responsive bidder on a public works demolition contract. Dynamic's bid was executed by Jeffrey Hymel, a member of Dynamic who was listed in the most current business records on file with the Secretary of State. Before PPG awarded the contract to Dynamic, Hamp's Construction, L.L.C. (Hamp's) submitted a bid protest challenging the responsiveness of Dynamic's bid on the bases that Dynamic (1) failed to attach to Dynamic's bid written evidence of the authority of the person signing the bid and (2) failed to provide a list of each member of Dynamic, as the bid instructions required. PPG found merit to the protest and rescinded its initial notice of award to Dynamic. PPG determined that Dynamic's bid was non-responsive because it did not contain written evidence of authority allowing Mr. Hymel to execute the bid on Dynamic's behalf.

Dynamic filed suit against PPG seeking: (1) a preliminary injunction prohibiting PPG from awarding the contract to any entity other than Dynamic and (2) a writ of mandamus directing PPG to award the contract to Dynamic. The trial court granted the preliminary injunction, holding "that [Dynamic] had complied with the requirements of the Public Bid Law because the signature of Mr. Hymel as 'Jeffrey R. Hymel, Jr., owner of Dynamic,' was sufficient under the law to qualify Mr. Hymel to sign the bid." Hamp's, which intervened in the action, appealed the trial court's judgment.

The Fourth Circuit framed the issue as whether, under the requirements of the Public Bid Law and the requirements of the bid instructions, the signature of Mr. Hymel, who was listed as a member of Dynamic in its most recent business records on file with the Secretary of State, was sufficient written evidence of his authority to sign the bid documents on Dynamic's behalf. The court began its analysis by examining the relevant text of La. R.S. 38:2212B:

(2)... The bidding documents shall require only the following information and documentation to be submitted by a bidder at the time designated in the advertisement for bid opening:... Signature of Bidder, Name, Title, and Address of Bidder, Name of Firm or Joint Venture, Corporate Resolution or written evidence of the authority of the person signing the bid....

* * *

(5) Written evidence of the authority of the person signing the bid for public works shall be submitted at the time of bidding. The authority of the signature of the person submitting the bid shall be deemed sufficient and acceptable if any of the following conditions are met:

(a) The signature on the bid is that of any corporate officer listed on the most current annual report on file with the secretary of state, or the signature on the bid is that of any member of a partnership, limited liability company, limited liability partnership, or other legal entity listed in the most current business records on file with the secretary of state.

Dynamic argued that Mr. Hymel's signature was sufficient under La. R.S. 38:2212B(5)(a) because he was listed as a member of Dynamic on its most current filing with the Secretary of State. Dynamic argued that "the Public Bid Law does not require that the bidder provide the pertinent records of the secretary of state as a part of the bid, only that the person signing the bid be, in fact, a member of the business entity submitting the bid."

The court disagreed. The court found that "Dynamic was required, at the opening of the bid, to present some form of written evidence or documentation (i.e., a copy of the company's current business record on file with the Secretary of State) substantiating that Jeffrey Hymel was, in fact, a member of the limited liability company and, thus, had the requisite authority to sign the bid on Dynamic's behalf." The court noted that its decision was consistent with the 2014 amendment to La. R.S. 38:2212, which previously did not expressly require submission of written evidence of authority at the opening of the bid. The court reasoned, "Clearly, in rewording the statute, the Legislature intended to change the law and to now require, at the time of the opening of the bid, written evidence of the authority of the person signing the bid on the bidder's behalf."

Therefore, the court concluded that Dynamic violated the Public Bid Law and the bid instructions by failing to include written evidence of Mr. Hymel's authority to sign the bid on its behalf, mandating that PPG rescind the notice of award to Dynamic. The court reversed the trial court's judgment granting Dynamic's request for a preliminary injunction and writ of mandamus.

It is worth noting that the bid instructions at issue in Dynamic required a limited liability company to list the name and address of every managing member. The instructions also required that evidence of agency, corporate or partnership authority be submitted with the bid and warned that PPG would rescind the notice of award if a bidder did not comply. In reaching its decision, the Fourth Circuit relied in part on Dynamic's failure to comply with those requirements of the bid instructions.

New Minnesota Revised Limited Liability Company Act Takes Effect August 1, 2015

By Jeffrey O'Brien
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The Minnesota Revised Uniform Limited Liability Company Act, codified as Minnesota Statutes Chapter 322C, was passed by the 2014 Minnesota Legislature and signed into law by Governor Dayton on April 11, 2014. The new Act becomes effective as of August 1, 2015.

The new Act is patterned after the Revised Uniform Limited Liability Company Act ("RULLCA"), which was adopted by the National Conference of Commissioners on Uniform Laws. Minnesota was the 11th state to adopt RULLCA, and the rationale behind adoption was to harmonize Minnesota's unique LLC statute with LLC statutes in other jurisdictions.

Following are some of the more significant provisions contained in the new Act of which Minnesota business owners should be aware:

1. **Shift From Corporate to Partnership Structure**.

A hallmark of Minnesota's prior LLC Act and perhaps its most unique aspect has been its reliance upon a "corporate" structure of governance. Similar to a board of directors in a corporation, a Minnesota LLC (prior to the enactment of the new Act) was managed by a board of governors.

Under the new 322C, an LLC can be "manager-managed" or "member-managed." Unless the LLC's operating agreement provides otherwise, an LLC is member-managed; meaning that the management of the LLC is vested in the members. Each member has equal rights in the management and conduct of the LLC's activities (in contrast to the prior Act where a select number of members could conceivably serve as the Board) and disagreements among the members as to a matter in the ordinary course of the LLC's business will be decided by a majority of the members.

Should the operating agreement so provide, a manager-managed LLC implies that any matter relating to the activities of the LLC is decided exclusively by the managers. Each manager has equally rights in the management and conduct of the LLC's activities and disagreements among the managers as to a matter in the ordinary course of the LLC's business will be decided by a majority of the managers.

Minnesota's new LLC Act does preserve the option of an LLC electing to be "board managed", which is a departure from RULLCA but nonetheless included in the new Act in part to ease the transition of a 322B LLC to the new statute. Under the new Act, the board may consist of one or more governors as determined by a majority vote of the members. The board acts only through the board, and no individual governor has any right or authority to bind the LLC. Instead, only officers, managers or other agents as designated by the board may act for the LLC, and such individuals' authority is limited to the authority granted to them by the board.

2. **Importance of the Operating Agreement**.

The key governing document for a 322C LLC is the operating agreement.

• *322C Operating Agreement vs. 322B Member Control Agreement*. The reliance upon an operating agreement as the key LLC document represents a departure from the prior Act which made the member control agreement the key document.

A 322C operating agreement, the foundational contract among the entity's owners, is defined as the agreement, regardless of what it is called, and whether oral, in a record, implied, or in any combination thereof of all the members of an LLC, including a sole member, concerning the (1) relations among the members as members and between the members and the LLC; (2) the rights and duties of a person in the capacity of manager or governor; (3) the activities of the LLC and the conduct of those activities; and (4) the means and conditions for amending the operating agreement.

By contrast, a member control agreement, must be in writing and must be signed by the persons who, on the date the agreement first becomes effective, comprise all the members of the LLC (regardless of voting power), and all persons who are party to contribution agreements that on that date have not yet been fully performed.

• *Voting Power*. Under Chapter 322B, the default rule for voting power is proportionate based on the value of the contributions of the Members, as reflected in the LLC records. Chapter 322C provides that the default rule for voting is per capita. In other words, unless the operating agreement provides otherwise, each member has equal voting rights in the management and conduct of the LLC's activities.

• *Distributions*. The default rule in Chapter 322B is that distributions must be allocated in proportion to the value of the contributions of the Members as reflected in the LLC records. Under Chapter 322C, the default rule is that operating distributions are per capita rather than per contribution and must be distributed in equal shares among the Members unless otherwise provided in the operating agreement. With respect to distributions upon dissolution and winding up (as opposed to normal, operating distributions), the default rule is that, unless otherwise provided in the operating agreement, the distributions are made first to each Member in an amount equal to the value of unreturned contributions, and then in equal shares among the Members on a per capita basis.

3. **Fiduciary Duties**.

• *Duty of Loyalty and Duty of Care*. Under the existing Chapter 322B, the duty of loyalty and the duty of care are required duties among those in management control of a limited liability company. The duty of loyalty is the requirement to proceed with management decisions in good faith in the manner the decision maker reasonably believes to be in the best interest of the LLC. The duty of care is to proceed with a level of care which an ordinarily prudent person in a like position would exercise under similar circumstances. These duties may not be waived under 322B, although a decision maker's personal liability for monetary damages for breach of such duties is subject to very limited modification and reduction.

Under new Chapter 322C, the duties of care and loyalty are applicable to the parties holding management control of the LLC (i.e., members, managers or board of governors, as the case may be) but may be reduced or modified under the operating agreement as follows: (1) the duty of care may be modified or restricted to the extent not "manifestly unreasonable", except that such modification or restriction may not authorize intentional misconduct or known violation of law; and (2) the duty of loyalty may be entirely eliminated to the extent not "manifestly unreasonable."

• *Duty of Good Faith and Fair Dealing*. Chapter 322C, unlike its predecessor, provides that, in the absence of modification or restriction in the operating agreement, a new contractual obligation of good faith and fair dealing is imposed upon all members under the new Act. The duty requires the members to discharge the members' duties and exercise any rights under the operating agreement consistently with the contractual obligations of good faith and fair dealing, including acting in a manner which, in light of the operating agreement, is honest, fair and reasonable. The obligation of good faith and fair dealing may be restricted by specifying standards by which to evaluate whether the obligation has been met, so long as those standards are not "manifestly unreasonable".

4. **Minnesota Modifications to RULLCA**. Despite the stated objective of harmonizing Minnesota's LLC statutes with other states through the adoption of RULLCA, Chapter 322C contains several modifications to RULLCA, the most significant of which are the following:

• *Board Management*. In addition to member-management and manager-management, provided for in RULLCA, Chapter 322C also includes provisions for board-management that are intended to support existing board managed entities when they become subject to the new Act, and incorporates the term "governor" in the Act's provisions regarding board management.

• *Plans of Exchange*. Chapter 322B currently authorizes LLCs to engage in mergers and plans of exchange. While RULLCA authorizes mergers, it does not address plans of exchange. The Minnesota proposal includes provisions retaining plans of exchange for Minnesota LLCs.

• *Attorney General Authority*. The proposal includes several provisions from Chapter 322B providing authority to the Attorney General to act in specified situations; for example when an LLC is organized for a purpose not permitted by the Act

• *Notice Provisions*. Chapter 322C modifies the provisions regarding filings of notices of authority, etc., to make them similar to those contained in the Uniform Partnership Act.

• *Minnesota Specific Terminology*. Several provisions of the Act were revised to conform to provisions of other Minnesota business entity laws with respect to names, annual reports, electronic signatures, and the like, as well as Secretary of State filing requirements. Also some terminology was changed to match the current law, for example, Chapter 322C uses "Articles of Organization" to refer to the initial organizational filing instead of RULLCA's "Certificate of Organization."

• *Nonprofit LLCs*. The Attorney General asked that the new LLC Act retain provisions similar to the Nonprofit LLC provisions of Minn. Stat. 322B.975. These provisions were added back to the new Act.

• *Piercing Issues*. Chapter 322B currently provides explicitly that that the case law regarding piercing the liability shield of a corporation also applies to limited liability companies. RULLCA had no such provision, and also provided that "the failure of a limited liability company to observe any particular formalities relating to the exercise of its powers or management of its activities is not a ground for imposing liability on the members or managers for the debts, obligations, or other liabilities of the company." In response to the Attorney General's concerns, Chapter 322C contains additional language to the effect that "[e]xcept as relates to the failure of a limited liability company to observe formalities relating exclusively to the management of its internal affairs, the case law that 'states the conditions and circumstances under which the corporate veil of a corporation may be pierced under Minnesota law also applies to limited liability companies."

• *Remedies for Minority Owner Oppression*. In response to the concerns of some regarding the omission of Chapter 322B's dissenters rights provisions, changes to the initial proposed language were made to clarify rights to dissolution and remedies short of dissolution if managers, governors, or members in control of an LLC have acted, are acting, or will act in a manner that is "oppressive". These changes make clearer what constitutes "oppressive" conduct, include provisions clarifying that a forced buy-out of a member may be ordered by the court at fair value, and incorporate certain other changes.

5. **Dissenters Rights**. Under the prior Minnesota Limited Liability Company Act, an LLC member may dissent and obtain payment for the fair value of the Member's membership interest in an LLC, in the event of certain company actions as enumerated in the prior Act (although the members were permitted to waive such rights in the LLC's member control agreement). The new Act contains no provision for dissenters' rights, thus removing a significant amount of leverage for a minority member of an LLC who objects to a course of action which the LLC has taken or proposes to take (although as noted earlier, the new Act includes additional language regarding oppressive conduct towards minority members).

As noted above, the new LLC Act requires all LLCs formed on or after August 1, 2015 to be governed by the new Act. Existing 322B LLCs may continue to be governed by Chapter 322B until January 1, 2018, at which time all LLCs shall thereafter be governed by the new Act. Existing 322B LLCs may choose to opt into the new Act prior to January 1, 2018 as well.

Tribunal Upholds Personal Liability of LLC Members For Sales Tax

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The New York State Tax Appeals Tribunal has affirmed the determination of an Administrative Law Judge that a member of a limited liability company ("LLC") holding a minority interest in the LLC is liable for a portion of a sales and use tax assessment against the LLC itself. *Matter of Eugene Boissiere and Jason Krystal*, DTA Nos. 824467, et al. (N.Y.S. Tax App. Trib., July 28, 2015).

Eugene Boissiere and Jason Krystal held 14% and 13% membership interests, respectively, in an LLC. Neither individual had managerial responsibility, knowledge or control over the LLC's financial affairs, or authority to sign the LLC's tax returns. The New York State Department of Taxation and Finance performed a sales tax audit of the LLC, and assessed sales tax, plus interest, against the company for the period June 1, 2004 through May 31, 2009. The Department also issued separate Notices of Determination to Mr. Boissiere and Mr. Krystal, each assessing the full amount of the sales tax, plus penalty and interest, for the period during which each held a membership interest in the LLC. After negotiations between the Department and the taxpayers, and in keeping with the Department's policy as set forth in Technical Memorandum, TSB-M-11(17)S (N.Y.S. Dep't of Taxation & Fin., Sept. 19, 2011), the Department reduced the individuals' liability for the sales tax to reflect their percentage of ownership in the business, plus interest.

Tax Law § 1131(1) imposes strict personal liability for sales tax on "any member of a partnership or limited liability company," regardless of whether that person is under a duty to act on behalf of the company. In contrast, the New York Limited Liability Company Law provides that a member of an LLC cannot be held personally responsible for an LLC's liabilities "solely by reason of being such member." LLC Law § 609(a).

Messrs. Boissiere and Krystal challenged the assessments imposing personal liability for a portion of the LLC's sales tax. The ALJ upheld the Department's assessments, noting that the definition of "persons responsible to collect sales tax" under the plain language of Tax Law § 1131(1) is unambiguous and includes any member of an LLC.

Messrs. Boissiere and Krystal appealed the ALJ's decision to the Tribunal, arguing that the conflict between the Tax Law, which provides that LLC members are per se liable for an LLC's sales tax obligations, and the LLC law, which provides that LLC members may not be held liable for an LLC's obligations, was the result of a "mistake" by the drafters of the Tax Law. The Tribunal rejected the taxpayers' contentions that the Legislature made a mistake as "speculative," and affirmed the determination of the ALJ.

Like the ALJ, the Tribunal held that the plain and unambiguous language of the Tax Law provided for per se liability. In so holding, the Department noted that the Department's policy, as set forth in TSB-M-11(17)S, of limiting a member's liability to its percentage interest in the LLC, ameliorated any "harsh consequences" that might warrant a departure from the literal language of the statute. Moreover, the Tribunal did not find the Tax Law and the LLC Law to be inconsistent. Instead, the Tribunal found that the laws evidenced an intent by the Legislature that the limitation of liability for LLC members under the LLC Law should not extend to sales tax liability under the Tax Law.

Additional Insights

The Tribunal's decision upholding the LLC members' strict liability for the LLC's sales tax obligations is in keeping with its decision in *Matter of Santo*, DTA No. 821797 (N.Y.S. Tax App. Trib., Dec. 23, 2009). In Matter of Santo, the Tribunal upheld the imposition of strict liability on an LLC member for the full amount of the LLC's sales tax liability. After Matter of Santo was decided, the Department issued TSB-M-11(17)S in response to public concern that the application of strict liability might work a hardship to LLC members that have little or no involvement in the actual business of the LLC. While generally beneficial to taxpayers, TSB-M-11(17)S conditions limited liability on the LLC members' cooperation with the Department, including identifying to the Department other potentially responsible persons. In addition, the relief is limited to LLC members who hold less than a 50% interest in the LLC.

In this case, as in Matter of Santo, the Tribunal held that the Tax Law authorizes the Department to hold LLC members strictly liable for an LLC's sales tax liabilities. However, the Tribunal also noted that it saw no "unjust or unreasonable result in the assertion of per se liability against [taxpayers] to warrant a departure from the literal interpretation of the words used in [the] Tax Law," because the Department reduced the taxpayers' liabilities to reflect their ownership interests in the LLC in accordance with TSB-M-11(17)S. While the Tribunal concluded that imposition of strict liability — limited to the members' ownership interest percentages — did not produce an unjust or unreasonable result in this case, there may still be circumstances where the Tribunal would not uphold strict liability where the Department does not consent to limited liability if the member does not meet certain conditions under the TSB-M.

Wrong: U.S. Supreme Court & 4575 Other Cases Say an LLC is a Corporation

By Joshua Fershee
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Originally Posted on the *Business Law Prof. Blog* (Sept. 8, 2015).

Limited liability companies (LLCs) are often viewed as some sort of a modified corporation. This is wrong, as LLCs are unique entities (as are, for example, limited partnerships), but that has not stopped lawyers and courts, including this nation's highest court, from conflating LLCs and corporations.

About four and a half years ago, in a short Harvard Business Law Review Online article, I focused on this oddity, noting that many courts seem to view LLCs as close cousins to corporations, and many even appear to view LLCs as subset or specialized types of corporations. A May 2011 search of Westlaw's "ALLCASES" database provides 2,773 documents with the phrase "limited liability corporation," yet most (if not all) such cases were actually referring to LLCs—limited liability *companies*. As such, it is not surprising that courts have often failed to treat LLCs as alternative entities unto themselves. It may be that some courts didn't even appreciate that fact. (footnotes omitted).

I have been writing about this subject again recently, so I decided to revisit the question of just how many courts call LLCs "limited liability *corporations*" instead of "limited liability *companies*." I returned to Westlaw, though this time it's WestlawNext, to do the search of cases for the term "limited liability corp!". (Exclamation point is to include corp., corporation, and corporations in my search, not to show excitement at the prospect.)

The result: 4575 cases use the phrase at least once.

That means that, since May 2011, 1802 additional cases have incorrectly identified the definition of an LLC. (I concede that some cases may have used the term to note it was wrong, but I didn't find any in a brief look.)

Even the United States Supreme Court published one case using the incorrect phrase, and it was decided around three years after my article was published. *See* *Daimler AG v. Bauman*, 134 S. Ct. 746, 752, 187 L. Ed. 2d 624 (2014) ("MBUSA, an indirect subsidiary of Daimler, is a Delaware limited liability corporation."). (Author's note: ARRRRGH!) The court also stated, "Jurisdiction over the lawsuit was predicated on the California contacts of *Mercedes–Benz USA, LLC (MBUSA), a subsidiary of Daimler incorporated in Delaware* with its principal place of business in New Jersey." *Id.* (emphasis added). (Author's Note: Really?)

This opinion was written by Justice Ginsberg, and joined by Chief Justice Roberts, and Justices Scalia, Kennedy, Thomas, Breyer, Alito, and Kagan. Justice Sotomayor filed a concurring opinion that did not, unfortunately, concur in judgment but disagree with the characterization of the LLC. The entire court at least acquiesced in the incorrect characterization of the LLC!

It appears things have to get worse before they can get better, but I will remain vigilant. I'm working on an article that builds on this, and it will hopefully help courts and practitioners keep LLCs and corporations distinct.

In the meantime, I humbly submit to Chief Justice Roberts, and the rest of the Court, that there are already some useful things in law reviews.

New Law Attempts To Clarify Legal Status Of LLC Employee Membership Purchase And Option Plans

By Keith Paul Bishop
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Posted on National Law Review, October 23, 2015

California Labor Code Section 407 may be a bit of a surprise to many lawyers both in and outside of the state. It provides:

> Investments and the sale of stock or an interest in a business in connection with the securing of a position are illegal as against the public policy of the State and shall not be advertised or held out in any way as a part of the consideration for any employment.

This statute raises obvious problems for a business (whether or not incorporated or formed under California law) that wants to adopt a stock option or purchase plan. The General Corporation Law addresses the problem with respect to foreign and domestic corporations by providing:

> Sections 406 and 407 of the Labor Code shall not apply to shares issued by any foreign or domestic corporation to the following persons:
>
> (1) Any employee of the corporation or of any parent or subsidiary thereof, pursuant to a stock purchase plan or agreement or stock option plan or agreement provided for in subdivision (a).
>
> (2) In any transaction in connection with securing employment, to a person who is or is about to become an officer of the corporation or of any parent or subsidiary thereof.

Cal. Corp. Code § 408(c). The legislature neglected to include a similar provision in the California Revised Uniform Limited Liability Company Act even though it had done so in the former Beverly-Killea Limited Liability Company Act (former Cal. Corp. Code § 17100(d).

The legislature will soon fill this lacuna by amending Corporations Code Section 17704.01 to add a new subdivision (e):

> (e) Sections 406 and 407 of the Labor Code shall not apply to membership interests issued by any limited liability company or foreign limited liability company to the following persons:
>
> (1) Any employee of the limited liability company or foreign limited liability company or of any parent or subsidiary of either, pursuant to a membership interest purchase plan or agreement, or a membership interest option plan or agreement.
>
> (2) In any transaction in connection with securing employment, a person who is or is about to become an officer or a manager of the limited liability company or the foreign limited liability company or of any parent or subsidiary of either.

This change does not become effective until January 1, 2016.

2015 Amendments to Delaware's Alternative Entity Statutes[1]

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In its last session, the Delaware legislature passed a number of amendments to three of Delaware's four "alternative entity" statutes—the Delaware Limited Liability Company Act ("DLLCA"), the Delaware Revised Uniform Limited Partnership Act ("DRULPA") and the Delaware Revised Uniform Partnership Act ("DRUPA").[2] Gov. Jack Markell signed the bill into law June 24, 2015. Except as otherwise noted below, all of the amendments are effective as of Aug. 1, 2015.

The amendments to the alternative entity statutes include several important changes. They eliminate, generally on a prospective basis, the class or group default voting in the DLLCA and DRULPA, which had applied to mergers, conversions, domestications, dissolutions and a number of other significant actions. They also confirm that the same rules governing irrevocability apply to a proxy as apply to a power of attorney and confirm that a delegation by a general partner or a manager is irrevocable if it states that it is irrevocable.

This article will discuss the amendments to the alternative entity statutes, each in turn.

Elimination of Default Class or Group Votes

[DLLCA § § 18-209(b), 18-213(b), 18-215(k), 18-215(l), 18-216(b), 18-801(a), 18-803(a); DRULPA § § 17-204(a)(3), 17-211(b), 17-214(a), 17-216(b), 17-218(k), 17-218(l), 17-219(b), 17-801, 17-803(a), 17-806]

The enumerated sections currently require a class or group vote for the actions taken thereunder, which include mergers and consolidations, transfers or continuances, termination and winding up of series, conversions and dissolution, if there is more than one class or group of members or limited partners, as applicable (unless otherwise provided in the limited liability company agreement or limited partnership agreement). Both the DLLCA and DRULPA permit the establishment of classes or groups [see § 18-302 of the DLLCA and § 17-302 of DRULPA]. However, neither the DLLCA nor DRULPA defines what a class or a group is. This has led to much uncertainty as to what constituted a "class or group" for purposes of the default voting provisions when a limited liability company agreement or limited partnership agreement gives certain members or partners different rights without designating those members or partners as a separate class or group. This uncertainty, in turn, has made numerous transactions difficult because it has been unclear what vote was required to approve them. The amendments eliminate these default rules throughout the DLLCA and DRULPA, although drafters may still put class or group votes in a limited liability company agreement or a limited partnership agreement if desired. For the most part, the changes are prospective only because the class or group voting requirements have been part of the statutes for so long that parties to limited liability company agreements and limited partnership agreements may have relied on them rather than putting class or group voting in their agreements. The exceptions are all in DRULPA and apply to Section 17-806 relating to revocation of dissolution because that section was just added last year so there would be no history of reliance on a default class or group vote and to Section 17-204(a)(3) relating to execution of a certificate of cancellation and Section 17-214(a) relating to election to be a limited liability limited partnership where, presumably, there would be little or no reliance on these provisions.

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[2] No amendments were enacted to the Delaware Statutory Trust Act in this legislative session.

Proxies

[DLLCA § 18-204(c); DRULPA § 17-204(c); DRUPA § 15-123]

Section 18-204(c) of the DLLCA, Section 17-204(c) of DRULPA and Section 15-123 of DRUPA currently address powers of attorney given with respect to limited liability companies, limited partnerships and general partnerships, respectively, and the circumstances under which they can be irrevocable. The amendments to these sections make clear that these provisions apply to proxies as well as powers of attorney. They also make clear that drafters can otherwise provide with respect to the provisions of an irrevocable power of attorney or irrevocable proxy in a limited liability company agreement or limited partnership agreement and that these subsections will not be construed to limit the enforceability of those powers of attorney or proxies. Thus, drafters should be able to expand or limit the circumstances under which a power of attorney or proxy will be deemed irrevocable in a limited partnership agreement or limited liability company agreement as well as in a general partnership agreement (although a similar change was not made to DRUPA because of its different structure relating to default rules).

Irrevocable Delegation

[DLLCA § 18-407; DRULPA § 17-403(c)]

Section 18-407 of the DLLCA currently provides that a member or manager of a limited liability company can delegate to one or more persons the member's or manager's rights and powers to manage and control the business and affairs of the limited liability company. Section 17-403(c) of DRULPA is to the same effect with regard to delegation by a general partner of a limited partnership of its rights and powers to manage and control the business of the limited partnership. The amendments confirm that any delegation by a member or manager or general partner will be irrevocable if it states that it is irrevocable, unless otherwise provided in the limited liability company agreement or the limited partnership agreement, as applicable, thus eliminating any question as to whether a delegation must be coupled with an interest or satisfy any additional requirements in order to be irrevocable.

Technical Change Regarding the Provision of Public Records

[DLLCA § 18-1105(a)(5); DRULPA § 17-1107(a)(5); DRUPA § 15-1207(a)(5)]

The final 2015 amendment to each of the DLLCA, DRULPA and DRUPA confirms that the Secretary of State may issue public records in the form of photocopies or electronic image copies and need not provide public records in any other form, in exchange for the statutorily prescribed fees. Unlike the other 2015 alternative entity amendments, these amendments took effect immediately upon enactment into law.

Washington State's New LLC Act

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After initially considering the Uniform Law Commission's Revised Uniform Limited Liability Company Act ("RULLCA"), Washington's Partnership and LLC Act Committee decided against adoption of RULLCA. The result is a complete replacement of Washington's LLC Act (the "New Act"). The current version of the LLC Act was initially passed in 1994. Washington's Senate and House passed the New Act by unanimous votes. The New Act will apply to new or existing LLCs on January 1, 2016.

The most significant changes to Washington's LLC Act are identified in summary form below:

1. **Default Rules and LLC Agreements.** The New Act identifies default rules that may not be changed by an LLC Agreement. The non-modifiable rules are codified in a single section in an effort to eliminate the need to review the complete statute when identifying non-modifiable rules. This approach is consistent with the Uniform Limited Partnership Act ("ULPA") and Washington's version of the Revised Uniform Partnership Act ("RUPA"). Of particular interest, pursuant to the New Act, an LLC Agreement may not:

   a. Eliminate or limit the duty of a member or manager to avoid intentional misconduct and knowing violations of law, or the implied contractual duty of good faith and fair dealing;

   b. Vary the power of a court to decree judicial dissolution; or

   c. Unreasonably restrict a member's right to maintain a derivative action.

2. **Oral or Implied LLC Agreements.** The previous LLC Act required LLC Agreements to be in writing. The New Act provides that an LLC Agreement may be "oral, implied, in a record, or in any combination."

3. **Manager Managed or Member Managed.** The New Act maintains the distinction between member managed and manager managed LLCs. However, there is no longer a requirement to identify in the Certificate of Formation whether the LLC is member managed or manager managed. Under the New Act the LLC Agreement will determine whether an LLC is member managed or manager managed. In the absence of an LLC Agreement identifying the distinction, the LLC will be member managed.

4. **No Statutory Apparent Authority.** The New Act removes a statement of a member's apparent authority in a member managed LLC for matters in the ordinary course of the LLC's business.

5. **Board as Manager.** The New Act clarifies that the Manager of an LLC may be "a person, board, committee, or other group of persons" designated by the LLC Agreement.

6. **Standards of Conduct.** The New Act describes a manager's or member's fiduciary duties as the duty of loyalty and the duty of care. "The only fiduciary duties that a member in a member managed LLC or a manager has to the LLC and its members are the duties of loyalty and care…."

   a. The duty of loyalty is limited "to account to the LLC and hold as trustee for it any property, profit, or benefit derived by such manager or member… To refrain from dealing with the LLC as or on behalf of a party having an interest adverse to the LLC… And to refrain from competing with the LLC…"

   b. The duty of care is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct or a knowing violation of law.

7. **Voting by Members.** For actions requiring member approval, the New Act's default rule requires a majority of members to vote on a per capita basis for members to approve an action. This replaces the current

Act's approval by members contributing more than 50% of the agreed value of contributions made by all members.

8. **Records and Information.** The New Act requires members seeking certain records of the LLC to have a purpose reasonably related to the member's interest in the LLC and their requested records must be directly related to the member's purpose.

9. **Allocations of Profits and Losses.** The New Act provides no default rule for allocating profits and losses, but provides a default rule for distributions based on the agreed value of contributions.

10. **Liability for Consenting to Improper Distributions.** The New Act imposes personal liability on a manager or member who consents to a distribution from an LLC when the LLC is insolvent.

11. **Mergers and Personal Liability.** The New Act provides that if a member of a merging LLC will have personal liability to the surviving entity, then the member must sign a separate written consent to become subject to such liability in order for the merger to be approved.

12. **Charging Orders.** The New Act continues to provide for charging orders such that a judgment creditor has only the rights of a transferee. The charging order constitutes a lien on the judgment debtor's transferable interest which may be foreclosed subject to certain rights of redemption prior to foreclosure. The New Act clarifies that the charging order procedure is the "exclusive remedy by which a judgment creditor … may satisfy a judgment out of the judgment debtor's transferable interest."

Hub Bill

In addition to the New Act, during the 2015 legislative session, the Washington Legislature adopted a "Hub Bill" based on the Uniform Law Commission's Uniform Business Organizations Code. The goal of the Hub Bill is to provide a more uniform approach to the administrative functions common to most Washington business entities. The Washington entities covered by the Hub Bill are corporations (profit and non-profit), partnerships, limited partnerships and LLCs.

Conversions

Although not new to the New Act, in 2014, Washington passed an Act authorizing the conversion of Washington LLCs and Corporations into other types of entities in Washington or other states and the conversion of entities from other states into Washington LLCs and Corporations. The language of the 2014 act was included in the New Act without modification.

2015 Legislative Amendments to the Florida Revised LLC Act

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Although initially begun as a "Glitch Bill" [1], the 2015 amendments ("***2015 Amendments***") to the Florida Revised LLC Act ("***Chapter 605***" or the "***2013 Legislation***") grew into legislation which did much more. This article will address the most significant changes to Florida's Revised LLC Act as a result of the 2015 Amendments.

The 2015 Amendments carried out their technical purpose to delete or replace obsolete references to the former Florida LLC Act ("***Chapter 608***"), and to make technical, stylistic and grammatical changes, including elimination of all references to "*managing member*", as a result of the repeal of Chapter 608.

The 2015 amendments then went on to make several substantive changes to the 2013 Legislation, the most significant of which is probably the "un-cabining" of fiduciary duties in Florida LLCs and the explicit application of common law principles to fiduciary duties. "Un-cabining" refers to the elimination of the concept of limiting or "cabining-in" fiduciary duties to those expressly stated in the LLC Act, which had been the law in Florida prior to the 2015 Amendments.

The substantive changes in the 2015 Amendments were the result of a number of forces:

(i) changes to the Uniform Limited Liability Company Act 2006 (as amended through 2013) (the "***Uniform LLC Act***")[2], which occurred after Florida enacted the 2013 Legislation;

(ii) concerns raised by Florida practitioners regarding a few of the provisions in the 2013 Legislation [3]; and

(iii) a policy change in the Florida legislature concerning fiduciary duties in Florida LLCs [4].

Effective Date

The 2015 Amendments to Chapter 605 were passed by the Legislature in April 2015, and signed into law by the Governor on June 11, 2015, with an effective date of July 1, 2015 for all provisions except the provision repealing Chapter 608, which had already been repealed with an effective date of January 1, 2015.

Repeal of Chapter 608

The 2013 Legislation initially became effective on January 1, 2014, with a delayed effective date for Florida LLCs which were in existence prior to January 1, 2014. The 2013 Legislation became effective for all Florida LLCs (regardless of when they were organized) on January 1, 2015, entirely replacing Chapter 608 with Chapter 605.

The 2015 Amendments formally repealed Chapter 608, as of January 1, 2015 and eliminates all references in other Florida Statutes to Chapter 608, and replaces them with references to Chapter 605 as the Florida Revised Limited Liability Company Act.

The formal action by the 2015 Legislature "in a current session" repealing Chapter 608 has the effect of deleting the statutory language which previously existed in Chapter 608.

Un-cabining of Default Fiduciary Duties and Application of Common Law Principles

The Florida Revised LLC Act, Chapter 605, when it was initially adopted in 2013, followed the approach of prior law in limiting fiduciary duties to those expressly stated in the LLC Act, essentially "cabining-in" fiduciary duties by using the language "*is limited to*" when describing the duty of loyalty [5] and the duty of care[6].

The 2015 Amendments "un-cabin" the duty of loyalty and the duty of care by: (i) deleting the phrase "*is limited to*" in s. 605.04091(2) in connection with the duty of loyalty and replacing it with the single word "*includes*" [7]; and (ii) deleting the word "*limited*" in s. 605.04091(3) in connection with the duty of care [8].

The changes to s. 605.04091(2) and (3), although a significant change from prior Florida statutory law, are now consistent with ULLCA Section 409, which does not limit or "cabin-in" the duties of loyalty and care. [9]

The 2015 Amendments then go further by making two additions to the rules of construction and supplemental principles of law found in s. 605.0111 to: (i) permit the restriction, expansion, or elimination of duties, including fiduciary duties and obligations (subject to the non-waivable rules of s. 605.0105), and (ii) explicitly incorporate the application of common law principles associated with the duties of loyalty and care into s. 605.0111.

The first change is the addition of a new subsection (2) within s. 605.0111, which now provides:

"To the extent that, at law or in equity, a member, manager or other person has duties, including fiduciary duties, to a limited liability company or to another member or manager or to another person that is a party to or bound by an operating agreement, the duties of the member, manager or other person may be restricted, expanded or eliminated including in the determination of applicable duties and obligations under this Chapter, by the operating agreement, to the extent allowed by s. 605.0105."

The second change to s. 605.0111 renumbers old subsection (2) as new subsection (3) and inserts the new phrase "*including the common law principles relating to the fiduciary duties of loyalty and care"*. So subsection (3) now reads: *"Unless displaced by particular provisions of Chapter 605, the principles of law and equity, <u>including the common law principles relating to the fiduciary duties of loyalty and care,</u> supplement Chapter 605*."

The above are non-Uniform Act changes since they are not found in ULLCA. The Supplemental Principles of Law provision in ULLCA, Section 111, simply provides: *"Unless displaced by particular provisions of this Act, the principals of Law and Equity supplement this Act."*

The official Comments to ULLCA are helpful here as they make it clear that common law principles of contract and agency (and other law) are particularly important in LLCs, and those common law principles should supplement a state's LLC Act [10].

Prior to the 2015 Amendments, the prevailing view was that the specific language limiting fiduciary duties under s. 605.04091 ("*is limited to*") trumped the general application of common law principles under s. 605.0111, because of the introductory clause in 605.0111(2) "*Unless displaced by particular provisions of this Chapter", the principles of law and equity supplement this chapter*...

However, an important legislative sponsor of both the 2013 Legislation and the 2015 Amendments wanted absolute clarity because of his experience that some courts in Florida have inconsistently followed the application of common law principles when it came to fiduciary duties in s. 605.04091.

Consequently, the 2015 Amendments now make it quite clear that the default fiduciary duties articulated in the Chapter 605 are to be supplemented by common law principles applicable to the duties of loyalty and care.

Another important aspect of the 2015 Amendments to s. 605.0111 worth highlighting is the codification of the right of members of a Florida LLC to limit, expand or eliminate fiduciary duties (including common law fiduciary duties) in their operating agreement, to the extent permitted in s. 605.0105 [11].

Member Dissociation as a Matter of Right is Now "Waivable"

The 2015 Amendments removes from the list of non-waivable provisions under s. 605.0105(3)(i) the provision that prohibited an LLC's operating agreement from varying the power of a member to dissociate from the LLC.

Section 605.0601(1) of the Florida Revised LLC Act provides, as a default rule, that a person has the power to dissociate as a member of an LLC at any time. The Florida Revised LLC Act, as adopted in 2013, made that provision a non-waivable provision based on the then current Uniform Act which also treated that right as non-waivable. The 2015 Amendments changed that, and will now allow the operating agreement to prohibit a member from dissociating from the LLC.

The 2015 Amendments reconcile the Florida Revised LLC Act with the latest version of the Uniform Act, which had made the same change to the Uniform Act after the 2013 Legislation was enacted. Finally, it resolves concerns raised by practitioners who were concerned that many LLC owners had already adopted operating agreements that prohibited members from dissociating at will, and unless the non-waivable rule was changed, existing LLCs would be harmed, and perhaps it would cause practitioners to recommend other jurisdictions for LLC formation if they wanted to assure that members could not dissociate at will.

Of course, the default rule remains that a member can dissociate from an LLC at any time without consent. If members want to prevent member dissociation at will, they need to ensure the operating agreement prohibits dissociation by members at will, or, if dissociation is to be permitted, the operating agreement should address the consequences of such dissociation.

Interested Transactions as an Exception to Appraisal Rights as the Exclusive Remedy

Section 605.1072(2) provides that the legality of a proposed or completed "appraisal event" may not be enjoined, set aside or rescinded in an equitable or legal proceeding by a member after the members have approved the appraisal event, unless the appraisal event:

(a) was not properly authorized and approved as required…;

(b) was procured as a result of fraud, a material misrepresentation or omission of a material fact; or

(c) is an interested transaction, unless it has been approved under s. 605.04092 (which addresses the approval of conflict of interest transactions by disinterested members) or is fair to the limited liability company as defined in s. 605.04092(1)(c).

The 2015 Amendments eliminated subsection 605.1072(2)(c), the third exception regarding interested transactions. As a result of the change, appraisal rights are the sole and exclusive remedy in most transactions in which appraisal rights are available, including interested party transactions.

This change was controversial within The Florida Bar drafting committee because the 2013 Legislation as originally enacted followed the Revised Model Business Corporations Act Section 13.40 which included interested transactions as an exception to the general rule. However, the prevailing view of the Drafting Committee was that for now the Revised LLC Act should more closely harmonize appraisal rights as the exclusive remedy in appraisal events with Florida's current corporate statute, s. 607.1302.

Note however, that the LLC Act provides more expansive language in s. 605.1072(2)(b), and in this author's view, the LLC Act language is preferable to the more narrowly focused language in the current Florida corporate statute analogue. [12]

Moreover, a current drafting committee of the Florida Bar is considering changes to the corporate statute and that committee may end up changing the corporate analogue to add interested transactions as an exception to the general rule, so we may be back to the 2013 Legislation formula again next year.

Deemed Knowledge and Notice of Authority or Limitation of Authority to Non-Members in connection with Real Property Transactions

Section 605.0103(4)(a) imputes knowledge, and (4)(b) imputes notice, on persons who are not members of an LLC in the case of certain filed records, including with respect to grants or limitations of authority contained in the LLC's articles of organization.

Specifically, under s. 605.0103(4)(b)(5), a third party is deemed to have knowledge of a grant of authority or limitation imposed on the authority of a person holding a position or having a specified status in an LLC if the grant of authority or limitation is described in the LLC's articles of organization. This was a change from prior law in Florida which generally required that deemed notice in connection a limitation of authority in connection with real property was tied to real property records, rather than a person's status as a member or manager in the articles of organization. [13]

The 2015 Amendments limits the deemed notice to third parties in the context of a real estate transaction. Amended s. 605.0103(4)(b)(5) adds a new sentence to the end of the subsection: "*A provision of the articles of organization that limits the authority of a person to transfer real property held in the name of the limited liability company is not notice of such limitation to a person who is not a member or manager of the company, unless such limitation appears in an affidavit, certificate, or other instrument that bears the name of the limited liability company and is recorded in the office for recording transfers of such real property*."

This clarification was requested by the Real Property, Probate and Trust Law Section and is important for real estate practitioners, since the first place one looks when dealing with real property is the real estate records in the county where the property is located. This also conforms more closely to prior Florida law under former Chapter 608.

Voting Rights of Members & Managers – Actions taken by Written Consent

The voting rights of Members and Managers are addressed in s. 605.04073 and provides that an action requiring the vote or consent of members can be taken without a meeting.

Subsection 605.04073(4) was revised by the 2015 Amendments to add language requiring that in connection with any action by members taken without a meeting, the action must: (i) be approved in a record, and (ii) be approved by members with at least the minimum number of votes necessary to authorize or take the action at a meeting of the members.

New Requirements for Responding to a Member's Demand for Records

Florida's Revised LLC Act specifies the minimum records which must be maintained by an LLC, and further provides rules regarding access to those records by members and managers of the LLC. There have been a number of cases where disputes have arisen in connection with a member's access to company records and the time in which a Florida LLC must respond to member requests for records or information.

Consequently, the 2015 Amendments revised s. 605.0410(2)(c), which now requires that in a member-managed LLC: "*Within 10 days after receiving a demand pursuant to subparagraph (b)2. The company shall provide to the member who made the demand a record of:*

1. The information the company will provide and when and where the company will provide the requested information, and

2. For any information that the company is not providing, the reasons the company is not providing the requested information.

This requirement was already in the s. 605.0410(3)(c) addressing requests for information in a manager-managed LLC as a result of the 2013 Legislation, so its application to member-managed LLCs is not controversial and was seen as a "glitch" fix.

Reinstatement of Administratively Dissolved LLC

At the request of the Florida Department of State, additional provisions were added to Sections 605.0715 and 605.0909 to specify information that administratively dissolved LLCs (both foreign and domestic) must include in their application for reinstatement.

The 2015 Amendments also provided that the filing of a current Annual Report and paying all delinquent fees and penalties, is an acceptable alternative to filing an application for reinstatement.

Discrepancy between filed Articles of Organization and Operating Agreement as to Management Structure in a Manager-Managed LLC.

When the 2013 Legislation became law on January 1, 2014, there was a one year transition period for LLC's formed prior to January 1, 2014, which could still be subject to chapter 608 instead of new chapter 605. Section 605.1108 provided for the application of the 2013 Legislation to LLCs formed prior to the effective date in certain instances.

For example, subsection 605.1108(3)(a) provided that the company's earlier filed articles of organization under 608 were deemed to be the articles of organization of the company under new Chapter 605.

Subsection 605.1108(3)(b) provided that in a manager-managed LLC, that the management structure described in an LLC's articles of organization "*operates as if that language were in the operating agreement"*.

The 2015 Amendments deleted subsection 605.1108(3)(b), since it was no longer necessary to apply that deemed construct because Chapter 605 requires that for an LLC to be manager-managed, there must be some affirmative clear indication that the members want a manager-managed entity, and most often in filed articles the articles often referred to a "managing member", but we eliminated the "managing member" term as part of the 2013 Legislation, so now that the transition period has expired, it not necessary to have the deemed attribution to the operating agreement. Particularly since the management structure is a de facto requirement in every operating agreement, so if there is an inconsistency between the articles and the operating agreement, we don't need the added complexity of a "deemed" inconsistency by virtue of old section 605.1108(3)(b).

Majority in Interest Definition Modified

The 2015 Amendments to subsection (37) of s. 605.0102 modified the "majority-in-interest" defined term by removing the phrase "*and who have the right to vote"*. As modified the default definition of the term is defined to mean "*those members who hold more than 50 percent of the then-current percentage or other interest in the profits of the limited liability company owned by all of its members.*"

This is not a substantive change in the law, but rather a clarification of the default rule in Florida that more than 50% of profits interests in an LLC constitutes a "majority-in interest" without having the "right to vote" trigger also included in the calculation since it was better dealt with elsewhere.

Of course the "*then current percentage interest in the profits*" standard is the default rule, which can be overridden by the standard adopted in the company operating agreement.

Revisions to Service of Process on Florida LLCs

The 2015 Amendments also changed the rules in Chapter 48.062 regarding service of process on Florida LLCs. The new rules substantial improve the rules for service of process (which previously were analogous to service on a partnership) to provide a clear cut waterfall for service of process.

Service may first be made on the company's registered agent, or any employee of the registered agent (even if the RA is an individual) so long as made at the registered agent's address during normal business hours, or if not possible to serve the registered agent because there is no registered agent or the registered agent is not available or cannot be served with reasonable diligence, service may be made on any member of a member-managed LLC, or any manager of a manager-managed LLC, or, if that is not possible, service may be made on an employee of the LLC if made during normal business hours.

[*Endnotes Follow*]

Endnotes:

1. CS/CS/CS/HB 531 sponsored in the House by Representative McGhee and in the Senate by Senator David Simmons.

2. The Uniform Limited Liability Company Act ("***ULLCA***")was initially promulgated by the Uniform Law Commission (a/k/a the National Conference of Commissioners on Uniform State Laws) in 2006 as amended through 2013, but it has undergone significant changes in the years since it was first adopted by the ULC. The ULLCA was the model, and formed the basis, with significant deviations, for the Florida Revised Limited Liability Company Act enacted in 2013.

3. Practitioners in the Real Property Probate and Trust Law section of The Florida Bar, as well as real estate industry professionals were troubled by the deemed notice and knowledge provisions in the 2013 Legislation; and transactional lawyers were concerned about the non-waivable provision which allowed a member to dissociate at any time. Both of these concerns resulted in changes addressed in the body of this article.

4. The Senate sponsor of the 2013 Legislation, who also was the Senate sponsor of the 2015 Amendments, was particularly concerned with Florida's treatment of fiduciary duties in limited liability companies and the inconsistent application of common law principles in addressing fiduciary duties, particularly the duty of loyalty.

5. Duty of loyalty in old Section 605.04091(2) - The duty of loyalty is limited to accounting to the limited liability company and holding as trustee any property, profit or benefit derived by the manager(s) or managing member(s) in certain enumerated circumstances including refraining from appropriating a company opportunity, refraining from dealing with the company with an interest adverse to the company, and refraining from competing with the company before dissolution of the company.

6. Duty of care in old Section 605.04091(3) "The duty of care in the conduct or winding up of the company's activities and affairs is limited to refraining from engaging in grossly negligent or reckless conduct, willful or intentional misconduct, or a knowing violation of law.

7. Under the 2015 Amendments Section 605.04091(2) is changed to read "The duty of loyalty *"includes"* accounting to the limited liability company and holding as trustee any property, profit or benefit derived…"

8. Under the 2015 Amendments Section 605.04091(3) "The duty of care in the conduct or winding up of the company's activities and affairs is to refraining from engaging in grossly negligent or reckless conduct, willful or intentional misconduct, or a knowing violation of law.

9. ULLCA 409 does not describe the duty of care as a fiduciary duty. The official comments to Section 409 describes the failure to do so as intentional, based on the premise that the duty of care arises in contexts outside of the fiduciary relationship. No change in the law was intended by the semantic change in labeling the duties differently. Also, the amendments to Section 409 changed the description of the duty of care to eliminate the reference to the Business Judgment Rule and to conform to the duty of care language found in the Uniform Limited Partnership Act and the Uniform Partnership Act as both Acts, along with ULLCA, were amended in 2013 as part of the ULC Harmonization of Business Entities Project.

10. ULLCA Comment to Section 111 provides: "*For this act, the common law rules of contract and agency are among the most important supplemental "principles of law. With regard to transactions under Article 10, noteworthy principles include the rights of creditors following leveraged buyouts, spinoffs, asset purchases, or similar transactions; and creditors' rights under other laws."*

11. Section 605.0105(4)(c), provides that an operating agreement may, if not manifestly unreasonable, alter or eliminate the duty of loyalty under Section 605.04091, identify specific activities that do not violate the duty of loyalty and alter the duty of care, but it may not authorize willful or intentional misconduct or a knowing violation of law.

12. Our corporate statute, Section 607.1302(4) provides two exceptions in subparagraphs (a) and (b) to the rule of exclusivity of appraisal rights, but they are different than the comparable provisions in our LLC Act . Section 607.1302(4)(b) provides the exception where the appraisal event "*was procured as a result of fraud or material misrepresentation".* The LLC Act in 605.1072(2)(b) uses the more expansive *"was procured as a result of fraud, material misrepresentation, or an omission of a material fact that is necessary to make statements made, in the light of the circumstances in which they are made, not misleading;"*

13. Former section 608.407(6) in addressing deemed notice of limitations of authority of a member or manager in connection with transfers of real property of the LLC, required the limitation of authority to be recorded in the office for recording transfers of real property.

August, 2015, the ABA House of Delegates approved a resolution in favor of amendment of 28 U.S.C. § 1332 to the effect that the existing rule for how the citizenship of a corporation for purposes of diversity jurisdiction will apply as well to all unincorporated business organizations.

That resolution and the related report are reproduced below.

AMERICAN BAR ASSOCIATION

ADOPTED BY THE HOUSE OF DELEGATES

AUGUST 3-4, 2015

RESOLUTION

RESOLVED, That the American Bar Association urges Congress to amend 28 U.S.C. §1332, to provide that any unincorporated association shall, for diversity jurisdiction purposes, be deemed a citizen of its state or territory of organization and the state or territory where the entity maintains its principal place of business.

REPORT

Introduction

Determining the citizenship of unincorporated business litigants has turned into a complicated jurisdictional morass. The subject matter diversity jurisdiction statute was last amended to address citizenship of business entities in 1958. At that time, as a matter of substantive law only corporations were treated as "entities" with an existence apart from that of their membership. Since that change, substantive law has changed with respect to general and other partnerships, and a host of other entities. Moreover, today exponentially more businesses are operating as unincorporated associations, such as general partnerships, limited liability companies (LLCs), limited partnerships (LPs), professional corporations (PCs), limited liability partnerships (LLPs), business trusts, and other forms of business entities. Yet, under the current subject matter jurisdiction statute, in determining whether diversity jurisdiction exists there is still a major difference between corporations and all other entities. Corporations are treated as citizens only of the states (i) where they are incorporated, and (ii) where they maintain their principal place of business. The identity of any or all of a corporation's shareholders is irrelevant to the diversity analysis. By contrast, for all business entities that are *not* organized as corporations the citizenship of every member, shareholder, or other owner of any portion of the entity must be examined to determine whether complete diversity exists. For example, if even one of one hundred members in an LLC is not diverse from even one of a hundred partners of an adversary LLP, then diversity is destroyed irrespective of whether the non-diverse LLC member or limited partner had any connection with the facts giving rise to the dispute.

The current diversity regime thus sets a potential trap for plaintiffs, defendants, and even trial court judges every time litigation involves an unincorporated association. For example, the existence of a single, passive member of an LLC who was not even involved in the dispute or event being litigated can destroy diversity if he or she hails from the same state as one adverse party. Unfortunately, the LLC's records may not even reveal the citizenship of every member, thus making it difficult if not impossible for any party to determine quickly (let alone with any assurance of accuracy) whether complete diversity exists prior to discovery. Yet because subject matter jurisdiction is not waivable and because federal courts must satisfy themselves *sua sponte* that they have subject matter jurisdiction over a matter, *see* Fed. R. Civ. P. 12(h)(3), this situation may be a ticking legal time bomb.

This problem affects plaintiffs and defendants alike. The uncertainty of whether a case can be filed in or removed to a federal forum not only increases the cost and complexity of litigation, it can completely undermine a fully-litigated case when it is discovered at the appellate stage that the trial court lacked jurisdiction in the first place. Given that litigants need absolute clarity in order to avoid litigating a case in federal court only to have it remanded on jurisdictional grounds after judgment, the diversity statute needs to be streamlined and simplified in order to apply the corporate citizenship test to unincorporated associations that are functionally equivalent to corporations.

Given the significant developments in the structure, recognition under the law, and usage of multiple non-corporate entities over the past five decades, no principled reason exists for continuing the divergent treatment of corporations and other business entities. Revising the diversity jurisdiction statute, 28 U.S.C. § 1332, can eliminate these traps and correlate federal court jurisdiction with modern business entity structures and abolish the "disconnect between the modern business realities" of unincorporated business entities "and the formalistic rules" for determining their citizenship, simplifying the forum selection process and avoiding the waste of judicial resources and time. Debra R. Cohen, *Limited Liability Company Citizenship: Reconsidering an Illogical and Inconsistent Choice*, 90 MARQUETTE L. REV. 269, 269 (2006).

Background

Through a judicially-created rule, federal courts sitting in diversity have long required *complete* diversity between each and every plaintiff, on the one hand and each and every defendant, on the other. *See Strawbridge v. Curtiss*, 7 U.S. 267 (1806). Shortly after *Strawbridge*, the Supreme Court declared that corporations were *not* citizens, "and, consequently, cannot sue or be sued in the courts of the United States, unless the rights of the members, in this respect, can be exercised in their corporate name." *Bank of the U.S. v. Deveaux*, 9 U.S. 61 (1809). Because corporations enjoyed the aggregate citizenship of their owners and members, they were able to force litigants into state court if a single shareholder was nondiverse from a single plaintiff. *See* Cohen, *supra,* p. 284 & n.95.

Although the Supreme Court later overruled *Deveaux* and declared that corporations were legal entities separate and apart from their members and owners, *see Louisville, Cincinnati & Charleston R.R. v. Letson*, 43 U.S. 497 (1844), it took Congress over a hundred years to codify this rule. In 1958, Congress amended the federal diversity statute, 28 U.S.C. § 1332, to tie corporate citizenship to the states where the entities are incorporated and where they maintain their principal places of business. *J.A. Olson Co. v. Winona*, 818 F.2d 401, 404-05 (5th Cir. 1987), abrogated on other grounds by *Hertz Corp. v. Friend*, 559 U.S. 77 (2010); *see also* Case Comment, *Seventh Circuit Holds that the Term "Corporation" is Entirely State-Defined*, Hoagland v. Sandberg, Phoenix, & von Gontard, P.C., 118 HARV. L. REV. 1347-48, 1352 (2005). The 1958 amendment also was "intended to further the original purpose of diversity jurisdiction . . . to provide to out-of-state litigants a forum free of local bias." *J.A. Olson*, 818 F.2d at 406. Indeed, "the need for diversity jurisdiction is lessened when a foreign corporation has substantial visibility in the community." *See id*. at 404, 406.

This logic made sense in 1958. At the time, the primary unincorporated business entities—partnerships—were merely contracts between individuals who both owned and controlled the business. Corporations, by contrast, were legal fictions created by their states of incorporation for the sole purpose of separating ownership from control. *See* Cohen, *supra,* p. 289. The 1958 amendment thus recognized the functional differences between corporations and partnerships as they existed at the time and "highlighted the citizenship of the true litigants." *Id.* Those states that allowed the formation of partnerships, limited partnerships, limited liability companies, and other business entities did *not* recognize those business forms as entities separate and apart from their owners and members. For example, at the time of the first Uniform Partnership Act, promulgated in 1914, partnerships were frequently treated as conglomerations of the individual partners. As explained by the drafters of the 1994 revisions to the Uniform Partnership Act ("RUPA"):

> "The first essential change in UPA (1994) over the 1914 Act that must be discussed as a prelude to the rest of the revision concerns the nature of a partnership. There is age-long conflict in partnership law over the nature of the organization. Should a partnership be considered merely an aggregation of individuals or should it be

> regarded as an entity by itself? The answer to these questions considerably affects such matters as a partner's capacity to do business for the partnership, how property is to be held and treated in the partnership, and what constitutes dissolution of the partnership. The 1914 Act made no effort to settle the controversy by express language, and has rightly been characterized as a hybrid, encompassing aspects of both theories. . . . [the Revised Uniform Partnership Act] (1994) makes a very clear choice that settles the controversy. To quote Section 201: 'A partnership is an entity.' All outcomes in [the Revised Uniform Partnership Act] (1994) must be evaluated in light of that clearly articulated language."

Summary of 1994 revisions to Uniform Partnership Act ("RUPA").[15]

Today, general partnerships are no longer viewed solely as aggregations of individuals. Thirty-seven states plus the District of Columbia have adopted the 1994 or 1997 version of the RUPA and its entity designation.[16] Even those states that have not adopted RUPA (1994) frequently recognize partnerships as a distinct entity for at least some purposes. In addition, while not adopting RUPA, Louisiana recognizes a partnership as a "judicial person, distinct from its partners." La. Civ. Code art. 2801. At least six other "non-RUPA (1994)" states recognize a partnership as a separate entity by statutes providing that partnerships can sue or be sued in the partnership name.[17] And some states have recognized entity status for at least some purposes, as recognized by case law. *See, e.g.*, *Hanson v. St. Luke United Methodist Church*, 704 N.E.2d 1020, 1026 (Ind. 1998) (explaining that a judgment by or against a partnership binds the partnership as if it were an entity and does not bind individual members unless they were named); *Michigan Employment Sec. Com. v. Crane*, 54 N.W.2d 616, 620 (Mich. 1952) ("The Michigan employment security act expressly recognizes that a partnership is an 'employing unit' within the meaning of the act."); *Philadelphia Tax Review Bd. v. Adams Ave. Assocs.*, 360 A.2d 817, 820 (Pa. Commw. Ct. 1976) ("[I]t does not follow that for purposes of taxation a partnership may not be taxed, or may not have a domicile for tax purposes, separate and distinct from that of the individuals who compose it. In other words, a partnership may be recognized as a legal entity for certain purposes."); *Dept. of Revenue v. Mark*, 483 N.W.2d 302, 304 (Wis. 1992) ("[T]he law recognizes a partnership as a separate legal entity for purposes of conveying real estate and for purposes of holding title." (emphasis omitted)). In short, contrary to the situation that existed in 1958, the concept of the partnership as a separate legal entity is now well established.

Much else has changed since 1958 as well. The past five decades have seen a rise in so-called "hybrid" business forms such as LLCs, LPs, MLPs, PCs, LLPs, and multi-state general partnerships. For example, the federal Internal Revenue Service reports that in 1993, roughly 275,000 LPs and only 17,335 LLCs filed federal tax returns; by 2008, over 534,000 LPs and over 1,898,000 LLCs filed federal tax returns.[18]

[15] Summary of 1994 revisions to Uniform Partnership Act ("RUPA"), "Uniform Partnership Act § 201 (1994), "Nature of a Partnership"; Partnership Act Summary, NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS, available at http://www.nccusl.org/ActSummary.aspx?title=Partnership%20Act (last visited Apr. 30, 2014).

[16] The states (13) that have not adopted the 1994 or subsequent versions of RUPA are: LA, GA, IN, MA, MI, MO, NH, NY, NC, PA, RI, SC and WI. Enactment Status Map, Partnership Act, NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS, available at http://www.nccusl.org/Act.aspx?title=Partnership%20Act (last visited Apr. 30, 2014).

[17] These "sue and be sued" as provided by statute states are Georgia (O.C.G.A. § 14-8-15.1), Indiana (Ind. R. Trial P. 17), Michigan (Mich. Comp. Laws 600.2051), New York (N.Y. C.P.L.R. § 1025), North Carolina (N.C. Gen Stat. § 1-69.1), and South Carolina (S.C. Code § 15-5-45). *Cf.* Pa. R. Civ. P. 2127; Pa. R. Civ. P. 2128 (together allowing a partnership to be sued in its firm name but requiring the partnership to bring suit as "A, B and C trading as X & Co.").

[18] *See* Internal Revenue Service, TABLE 1: NUMBER OF RETURNS, TOTAL RECEIPTS, BUSINESS RECEIPTS, NET INCOME (LESS DEFICIT), NET INCOME, AND DEFICIT BY FORM OF BUSINESS (1980-2008), available at http://www.irs.gov/uac/SOI-Tax-Stats-Integrated-Business-Data (last visited Apr. 30, 2014) and Internal Revenue Service, TABLE 1: NUMBER OF RETURNS, TOTAL RECEIPTS, BUSINESS RECEIPTS, NET INCOME (LESS DEFICIT), NET INCOME, AND DEFICIT BY FORM OF BUSINESS (1980-2008), available at http://www.irs.gov/uac/SOI-Tax-Stats-Integrated-Business-Data (last visited Apr. 30, 2014).

Accordingly, the prospect of facing a limited partnership nearly doubled from 1993 to 2008, while the prospect of facing a limited liability company increased nearly one hundred and tenfold.

With the rise of these hybrid entities, "[e]volving organizational laws caused the distinction between business organizations to blur." Cohen, *supra*, p. 289. Many states now recognize these other entities as existing separate and apart from their owners and members. *See* Christine M. Kailus, *Diversity Jurisdiction and Unincorporated Businesses: Collapsing the Doctrinal Wall*, 2007 UNIV. OF ILL. L.R. 1543, 1545-47 (Sept. 7, 2007). Similarly, the Uniform Limited Partnership Act ("ULPA") also now recognizes that a "limited partnership is an entity distinct from its partners."[19] Eighteen (18) states plus the District of Columbia have adopted the 2001 version of the ULPA.[20] And likewise, the 2006 revisions to the Uniform Limited Liability Company Act of 1996 ("ULLCA") recognizes that an LLC "is an entity distinct from its members."[21] Nine (9) states plus the District of Columbia have adopted the 2006 version of the ULLCA.[22]

The existing law concerning the status and determination of the citizenship of non-corporate entities for diversity jurisdiction purposes has not kept up with reality. The corporate landscape simply looks much different than it did in 1958, but Section 1332(c) has not been amended to acknowledge unincorporated entities as "citizens" for diversity purposes. Nor have courts been willing to impute citizenship status on these entities because they are "corporate-like," as courts narrowly construe statutes conferring federal jurisdiction. *See, e.g., Carden v. Arkoma Assocs.*, 494 U.S. 185 (1990); *Northbrook Nat'l Ins. v. Brewer*, 493 U.S. 6, 9 (1989) ("'We must take the intent of Congress with regard to the filing of diversity cases in Federal District Courts to be that which its language clearly sets forth.'" (quoting *Horton v. Liberty Mutual Insurance Co.*, 367 U.S. 348, 352 (1961))); *Thompson v. Gaskill*, 315 U.S. 442, 446 (1942) ("The policy of the statute conferring diversity jurisdiction upon the district courts calls for its strict construction.").

The Supreme Court has explicitly held that due to the plain and limited language of Section 1332(c), the statute only applies to traditional corporations. *See Carden*, 494 U.S. at 195-96. *Cf. Steelworkers v. R. H. Bouligny, Inc.*, 382 U.S. 145 (1965) (holding that unincorporated labor union was not itself a "citizen" for diversity jurisdiction purposes, but that citizenship was to be determined based upon the citizenship of each individual member of the unincorporated entity). In *Carden*, the trial court dismissed an action brought by a limited partnership on the ground that one of the plaintiff's limited partners was a citizen of the same state as the defendants. The Court "firmly resist[s]" any judicial extension of "citizenship" status to entities other than corporations, and leaves any "further adjustments" to the status of business entities for diversity purposes in the hands of Congress. *Carden*, 494 U.S. at 189, 196.

Following *Carden's* clear mandate, courts have routinely concluded that the citizenship of every member of unincorporated business entities must be diverse from all opposing parties before complete diversity of citizenship exists. In one of the earliest post-*Carden* decisions, the Seventh Circuit concluded that *Carden* "crystallized as a principle" that members of an entity are citizens for diversity purposes, at least until "Congress provides otherwise." *Cosgrove v. Bartolotta*, 150 F.3d 729, 731 (7th Cir. 1998). Given the similarities between LLC's and LP's, the court applied *Carden* to LLC's. *Id.; see also Belleville Catering Co. v. Champaign Market Place L.L.C.*, 350 F.3d 691, 692 (7th Cir. 2003) (same). It

[19] Uniform Limited Partnership Act § 104(a) (2001), NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS, available at http://www.uniformlaws.org/shared/docs/limited%20partnership/ulpa_final_2001rev.pdf (last visited Apr. 30, 2014).

[20] These states are: AL, AR, CA, DC, FL, HI, ID, IL, IA, KY, ME, MN, MO, NV, NM, ND, OK, UT, and WA. Legislative Fact Sheet, NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS, available at http://www.uniformlaws.org/LegislativeFactSheet.aspx?title=Limited%20Partnership%20Act (last visited Apr. 30, 2014).

[21] Uniform Limited Liability Company Act § 104(a) (2006), NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS, available at http://www.uniformlaws.org/shared/docs/limited%20liability%20company/ullca_final_06rev.pdf (last visited Apr. 30, 2014).

[22] These states include: CA, DC, FL, ID, IA, MN, NE, NJ, UT, and WY. Legislative Fact Sheet, NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS, available at http://www.uniformlaws.org/LegislativeFactSheet.aspx?title=Limited%20Liability%20Company%20(Revised) (last visited Apr. 30, 2014).

does not matter that LP's and LLCs "are functionally similar to corporations;" they are not entitled to corporate treatment for diversity purposes. *See also Hoagland v. Sandberg, Phoenix & von Gontard, P.C.*, 385 F.3d 737, 739 (7th Cir. 2004). The Supreme Court drew a "bright line" in *Carden* between entities that are technically called "corporations" and all other types of entities, *see id.* at 741, such that judges need not "entangle themselves in functional inquiries into the differences among corporations," *see id.* at 743.

Every court of appeals to address this question directly has followed the 7th Circuit in analogizing to *Carden*'s treatment of limited partnerships and requiring the examination of the citizenship of all owners/members of LLCs in determining whether diversity jurisdiction exists. *See, e.g., Rolling Greens MHP, LP v. Comcast SCH Holdings LLC*, 374 F.3d 1020 (11th Cir. 2004) (remanding appeal from grant of summary judgment to consider citizenship of every member of LP and LLC; noting unanimity among circuits regarding both LPs and LLCs and citing cases from 2d, 6th, 7th, 8th, and 9th Circuit Courts of Appeal); *Johnson v. Smithkline Beecham Corp.*, 724 F.3d 337 (3d Cir. 2013); *Zambelli Fireworks Mfg. Co. v. Wood*, 592 F.3d 412 (3d Cir. 2010); *Delay v. Rosenthal Collins Group, Inc.*, 585 F.3d 1003 (6th Cir. 2009); *Harvey v. Grey Wolf Drilling Co.*, 542 F.3d 1077 (5th Cir. 2008); *Pramco LLC v. San Juan Bay Marina, Inc.*, 435 F.3d 51 (1st Cir. 2006); *Johnson v. Columbia Properties Anchorage, LP*, 437 F.3d 894 (9th Cir. 2006); *Gen. Tech. Applications, Inc. v. Extro Ltda.*, 388 F.3d 114 (4th Cir. 2004); *GMAC Commercial Credit LLC v. Dillard Dept. Stores*, 357 F.3d 827 (8th Cir. 2004);; *Belleville Catering Co. v. Champaign Mkt. Place, LLC*, 350 F.3d 691(7th Cir. 2003); *Handelsman v. Bedford Village Associates Ltd. Partnership*, 213 F.3d 48 (2d Cir. 2000). Neither the D.C. Circuit Court of Appeals nor the 10th Circuit Court of Appeals has directly decided this issue, though both the District of D.C. and at least the District of Colorado have agreed with other circuits that the citizenship of an LLC is determined by the citizenship of each of its members. *See, e.g., Makris v. Tindall*, No. 13-00750, 2013 U.S. Dist. LEXIS 41397 (D. Colo. Mar. 25, 2013); *Jackson v. HCA-HeathOne, LLC*, No. 13-02615, 2013 U.S. Dist. LEXIS 146023 (D. Colo. Oct. 9, 2013); *Shulman v. Voyou, LLC*, 305 F. Supp. 2d 36 (D.D.C. 2004); *Johnson-Brown v. 2200 M. St. LLC*, 257 F. Supp. 2d 175 (D.D.C. 2003).

The courts have made clear that any change in how citizenship is to be determined for diversity jurisdiction purposes must be enacted by Congress. Accordingly, we propose an amendment to 28 U.S.C. § 1332 to address these issues.

Proposed Rule Revision

Attached as Appendix 1 is a proposed revision to the diversity statute that serves primarily to ensure that the letter of the diversity statute mirrors its spirit. This idea is nothing new or radical. In 1965—almost fifty years ago—the American Law Institute proposed giving unincorporated business entities the same citizenship status as corporations for diversity purposes. *See Diversity Jurisdiction Over Unincorporated Business Entities: The Real Party in Interest as a Jurisdictional Rule*, 56 TEXAS L. REV. 243, 244 n.8 (1978) (citing ALI, STUDY OF THE DIVISION OF JURISDICTION BETWEEN STATE AND FEDERAL COURTS, PART I, 59 (Sept. 25, 1965, Official Draft)). It is well past time that the diversity statute recognizes unincorporated associations as what they effectively are—legal constructs, like corporations, with rights and duties separate and apart from the rights and duties of their members and owners.

Why the Federal Diversity Rule Should Be Amended

A. The current statute leads to unacceptable and readily avoidable wastes of time, money, and judicial resources.

Uncertainty as to whether a case belongs in federal court increases not only the "cost and complexity of litigation," but also "the parties will often find themselves having to start their litigation over from the beginning." *Hoagland*, 385 F.3d at 739-40. Both potential plaintiffs and defendants often have difficulty determining the identities, let alone citizenships, of non-management members of opposing party entities, particularly if such membership is not public information. As a result, they lack a good faith basis for pursuing (or challenging) the propriety of the federal forum. The resulting uncertainties have led appellate courts to criticize the efforts expended to address citizenship at the outset and on appeal. *See,* *e.g.*, *Smoot v. Mazda Motors of America, Inc.* 469 F.3d 675, 677-78 (7th Cir. 2006) (and cases cited therein) (criticizing jurisdictional statements of all parties on appeal and noting "the lawyers have wasted our time as well as their own and (depending on the fee arrangements) their clients' money. We have been plagued by the carelessness of a number of the lawyers practicing before the courts of this circuit with regard to the required contents of jurisdictional statements in diversity cases.").

This uncertainty means that parties can fully litigate a case, only to have an appellate court determine that the district court lacked jurisdiction in the first instance. *GMAC Commercial Credit LLC v. Dillard Department Stores, Inc.*, 357 F.3d 827 (8th Cir. 2004), presents an example of this waste of judicial resources and the court's inability effectively to address the waste. In that case, the LLC plaintiff sued the defendant in federal court on diversity grounds. Neither party challenged subject matter jurisdiction before the district court. The defendant won partial summary judgment and a jury verdict. *Id.* at 828. After obtaining new counsel, plaintiff moved to vacate the judgment award on the ground that diversity of citizenship did not exist and thus the court lacked subject matter jurisdiction from the outset. *Id.* Unable to determine, based on the record below, whether the citizenship of the plaintiff's members in fact destroyed complete diversity, the Eighth Circuit remanded for a discovery hearing on diversity. *Id.* at 829. Defendants also moved for attorneys' fees because plaintiff—who chose the federal forum—never raised the diversity issue until appeal. *Id.* The appellate court left the decision of whether to award fees to the district court on remand. *Id.*

Sometimes even the type of entity involved can be unclear. *Tuck v. United Servs. Auto. Ass'n*, 859 F.2d 842 (10th Cir. 1988), involved an uninsured motorist who had killed Johnny Tuck in a collision. Tuck's estate and parents sued United Services Automobile Association ("USAA") to recover benefits under an uninsured motorist provision of Tuck's insurance policy. *Id.* Believing that USAA was a corporation, the Tucks alleged that USAA was diverse from the Tucks, and the pretrial order incorporated the jurisdictional allegations. *Id.* at 844. The jury returned a verdict for the Tucks on all claims. *Id.* at 843. USAA filed a motion for judgment notwithstanding the verdict, or in the alternative, for a new trial. *Id.* The district court denied both motions but did reduce the Tucks' actual damage award. *Id.* USAA appealed and "revealed, for the first time, that it was not a corporation, but rather an unincorporated association organized under the insurance laws of the state of Texas." *Id.* USAA's status as an association made it a citizen of every state in which its members were citizens, and in consequence, USAA argued, the court lacked subject matter jurisdiction. *Id.* at 844. Admonishing USAA, the court stated, "[t]his is not the first time that USAA has faced this problem." *Id.* at 845 (citing *Baer v. United Servs. Auto. Ass'n*, 503 F.2d 393 (2d Cir. 1974)). To salvage the case and halt USAA's attempted jettisoning of an unfavorable verdict, the court allowed the Tucks to amend their complaint on remand by dismissing all of the Oklahoma citizens who were "members" of USAA. *Id.* at 846. However, the court noted that even this dismissal plan might not work on the case before it as USAA had been sued as an entity, and not the individual members. Still, the appellate court remanded to allow the district court to determine if a jurisdictional basis could be identified. Otherwise, the jury verdict (even as reduced) could not stand. *Id.* at 846-67.

Two problems are highlighted by *Tuck*. First, under the current regime the distinction between a corporation and any other form of unincorporated association drives whose "citizenship" determines the entity's citizenship. Thus, mistakenly believing that an entity with a national presence and operations in multiple states is a corporation can result in plaintiffs, defendants, and trial courts failing to examine citizenship properly. Second, and perhaps more substantively disturbing, *Tuck* highlights that once the proper analysis is applied some large unincorporated associations, with members in all 50 states, simply cannot be haled into federal court (or seek relief in federal court) unless a federal question is presented. There is no practical reason for closing off access to federal courts in this manner either to plaintiffs who wish to bring a case in, or to non-corporate entity defendants who wish to remove a case to, federal courts.

Because federal courts are obligated to determine whether they may exercise subject matter jurisdiction *regardless* of whether the parties ever raise the issue, *see Chapman v.*

Barney, 129 U.S. 677, 681 (1889), uncertainty as to forum can be an expensive and unexpected problem to address well into litigation, possibly requiring jurisdictional discovery. For example, one court addressed the LLC defendant's citizenship *sua sponte* in order to "satisfy itself" that federal jurisdiction existed, even though neither litigant raised the question of whether any LLC members were citizens of the same state (and the complaint failed to allege facts regarding the citizenship of the LLC's members). *Delay v. Rosenthal Collins Group, Inc.*, 585 F.3d 1003, 1004-05 (6th Cir. 2009) (directing the defendant "to submit a jurisdictional statement identifying the citizenship of all of its members.").

In addition to the problems highlighted by *Tuck*, the problem of a case being reversed on appeal for lack of subject matter jurisdiction can wreak immense consequences upon plaintiffs. Should years pass and then a case be remanded as void ab initio due to a lack of subject matter jurisdiction, the plaintiff-litigant may discover that the statute of limitations has run during the time the matter was pending, although improperly, in federal court. Because states' tolling statutes will vary from state to state, particularly with respect to an action that was void (as opposed to voidable or subject to an affirmative defense) from the outset, further uncertainty is injected into an already uncertain process.

While the *Smoot* and *Tuck* courts, and others, have been quick to criticize attorneys for failing to investigate sufficiently deeply, the criticism can gloss over the difficulty of the investigation. It is not enough to examine who the members were of the unincorporated association at the time it came into existence; citizenship is determined as of the time of filing. Thus, an individual member who had moved from a diverse state to a non-diverse state before the lawsuit began can destroy diversity, even if the unincorporated association was not aware of the move. And as more and more communications take place via cell phones (with "traveling" area codes) and internet communications (which do not necessarily reflect physical addresses at all), the ability to unearth this information, let alone to unearth it in a timely enough manner to gather the information to file or remove a lawsuit, presents substantial practical difficulties. These difficulties are highlighted by the increased reliance upon unincorporated entities as a means of doing business that are shown in the IRS filing statistics quoted *supra*.

Given that litigants need absolute clarity in order to avoid litigating a case in federal court only to have it remanded on jurisdictional grounds after judgment, the diversity statute needs to be streamlined and simplified in order to apply the corporate citizenship test to unincorporated associations that are functionally equivalent to corporations.

B. The proposed amendment provides a workable, bright line rule that courts have been applying for decades to corporations.

Currently, counsel for plaintiffs and for defendants can find themselves guessing about citizenship at critical filing or removal stages. Plaintiffs in non-federal question cases who choose to file their lawsuits in federal court must plead that diversity jurisdiction exists. This requires pleading the citizenship of the defendant. Should the defendant be an LLC or other unincorporated association, however, the information may not be available to the plaintiff. Information regarding the ownership of unincorporated entities like LLCs frequently is not a matter of public record. While the LLCs themselves should be able to identify their members, even they may have difficulty identifying the citizenship of every member on any given date. Cohen, *supra*, p. 303. Yet plaintiffs filing or defendants trying to remove, are forced to determine and plead citizenship under tight timeframes.

Further, the current rules, which ignore the reality of where an unincorporated association actually does business, can result in diversity citizenship, and thus removal, being available where the purposes of diversity jurisdiction are not met. In *Johnson v. Smithkline Beecham Corp.*, 724 F.3d 337 (3d Cir. 2013), the Third Circuit granted interlocutory appeal after plaintiffs unsuccessfully tried to remand their personal injury lawsuit after the defendants, including two LLC's, removed the action to federal court. Plaintiffs, who were citizens of Pennsylvania, argued that one LLC defendant was headquartered and largely managed in Pennsylvania. *See id.* at 342. The defendant's sole member, however, was incorporated in and operated primarily out of Delaware. The Third Circuit concluded that even though the LLC was based in the same state where plaintiffs were citizens, the district court properly exercised diversity jurisdiction. *Id.* at 346-48; *see also Gen. Tech. Applications, Inc. v. Exro Ltda*, 388 F.3d 114, 116 (4th Cir. 2004) (remanding case after defendants removed and won summary judgment, concluding that there was not complete diversity, and the case should proceed in state court).

C. The proposed change will bring cohesion between 28 U.S.C. §1332(c) and the Class Action Fairness Act.

Other changes to federal law have recognized the benefit of treating all unincorporated associations in the same manner as corporations. The Class Action Fairness Act of 2005 ("CAFA") expressly defines the citizenship of "unincorporated association[s]" as limited to the state where the association has its principal place of business and the state under whose laws the association is organized. *See* 28 U.S.C. §1332(d)(10). While the statute does not clarify what entities are considered "unincorporated associations," several courts have construed it to include any business entity that is not organized as a corporation. *See, e.g., Ferrell v. Express Check Advance of SC LLC*, 591 F.3d 698, 699 (4th Cir. 2010) (holding that a limited liability company is an "unincorporated association" for diversity purposes under CAFA); *Bond v. Veolia Water Indianapolis, LLC*, 571 F. Supp. 2d 905, 910 (S.D. Ind. 2008) (same). Indeed, Congress' express purpose in adding subsection (d)(10) was to ensure that unincorporated entities were as protected from state-court bias in class actions as were incorporated entities. *See* Christine M. Kailus, *Diversity Jurisdiction and Unincorporated Businesses: Collapsing the Doctrinal Wall*, 2007 UNIV. OF ILL. L.R. 1543, 1554 (Sept. 7, 2007).

The CAFA citizenship test for unincorporated associations mirrors the test for corporations under the existing 28 U.S.C. §1332(c), but it applies only in the context of class action litigation. This disconnect means that an LLC, for example, is a legal fiction with "separate entity" status if the lawsuit is a class action; whereas in a non-class suit, the LLC is merely the sum of its members. It begs the question whether, had the Supreme Court decided *Carden* after CAFA was passed rather than 15 years prior, the Court might have reached a different result in order to avoid interpreting the diversity statute in a manner that yields an absurd result. Regardless, the proposed revision will ensure uniform treatment of unincorporated associations regardless of whether the plaintiff sues solely on his or her own behalf or on behalf of a putative class.

D. The proposed change will not lead to additional administrative difficulties but will lessen existing administrative burdens.

The proposed change should not result in new administrative difficulties. Experience with the Class Action Fairness Act (28 U.S.C. §1332(d)(10)) has not led to difficulties in determining either the state under which entities are organized or where they have their principal places of business. To the extent issues may arise with respect to identifying an unincorporated association's principal place of business, the guidance regarding determining the same for corporations, as cited in *Hertz Corp. v. Friend*, 559 U.S. 77 (2010), and subsequent cases applying that decision, is available, as well as nearly a decade of precedent under the Class Action Fairness Act. Moreover, removing the requirement of examining the citizenship of every member of unincorporated business associations can greatly simplify administrative burdens upon parties both filing and removing actions on the basis of diversity of citizenship.

E. The proposed change will not greatly increase filings in federal courts or removals to federal courts.

Criticism of the proposed change has focused upon whether a change is necessary and whether federal filings will greatly increase. The need and rationale for the change are set forth above in the "Background" section and sections A-D above. One case that goes to trial, only to be reversed due to a "hidden" lack of subject matter jurisdiction from the outset, represents a tremendous waste of judicial resources. The proposed change will allow lawyers and judges at the outset to achieve certainty about the citizenship of parties and then proceed accordingly.

The proposed change should not greatly increase the number of filings in federal courts or removals to federal court. Only situations where the citizenship of an uninvolved owner/shareholder would have been at issue and would have a different result. The proposed change only deals with citizenship of entities. The "complete diversity" requirement of *Strawbridge v. Curtiss* is retained. As a result, in situations where a member of an unincorporated association is an active participant in providing the services at issue (frequently professional services for various LLCs and LLPs), that individual may still be named as a defendant. If that naming destroys diversity because that individual is a citizen of the same state as the plaintiff, then the plaintiff's choice of a state forum will remain. The only situation in which a plaintiff would lose the ability to keep a case in state court due to the proposed change would involve the fortuitous citizenship of an uninvolved member of an entity, and even that fortuitous citizenship must be different from that of the state in which the entity is organized or where the entity has its principal place of business.

While it is impossible to forecast the total number of "new" federal filings (including removed actions) that would become available,[23] and thus might result, under the new proposal the impact should be minimal. Unincorporated associations with their principal place of business where they generally perform work (and thus impact potential plaintiffs), and which have as members citizens of that same state, will still have the same citizenship. The major change involves providing clarity concerning where to look – the now well-developed "principal place of business" and state of organization sites – and where not to look – eliminating the need to examine the citizenship of every record owner at the time the suit is filed.

A presumably accurate forecast of the potential number of new filings and removals would require knowing or estimating the total number of cases currently being filed in state courts where (i) there is a lack of diversity *solely* because of the citizenship of a member of an unincorporated association and that member is a citizen of a state other than the principal place of business of the entity, [24] and (ii) either the plaintiff would wish to file in federal court or the defendant would wish to remove (assuming that the forum state is not the defendant's principal place of business). We are not aware of research from state court dockets that would reveal this type of information.

Removal experience under CAFA is instructive for some comparative purposes. From 2005 through 2008 the Federal Judicial Center published four annual interim reports on "The Impact of the Class Action Fairness Act of 2005 on the Federal Courts." The final report of a two-phase study was published in April 2008,[25] and concluded the statistical analysis of filings through June 2007 with prior years, including a year-by-year comparison with experience under CAFA and a comparison to the pre-CAFA year of 2001. This study was limited to class actions, and the authors note that while there was an increase in federal filings, "[m]uch of that increase was in federal question cases, especially labor class actions and class actions filed under federal consumer protection statutes." Lee & Willging, "Impact" (April 2008) at 1. In fact, "about 86 percent of [of the increase in federal filings and removals from the pre-CAFA to post-CAFA periods studied] was accounted for by the increase in federal question class action filings and removals." id, at 3, n.2. This impact in federal question cases does not reflect an increase due to CAFA, and serves as a noteworthy reminder that increased federal filings pursuant to federal statutes providing federal jurisdiction will not be impacted by the current proposal to change the citizenship analysis for diversity jurisdiction. That is, increased filings under consumer protection statutes such as the Fair Debt Collection Practices Act, Fair Credit Reporting Act, and similar statutes will be unaffected.

The April 2008 "Impact" study revealed two key points. First, there was an increase in class actions filed under CAFA's expanded diversity jurisdictions. This was, of course, one of the

[23] The "Judicial Caseload Indicators" for the twelve-month periods ending September 30 show that between September 30, 2014 and September 30, 2013, civil filings in United States District Courts increased 3.8 percent. The percent increase from 2010 to 2014 was 3.8 percent. http://www.uscourts.gov/Statistics/JudicialBusiness/2014/judicial-caseload-indicators.aspx#fn2

[24] For purposes of this analysis this Report assumes that the jurisdictional amount can be satisfied at a pleading stage for a complaint or at the removal stage, if a defendant removes.

[25] Emery G. Lee, III, & Thomas E Willging, "The Impact of the Class Action Fairness Act of 2005 on the Federal Courts: Fourth Interim Report to the Judicial Conference Advisory Committee on the Civil Rules" (April 2008) (available online at http://www.classactionlitigation.com/cafa0408.pdf).

express purposes of CAFA.[26] The April 2008 "Impact" study notes that the number of cases varied widely jurisdiction to jurisdiction.

The "Impact" study also separately examined removed actions. As shown in the tables accompanying the study, "[a]lthough diversity class action removals, like filings, increased in the immediate post-CAFA period, the prevailing trend for such cases in both the pre-CAFA and post-CAFA periods is downward. . . . [D]iversity class action removals have been initiated in federal court in the last twelve months of the study period [2006-2007] at about the same rate as they were in the pre-CAFA period. CAFA appears to have temporarily increased the number of diversity class action removals to the federal courts, especially in comparison with the immediate pre-CAFA period, when removals of such cases were few. But in both the pre-CAFA and post-CAFA periods, the trend has been for fewer class actions to be removed to federal courts on the basis of diversity of citizenship jurisdiction." Lee & Willging, "Impact" (April 2008), at 7. In short, following CAFA's passage there was a temporary uptick in removals and then removals returned to pre-CAFA levels.[27]

With the proposed change in diversity jurisdiction, one would not expect the type of increase in original filings and removals created with CAFA. CAFA's citizenship provisions were expressly crafted to increase diversity jurisdiction in a class action context and in response to concerns that a more uniform rule was needed. The diversity changes in the current proposal are more limited. Also significantly, the current proposal will still allow "local" disputes to be adjudicated "locally," because when the unincorporated association has its principal place of business in a state and deals with others within that state, diversity jurisdiction will not exist. Similarly, if a member, shareholder, partner, or other stakeholder of an entity is non-diverse from a party on the other side of the case, and if that member or shareholder or partner or the like was sufficiently actively involved in the matter giving rise to the lawsuit, then naming the member, shareholder, partner or the like would also defeat diversity. The only change occurs when a non-involved member, shareholder, partner, or the like happens to have the same citizenship as a party on the other side of the dispute.

Removal experience under the proposed statutory change may track that of CAFA. While there may be an initial increase in removals to federal court, the ability to craft a complaint within ethical bounds to still add non-diverse defendants and the fact that truly local disputes will likely remain local should avoid a long-term increase. The structure and purpose of CAFA would likely have resulted in a more significant prospect for removal, as unlike the current proposal, one of CAFA's stated goals was to move multi-state actions filed in state courts to federal courts via the removal process.

Summary of Potential Costs/Benefits

Any analysis of the impact of the proposed change must not stop at attempting to "count new cases." Under the present system, as shown by cases such as *Smoot*, *Tuck,* and *GMAC Commercial Credit LLC v. Dillard Department Stores* (all cited *supra*), the judicial resources that can be expended are huge when a case is improperly in federal court due to a misapprehension of the current jurisdictional rules. A mistake on the part of both parties can result in the appellate reversal of a case tried to a jury because lack of subject matter jurisdiction is an unwaivable defect. On the other side of the equation, one can predict that a substantial percentage of new cases that are filed or removed solely because of the new citizenship proposal for unincorporated entities will not result in the resources of a full jury trial being expended. In short, for every case that, like *Dillard*, results in an appellate reversal, multiple cases would have to be filed and resolved

[26] The purpose section of CAFA expressly noted that: "Abuses in class actions undermine the national judicial system, the free flow of interstate commerce, and the concept of diversity jurisdiction as intended by the framers of the United States Constitution, in that State and local courts are—

(A) keeping cases of national importance out of Federal court;

(B) sometimes acting in ways that demonstrate bias against out-of-State defendants; and

(C) making judgments that impose their view of the law on other States and bind the rights of the residents of those States."

28 U.S.C. §1711(a)(4).

[27] A variety of reasons may be postulated for the return to pre-CAFA levels. Plaintiffs may have begun filing cases in federal court initially, thus obviating the need for removal. Or plaintiffs desiring to litigate in state courts may have changed the mix of defendants named.

before the same level of resources expended is reached. One late reversal under the current system would equate the same resources as multiple new filings made possible by the proposed change in the statute.

The current difference in treatment between corporations and unincorporated associations was defensible when (i) there were far few unincorporated associations being used, (ii) partnership and other unincorporated association rules in the majority of states did not recognize the association as distinct from its members, and (iii) entities could reasonably be expected to keep up with the citizenship of their individual members at all times. Today, every one of these considerations has changed. Unincorporated associations are chosen as the appropriate structure for businesses at an ever-increasing rate. The rules on the association/partnership distinction have completely reversed, with the association being recognized as separate from its individual members and capable of suing and being sued in model statutes enacted across the country. And increased communication to non-physical locations has increased substantially the difficulty of knowing "where" individual members are "citizens" in an increasingly mobile society. In short, the time to re-examine the citizenship rules has long since arrived.

Respectfully submitted,

Nancy Scott Degan
Chair, ABA Section of Litigation
Submitted August 2015

Appendix 1: Proposed Revision

Existing Provisions (No changes to § 1332(c)(1) and (2) are proposed except the addition of a semicolon at the end of (2) in lieu of a period.)

28 U.S.C. 1332(c)(1):

A corporation shall be deemed to be a citizen of every State and foreign state by which it has been incorporated and of the State or foreign state where it has its principal place of business, except that in any direct action against the insurer of a policy or contract of liability insurance, whether incorporated or unincorporated, to which action the insured is not joined as a party-defendant, such insurer shall be deemed a citizen of—

(A) every State and foreign state of which the insured is a citizen;

(B) every State and foreign state by which the insurer has been incorporated; and

(C) the State or foreign state where the insurer has its principal place of business; and

28 U.S.C. 1332(c)(2):

The legal representative of the estate of a decedent shall be deemed to be a citizen only of the same State as the decedent, and the legal representative of an infant or incompetent shall be deemed to be a citizen only of the same State as the infant or incompetent; New Provisions

and

28 U.S.C. 1332(c)(3):

Any unincorporated association that has the capacity to sue or be sued as determined as set forth in Federal Rule of Civil Procedure 17(b) (including any amendments or revisions as may subsequently be made thereto), including without limitation an entity that is a general partnership, a limited partnership, a master limited partnership, a professional corporation, a limited company, a limited liability company, a professional limited liability company, a business trust, a union, or any other unincorporated association irrespective of name or designation, shall be deemed to be a citizen of every State and foreign state in or by which it has been organized and of the State or foreign state where it has its principal place of business without reference to the citizenship of each partner, shareholder, member, or beneficiary, except that in any direct action against the insurer of a policy or contract of liability insurance, whether incorporated or unincorporated, to which action the insured is not joined as a party-defendant, such insurer shall be deemed a citizen of—

(A) every State and foreign state of which the insured is a citizen;

(B) every State and foreign state by which the insurer has been organized; and

(C) the State or foreign state where the insurer has its principal place of business.

GENERAL INFORMATION FORM

Submitting Entity: Section of Litigation

Submitted By: Nancy Scott Degan, Chair, Section of Litigation

1. Summary of Resolution(s).

   The resolution requests that Congress change the definition of “citizenship” for purposes of 28 U.S.C. § 1332 to provide that all unincorporated associations be treated in the same manner as corporations.

2. Approval by Submitting Entity.

   Approved by Section of Litigation Council on April 18, 2015.

3. Has this or a similar resolution been submitted to the House or Board previously?

   No.

4. What existing Association policies are relevant to this Resolution and how would they be affected by its adoption?

   None identified.

5. If this is a late report, what urgency exists which requires action at this meeting of the House?

   This is not a late report.

6. Status of Legislation. (If applicable)

   Legislation has not yet been introduced.

7. Brief explanation regarding plans for implementation of the policy, if adopted by the House of Delegates.

   Coordinate concerning identification of appropriate contacts for planned

   submission to Congress once ABA Policy.

8. Cost to the Association. (Both direct and indirect costs)

   None

9. Disclosure of Interest. (If applicable)

   None.

10. Referrals.

    Business Law Section
    Judicial Division
    Standing Committee on the American Judicial System
    Tort Trial Insurance Practice Section

11. Contact Name and Address Information. (Prior to the meeting. Please include name, address, telephone number and e-mail address)

    Dennis Drasco
    Lum, Drasco & Positan LLC
    103 Eisenhower Parkway
    Roseland, NJ 07068
    973-228-6770
    ddrasco@lumlaw.com

    Gregory Hanthorn
    Jones Day
    1420 Peachtree Street NE, Suite 800
    Atlanta, GA 30309
    404-581-8425
    ghanthorn@jonesday.com

12. Contact Name and Address Information. (Who will present the report to the House? Please include name, address, telephone number, cell phone number and e-mail address.)

    Dennis Drasco and/or Greg Hanthorn, information above.

EXECUTIVE SUMMARY

1. Summary of the Resolution

The resolution requests that Congress change the definition of “citizenship” for purposes of 28 U.S.C. § 1332 to provide that all unincorporated associations be treated in the same manner as corporations.

2. Summary of the Issue that the Resolution Addresses

Currently, the definition of “citizenship” of unincorporated associations ignores that today (unlike when § 1332 was last amended in 1958) unincorporated associations are both widespread and generally recognized as separate entities capable of suing and being sued and distinct from their members and partners. Moreover, the current definition of “citizenship” can lead to waste of judicial time and effort, needless appellate review and even reversals even following jury verdicts and judgments, and related problems with determining the citizenship of unincorporated associations. Because unincorporated associations are currently treated as citizens of every state where any of their members, shareholders, partners, beneficiaries, etc., are citizens; there can be significant problems arising when determining whether to sue in federal court in the first instance and whether a case can be removed to federal court. Because the citizenship issue impacts subject matter jurisdiction, an erroneous determination mandates a dismissal from the outset, no matter how long the proceedings have been pending or what stage has been reached. Subject matter jurisdiction issues are not waivable.

3. Please Explain How the Proposed Policy Position will address the issue

The proposed amendments to the statute will treat unincorporated associations in the same manner as corporations. For diversity of citizenship purposes, the unincorporated association will be deemed to be a citizen of up to two places: (i) the state of organization and (ii) the unincorporated association’s principal place of business. As with corporations, the citizenship of the individual members or partners would not be a factor.

4. Summary of Minority Views

The one potential, expected minority view is a concern that the amendment might result in more cases finding their way to federal courts. Yet, by replacing uncertainty with a more workable rule, the extreme judicial waste of cases being tried that would never have been filed in federal court can be substantially avoided. The avoidance of this waste alone may counterbalance any minimal increase in filings or removals. Moreover, the “complete diversity” rule will remain and is likely to lessen any potential, minimal increase in filings or removals.

The ULC Series LLC Project

This July, at the annual meeting of Uniform Laws Commission, the working draft of the series act was read, and comments were provided.

Speaking entirely for myself, and setting aside for now remarks dealing with either the technical wording of the act or its scope (i.e., should it be restricted to LLCs or apply to a broader range of unincorporated business), my take on the comments divided them into three inter-related questions:

- Initially, why series? Essentially, this question comes down to one of function, namely what is achieved by this organizational form that cannot be achieved with already existing forms?

- Second, assuming a valid place for the series in the range of available business organizational forms that should be available, does the statute successfully describe the functions and limitations of the form.

- Third, even as the statute describes the series, does it preclude the misuse of the form (*i.e.*, the "shell game" of assets, public disclosure of the existence of the series)?

Implicit in the third question is the degree to which the broader public recognition of series embodied in a uniform act will serve as an endorsement of the organizational form even when jurisdictions such as Delaware that do not and it must be anticipated will not provide by statute for similar protections. As to the same point but reversing the point of perspective, to what degree should the uniform act in the states adopting it condition recognition on the series organized in a foreign jurisdiction upon compliance with the domestic state's rules as to, for example, public filing of the existence of the series, public recordation of the association of titled assets with the series, etc.

More generally, certain individuals raise the question that the adoption of the Uniform Series Act will serve as an "imprimatur" indicating that this very complicated form is fairly and appropriately used in a general manner. Others argue that, irrespective of the complexities and issues that will remain in a statute which should be utilized only in highly lawyered transactions, the existing statutes are manifestly deficient in that they are incomplete and ambiguous. Given that states are going to adopt series acts, and we must anticipate that they will, it is important to give them a better product, even if it is not perfect, than what is currently available.

The ULC drafting committee had a rump meeting in Chicago in connection with the BLS annual meeting and there identified a number of points to be addressed. A two and a half day drafting session will be held the weekend before the LLC Institute, and a report on the then status of the project will be made at the Committee working lunch on the Friday of the Institute.

Much work remains to be done, and it is a fascinating project.

Thomas E. Rutledge

Selected Recent LLC Cases

By: Elizabeth S. Miller
Baylor Law School
Waco, Texas

<u>Scope of Discovery (Confidentiality Rights Regarding Identities of Members of LLCs)</u>

Block Communications, Inc. v. Pounds, 34 N.E.3d 984 (Ohio App. 2015).

Block Communications, Inc. ("BCI"), the former employer of Pounds, sued Pounds for violating a separation agreement between Pounds and BCI. Pounds was a general manager of The Toledo Blade ("The Blade"), a newspaper owned by BCI. After Pounds left The Blade, he formed an LLC that published the Free Press, a newspaper distributed free of charge in the Toledo area. Based on a series of articles about The Blade that appeared in the Free Press, BCI sued Pounds and the LLC alleging that the articles included information that was obtained and disseminated in violation of the separation agreement. In the course of discovery, BIC requested information from the LLC, including disclosure of the identity of the members of the LLC. The LLC sought a protective order or in camera review on relevance and confidentiality grounds. The trial court rejected the LLC's motion, and the LLC appealed. John Doe, a member of the LLC, filed an amicus curiae brief in support of the LLC.

On appeal, John Doe argued that the Ohio LLC statute implicitly shields the names of members from public disclosure because the LLC statute only mandates disclosure of the names of members and financial information to members. The court stated that the fact that the LLC statute did not mandate disclosure of this information to third parties did not establish that the statute prohibits the disclosure of that information, either expressly or by implication. Although the LLC's operating agreement prohibited disclosure of this information, the operating agreement contained exceptions if the members agreed to the disclosure or a court ordered disclosure. The court found no support for Doe's argument that Ohio law created an express or implied protectable interest in preserving the confidentiality of LLC members.

Doe and the LLC both argued that the information sought by BCI was not relevant to the issues in the case. The LLC had argued to the trial court that the names of the members other than Pounds were not relevant because Pounds held a 60% interest and the other members did not have a controlling interest. The court of appeals stated that the standard for relevancy during discovery is broader than at trial. While the admission or exclusion of evidence can be overturned on an abuse of discretion by the trial court, Ohio courts have held that the trial court's determination of relevancy of discovery materials is not a final, appealable order; therefore, the court did not have to reach a determination as to relevancy or whether the trial court erred in abusing its discretion by compelling discovery.

Doe and the LLC next argued that the LLC's business records, including the names of members, were protected trade secrets. Doe and the LLC also argued that the trial court erred in failing to consider the negative impact on the LLC's members if BIC obtained this information. Because it was necessary to interpret and apply statutory language (the Ohio Uniform Trade Secrets Act) to determine the confidentiality of the information, the court applied a de novo standard of review as to this argument. After setting forth the definition of a trade secret under the Ohio Uniform Trade Secrets Act and the six factors used to analyze a trade-secret claim as adopted by the Ohio Supreme Court, the court of appeals concluded that the LLC had not produced any evidence to substantiate its claims that it would be irreparably harmed by disclosure of its members names. Although the operating agreement limited the members' ability to disclose each others' names, the agreement provided for disclosure pursuant to a court order.

The LLC further asserted that there would be a "chilling effect on business in Ohio" if the LLC was required to disclose the members' names. In support of this assertion, the LLC argued that the trial court's ruling strips Ohio LLC members of any claim of privacy and makes it difficult or impossible for businesses to obtain investors in Ohio. The LLC argued that, as a matter of public policy, an Ohio LLC's members should not be forced to identify themselves where the members are merely "innocent bystanders" who have no direct interest in the outcome of a legal action. The court did not find these arguments convincing and pointed out that the LLC had made no effort to have the requested discovery information classified as "confidential information" or “confidential information—attorney’s eyes only,” under the parties’ existing stipulated protection order. Thus, the court could not say that the trial court abused its discretion by refusing to grant the LLC’s request for a protective order or in camera inspection, based on the LLC’s subjective belief that disclosure might cause it and its members intimidation or harassment.

Finally, the LLC argued that the trial court erroneously relied on the provision of the Ohio LLC statute recognizing LLC veil piercing to bolster its decision to require disclosure of members’ names when BCI was not attempting to pierce the veil of the LLC. The court said that the trial court’s statement regarding personal liability of an LLC’s members under the statute was part of a discussion regarding the members’ rights and responsibilities in the context of their expectation of privacy. According to the court of appeals, the trial court did not suggest or find that BCI would have to “pierce the corporate veil” in order to obtain the members’ names.

Derivative Litigation

Northwest Wholesale, Inc. v. PAC Organic Fruit, LLC, 2015 WL 5286198, __ P.3d __ (Wash. 2015).

The Washington Supreme Court held that a debtor in bankruptcy did not have standing to bring a derivative action on behalf of a Washington LLC because the Washington LLC statute provides that a plaintiff in a derivative action must be a member of the LLC, the debtor was dissociated as a member pursuant to the Washington LLC statute when the debtor filed bankruptcy, and the dissociation provision of the Washington LLC statute was not preempted by Section 541 or 365 of the Bankruptcy Code.

Nature of LLC

Excellence Community Management, LLC v. Gilmore, 351 P.3d 720 (Nev. 2015).

A former employee of an LLC argued that she was no longer bound by the post-termination covenant not to compete in her employment agreement with the LLC because 100% of the membership interests in the LLC had been sold by the individuals that were members of the LLC when she entered into the employment agreement. The trial court denied the LLC’s motion for a preliminary injunction enforcing the noncompetition agreement, relying on a decision of the Nevada Supreme Court in which the court held that a noncompetition agreement was not assignable in an asset sale by a corporation. The trial court also found that the LLC failed to show irreparable harm for which compensatory damages were inadequate. The Nevada Supreme Court in this case held that the sale of membership interests in an LLC is analogous to the sale of stock in a corporation rather than an asset sale; therefore, the trial court erred in relying on case law in the asset-sale context. The court agreed with the LLC that the reasoning that should be applied in this case was that applied in case law holding that the enforceability of restrictive covenants is not affected in the context of a corporate merger or a sale of 100% of the stock of a corporation because in those cases there is no new employer. In a 100% stock sale, there is no new entity because the existence of the corporate entity is not affected by changes in ownership. The supreme court agreed that the sale of 100% of the membership interests in this case was equivalent to the sale of 100% of the stock of a corporation. The former employee pointed out that the Nevada LLC statute uses the phrase “membership interest” rather than the word “stock” and that a member’s interest is defined as “a share of the economic interests in a limited-liability company, including profits, losses and distributions of assets.” But the court stated that the former employee failed to address the fact that LLCs, like corporations, have perpetual existence and are distinct from their managers and members. The court concluded that these features mandated that the court treat assignability of employment agreements in a sale of LLC membership interests like employment agreements are treated in a stock sale. Because no other entity was introduced and the LLC remained in existence after the acquisition of 100% of the membership interests, the reasoning in case law distinguishing asset sales from corporate stock sales and mergers applied to this case.

Hoffman v. L & M Arts, Civil Action No. 3:10-CV-0953-D, 2015 WL 1000838 (N.D. Tex. Mar. 6, 2015).

The court concluded that Section 38.001 of the Texas Civil Practice and Remedies Code, which permits a prevailing party in a breach-of-contract case to recover attorney’s fees from “an individual or corporation,” does not permit recovery of attorney’s fees from a limited liability company.

The plaintiff prevailed on a breach-of-contract claim against the defendant, and the plaintiff sought to recover attorney's fees under Section 38.001 of the Texas Civil Practice and Remedies Code. Section 38.001 provides that, if a claim is for any of eight specific categories, including a valid claim for "an oral or written contract," "[a] person may recover reasonable attorney's fees from an individual or corporation, in addition to the amount of a valid claim and costs." The defendant in this case was an LLC. The Supreme Court of Texas has not yet addressed whether Section 38.001 permits the recovery of attorney's fees from an LLC; therefore, the court was required to predict how the Texas Supreme Court would resolve the issue if presented with the same case. Section 38.001 differentiates between who may recover attorney's fees and from whom such fees may be recovered by providing that a "person" may recover attorney's fees from "an individual or corporation." The Texas Code Construction Act broadly defines "person" to include a "corporation, organization, government or governmental subdivision or agency, business trust, estate, trust, partnership, association, and any other legal entity." But Section 38.001provides that attorney's fees maybe recovered from "an individual or corporation" rather than a "person." Neither the Civil Practice and Remedies Code nor the Code Construction Act defines the term "individual" or "corporation." Thus, the court was faced with the question of whether an LLC falls within the scope of "an individual or corporation." The court stated that an LLC clearly was not an "individual" within the ordinary meaning of the term, and Texas courts of appeals and federal courts interpreting Section 38.001 have held that the term "individual" refers to humans rather than partnerships, governmental subdivisions, or other legal entities. The plaintiff argued that the term "individual" should be construed to include LLCs because the Texas Business Organizations Code provides that *"'a domestic entity has the same powers as an individual* to take action necessary or convenient to carry out its business and affairs,' including the power to 'sue [and] be sued,' 'make contracts,' and *'incur liabilities.'"* The court was unpersuaded by this argument. Likewise, the court rejected the plaintiff's argument that the Texas Supreme Court would interpret the term "corporation" in Section 38.001 to include an LLC. The court discussed the nature of LLCs and acknowledged that LLCs and corporations have some similarities, but the court concluded that LLCs and corporations are distinct legal entities. Further, the court concluded that the history of Section 38.001 and its predecessor statute supports the conclusion that the term "corporation" does not include an LLC. The court stated that the predecessor statute clearly distinguished between corporations, on the one hand, which could both recover attorney's fees and from whom attorney's fees could be awarded, and "partnerships" and "other legal entities," on the other hand, which could themselves recover attorney's fees but from whom such fees could not be recovered. According to the court, because the term "corporation" in the predecessor statute did not include a "partnership" or "other legal entity," the term "corporation" in Section 38.001 likewise does not include a "partnership" or "other legal entity" such as an LLC. The court stated that cases applying the predecessor statute in which courts awarded attorney's fees against non-corporate entities did not squarely address the question. And even if Texas courts permitted attorney's fees to be recovered from non-corporate business entities before the re-codification of the predecessor statute, the court stated that the current version rather than the prior, repealed statute must be given effect when "specific provisions of a 'nonsubstantive' codification and the code as a whole are direct, unambiguous, and cannot be reconciled with prior law." The court was also unpersuaded by Texas cases that have awarded attorney's fees to non-corporate business entities under Section 38.001. In these cases, there was no indication that the question whether such an award was permitted under Section 38.001 was raised or considered.

<u>Limited Liability of Members and Managers; Personal Liability Under Agency or Other Principles</u>

In re White-Robinson, 777 F.3d 792 (5th Cir. 2015).

The court of appeals upheld the bankruptcy court's contempt order against an individual lawyer. The bankruptcy court had sanctioned the individual lawyer and her firm, a professional limited liability company, for bringing a frivolous and procedurally deficient motion. When the lawyer and her firm did not pay the ordered sanctions, the court held the lawyer and her firm in civil contempt. The lawyer argued that the bankruptcy court improperly held her jointly and severally liable for actions she performed as a member of her law firm, a Texas LLC. The court stated that Texas law only protects members from being liable for the LLC's obligations, not their own, citing Section 101.114 of the Business Organizations Code. The lawyer was held in civil contempt for her failure to pay sanctions she owed because of her own misconduct in prior bankruptcy proceedings. Thus, she was not protected by her membership in the LLC.

LLC Veil Piercing

Volvo Construction Equipment Rents, Inc. v. NRL Rentals, LLC, 2015 WL 3620708, __ Fed. App'x __ (9th Cir. 2015).

The plaintiff sought to hold Dwight and Marcel Bosworth personally liable under an alter-ego theory for a $10 million judgment against a Nevada LLC and a $10 million judgment against a Texas LLC and Texas limited partnership. The court of appeals held that the plaintiff failed to present sufficient evidence to prevail on its alter-ego claim against the Nevada LLC under Nevada law and failed to present sufficient evidence to prevail on its alter-ego claim against the Texas LLC under Texas law. The plaintiff's claim against the Bosworths as limited partners of the limited partnership failed under Texas law because Texas courts have held that veil-piercing theory does not apply to limited partnerships, and a limited partner is protected from personal liability by statute unless the limited partner induces someone to reasonably believe that the limited partner is a general partner.

With respect to the plaintiff's claim that the Bosworths were liable as the alter egos of their Nevada LLC, the court noted that the parties as well as Nevada courts had assumed that the standard for piercing the veil set forth in the Nevada corporate statute applied to LLCs. Under that standard, the claimant must demonstrate that: (1) the LLC is "influenced or governed by" the member; (2) there is "such unity of interest and ownership that the [LLC] and the [member] are inseparable"; and (3) "[a]dherence to the corporate fiction of a separate entity would sanction fraud or promote a manifest injustice." The plaintiff argued that the Bosworths treated the Nevada LLC as their alter ego by allegedly undercapitalizing the LLC, lending funds to a Texas LLC operated by a former business associate and helping the Texas LLC obtain outside financing, overseeing the filing of certain tax documents, and failing to keep precise records. The court characterized may of these allegations as not even being relevant to establishing alter-ego liability and held that the district court correctly concluded that the allegations were not supported by the trial record.

Although the trial court had proceeded under the assumption that the plaintiff's alter-ego claim against the Bosworths with respect to the Texas LLC and Texas limited partnership should be decided under Nevada law, and that there were no substantive differences between Nevada and Texas law concerning alter-ego liability, the court of appeals held that Texas law applied to the claims because the entities were organized under Texas law. The court stated that this result was required under the Restatement (Second) of Conflict of Laws, which is followed by Nevada, as well as the governing-law provisions of the Nevada limited partnership and LLC statutes. The court stated that Texas case law is replete with cases where courts have applied the alter-ego doctrine to impose liability on a shareholder or officer of a corporation but that there do not appear to be any Texas cases imposing liability on individuals for the debts of a corporation in which the individuals did not own or control a stake. Because the Texas LLC was operated solely by the Bosworths' former business associate, and the Bosworths themselves were never members, managers, or officers of the Texas LLC, the court said that the Bosworths could not be held liable for the LLC's debts and obligations. Even if they could theoretically be held liable, the evidence was not sufficient to show they treated the LLC as their alter ego under Texas law. The court pointed out that Texas law requires a showing that the LLC was used to perpetrate actual fraud for the defendant's direct personal benefit to pierce the veil with respect to a contractual liability. The plaintiff did not present evidence of "actual fraud" committed by the Bosworths for their "direct personal benefit."

A.G. Cullen Construction, Inc. v. Burnham Partners, LLC, 29 N.E.3d 579 (Ill. App. 2015).

The court of appeals concluded that a Delaware LLC's payments to the LLC's parent member and the member's owner, which left the LLC unable to pay an arbitration award entered against the LLC after the payments were made, were fraudulent transfers and provided a basis to pierce the veil of the LLC. The court also held that the LLC's manager breached a fiduciary duty owed to the creditor in the context of the LLC's insolvency.

An LLC hired a construction firm to build a facility in Pennsylvania, and the LLC and the construction firm had a disagreement as the project neared completion. The LLC stopped paying the construction firm, and the firm sought relief through arbitration. Before the arbitration award was entered, the LLC began to liquidate its assets and windup. After paying off a secured loan, most of the remaining cash was disbursed to the LLC's member as a development fee and to repay a loan made to the individual owner of the LLC's member. The LLC had no funds remaining to pay the arbitration award, and the construction firm sued the LLC, its member, and the manager (who was also the owner of the LLC's parent member) in Illinois to recover the amount of the arbitration award, alleging claims based on fraudulent transfer, veil piercing, and breach of fiduciary duty.

The court concluded that the payments of a development fee to the parent of the LLC and the repayment of a loan made to the parent's sole owner were fraudulent transfers based on the fact that 9 of the 11 badges of fraud were present in connection with the payments. Although the parent and its owner claimed that they did not think the construction firm would be awarded damages in the arbitration, the court pointed out that they were insiders who were on notice of a threatened lawsuit and the real possibility of a judgment. The court concluded that reasonably equivalent value was not received by the LLC in exchange for the transfers. According to the court, there was no consideration for the development fee because the parent was obligated to perform those functions as the majority owner, and the parent was not able to produce invoices showing what services were performed beyond what it was already obligated to perform (claiming that the records were probably lost). The LLC's repayment of a loan that had been made to the owner of the parent was not supported by consideration because the loan proceeds had in turn been lent to the parent by its owner in order to allow the parent to make its capital contribution to the LLC. The LLC was thus in essence repaying a capital contribution that its parent was obligated to pay. The assets transferred comprised substantially all of the LLC's assets. Further, by its transfers, the court stated that the LLC became insolvent and concealed its assets from the construction firm, all of which occurred just two months after the arbitration award and 10 months after the demand for arbitration. The court stated that a debtor may prefer one creditor over another so long as the debtor acts without fraudulent intent, but the court concluded that these transfers were fraudulent in violation of Section 5 of the Illinois Uniform Fraudulent Transfer Act.

The court of appeals next held that the trial court erred in failing to pierce the veil of the LLC to impose joint and several liability on the LLC's parent and the parent's owner for the Pennsylvania judgment. Under Illinois law, the law of the state of incorporation governs efforts to pierce the corporate veil. Because the LLC was a Delaware LLC, the court applied Delaware law to determine whether to pierce the LLC's veil. The court stated that Delaware courts do not lightly disregard the corporate form, but the corporate veil may be pierced when there is fraud or the subsidiary is in fact the alter ego of the parent. The factors that reveal the relationship between the parent and subsidiary include whether the corporation was adequately capitalized for the corporate undertaking; whether the corporation was solvent; whether dividends were paid, corporate records kept, officers and directors functioned properly, and other corporate formalities were observed; whether the dominant shareholder siphoned corporate funds; and whether, in general, the corporation simply functioned as a facade for the dominant shareholder. The defendants contended that the LLC kept separate records, was properly funded, and did not have funds that were commingled with the funds of its parent or the parent's owner, but the occurrence of a fraudulent transfer gave rise to a "strong presumption for piercing the corporate veil." Thus, the court held that the trial court erred in entering judgment in favor of the defendants on the construction firm's claim to pierce the corporate veil.

In re Opus East, LLC (Burtch v. Opus, LLC), 528 B.R. 30 (Bankr. D. Del. 2015).

The debtor was a Delaware limited liability company formed in 1994 to develop and sell commercial real estate projects in the northeastern and mid–Atlantic states. The debtor was part of a network of real estate companies (sometimes referred to as the "Opus Group") that originated with a construction company founded by Gerald Rauenhorst in 1953. In 1982, Gerald Rauenhorst created two trusts (the "Trusts") for the benefit of his children and grandchildren, and the Trusts owned and controlled two holding companies: Opus Corporation ("Corp") and Opus, LLC ("LLC").

The holding companies owned five subsidiaries that operated in different geographical areas. The debtor was an operating subsidiary of LLC. For each real estate project the debtor developed, it created a special purpose entity. The Trusts owned other subsidiaries, and Corp owned subsidiaries through which architectural and engineering services were provided to the debtor and its SPEs. Corp itself provided certain services directly to the operating subsidiaries, including the debtor. Those services included corporate accounting, human resources, legal, risk management, payroll, office services, and tax services (the "Shared Services"). Historically, the subsidiaries of Corp and LLC were required to make certain upstream distributions from excess income to Corp or LLC, which would then make upstream distributions to the Trusts.

The debtor successfully operated from 1994 until 2008, growing its equity from $12 to $75 million. With the failure of Lehman Brothers in 2008 and the subsequent collapse of the financial markets, the debtor was unable to sell its completed real estate projects because buyers could not obtain financing. The debtor was also unable to obtain financing to complete projects in process. The debtor was ultimately forced to file a Chapter 7 bankruptcy petition in 2009. The insolvency of the debtor was a predicate to several of the trustee's claims in this adversary proceeding, including piercing the corporate veil, fraudulent transfers, and preferences. The trustee and defendants disagreed on the date the debtor became insolvent. After reviewing the evidence bearing on this issue, the court concluded that the debtor was solvent until February 1, 2009, under the balance-sheet, inadequate-capital, and cash-flow tests.

To prevail on an alter-ego claim under Delaware law, the court stated that the trustee had to show that the debtor, LLC, and the Trusts operated as a single economic entity that resulted in an overall element of injustice or unfairness. Respect for the corporate form is strong, and the standard of proof is greater than a preponderance of the evidence. The corporate identity of single-member LLCs is also respected. In order to determine if the Trusts, LLC, and the debtor operated as a single economic entity, the court stated that it must consider whether: (1) the debtor was undercapitalized; (2) there was a failure to observe corporate formalities; (3) a dividend was paid; (4) the debtor was insolvent; (5) the dominant stockholder siphoned funds from the debtor; (6) there was an absence of corporate records; and (7) the debtor was a facade for the operations of its stockholder.

The trustee argued that the Opus Group, though proper in form, operated as a single economic unit. Gerald Rauenhorst described the five operating subsidiaries as battleships surrounding the Trusts who would take the torpedo (or any losses) instead of the Trusts. The trustee pointed to the interlocking directors and officers as evidence that the separate entities were mere facades for the single enterprise. The trustee pointed out that no distinction was made between the operations and financial health of one operating company versus the others during meetings of the boards of the holding companies and that the operating companies themselves could not make final decisions on projects (approval being required by Mark Rauenhorst). The court, however, was not convinced that the debtor was created only as a facade for LLC and the Trusts. The court found that the debtor was created for a legitimate business purpose and acted independently of LLC and the Trusts. No loan or contract was ever made by or with the "Opus Group," and banks, vendors, and other business partners of the debtor were never told or misled into believing that they were doing business with any legal entity called "The Opus Group of Companies" or the "Opus Group." Corp, LLC, and the operating companies were all separately incorporated and operated in a decentralized fashion in which each operating company had its own management, financing, and financial-reporting department. The debtor was a separate legal entity, a Delaware limited liability company. The debtor's executive team ran the debtor, and its officers understood that the companies were separate and that the debtor was their employer. Under the leadership of the debtor's CEO, the debtor successfully completed a significant portfolio of projects, generating over a billion dollars in revenue and increasing equity to $75 million. Though Rauenhorst had to approve major projects, the court did not find that unusual because Rauenhorst was the chairman of the debtor's board and major projects cost many millions of dollars and took years to complete and earn a return. The primary source of capital for the debtor was its operations, and the debtor also obtained financing from banks to operate the business, including a $20 million line of credit from Bank of America and construction financing for projects, none of which was guaranteed by LLC or the Trusts. The debtor borrowed from related entities to assist with cash flow management, and these loans were properly recorded on the books and records of the debtor and were evidenced by demand notes whose terms were similar to other lenders' terms and were acceptable to the debtor. The debtor decided when to repay these loans from its affiliates and only made payments when it had excess cash. The debtor maintained headquarters in Maryland and offices in Philadelphia and Stamford, Connecticut, and the debtor did not share offices with LLC, Corp, any other operating subsidiary, or the Trusts. All of the debtor's employees worked in the debtor's offices or at its project sites, not in the offices of any other entities. No other operating subsidiary did business in the states where the debtor operated. LLC and the Trusts never did business under the debtor's name, and the debtor did not do business under the Trusts' or LLC's name. Based on this record, the court found that the debtor was not a mere facade for LLC or the Trusts.

The trustee contended that the Trusts, LLC, Corp, and all the operating subsidiaries, including the debtor, comprised one operation and that corporate formalities were not observed. The trustee pointed out that the debtor, LLC, and Trusts had overlapping officers and directors and that the debtor's "independent" directors were hand-picked by the holding companies and were expected to support Rauenhorst's decisions. The trustee contended that the debtor was not run as an "independent" operating company, but rather as an operating division of a single entity. For example, the trustee contended that the debtor's board meetings were a sham. The defendants responded that Delaware law does not require limited liability companies to observe corporate formalities but contended that the debtor did observe corporate formalities in any event. The court found that the evidence supported a finding that the debtor observed corporate formalities. The debtor had a separate board of directors and had its own officers. It held periodic board meetings at which its affairs were discussed in depth, and it maintained separate corporate records. The debtor had its own accounting and finance department and personnel that kept its financial records. The debtor borrowed from banks in its own name, with no guarantors. The debtor operated in a distinct geographic region of the United States in which none of the other operating subsidiaries did business. Because the debtor observed corporate formalities and maintained its own independent books and records, the court concluded that this factor did not favor piercing the corporate veil. The court agreed with the trustee that the debtor's observance of corporate formalities did not foreclose piercing the corporate veil if other factors weighed in favor of doing so, and the court thus considered all factors in determining whether to pierce the corporate veil.

The trustee argued that both the distribution policy and specific transfers of assets from the debtor to affiliates were examples of improper siphoning of funds from the debtor. However, the court stated that payment of dividends annually is not sufficient evidence to pierce the corporate veil, and it is usually the failure to pay dividends (while instead siphoning funds from the subsidiary through other means) that evidences a subsidiary is a mere facade of the parent. The court found that the regular payment of dividends by the debtor to its parent LLC (which paid dividends to the Trusts) was insufficient to cause the court to pierce the corporate veil, particularly when dividend payments were only made while the debtor was profitable and did not jeopardize the debtor's ability to run or grow its business. Similarly, the policy requiring the debtor to upstream taxes based on its income did not support the trustee's claim to pierce the corporate veil. The fact that the debtor, like many companies, was a pass-through entity for tax purposes, did not warrant piercing the corporate veil. Further, many of the cited distributions were used to pay for Shared Services provided to the debtor by related entities. The court found that the debtor received an actual benefit from the Shared Services performed for it and concluded that the payment for Shared Services was not the siphoning of assets away from the debtor to avoid creditors that would justify piercing the corporate veil.

The trustee also asserted that the transfer of assets under the debtor's control to other Opus entities justified piercing the corporate veil. The court found that the transfers of which the trustee complained were insufficient to show a pattern of siphoning of funds away from the debtor. In contrast, the debtor maintained bank accounts in its own name separate from all other Opus-related entities, and the debtor's funds were not commingled with any other entity's funds or taken from its accounts by LLC or the Trusts. Neither Rauenhorst nor anyone else other than the debtor's officers had signing authority for any of the debtor's bank accounts. Neither LLC, the Trusts, nor any other related entity ever paid the debtor's bills or any other obligation of the debtor. Funds were not taken from any of the debtor's bank accounts against its will.

The defendants argued that the trustee's veil-piercing claim failed even if all other factors favored piercing because the parties' actions had no element of injustice or unfairness. Dominion or control is insufficient to hold a parent liable for a subsidiary's obligation without proof that the corporate form was used to "defeat the ends of justice, to perpetuate fraud, to accomplish a crime, or otherwise evade the law." The trustee argued that such injustice or unfairness existed in that the Opus Group held itself out to the world as being a single economic entity headed and financially backed by the Trusts. The trustee contended that the Trusts knew that creditors of the Opus Group believed they were a single entity backed by the Trusts. The trustee also complained that LLC made an equity contribution to the debtor in 2008 so that the debtor could make distributions required to LLC and the Trusts, but LLC refused to extend a loan to the debtor later in the year to continue its operations as the economy worsened.

The court stated that the debtor was not harmed by the 2008 equity infusion and that there was no legal obligation on the part of LLC to continue to support the debtor after the recession hit. The trustee relied on cases for the proposition that the obligation to provide sufficient capitalization is an ongoing one, which begins at the time of incorporation and continues throughout the corporation's existence, but the court distinguished the cases relied on by the trustee from the instant case. Here the debtor had been adequately capitalized initially and had almost fifteen successful years of operation while growing its equity to $75 million. The debtor continued to operate only five months after it became insolvent, and the court found no legal obligation to continue to support the debtor when the recession hit. The court pointed out that, given the depth and length of the recession, LLC might have had to continue to prop up the debtor (and the other operating subsidiaries) for years. If the law required that, every parent of an insolvent company would have to support its subsidiary, completely blurring corporate lines. Thus, the court concluded that there was no injustice or unfairness in the treatment of the debtor by LLC or the Trusts.

Because the trustee failed to prove by a preponderance of the evidence any of the factors necessary to establish an alter-ego claim, the court entered judgment for the defendants on this claim.

<u>LLC Property; Interest of Members</u>

Wen v. Willis, 2015 WL 4611903, __ F.Supp.3d __ (E.D. Penn. 2015).

Wen, an undergraduate student from China who was enrolled at Temple University, sued Foxcode, Inc. ("Foxcode"), an investment and merchant banking firm, and Foxcode's principal, Robert Willis, for common-law fraud, conversion, breach of fiduciary duty, and federal and state securities fraud. Wen alleged that Willis represented that the defendants would manage $4 million invested by Wen with the defendants for Wen's benefit, deliver a return on the investment, and guarantee the full return of the $4 million principal when the investment concluded. The defendants created two Delaware LLCs to carry out the plan to invest Wen's funds—Foxcode Far East, LLC ("FFE"), and Foxcode Capital Markets, LLC ("Foxcode Capital"). The LLC agreement of FFE ("FFE Agreement") provided that Wen would contribute $4 million in exchange for a 99.9% membership interest in FFE, and Foxcode Capital would contribute $4,000 for a 0.1% membership interest. Foxcode would also provide all financial advisory services to generate earnings for FFE and would be paid management and performance fees. Wen alleged that the defendants drained the funds from FFE's account, transferring nearly all the funds to their own accounts. After Wen became suspicious and was not provided satisfactory reports and information, he brought this suit. In this opinion, the court addressed the defendants' motion to dismiss the claims. Wen's conversion claim failed because money may be the subject of a claim for conversion under Pennsylvania law only where the plaintiff has a property interest in the money at the time of the alleged conversion. Under Delaware LLC law, the $4 million invested by Wen became LLC property in which Wen as a member had no specific interest once he contributed the funds to the LLC.

<u>Authority of Member, Manager, or Agent</u>

Penny v. El Patio, LLC, 2015 WL 3543056, __ S.W.3d __ (Tex. App. 2015).

In this dispute over the authority of an LLC's operating manager to hire an attorney to assert claims on behalf of the LLC against some of its members and affiliates of the members, the court concluded that the trial court did not err in concluding that the operating manager had authority to hire the attorney on behalf of the LLC without a vote of the members.

This lawsuit started out as a suit to set aside an LLC member's foreclosure on the LLC's property after the LLC defaulted on a loan to the member, but the suit expanded to include additional parties and claims by the LLC against other members relating to the management of the LLC's property before the foreclosure. The principal issue on appeal was whether the operating manager of the LLC had authority to hire an attorney for the LLC to assert claims against other members of the LLC and affiliates of those other members.

The LLC at issue was formed by several investors, including David Penny, Richard Cheroske, and Stephen Hyde, to purchase and own a hotel. Hyde was named as the LLC's operating manager, and the LLC hired Blue Castle Property Management, LLC ("Blue Castle") to operate and manage the motel's day-to-day business. Blue Castle was owned by 190 Orange Avenue, Inc. ("190 Orange"), which was owned by Penny and Cheroske. Penny and Cheroske filed this suit as a derivative action to set aside a foreclosure on the LLC's property, and the LLC intervened to assert several claims against Penny, Cheroske, Blue Castle, Blue Castle's accountant, and 190 Orange for conversion, theft liability, breach of fiduciary duty, breach of contract, fraud, and other causes of action in relation to the management of the motel. After the claims relating to the foreclosure were resolved and the foreclosure was set aside, the claims against Penny, Cheroske, and the other third-party defendants remained. Penny, Cheroske, and the other third-party defendants filed a motion to require the LLC's attorney to show the trial court that he had authority to prosecute the suit against them on the LLC's behalf. The trial court ruled that the LLC's attorney had authority to prosecute the suit, and Penny, Cheroske, and the other third-party defendants failed to respond to the LLC's discovery requests and motions thereafter. The trial court eventually struck their pleadings and awarded the LLC judgment on all its claims. Penny appealed from that judgment.

On appeal, Penny challenged the trial court's determination that the LLC's attorney had authority to prosecute the suit. Penny argued that Hyde's position as operating manager of the LLC did not vest him with the authority to hire an attorney to prosecute the LLC's claim because the LLC's operating agreement did not contain express language authorizing litigation and because Hyde lacked specific approval from a majority in interest of the members to conduct the litigation. Penny relied on Texas cases that he said stood for the proposition that the officers of a corporation do not have authority to employ counsel or initiate litigation in the absence of either approval of the board of directors or express authorization in the bylaws.

The court disagreed with Penny's interpretation of the LLC's operating based on the plain language of the agreement. The agreement named Hyde as the initial operating manager as follows: "Management of the Company shall be vested in the Members who shall serve as Operating Managers of the Company, initially Stephen Hyde." Though the provision of the operating agreement regarding management of the LLC did not reference litigation, it gave the operating manager sole and exclusive control over the company's business and granted to the operating manager all the powers and rights needed to conduct that business as follows:

> The Company shall be managed by the Operating Managers, who shall be paid a fee for serving as Operating Managers, and the conduct of the Company's business shall be controlled and conducted solely and exclusively by the Operating Managers in accordance with this Agreement. In addition to and not in limitation to any rights and power conferred by law or other provisions of this Agreement, the Operating Managers shall have and may exercise on behalf of the Company *all powers and rights necessary, proper, convenient or advisable to effectuate and carry out the purposes, business and objectives of the Company, and to maximize Company profits.* (Emphasis added.)

The court said it was hard to imagine a broader grant of managerial authority, and protecting the

LLC's interests by asserting the claims asserted in this case certainly fell within the purposes, business, and objectives of the company according to the court.

Even assuming the LLC's operating agreement did not expressly grant Hyde the authority to conduct litigation on the LLC's behalf, the court said that the cases Penny cited in support of his argument did not inform the court's decision. The cases cited by Penny (for the proposition that Texas law requires express language in the bylaws or approval from the board of directors for an officer to litigate) involved corporations rather than LLCs and were decided under a provision of the now recodified Texas Business Corporation Act. The current version of that statutory provision is now located in Title 2 of the Texas Business Organizations Code (BOC) and is specific to for-profit corporations. Thus, the provision does not apply to an LLC. Moreover, the court pointed out that the BOC provisions applicable in this case provide that, unless the entity's governing documents provide otherwise, an LLC's affairs are managed and directed by managers.

Penny next argued that the second sentence in the following paragraph of the operating agreement required that all actions by the LLC must be voted on and approved by a majority in interest of the member owners:

> Management of the Company shall be vested in the Members who shall serve as Operating Managers of the Company, initially Stephen Hyde, or a company controlled by him. Except as otherwise provided in this Agreement, *all decisions of the Operating Managers shall be by a majority in interest of the Members.* All Operating Managers must be Members of the Company, or a company controlled by a member....(Emphasis added.)

The court rejected this argument based on the agreement as a whole and harmonizing its provisions with an eye to the particular business activity sought to be served. The court concluded that the language relied on by Penny merely explained the method by which the managers reach a decision in a situation where there is more than one operating manager and they are not in complete agreement. Staying within the context of the first sentence (which provides that management of the company will be vested in operating managers, that only members can serve as operating managers, and that Hyde will be the first member to serve as operating manager), the court said the second sentence explains that the *operating managers'* decisions, i.e., "decisions of the Operating Managers," are achieved based on their membership interest. The court stated that Penny's interpretation, which would require a majority vote on *every* company decision, would "render the operating agreement unreasonable, inequitable, and oppressive." The court said that Penny's interpretation would make the agreement's creation of operating managers and their duties meaningless given that a member vote would be required for any and every action. In other words, there would be no need for operating managers if all decisions must be made by the members. In addition, Penny's interpretation would render redundant the agreement's requirement that a majority in interest of the members approve the selling or refinancing of real property.

In sum, the court determined that the operating agreement vested Hyde with authority to litigate on the LLC's behalf, and the trial court thus did not err in holding that the LLC's attorney satisfied his burden to show his authority by offering the LLC's operating agreement and Hyde's affidavit.

Bigham v. Southeast Texas Environmental, LLC, 458 S.W.3d 650 (Tex. App. 2015).

An LLC sued one of its members and an attorney-in-fact for breach of fiduciary duty and other causes of action and obtained a judgment. On appeal, the court held that there was evidence to support the jury's finding that the member who caused the LLC to file suit was authorized to do so, and there was sufficient evidence to support the jury's finding that the defendants breached their fiduciary duties to the LLC.

Jeffrey Pitsenbarger ("Jeff"), Tracy Hollister, and two other individuals formed an LLC that purchased some property, which was unexpectedly declared a Superfund site a short time after its purchase. The LLC, as an innocent owner, could pursue contribution for the clean-up costs, and Hollister introduced Jeff to

Bigham, whom Hollister represented possessed expertise in managing environmental litigation. The LLC entered into a power-of-attorney agreement with Bigham. Under the power-of-attorney agreement, Bigham was to manage the litigation. The LLC alleged that Bigham and Hollister breached their fiduciary duties by sabotaging the litigation, and the LLC obtained a favorable jury verdict and judgment.

On appeal, Bigham and Hollister argued that the evidence conclusively established that Jeff lacked authority to file the suit on the LLC's behalf, relying in part on statutory provisions that stated that managers could take actions on behalf of an LLC by obtaining a vote of a majority of the managers at a meeting where a quorum was present or a vote or consent of a majority of the managers without a meeting. Bigham and Hollister asserted that the evidence showed that, even if Jeff were a manager, he did not obtain the vote or consent of the majority of the managers. Because the jury was not instructed or given evidence regarding this statutory standard, however, the court did not consider it. The court measured the sufficiency of the evidence against the charge submitted. The broad question submitted to the jury asked generally whether Jeff had "authority" to file the suit. Bigham and Hollister pointed to the articles of organization of the LLC, which provided that the LLC was manager-managed. Bigham and Hollister argued that Jeff was not a manager when the suit was filed in September 2007 based on a Texas Franchise Tax Public Information Report signed by Hollister and filed by the LLC in April of 2007. The report listed Hollister as managing member and the two owners who were not involved in this case as managers or officers, but the report did not list Jeff as a manager or officer. The court disagreed that this evidence prevented a reasonable jury from finding that Jeff had authority to file the suit. That the articles of organization provided for management of the LLC by managers did not conclusively establish that only a manager could authorize a suit. There was evidence that Jeff was a member or owner of the LLC, and Jeff testified that he had authority to file the suit. Additionally, even if the authorization of a manager were required, there was conflicting evidence regarding whether Jeff was a manager. Jeff testified that the role of manager evolved to him by 2000 or 2001 and that the information in the Texas Franchise Tax Public Information Report was incorrect. In addition, Bigham referred to Jeff as the registered manager of LLC in an email in 2004. Thus, the court concluded the evidence was sufficient to support the jury's answer to the question as submitted.

Twenty First Century Holdings, Inc. v. Precision Geothermal Drilling, L.L.C., No. 03-13-00081-CV, 2015 WL 1882267 (Tex. App. Apr. 23, 2015).

The court of appeals concluded that a manager of an LLC did not have authority to enter into a settlement agreement releasing the LLC's claims against an entity owned by the manager because he was an interested governing person, and the provisions of the Texas Business Organizations Code regarding approval of a transaction between an LLC and an entity in which a governing person has a financial interest were not met.

DeMarco and Denny formed an LLC to perform drilling work. DeMarco was 49% owner and Denny was 51% owner of the LLC, and both were managers. The LLC contracted with American Geothermal Systems, Inc. ("AGSI"), a company owned by DeMarco, and disputes arose between Denny and DeMarco over the drilling work and payment. Denny filed suit in the justice court on behalf of the LLC against AGSI seeking to recover $8,000 from AGSI. Denny and DeMarco eventually reached a settlement agreement in principle, but additional disputes arose regarding the operation of the LLC during the final settlement negotiations. DeMarco or AGSI's counsel drafted a new settlement agreement, which DeMarco signed on behalf of both the LLC and AGSI. DeMarco then filed a nonsuit of the LLC's case. On motion by the LLC, the justice court vacated the dismissal it had entered after DeMarco filed the nonsuit. AGSI sought to compel arbitration based on an arbitration clause in the settlement agreement. The justice court denied the motion for arbitration on the basis that the settlement agreement was invalid and also sanctioned DeMarco and the attorney for AGSI, whom the record showed represented DeMarco in virtually all matters related to the dispute and lawsuit. After unsuccessfully appealing to the county court, AGSI appealed to the court of appeals.

On appeal, AGSI contended that DeMarco had authority to execute the settlement agreement, the arbitration provision in the settlement agreement was thus valid, and the county court abused its discretion in not compelling arbitration. AGSI argued that DeMarco, as a manager of LLC, had authority to act on behalf of LLC in drafting and signing the settlement agreement that included the arbitration provision because the Texas LLC statute provides that the managers of an LLC are its "governing authority," and each governing person vested with actual or apparent authority by the governing authority is an agent of company for purposes of carrying out the company's business. The LLC argued that DeMarco's actions are controlled by a provision of the Texas LLC statute that applies to transactions Involving interested governing persons. Under this provision, an otherwise valid and enforceable contract or transaction between an LLC and a governing person, or an entity in which a governing person is a managerial official or has a financial interest, "is valid and enforceable, and is not void or voidable" if it is (1) known by or disclosed to and authorized by the "governing authority," i.e., the managers, or (2) fair to the company. The LLC argued that DeMarco, as the sole owner of AGSI, was an "interested governing person" and that the settlement agreement between AGSI and the LLC thus had to be (1) known by or disclosed to and authorized by the managers, which included Denny, or (2) fair to the LLC. DeMarco did not dispute that DeMarco entered the settlement agreement without informing Denny and that Denny did not otherwise know of the agreement. The LLC contended that the settlement agreement was not fair to the LLC because it settled its breach-of-contract claim for no payment of money when the earlier settlement agreement had called for payment of $5,100 to the LLC. The court of appeals agreed with the LLC that the settlement agreement did not meet either of the requirements of the statutory provision governing conflict-of-interest transactions. It was undisputed that DeMarco acted without consulting or even informing Denny in drafting and signing the settlement agreement. Further, unbeknownst to Denny, the settlement agreement released the LLC's claims against AGSI and DeMarco in return for no consideration other than AGSI's release of claims against the LLC, despite a prior offer of $5,100. Thus, the settlement agreement, with the arbitration clause, could not be construed as "fair" to the LLC within the plain meaning of the term. The court cited sources defining "fair" as "characterized by honesty and justice" or "free from fraud, injustice, prejudice, or favoritism." On the record before the court, it could not conclude that the parties entered into a valid and enforceable agreement to arbitrate.

Fiduciary Duties of Members and Managers

Wen v. Willis, 2015 WL 4611903, __ F.Supp.3d __ (E.D. Penn. 2015).

Wen, an undergraduate student from China who was enrolled at Temple University, sued Foxcode, Inc. ("Foxcode"), an investment and merchant banking firm, and Foxcode's principal, Robert Willis, for common-law fraud, conversion, breach of fiduciary duty, and federal and state securities fraud. Wen alleged that Willis represented that the defendants would manage $4 million invested by Wen with the defendants for Wen's benefit, deliver a return on the investment, and guarantee the full return of the $4 million principal when the investment concluded. The defendants created two Delaware LLCs to carry out the plan to invest Wen's funds—Foxcode Far East, LLC ("FFE"), and Foxcode Capital Markets, LLC ("Foxcode Capital"). The LLC agreement of FFE ("FFE Agreement") provided that Wen would contribute $4 million in exchange for a 99.9% membership interest in FFE, and Foxcode Capital would contribute $4,000 for a 0.1% membership interest. Foxcode would also provide all financial advisory services to generate earnings for FFE and would be paid management and performance fees. The FFE Agreement provided that the LLC was managed by its members, and both members had the ability to bind the LLC, call a meeting, demand access to the books and records, and withdraw and dissolve the LLC after 24 months. Numerous business decisions required unanimous consent of both members. Wen alleged that the defendants drained the funds from FFE's account, transferring nearly all the funds to their own accounts. After Wen became suspicious and was not provided satisfactory reports and information, he brought this suit. In this opinion, the court addressed the defendants' motion to dismiss the claims. The court recognized that the Delaware LLC statute contemplates that equitable fiduciary duties of care and loyalty will apply by default to a manager or managing member of a Delaware LLC, but Wen's breach-of-fiduciary-duty claim failed because Wen did not sue the other managing member of the LLC. Because the FFE Agreement vested management in the members of FFE, the court stated that the only parties owing fiduciary duties to FFE were its members–Wen and Foxcode Capital–and Wen did not sue Foxcode Capital. The court noted in a footnote that Wen alleged that the defendants owned, controlled, and dominated the affairs of FFE and Foxcode Capital, thus suggesting that Wen might be seeking to pierce the corporate veil to allege a breach of fiduciary duty claim against the named defendants, but Wen stated in his opposition to the defendants' motion to dismiss that he was not seeking to pierce the corporate veil.

Texas Ear Nose & Throat Consultants, PLLC v. Jones, 2015 WL 3918130, __ S.W.3d __ (Tex. App. 2015).

In this dispute between a departing member of a medical practice organized as a professional limited liability company and the other members, the court of appeals held that the departing member's membership in the LLC did not terminate when he left the medical practice, that the departing member was entitled to recover attorney's fees from the PLLC but not from the individual members in connection with denial of his right to access the PLLC's books and records, and the departing member's oppression claim should be remanded for further proceedings in the interest of justice in light of the Texas Supreme Court's decision in *Ritchie v. Rupe* after the trial of this case.

Jones was a founding member of Texas Ear Nose & Throat Consultants, PLLC ("TENT"), a closely held medical practice. Relations between Jones and the other members became strained, and the member who served as president of TENT accused Jones of undermining the practice and told Jones to leave. Jones delivered his notice of retirement and went to work for Baylor College of Medicine. Jones sued TENT and the other members alleging breach of the agreements between them, shareholder oppression, and denial of access to the practice's books and records. TENT and the other members counterclaimed against Jones for breach of contract. Based on an extensive jury verdict, the trial court awarded each side breach-of-contract damages and related attorney's fees, awarded Jones additional attorney's fees on his claim seeking access to books and records, and ordered the other members to buy out Jones's membership as a remedy for shareholder oppression. TENT (and the other members) appealed.

Among the issues addressed on appeal was the appellants' challenge to the jury's findings in favor of Jones on his "shareholder oppression" claims as well as the trial court's buyout order requiring the appellants to pay Jones $277,500 for his interest in TENT. After the trial of the case and the original round of briefing on appeal, the Texas Supreme Court held in *Ritchie v. Rupe*, 443 S.W.3d 877 (Tex. 2014), that there is no common-law cause of action for shareholder oppression under Texas law and that the only available remedy under the shareholder oppression statute is the appointment of a rehabilitative receiver. The court of appeals referred to this opinion as a "sea change in the realm of shareholder oppression law." Based on *Ritchie*, the trial court's buyout order could not stand. Additionally, the court of appeals had to determine whether to render judgment on Jones's oppression claim or remand for additional proceedings. In *Ritchie,* the supreme court explained that ordinarily it would consider remanding for a new trial when it announced a new legal standard, but in the case before it, remand of the shareholder oppression claims was not necessary because the plaintiff had sought only a buyout and had not requested the appointment of a rehabilitative receiver as alternate relief. Here, however, Jones did plead for appointment of a receiver under Section 11.404 of the BOC as one of the possible remedies. The appellants nevertheless urged that remand for consideration of other relief was not necessary in this case because the evidence presented at trial was legally insufficient to support the jury's findings and the trial court's judgment. The court of appeals said that the difficulty with this argument was that Jones prepared his case and presented his evidence without the benefit of knowing that the standard for proving shareholder oppression would change after the verdict.

For example, the court said that Jones may have perceived no need to present evidence as to whether the appellants' actions were justified under the business judgment rule, which typically was not applied in shareholder oppression cases prior to *Ritchie*. Thus, the court of appeals reversed the trial court's buyout order, but, in the interest of justice, remanded Jones's shareholder oppression claims for further proceedings in keeping with recent supreme court precedent.

A.G. Cullen Construction, Inc. v. Burnham Partners, LLC, 29 N.E.3d 579 (Ill. App. 2015).

A Delaware LLC hired a construction firm to build a facility in Pennsylvania, and the LLC and the construction firm had a disagreement as the project neared completion. The LLC stopped paying the construction firm, and the firm sought relief through arbitration. Before the arbitration award was entered, the LLC began to liquidate its assets and wind up. After paying off a secured loan, most of the remaining cash was disbursed to the LLC's member as a development fee and to repay a loan made to the individual owner of the LLC's member. The LLC had no funds remaining to pay the arbitration award, and the construction firm sued the LLC, its member, and the manager (who was also the owner of the LLC's parent member) in Illinois to recover the amount of the arbitration award, alleging claims based on fraudulent transfer, veil piercing, and breach of fiduciary duty. The court concluded that payment of the development fee to the parent of the LLC and repayment of the loan made to the parent's sole owner were fraudulent transfers based on the fact that 9 of the 11 badges of fraud were present in connection with the payments. The court applied Delaware law to the veil-piercing claim and concluded that the fraudulent transfer gave rise to a strong presumption for piercing the veil of the LLC. The court relied on Illinois law for the proposition that, once the LLC was insolvent, the LLC's manager (who was also the owner of the LLC's parent) owed a fiduciary duty to the construction firm, as a creditor, to manage the LLC's assets properly and in the best interest of creditors. The court held that the manager breached that duty by making fraudulent, insider disbursements to the parent and himself that left the LLC with no assets to pay the amount owed to the construction firm on the contract.

Bigham v. Southeast Texas Environmental, LLC, 458 S.W.3d 650 (Tex. App. 2015).

An LLC sued one of its members and an attorney-in-fact for breach of fiduciary duty and other causes of action and obtained a judgment. On appeal, the court held that there was evidence to support the jury's finding that the member who caused the LLC to file suit was authorized to do so, and there was sufficient evidence to support the jury's finding that the defendants breached their fiduciary duties to the LLC.

Jeffrey Pitsenbarger ("Jeff"), Tracy Hollister, and two other individuals formed an LLC that purchased some property, which was unexpectedly declared a Superfund site a short time after its purchase. The LLC, as an innocent owner, could pursue contribution for the clean-up costs, and Hollister introduced Jeff to Bigham, whom Hollister represented possessed expertise in managing environmental litigation. The LLC entered into a power-of-attorney agreement with Bigham. Under the power-of-attorney agreement, Bigham was to manage the litigation. The LLC alleged that Bigham and Hollister breached their fiduciary duties by sabotaging the litigation, and the LLC obtained a favorable jury verdict and judgment.

The jury found that Bigham and Hollister had a relationship of trust and confidence with the LLC, that they failed to comply with their fiduciary duties, and that the breaches were committed with malice. The jury also found actual and exemplary damages. The court of appeals stated that it was undisputed that Hollister owed fiduciary duties as a member of the LLC. (Hollister's fiduciary duties were not based on the power of attorney because he was not a signatory to the power of attorney even though he was designated under the power of attorney to receive a percentage of the LLC's recovery in the environmental contamination litigation. Although the court referred to Hollister's duties as relating to his status as member, an earlier portion of the opinion indicated that the LLC was manager-managed and referred to a Texas Franchise Tax Public Information Report signed by Hollister and listing Hollister as managing member.) Bigham owed the LLC fiduciary duties solely based on the power of attorney. Bigham and Hollister challenged the sufficiency of the evidence to support the jury's finding that they failed to comply with their fiduciary duties. Although the LLC was the claimant, the jury question placed the burden on Bigham and Hollister to prove they complied with their fiduciary duties. As the question was phrased, Bigham and Hollister were required to establish all five factors listed: (1) the transaction in question was fair and equitable to the LLC; (2) they made reasonable use of the confidence that the LLC placed in them; (3) they acted in the utmost good faith and exercised the most scrupulous honesty toward the LLC; (4) they placed the interest of the LLC before their own, did not use the advantage of their position to gain any benefit for themselves in any position where their self-interest might conflict with their obligations as a fiduciary; and(5) they fully and fairly disclosed all important information to the LLC concerning the transaction. The court reviewed the evidence and concluded that it was sufficient to support the jury's finding that Bigham and Hollister did not comply with their fiduciary duties. Based on the evidence, the jury could have concluded that Bigham and Hollister violated their fiduciary duties by threatening to provide harmful information to the defendants in the environmental litigation and withholding Hollister's cooperation in the litigation when Hollister, as a member, had a duty to achieve an optimal result at trial, irrespective of whether he received any proceeds under the power of attorney.

Information Rights

Texas Ear Nose & Throat Consultants, PLLC v. Jones, 2015 WL 3918130, __ S.W.3d __ (Tex. App. 2015).

In this dispute between a departing member of a medical practice organized as a professional limited liability company and the other members, the court of appeals held that the departing member's membership in the LLC did not terminate when he left the medical practice, that the departing member was entitled to recover attorney's fees from the PLLC but not from the individual members in connection with denial of his right to access the PLLC's books and records, and the departing member's oppression claim should be remanded for further proceedings in the interest of justice in light of the Texas Supreme Court's decision in *Ritchie v. Rupe* after the trial of this case.

Jones was a founding member of Texas Ear Nose & Throat Consultants, PLLC ("TENT"), a closely held medical practice. Three basic documents governed the relationship between each member, TENT, and the other members: (1) a member agreement, (2) regulations (i.e., LLC operating agreement), and (3) a physician's employment agreement (one for each member). In November 2009, relations between Jones and the other members became strained, and the member who served as president of TENT accused Jones of undermining the practice and told Jones to leave by January 2010. Jones delivered his notice of retirement two days later on November 19, 2009, and his last day of work for TENT was December 15, 2009, after which he went to work for Baylor College of Medicine. In February 2010, Jones sued TENT and the other members alleging breach of the agreements between them, shareholder oppression, and denial of access to the practice's books and records. TENT and the other members counterclaimed against Jones for breach of contract. Based on an extensive jury verdict, the trial court awarded each side breach-of-contract damages and related attorney's fees, awarded Jones additional attorney's fees on his claim seeking access to books and records, and ordered the other members to buy out Jones's membership as a remedy for shareholder oppression. TENT (and the other members) appealed.

The appellants relied on the terms of the LLC operating agreement and the member agreement for their contention that Jones's membership was terminated when he announced his retirement and that his interest was then "involuntarily transferred" back to TENT, but the court of appeals analyzed the provisions of those agreements as well as communication between the parties and concluded that there was evidence to support the jury's finding that Jones was still a member at the time of trial.

The appellants next challenged the award of attorney's fees to Jones for denial of access to TENT's books and records, the only relief sought or awarded for this cause of action at trial. The trial court based the award on the jury's finding as well as provisions of the Texas Business Organizations Code. The individual physicians and not TENT as an entity were ordered to pay the attorney's fees. Jones made his first written request for access on November 18, 2009, but he made subsequent requests as well. The appellants raised numerous sub-issues regarding the award of attorney's fees, including that (1) Jones failed to state a proper purpose for requesting access; (2) applicable law did not provide for the recovery; (3) Jones was not a "governing person" entitled to recovery; (4) the court erred in its jury submission on the issue; (5) the evidence was insufficient to support the finding that Jones was denied access; (6) if denial occurred, it was only after his membership was terminated; (7) the court erred in ordering the individual defendants, rather than TENT, to pay the fees; and (8) Jones failed to properly segregate his attorney's fees. The court of appeals concluded that Jones was entitled to recover attorney's fees against TENT but not the individual defendants and that Jones failed to segregate his attorney's fees properly.

The appellants first two arguments—that Jones failed to state a proper purpose for requesting access and that applicable law did not provide for the recovery of attorney's fees—were both based on the proposition that Jones's rights regarding access were governed by the now-expired Texas Limited Liability Company Act (TLLCA) and not the current Texas Business Organizations Code (BOC). The TLLCA provided that a member had the right, on written request stating the purpose, to examine and copy for any proper purpose records required to be kept under that statute and other information. The BOC provides that "[a] member ... on written request and for a proper purpose, may examine and copy" the required records, and the BOC additionally provides that a "governing person ... may examine the entity's books and records ... for a purpose reasonably related to the governing person's service as a governing person." The BOC further authorizes an award of attorney's fees as a remedy for denial of access as to a request by a governing person. The appellants argued that the TLLCA rather than the BOC governed this case because Jones made his first request for access on November 18, 2009, prior to the expiration of the TLLCA and the BOC's mandatory application date of January 1, 2010. On that basis, the appellants argued that the trial court erred because Jones's written request did not state a purpose, as required by the TLLCA but not the BOC, and attorney's fees were not an available remedy under the TLLCA. The transition provisions of the BOC provide that the BOC governs "acts, contracts, or other transactions by an entity subject to this code or its managerial officials, owners, or members that occur on or after the mandatory application date." Prior law (i.e., the TLLCA in this case) continues to govern acts, contracts, and transactions that occurred before the mandatory application date. Although Jones made his first written request for access on November 18, 2009, the record made clear that he continued to make requests for information after the mandatory application date and never received access to all of the information sought. Thus, the trial court did not err in holding that the BOC governed.

The appellants also argued that Jones was not a "governing person" entitled to recover attorney's fees under the BOC. (The BOC provides that "[a] court may award a governing person attorney's fees and any other proper relief in a suit to require a filing entity to open its books and records....") The appellants relied solely on a statement in Jones's third amended petition in which Jones referred to his right to examine books and records under certain provisions of the BOC after his retirement because he remained a member. The appellants contended that Jones admitted in this assertion that he was not a governing person. The court of appeals found nothing in this assertion that addressed whether Jones was a governing person and concluded that the appellants had waived this pleading deficiency argument in any event.

Next, the appellants complained of the trial court's refusal to submit their tendered instruction to the question on denial of access. The requested instruction read as follows: "You are instructed that John Jones was entitled to access to TENT's books and records for a 'proper purpose.' You are instructed that demands for records to harass TENT, force TENT to purchase Jones' interest at an inflated price, or made in bad faith, are not 'proper purposes.'" Based on the trial court's discretion in determining necessary and proper jury instructions, the court of appeals concluded the trial court did not err. Explanatory instructions should be submitted when, in the discretion of the trial court, the instructions will help jurors understand the meaning and effect of the law and the presumptions the law creates. When a trial court refuses to submit a requested instruction, the ultimate question on appeal is whether the instruction was reasonably necessary to enable the jury to render a proper verdict. The appellants derived the language in their proposed instruction from a case in which the court of appeals had listed allegations that had been found sufficient to entitle a corporation to a jury trial on the issue of whether a shareholder had a proper purpose in requesting access under the Texas Business Corporation Act, which provided similar access to that provided by the BOC provisions at issue here. Assuming that analysis was applicable in this case, the court said that not every correct statement of the law belongs in the charge. The trial court here reasonably could have determined that the requested instruction was unnecessary for the jury's understanding of the issue and that it only served to emphasize the appellants' position.

The court next reviewed the evidence to determine if it was sufficient to support the jury's finding that Jones was denied access to TENT's records. The court concluded that the appellants did not properly brief this argument, which hinged on their assertion that the company was not required to keep all the information Jones requested. Accordingly, the court found no merit in the appellants' sufficiency assertions.

The appellants' argument that TENT was not required to furnish information to Jones because he was no longer a member failed because the court of appeals previously concluded that the evidence supported the jury's finding that Jones was still a member of TENT at the time of trial. He was thus a member when he requested access to TENT's books and records.

The appellants next argued that the trial court erred in ordering the individual defendants to pay Jones's attorney's fees instead of TENT. The BOC provides that a court may order an entity to open its books and records if the entity has improperly refused access, and the court may award attorney's fees and other proper relief "in a suit to require a filing entity to open its books and records." To be entitled to this relief, the requesting person must establish, among other things, that "the entity refused the person's good faith demand to inspect the books and records." The court stated that the focus of the provision is on the actions of the entity, and the provision does not suggest that any individual connected with an entity can be ordered to open the books and records or to pay attorney's fees. Jones noted that the jury specifically found that the individual defendants acted in concert to deny Jones's access, and Jones argued that awarding fees against TENT would punish TENT for the actions of its members. Jones also suggested that the award of fees could jeopardize the possible sale of TENT. But the court of appeals stated that the fees were awarded pursuant to the BOC, not based on shareholder oppression by the individual defendants, and the fact that the individual defendants may have caused the denial of access and that TENT might be affected by the award did not change the statutory language. The court of appeals thus concluded that the trial court should have ordered TENT and not the individual defendants to pay Jones's attorney's fees, and that the judgment should be modified to order TENT to pay the fees instead of the individual defendants.

The final issue addressed by the court of appeals regarding the denial of access claim was the appellants' contention that Jones failed to properly segregate the portion of his attorney's fees related to this claim from the fees related to other claims. The court of appeals agreed and remanded this issue for further consideration by the trial court.

Interpretation of Operating Agreement

White v. Pottorff, 2015 WL 4914726, __ S.W.3d __ (Tex. App. 2015).

A Delaware LLC, White Energy Partners, LLC ("WEP"), agreed to repurchase the Class B units of the Class B member, White Ventures Energy, LLC ("White Ventures"). Members of the Class A member, We Investors Group, LLC ("WEIG"), brought a derivative suit against Trey White, who was the manager of WEIG as well as the manager of White Ventures and a member of the board of managers of WEP, asserting breach-of-fiduciary and other claims against White related to WEP's repurchase of White Venture's Class B units. The plaintiffs also sued White Ventures for breach of contract, alleging that White Ventures violated a provision of the WEP operating agreement allowing WEIG to "tag along" with White Venture's sale of its Class B units to WEP. The trial court concluded that the tag-along provision applied to the repurchase, but the court of appeals analyzed the tag-along provision and concluded that the provision did not entitle a Class A member to participate in a Class B member's sale of Class B units. Even assuming the tag-along provision generally entitled a Class A member to participate in a Class B member's sale of Class B units, the court concluded that the provision did not apply in this case because the Delaware LLC statute provided that the units repurchased by WEP were canceled on their repurchase, and the operating agreement contemplated that the purchaser in a transaction described in the tag-along provision would be capable of becoming a substituted member who would have the right to vote the units and receive distributions and allocations of profits and losses with respect to the units.

After White Ventures executed an agreement in which it agreed to transfer its Class B units to WEP, White Ventures sent WEIG a written notice of the proposed sale pursuant to a right-of-first-refusal provision in the WEP operating agreement. The right-of-first-refusal provision was one of two provisions contained in Section 10.4 of the WEP operating agreement. Section 10.4 was entitled "Sale by a Class A Member or Class B Member." Section 10.4.1 was entitled "Right of First Refusal," and Section 10.4.2 was entitled "Tag Along." White decided not to have WEIG purchase any of the Class B units under the right-of-first-refusal provision. The trial court concluded that WEIG was entitled to the rights provided under the tag-along provision of the operating agreement in addition to the right-of-first-refusal provision and entered a judgment for relief based on the breach of the tag-along provision by White Ventures and related breaches of fiduciary duty by White. White and White Ventures appealed.

The court of appeals agreed with the appellants' argument that the tag-along privileges applied only to members holding the same class of units as the class that was the subject of the third-party offer. Under the tag-along provision, a member that elected to participate in a sale of units was entitled to sell in such proposed sale, at the same price and on the same terms, *"a number of Units included in [such sale of Class B Units]"* determined by a formula set forth in the provision. The court stated that the emphasized language limited the type of units that could tag along to the class of units included in the purchase. Moreover, even assuming the agreement could be read to apply to both classes of units, the number of units that WEIG would be entitled to sell would be zero under the formula in the agreement because the pro rata portion was determined by dividing the number of WEIG's Class B units, which was zero, into the total number of Class B units.

The court of appeals explained that there was another reason in this case that the language of the tag-along provision precluded WEIG from having tag-along rights in the transaction at issue. The provision described the field of buyers whose purchases could trigger tag-along rights as a "Person" who could become a substituted WEP member. Although "Person" was defined to include an LLC, WEP could not become a member of itself, and its repurchase of White Ventures' units thus did not trigger tag-along rights. Section 10.1 stated that it applied to an offer to purchase Class A or B units from any Person, but the provision later stated that a Person who purchased a member's interest did not become a substituted member unless the terms and conditions of another provision of the operating agreement were satisfied. A substituted member under the operating agreement was entitled to all of the rights and benefits under the agreement of the transferor of the interest. These rights would include voting and economic rights. Because the Delaware LLC statute provides that an interest in an LLC that is acquired by the LLC is deemed canceled unless otherwise provided in the LLC agreement, and the WEP agreement did not override this provision, the court concluded that White Venture's units were canceled when repurchased by WEP, and WEP was not a Person whose offer triggered the provisions of Section 10.1.

Block Communications, Inc. v. Pounds, 34 N.E.3d 984 (Ohio App. 2015).

Block Communications, Inc. ("BCI"), the former employer of Pounds, sued Pounds for violating a separation agreement between Pounds and BCI. Pounds was a general manager of The Toledo Blade ("The Blade"), a newspaper owned by BCI. After Pounds left The Blade, he formed an LLC that published the Free Press, a newspaper distributed free of charge in the Toledo area. Based on a series of articles about The Blade that appeared in the Free Press, BCI sued Pounds and the LLC alleging that the articles included information that was obtained and disseminated in violation of the separation agreement. In the course of discovery, BIC requested information from the LLC, including disclosure of the identity of the members of the LLC. The LLC sought a protective order or in camera review on relevance and confidentiality grounds. The trial court rejected the LLC's motion, and the LLC appealed. John Doe, a member of the LLC filed an amicus curiae brief in support of the LLC.

On appeal, John Doe argued that the Ohio LLC statute implicitly shields the names of members from public disclosure because the LLC statute only mandates disclosure of the names of members and financial information to members. The court stated that the fact that the LLC statute did not mandate disclosure of this information to third parties did not establish that the statute prohibits the disclosure of that information, either expressly or by implication. Although the LLC's operating agreement prohibited disclosure of this information, the operating agreement contained exceptions if the members agreed to the disclosure or a court ordered disclosure. The court found no support for Doe's argument that Ohio law created an express or implied protectable interest in preserving the confidentiality of LLC members.

Doe and the LLC both argued that the information sought by BCI was not relevant to the issues in the case. The LLC had argued to the trial court that the names of the members other than Pounds were not relevant because Pounds held a 60% interest and the other members did not have a controlling interest. The court of appeals stated that the standard for relevancy during discovery is broader than at trial. While the admission or exclusion of evidence can be overturned on an abuse of discretion by the trial court, Ohio courts have held that the trial court's determination of relevancy of discovery materials is not a final, appealable order; therefore, the court did not have to reach a determination as to relevancy or whether the trial court erred in abusing its discretion by compelling discovery.

Doe and the LLC next argued that the LLC's business records, including the names of members, were protected trade secrets. Doe and the LLC also argued that the trial court erred in failing to consider the negative impact on the LLC's members if BIC obtained this information. Because it was necessary to interpret and apply statutory language (the Ohio Uniform Trade Secrets Act) to determine the confidentiality of the information, the court applied a de novo standard of review as to this argument. After setting forth the definition of a trade secret under the Ohio Uniform Trade Secrets Act and the six factors used to analyze a trade-secret claim as adopted by the Ohio Supreme Court, the court of appeals concluded that the LLC had not produced any evidence to substantiate its claims that it would be irreparably harmed by disclosure of its members names. Although the operating agreement limited the members' ability to disclose each others' names, the agreement provided for disclosure pursuant to a court order.

The LLC further asserted that there would be a "chilling effect on business in Ohio" if the LLC was required to disclose the members' names. In support of this assertion, the LLC argued that the trial court's ruling strips Ohio LLC members of any claim of privacy and makes it difficult or impossible for businesses to obtain investors in Ohio. The LLC argued that, as a matter of public policy, an Ohio LLC's members should not be forced to identify themselves where the members are merely "innocent bystanders" who have no direct interest in the outcome of a legal action. The court did not find these arguments convincing and pointed out that the LLC had made no effort to have the requested discovery information classified as "confidential information" or "confidential information—attorney's eyes only," under the parties' existing stipulated protection order. Thus, the court could not say that the trial court abused its discretion by refusing to grant the LLC's request for a protective order or in camera inspection, based on the LLC's subjective belief that disclosure might cause it and its members intimidation or harassment.

Finally, the LLC argued that the trial court erroneously relied on the provision of the Ohio LLC statute recognizing LLC veil piercing to bolster its decision to require disclosure of members' names when BCI was not attempting to pierce the veil of the LLC. The court said that the trial court's statement regarding personal liability of an LLC's members under the statute was part of a discussion regarding the members' rights and responsibilities in the context of their expectation of privacy. According to the court of appeals, the trial court did not suggest or find that BCI would have to "pierce the corporate veil" in order to obtain the members' names.

Wen v. Willis, 2015 WL 4611903, __ F.Supp.3d __ (E.D. Penn. 2015).

Wen, an undergraduate student from China who was enrolled at Temple University, sued Foxcode, Inc. ("Foxcode"), an investment and merchant banking firm, and Foxcode's principal, Robert Willis, for common-law fraud, conversion, breach of fiduciary duty, and federal and state securities fraud. Wen alleged that Willis represented that the defendants would manage $4 million invested by Wen with the defendants for Wen's benefit, deliver a return on the investment, and guarantee the full return of the $4 million principal when the investment concluded. The defendants created two Delaware LLCs to carry out the plan to invest Wen's funds—Foxcode Far East, LLC ("FFE"), and Foxcode Capital Markets, LLC ("Foxcode Capital"). The LLC agreement of FFE ("FFE Agreement") provided that Wen would contribute $4 million in exchange for a 99.9% membership interest in FFE, and Foxcode Capital would contribute $4,000 for a 0.1% membership interest. Foxcode would also provide all financial advisory services to generate earnings for FFE and would be paid management and performance fees. The FFE Agreement provided that the LLC was managed by its members, and both members had the ability to bind the LLC, call a meeting, demand access to the books and records, and withdraw and dissolve the LLC after 24 months. Numerous business decisions required unanimous consent of both members. Wen alleged that the defendants drained the funds from FFE's account, transferring nearly all the funds to their own accounts. After Wen became suspicious and was not provided satisfactory reports and information, he brought this suit. In this opinion, the court addressed the defendants' motion to dismiss the claims.

The court held that the "gist-of-the-action" doctrine barred Wen's common-law fraud claim because the alleged misrepresentations were later incorporated into the FFE Agreement, and the gist-of-the-action doctrine forecloses a party's pursuit of a tort action for the mere breach of contractual duties without any separate or independent event giving rise to the tort. Wen argued that the fraud claims were collateral to the investment contract and sounded in tort rather than contract. Wen relied on case law suggesting that fraudulent inducement claims tend to be collateral to, and not interwoven with, the terms of the contract itself. But the court stated that where precontractual statements that are the basis for the fraudulent inducement claim concern specific duties that the parties later include in a contract, courts have concluded that such claims sound in contract and are thus barred by the gist-of-the-action doctrine. Wen's fraud allegations– that the defendants "would manage Wen's $4 million investment for his benefit, deliver a return on the investment, and guarantee that the $4 million principal would be returned in full when the investment concluded"—involved misrepresentations that were all later included in the FFE Agreement. The FFE Agreement provided that: (1) Foxcode Capital would provide cash and all financial advisory services necessary to generate earnings for FFE; (2) Wen would receive 99.9% of the net profits of FFE; (3) when FFE was dissolved, Foxcode Capital guaranteed the return of an amount sufficient to make the total distributions to Wen equal to $4 million. Thus, the court concluded that Wen's fraudulent inducement claims were barred by the gist-of-the-action rule and should be dismissed.

Wen's conversion claim, which was based on the defendants' use of his $4 million investment in the LLC for the defendants' personal benefit, was not barred by the gist-of-the-action doctrine because the allegation implicated broader social duties imposed by the law of torts such as a prohibition of theft. The conversion claim failed, however, because money may be the subject of a claim for conversion under Pennsylvania law only where the plaintiff has a property interest in the money at the time of the alleged conversion. Under Delaware LLC law, the $4 million invested by Wen became LLC property in which Wen as a member had no specific interest once he contributed the funds to the LLC.

The court recognized that the Delaware LLC statute contemplates that equitable fiduciary duties of care and loyalty will apply by default to a manager or managing member of a Delaware LLC, but Wen's breach-of-fiduciary-duty claim failed because Wen did not sue the other managing member of the LLC. Because the FFE Agreement vested management in the members of FFE, the court stated that the only parties owing fiduciary duties to FFE were its members–Wen and Foxcode Capital–and Wen did not sue Foxcode Capital. The court noted in a footnote that Wen alleged that the defendants owned, controlled, and dominated the affairs of FFE and Foxcode Capital, thus suggesting that Wen might be seeking to pierce the corporate veil to allege a breach of fiduciary duty claim against the named defendants, but Wen stated in his opposition to the defendants' motion to dismiss that he was not seeking to pierce the corporate veil.

Wen's claim for securities fraud under federal law was dismissed because the plaintiff had powers as a managing member of the LLC that precluded characterizing his interest in the LLC as a "security" under federal law. The court applied the United States Supreme Court's definition of an investment contract in *Howey* as interpreted by the Third Circuit. The three elements for showing an investment contract as articulated by the Third Circuit are: (1) "an investment of money"; (2) "in a common enterprise"; (3) "with profits to come solely from the efforts of others." The defendants did not dispute the first two elements but disagreed with Wen that his interest in FFE met the third requirement, i.e., that his profits were to come solely from the efforts of others. The court stated that the inquiry with regard to the third element began and ended with the operating agreement. The court listed the powers enjoyed by Wen as a member under the FFE Agreement and discussed case law in the Third Circuit in the partnership and LLC context, and the court concluded that the weight of authority dictated that Wen's membership interest in FFE was not a security because Wen was granted significant control over FFE as a manager by the terms of the FFE Agreement. Wen attempted to distinguish the cases relied on by the court by arguing that the cases involved plaintiffs who had in fact been actively involved in management. Wen argued that, unlike those cases, he was not a sophisticated investor and did not in fact exercise any control over the investment. But the court concluded that "a variance, even a significant one, between the powers enjoyed by a plaintiff-investor in an agreement and the operation of those powers in reality does not *per se* convert an interest from a nonsecurity into a security." Wen tried to convince the court to adopt the Fifth Circuit's reasoning in *Williamson v. Tucker,* in which the Fifth Circuit held that an investor in a partnership could have an interest that constituted an investment contract, despite the powers afforded by agremeent, "if he could show he was 'so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers.'" The court was not persuaded to adopt the *Williamson* rule and apply it to Wen's case when the Third Circuit would not do so under its existing jurisprudence. The court stated that Wen enjoyed a "plethora of powers" as a managing member of FFE and had significant control over the management of the company. The fact that he did not exercise those powers, or even the fact that the defendants thwarted his attempts to exercise those powers, did not make his membership interest in FFE a security for purposes of the federal securities laws. Thus, the court granted the defendants' motion to dismiss Wen's federal securities fraud claim.

Because an LLC interest is presumptively a security under Pennsylvania securities law and Wen did not participate actively and completely in the management of the LLC as required for Wen's membership interest to meet an exclusion from the definition of a security, Wen established that his membership interest was a security under the Pennsylvania Securities Act (PSA). The PSA provides that a "security" presumptively includes any membership interest in a limited liability company, but the definition does not include an LLC membership interest where all of the following conditions are satisfied: (1) the membership interest is in an LLC that is not managed by managers; (2) the purchaser of the membership interest enters into a written commitment to be engaged actively and directly in the management of the LLC; and (3) the purchaser of the membership interest, in fact, does participate actively and directly in the management of the LLC. The first condition was met because the FFE Agreement provided that FFE was managed by its members, but the parties disagreed with regard to the second and third conditions. The court noted a dearth of case law defining what exactly is meant by "engaged actively and directly" for purposes of the second condition. The affirmative responsibilities of the day-to-day management of FFE were assigned solely to Foxcode Capital, but both Wen and Foxcode Capital were required to devote "time and attention" to the business of FFE, and numerous transactions required unanimous consent of Foxcode Capital and Wen. The court stated that the statutory language does not require that a certain quantum of active and direct engagement in the management of the company be defined, but rather suggests that any amount will do. The court thus concluded that Wen did enter into a written commitment to be engaged actively and directly in the management of FFE so that the second condition was satisfied. However, the court concluded that the third condition was not satisfied. That condition calls for a factual inquiry—whether Wen did, in fact, participate actively and directly in the management of the FFE. Wen pointed to allegations in his complaint that the defendants transferred almost all of his $4 million investment out of the FFE account and into their own accounts and kept Wen in the dark and then froze him out when he made inquiries about the dissipation of the investment. Viewing the inferences drawn from these allegations in the light most favorable to Wen, the court found that Wen had sufficiently pleaded that this third condition did not apply. Because not all three conditions were satisfied, Wen established that his membership interest in FFE was a security for the purposes of stating a PSA securities fraud claim. The court also concluded that Wen had sufficiently pled scienter so as to survive the motion to dismiss his claim for securities fraud under the PSA.

Texas Ear Nose & Throat Consultants, PLLC v. Jones, 2015 WL 3918130, __ S.W.3d __ (Tex. App. 2015).

In this dispute between a departing member of a medical practice organized as a professional limited liability company and the other members, the court of appeals held that the departing member's membership in the LLC did not terminate when he left the medical practice, that the departing member was entitled to recover attorney's fees from the PLLC but not from the individual members in connection with denial of his right to access the PLLC's books and records, and the departing member's oppression claim should be remanded for further proceedings in the interest of justice in light of the Texas Supreme Court's decision in *Ritchie v. Rupe* after the trial of this case.

Jones was a founding member of Texas Ear Nose & Throat Consultants, PLLC ("TENT"), a closely held medical practice. Three basic documents governed the relationship between each member, TENT, and the other members: (1) a member agreement, (2) regulations (i.e., LLC operating agreement), and (3) a physician's employment agreement (one for each member). In November 2009, relations between Jones and the other members became strained, and the member who served as president of TENT accused Jones of undermining the practice and told Jones to leave by January 2010. Jones delivered his notice of retirement two days later on November 19, 2009, and his last day of work for TENT was December 15, 2009, after which he went to work for Baylor College of Medicine. In February 2010, Jones sued TENT and the other members alleging breach of the agreements between them, shareholder oppression, and denial of access to the practice's books and records. TENT and the other members counterclaimed against Jones for breach of contract. Based on an extensive jury verdict, the trial court awarded each side breach-of-contract damages and related attorney's fees, awarded Jones additional attorney's fees on his claim seeking access to books and records, and ordered the other members to buy out Jones's membership as a remedy for shareholder oppression. TENT (and the other members) appealed.

The first several issues addressed by the court of appeals related to the appellants' contentions that the evidence did not support the jury's findings that TENT breached Jones's employment agreement, that Jones was entitled to $374,694.01 in "ancillary income" due to the alleged breach, and that Jones's own breach of the agreement was excused. The court of appeals analyzed the terms of the employment agreement and the evidence and concluded that the evidence supported the jury's findings.

The court of appeals next addressed the appellants' challenge to the jury finding that Jones was still a member of TENT at the time of trial. The appellants' argued that Jones's status was proven as a matter of law and that the trial court thus should have disregarded the jury's finding. The appellants relied on the terms of the LLC operating agreement and the member agreement for their contention that Jones's membership was terminated when he announced his retirement and that his interest was then "involuntarily transferred" back to TENT. According to the appellants, Jones had no membership for the trial court to order to be bought out at the time of trial. The court of appeals concluded that the provision of the operating agreement relied on by the appellants did not exactly provide what the appellants argued it did. The appellants argued that the operating agreement provided that the retirement of a member immediately terminated the member's membership in TENT, but the court noted that the following provision relied upon by the appellants did not say what became of a member's ownership interest on retirement:

> The death, retirement, resignation, or dissolution of a Member, or the period for the duration of the Company [i.e., TENT] as stated in the Articles [i.e., TENT's Articles of Organization] expires, or the occurrence of any other event which terminates the continued membership of a Member in the Company (a "Dissolution Event"), dissolves the Company unless the remaining Member(s) unanimously consent in writing to the continuation of the business of the Company ("Unanimous Consent").

The effect of retirement on a member's interest was covered by the member agreement, which set forth numerous occurrences that could result in the involuntary transfer of a member's ownership interest in TENT as well as procedures for handling those transfers. The occurrences listed included death of the member, termination of the member's employment with the medical group with or without cause, termination of employment by the member with or without cause, and "Total and Permanent Retirement of the Member from the Practice of Medicine and from the Medical Group." Another provision of the member agreement provided various methods of valuation of a member's interest depending on the nature of the termination of membership. The appellants argued that Jones's attempt to retire on November 19, 2009 was ineffective under the member agreement because Jones did not at that time retire from the practice of medicine. They argued that Jones instead simply terminated his employment with TENT without cause, which according to the member agreement would entitle him to $10 as payment for his interest in TENT. However, this argument glossed over the jury's finding that the appellants improperly terminated Jones's employment before his attempted retirement. In any event, the termination of Jones's employment with TENT, whether a retirement, resignation, or termination, did not determine whether he retained his membership interest in TENT. Rather than being automatic on the occurrence of one of these events, specific steps had to be taken under the member agreement before a transfer could be effected. Occurrence of any of the listed events triggered successive rights of first refusal to purchase the departing member's ownership interest. If neither the group nor individual members exercised the right of first refusal, the departing member (or his legal representative) could continue to hold the ownership interest so long as ownership did not violate laws and regulations governing medical practices. In that situation, the member had the right to demand redemption by the medical group. The appellants alternatively contended that the medical group in fact exercised its right of first refusal, pointing to testimony of TENT's bookkeeper that Jones was given a $10 credit in TENT's books for his "stock" in January2010. In support of the jury's finding, Jones cited numerous external communications after January 2010 in which TENT continued to represent that he was a member, including TENT's tax returns and his own K–1s from TENT, emails stating that Jones should be invited to board meetings, and a letter from TENT to its bank listing Jones as a "remaining partner." Thus, there was evidence to support the jury's finding that Jones was still a member at the time of trial.

Davis v. VCP South, LLC, 774 S.E.2d 606 (Ga. 2015).

Davis and Roth were plastic surgeons that formed an LLC governed by an operating agreement that provided the surviving member a first option to purchase the membership units of the other member on the other member's death. Davis died suddenly in January of 2010, and his wife was appointed personal representative of his estate in October of 2010. The option to purchase Davis's membership units under the operating agreement existed for 90 days following the qualification of Davis's personal representative. In November of 2010, Roth sought to exercise his option to purchase Davis's 50% interest in the LLC. Absent an agreement on value, the operating agreement provided that the value of the membership units would be determined in a commercially reasonable manner by the CPA regularly representing the practice. When negotiations between Roth and Davis's personal representative broke down, Roth sued Davis's estate in December of 2010 to enforce the operating agreement. Davis's estate argued that the CPA for the LLC should not be allowed to do the valuation because he continued to provide services to the LLC and had a conflict of interest. The trial court granted Roth summary judgment on this point, and the CPA completed the valuation in September of 2011. The trial court then appointed a special master to consider the objections of Davis's estate to the valuation. The special master issued a report in December of 2011 in which the special master found that Davis ceased to be a member the day he died and that his estate thereafter only had financial rights, including the right to share in the profits and losses of the LLC, the right to interim and terminating distributions, and the right to capital interest until the closing of the purchase of Davis's membership units. Because the agreement did not set a time for the closing, and recognizing that a party might unreasonably delay the purchase of a former member's interest, the special master determined that a reasonable cut-off date for allocation of profits and losses should be the end of the month when a reasonable value is determined, which in this case was the end of September 2011. The trial court adopted the special master's report and granted summary judgment on the valuation of Davis's interest, and the court of appeals affirmed. The sale of Davis's membership units to Roth was closed in December of 2013.

In this appeal to the Georgia Supreme Court, Davis's estate argued that the special master erred by considering provisions of federal tax law in construing the provisions of the operating agreement and contended that the construction adopted by the trial court worked a forfeiture of financial interests to which Davis's estate was entitled on the theory that the estate should have continued to receive distributions equal to those made to Roth until the closing of the sale of Davis's membership units in December of 2013. The supreme court rejected this argument, stating it was clear that the operating agreement not only authorized, but required, consideration of the tax law in construing its terms. The court relied on a provision of the operating agreement that stated: “The Members acknowledge that the Company will be treated as a ‘partnership’ for federal and Georgia state tax purposes. All provisions of this Agreement and the Company’s articles of organization are to be construed so as to preserve that status.”

The court also rejected challenges by both parties to the trial court’s establishment of September 30, 2011, as a reasonable cut-off date for determining financial rights. Roth argued that the financial rights of Davis’s estate should have ended on January 31, 2010, the month of Davis’s death, or on November 10, 2010, when Roth exercised his option to purchase. Davis’s estate, on the other hand, argued that it should have continued to share in profits and losses and distributions beyond September 30, 2011. In response to the argument of Davis’s estate, the court pointed out that the buy-out procedure established by the agreement was “a simple and expeditious procedure.” The court relied on a Georgia statute requiring that the performance of contractual obligations by a contracting party “be substantially in compliance with the spirit and the letter of the contract and completed within a reasonable time” as well as case law stating that every contract imposes on each party a duty of good faith and fair dealing. Given the delays in closing caused by Davis’s estate, the court concluded that the trial court did not err in establishing September 30, 2011, which was more than 20 months after Davis’s death, as the cut-off date for allocation of profits and losses and accrual of distribution rights. With respect to Roth’s argument in favor of an earlier cut-off date, the court pointed out that the valuation of Davis’s membership units was not completed at the time Roth exercised his option. The special master acknowledged that the efforts of Davis’s estate to have the CPA replaced hampered the CPA’s valuation, but the special master also observed that the LLC had complete control over how quickly the valuation was completed. The court thus found no error in the special master’s determination that a reasonable cut-off date for the estate’s financial rights was the last day of the month in which the CPA’s valuation was completed and presented to the estate.

Blechman v. Estate ofBlechman, 160 So.3d 152 (Fla. App. 2015).

Blechman and his sister formed an LLC in New Jersey and executed an operating agreement with a provision specifying that the membership interest of a deceased member would vest in the deceased member’s children under certain circumstances. On Blechman’s death, his children claimed that Blechman’s membership interest passed to them outside of probate under the terms of the operating agreement, but the trial court held that the membership interest was a probate asset that passed under the residuary clause of Blechman’s will to a trust that included Blechman’s girlfriend as well as his children as beneficiaries. The court of appeals held that the trial court erred and that the membership interested vested in Blechman’s children outside of probate pursuant to the LLC operating agreement.

Blechman’s will contained no provision addressing his membership interest, and the residuary clause of the will specified that the residue of his estate would pour over into a previously unfunded revocable living trust. The trust was originally silent as to the LLC and provided only for Blechman’s children and their issue; however, before his death, Blechman amended the trust to provide a specific gift of the use of his residence and a portion of the distributions from the LLC for the benefit of his girlfriend during her lifetime. The provision of the operating agreement at issue provided as follows:

> ***6.3 Death of Member***
>
> (a) Unless (i) a Member shall Transfer all or a portion of his or her Membership Interest in accordance with 6.1 or 6.2 hereof, or (ii) a Member bequeaths the Membership Interest in the Member's last will and testament to members of the Immediate Family of the respective Member, or (iii) all such Membership Interests of a deceased Member are inherited, or succeeded to, by Members of the Immediate Family of the deceased Member, then in the event of a death of a Member during the duration of this Agreement, the Membership Interest of the deceased Member shall pass to and immediately vest in the deceased Member’s then living children and issue of any deceased child per stirpes.

The trial court agreed with the girlfriend that Blechman's membership interest was an estate asset that passed under the residuary clause to the trust. On appeal, Blechman's children argued that the trial court erred in treating the membership interest as an estate asset because the interest passed to them outside of probate upon his death pursuant to the operating agreement. The children argued that Blechman did not specifically devise his membership interest and thus activated the provision in the operating agreement vesting his interest in his children immediately at his death. The girlfriend countered that the operating agreement did not effectuate a transfer of Blechman's membership interest because he owned a 50% membership interest in the LLC at his death and complied with the operating agreement by bequeathing the interest to his children as vested residual beneficiaries.

The court of appeals noted that the Florida Probate Code broadly defines the probate "estate" as encompassing the decedent's property "that is the subject of administration." The estate does not include property that passes outside of probate, and the court recognized that estate planners frequently use non-probate mechanisms to transfer a decedent's property outside of probate. The common thread of non-probate mechanisms used by estate planners "is that the assets to which they apply are 'distributed to the designated beneficiaries immediately upon the transferor's death' without the need for judicial intervention." In contrast, "property transferred from a 'pour-over' will to a trust constitutes part of the decedent's probate estate, albeit briefly, since the property is devised by way of a will." Thus, the question before the court was whether Blechman's membership interest in the LLC was subject to his will or whether the interest passed immediately to his children under the operating agreement on his death.

The court applied New Jersey law because "the 'laws of the jurisdiction where [a] contract was executed govern interpretation of the substantive issues regarding the contract" under Florida's choice-of-law rules. The court stated that parties in New Jersey may provide by contract that ownership or rights in property may pass according to the terms of the contract at the promisor's death. Based on case law in the partnership context and provisions of the New Jersey LLC statute that confer broad contractual freedom on the members, the court inferred that New Jersey permits the members of an LLC to include a provision in an operating agreement that will be followed upon the death of a member. According to the court, "'[w]here supported by adequate consideration, such contracts transferring a property interest upon death are neither testamentary nor subject to the Statute of Wills, but are instead evaluated under contract law."

The girlfriend conceded that neither the first nor third situations in Section 6.3(a) of the operating agreement occurred, but she argued that the second condition was satisfied by a bequest in Blechman's will to his children as residual beneficiaries of his trust. The girlfriend further argued that her life interest made her a contingent beneficiary whose interest was certain to terminate leaving only the children as vested beneficiaries of the trust. The court, however, concluded that the girlfriend's interest was vested once Blechman died, and the clear intent of the operating agreement was to limit a member's ability to transfer his or her interest so as to keep the LLC within the family. By bequeathing a significant aspect of his membership interest (a right to distributions) to a trustee for the benefit of his girlfriend, Blechman violated the terms and intent of the operating agreement. The bequest triggered the default provision of Section 6.3(a) of the operating agreement, immediately vesting the membership interest in his children. Because Blechman's membership interest immediately passed outside of probate to his children upon his death, his attempted testamentary disposition of property he did not own was not effective.

Grants Pass Imaging & Diagnostic Center, LLC v. Marchini, 346 P.3d 644 (Or. App. 2015).

The court of appeals agreed with the trial court that the term "member" as used in an LLC operating agreement included only current members, not former members, and that the noncompetition provision in the agreement thus did not apply to a withdrawn member. The members of the LLC were physicians, and the LLC provided diagnostic testing services. When one of the members started constructing a sleep laboratory, the LLC informed the member that operating the laboratory would violate the operating agreement. The member withdrew from the LLC and began operating the sleep laboratory. The LLC and its members sued the withdrawn member for various causes of action alleging that the withdrawn member's operation of the sleep laboratory violated the operating agreement. The provision at issue stated:

> 1.8 *Other Business of Members.* Each member shall (i) account to the Company and hold for the Company any property, profit or benefit derived by the member in the conduct and winding up of the Company's business or derived from a use by the member of any Company property, including appropriation of a Company opportunity; and (ii) refrain from competing with the Company within Josephine County and Jackson County, Oregon, without the consent of all members after full disclosure of all material facts. Each member hereby acknowledges and agrees that a member's ownership of or other participation in the conduct of any business shall not be considered to be in competition with the Company if the business is not conducted within Josephine and Jackson County, Oregon.

The plaintiffs argued that the term "member" as explained through extrinsic evidence, included former members and that the withdrawn member thus violated the noncompete provision in the agreement. The court of appeals noted that the operating agreement did not define the term "member," and the court examined the ordinary meaning as well as the definition in the Oregon LLC statute. The court then analyzed the text of the disputed provision using the broadest meaning of the term "member" in the context of the entire agreement. According to the plaintiffs, the noncompetition clause prohibited both current and former members from competing with the LLC without the consent of all the current members. Thus, the term "member" had different meanings in different clauses of the same provision. The court disagreed with this interpretation because the plaintiffs' construction was at odds with the use of the term "member" throughout the remainder of the agreement. The court gave examples of provisions in the agreement that distinguished between a "member," "additional member," and "dissociated member."

Even though the text of paragraph 1.8, considered in the context of the entire agreement, appeared to support only one plausible interpretation of the term "member" (i.e., an active or current member of the LLC), the court stated that case law did not foreclose the use of extrinsic evidence to determine whether a contractual term is ambiguous. The plaintiffs argued that statements made by the members at several planning meetings established that the unambiguous meaning of the term "member" under paragraph 1.8 included both current and former members. However, the court concluded that the extrinsic evidence proffered by the plaintiffs did not aid in establishing the meaning of the term because the evidence showed that discussions at the planning meetings regarding the specific scope of any post-withdrawal, non-competition provision included varying durations, none of which was included in any draft or the signed agreement, and there was no indication that the meaning of the term "member" was ever discussed. The plaintiffs also argued that paragraph 1.8(ii) should be interpreted to include former members because it would otherwise add nothing to paragraph 1.8(i), but the court pointed out that the legislature had clearly differentiated between competition with an LLC and appropriation of an LLC opportunity and that the language of the agreement mirrored the statutory scheme.

The court also rejected the plaintiffs' alternative argument that the term "member" was ambiguous. The plaintiffs argued that the term "member" must include former members under paragraph 5.3 of the agreement, thus creating an internal inconsistency that would require the court to conclude that the term is ambiguous. Paragraph 5.3 required the LLC to furnish "a statement suitable for use in the preparation of the member's income tax return" within 90 days of the end of the fiscal year. The court characterized this provision as "[s]imply ... reflect[ing] the external legal obligation of all business entities to provide tax statements to owners and employees," and not creating an internal inconsistency that would render the term "member" ambiguous.

In sum, the court held that "[t]he specific context of the term 'member' within paragraph 1.8 and the other provisions in the agreement allowed for only one reasonable interpretation of the term 'member,' that is a current, or active, member."

Penny v. El Patio, LLC, 2015 WL 3543056, __ S.W.3d __ (Tex. App. 2015).

In this dispute over the authority of an LLC's operating manager to hire an attorney to assert claims on behalf of the LLC against some of its members and affiliates of the members, the court concluded that the trial court did not err in concluding that the operating manager had authority to hire the attorney on behalf of the LLC without a vote of the members.

This lawsuit started out as a suit to set aside an LLC member's foreclosure on the LLC's property after the LLC defaulted on a loan to the member, but the suit expanded to include additional parties and claims by the LLC against other members relating to the management of the LLC's property before the foreclosure. The principal issue on appeal was whether the operating manager of the LLC had authority to hire an attorney for the LLC to assert claims against other members of the LLC and affiliates of those other members.

The LLC at issue was formed by several investors, including David Penny, Richard Cheroske, and Stephen Hyde, to purchase and own a hotel. Hyde was named as the LLC's operating manager, and the LLC hired Blue Castle Property Management, LLC ("Blue Castle") to operate and manage the motel's day-to-day business. Blue Castle was owned by 190 Orange Avenue, Inc. ("190 Orange"), which was owned by Penny and Cheroske. Penny and Cheroske filed this suit as a derivative action to set aside a foreclosure on the LLC's property, and the LLC intervened to assert several claims against Penny, Cheroske, Blue Castle, Blue Castle's accountant, and 190 Orange for conversion, theft liability, breach of fiduciary duty, breach of contract, fraud, and other causes of action in relation to the management of the motel. After the claims relating to the foreclosure were resolved and the foreclosure was set aside, the claims against Penny, Cheroske, and the other third-party defendants remained. Penny, Cheroske, and the other third-party defendants filed a motion to require the LLC's attorney to show the trial court that he had authority to prosecute the suit against them on the LLC's behalf. The trial court ruled that the LLC's attorney had authority to prosecute the suit, and Penny, Cheroske, and the other third-party defendants failed to respond to the LLC's discovery requests and motions thereafter. The trial court eventually struck their pleadings and awarded the LLC judgment on all its claims. Penny appealed from that judgment.

On appeal, Penny challenged the trial court's determination that the LLC's attorney had authority to prosecute the suit. Penny argued that Hyde's position as operating manager of the LLC did not vest him with the authority to hire an attorney to prosecute the LLC's claim because the LLC's operating agreement did not contain express language authorizing litigation and because Hyde lacked specific approval from a majority in interest of the members to conduct the litigation. Penny relied on Texas cases that he said stood for the proposition that the officers of a corporation do not have authority to employ counsel or initiate litigation in the absence of either approval of the board of directors or express authorization in the bylaws.

The court disagreed with Penny's interpretation of the LLC's operating based on the plain language of the agreement. The agreement named Hyde as the initial operating manager as follows: "Management of the Company shall be vested in the Members who shall serve as Operating Managers of the Company, initially Stephen Hyde." Though the provision of the operating agreement regarding management of the LLC did not reference litigation, it gave the operating manager sole and exclusive control over the company's business and granted to the operating manager all the powers and rights needed to conduct that business as follows:

> The Company shall be managed by the Operating Managers, who shall be paid a fee for serving as Operating Managers, and the conduct of the Company's business shall be controlled and conducted solely and exclusively by the Operating Managers in accordance with this Agreement. In addition to and not in limitation to any rights and power conferred by law or other provisions of this Agreement, the Operating Managers shall have and may exercise on behalf of the Company *all powers and rights necessary, proper, convenient or advisable to effectuate and carry out the purposes, business and*

> *objectives of the Company, and to maximize Company profits.* (Emphasis added.)

The court said it was hard to imagine a broader grant of managerial authority, and protecting the LLC's interests by asserting the claims asserted in this case certainly fell within the purposes, business, and objectives of the company according to the court.

Even assuming the LLC's operating agreement did not expressly grant Hyde the authority to conduct litigation on the LLC's behalf, the court said that the cases Penny cited in support of his argument did not inform the court's decision. The cases cited by Penny (for the proposition that Texas law requires express language in the bylaws or approval from the board of directors for an officer to litigate) involved corporations rather than LLCs and were decided under a provision of the now recodified Texas Business Corporation Act. The current version of that statutory provision is now located in Title 2 of the Texas Business Organizations Code (BOC) and is specific to for-profit corporations. Thus, the provision does not apply to an LLC. Moreover, the court pointed out that the BOC provisions applicable in this case provide that, unless the entity's governing documents provide otherwise, an LLC's affairs are managed and directed by managers.

Penny next argued that the second sentence in the following paragraph of the operating agreement required that all actions by the LLC must be voted on and approved by a majority in interest of the member owners:

> Management of the Company shall be vested in the Members who shall serve as Operating Managers of the Company, initially Stephen Hyde, or a company controlled by him. Except as otherwise provided in this Agreement, *all decisions of the Operating Managers shall be by a majority in interest of the Members.* All Operating Managers must be Members of the Company, or a company controlled by a member.... (Emphasis added.)

The court rejected this argument based on the agreement as a whole and harmonizing its provisions with an eye to the particular business activity sought to be served. The court concluded that the language relied on by Penny merely explained the method by which the managers reach a decision in a situation where there is more than one operating manager and they are not in complete agreement. Staying within the context of the first sentence (which provides that management of the company will be vested in operating managers, that only members can serve as operating managers, and that Hyde will be the first member to serve as operating manager), the court said the second sentence explains that the *operating managers'* decisions, i.e., "decisions of the Operating Managers," are achieved based on their membership interest. The court stated that Penny's interpretation, which would require a majority vote on *every* company decision, would "render the operating agreement unreasonable, inequitable, and oppressive." The court said that Penny's interpretation would make the agreement's creation of operating managers and their duties meaningless given that a member vote would be required for any and every action. In other words, there would be no need for operating managers if all decisions must be made by the members. In addition, Penny's interpretation would render redundant the agreement's requirement that a majority in interest of the members approve the selling or refinancing of real property.

In sum, the court determined that the operating agreement vested Hyde with authority to litigate on the LLC's behalf, and the trial court thus did not err in holding that the LLC's attorney satisfied his burden to show his authority by offering the LLC's operating agreement and Hyde's affidavit.

Transfer of Interest/ Buyout of Member

White v. Pottorff, 2015 WL 4914726, __ S.W.3d __ (Tex. App. 2015).

A Delaware LLC, White Energy Partners, LLC ("WEP"), agreed to repurchase the Class B units of the Class B member, White Ventures Energy, LLC ("White Ventures"). Members of the Class A member, We Investors Group, LLC ("WEIG"), brought a derivative suit against Trey White, who was the manager of WEIG as well as the manager of White Ventures and a member of the board of managers of WEP, asserting breach-of-fiduciary and other claims against White related to WEP's repurchase of White Venture's Class B units. The plaintiffs also sued White Ventures for breach of contract, alleging that White Ventures violated a provision of the WEP operating agreement allowing WEIG to "tag along" with White Venture's sale of its Class B units to WEP. The trial court concluded that the tag-along provision applied to the repurchase, but the court of appeals analyzed the tag-along provision and concluded that the provision did not entitle a Class A member to participate in a Class B member's sale of Class B units. Even assuming the tag-along provision generally entitled a Class A member to participate in a Class B member's sale of Class B units, the court concluded that the provision did not apply in this case because the Delaware LLC statute provided that the units repurchased by WEP were canceled on their repurchase, and the operating agreement contemplated that the purchaser in a transaction described in the tag-along provision would be capable of becoming a substituted member who would have the right to vote the units and receive distributions and allocations of profits and losses with respect to the units.

After White Ventures executed an agreement in which it agreed to transfer its Class B units to WEP, White Ventures sent WEIG a written notice of the proposed sale pursuant to a right-of-first-refusal provision in the WEP operating agreement. The right-of-first-refusal provision was one of two provisions contained in Section 10.4 of the WEP operating agreement. Section 10.4 was entitled "Sale by a Class A Member or Class B Member." Section 10.4.1 was entitled "Right of First Refusal," and Section 10.4.2 was entitled "Tag Along." White decided not to have WEIG purchase any of the Class B units under the right-of-first-refusal provision. The trial court concluded that WEIG was entitled to the rights provided under the tag-along provision of the operating agreement in addition to the right-of-first-refusal provision and entered a judgment for relief based on the breach of the tag-along provision by White Ventures and related breaches of fiduciary duty by White. White and White Ventures appealed.

The court of appeals agreed with the appellants' argument that the tag-along privileges applied only to members holding the same class of units as the class that was the subject of the third-party offer. Under the tag-along provision, a member that elected to participate in a sale of units was entitled to sell in such proposed sale, at the same price and on the same terms, *"a number of Units included in [such sale of Class B Units]"* determined by a formula set forth in the provision. The court stated that the emphasized language limited the type of units that could tag along to the class of units included in the purchase. Moreover, even assuming the agreement could be read to apply to both classes of units, the number of units that WEIG would be entitled to sell would be zero under the formula in the agreement because the pro rata portion was determined by dividing the number of WEIG's Class B units, which was zero, into the total number of Class B units.

The court of appeals explained that there was another reason in this case that the language of the tag-along provision precluded WEIG from having tag-along rights in the transaction at issue. The provision described the field of buyers whose purchases could trigger tag-along rights as a "Person" who could become a substituted WEP member. Although "Person" was defined to include an LLC, WEP could not become a member of itself, and its repurchase of White Ventures' units thus did not trigger tag-along rights. Section 10.1 stated that it applied to an offer to purchase Class A or B units from any Person, but the provision later stated that a Person who purchased a member's interest did not become a substituted member unless the terms and conditions of another provision of the operating agreement were satisfied. A substituted member under the operating agreement was entitled to all of the rights and benefits under the agreement of the transferor of the interest. These rights would include voting and economic rights. Because the Delaware LLC statute provides that an interest in an LLC that is acquired by the LLC is deemed canceled unless otherwise provided in the LLC agreement, and the WEP agreement did not override this provision, the court concluded that White Venture's units were canceled when repurchased by WEP, and WEP was not a Person whose offer triggered the provisions of Section 10.1.

Davis v. VCP South, LLC, 774 S.E.2d 606 (Ga. 2015).

Davis and Roth were plastic surgeons that formed an LLC governed by an operating agreement that provided the surviving member a first option to purchase the membership units of the other member on the other member's death. Davis died suddenly in January of 2010, and his wife was appointed personal representative of his estate in October of 2010. The option to purchase Davis's membership units under the operating agreement existed for 90 days following the qualification of Davis's personal representative. In November of 2010, Roth sought to exercise his option to purchase Davis's 50% interest in the LLC. Absent an agreement on value, the operating agreement provided that the value of the membership units would be determined in a commercially reasonable manner by the CPA regularly representing the practice. When negotiations between Roth and Davis's personal representative broke down, Roth sued Davis's estate in December of 2010 to enforce the operating agreement. Davis's estate argued that the CPA for the LLC should not be allowed to do the valuation because he continued to provide services to the LLC and had a conflict of interest. The trial court granted Roth summary judgment on this point, and the CPA completed the valuation in September of 2011. The trial court then appointed a special master to consider the objections of Davis's estate to the valuation. The special master issued a report in December of 2011 in which the special master found that Davis ceased to be a member the day he died and that his estate thereafter only had financial rights, including the right to share in the profits and losses of the LLC, the right to interim and terminating distributions, and the right to capital interest until the closing of the purchase of Davis's membership units. Because the agreement did not set a time for the closing, and recognizing that a party might unreasonably delay the purchase of a former member's interest, the special master determined that a reasonable cut-off date for allocation of profits and losses should be the end of the month when a reasonable value is determined, which in this case was the end of September 2011. The trial court adopted the special master's report and granted summary judgment on the valuation of Davis's interest, and the court of appeals affirmed. The sale of Davis's membership units to Roth was closed in December of 2013.

In this appeal to the Georgia Supreme Court, Davis's estate argued that the special master erred by considering provisions of federal tax law in construing the provisions of the operating agreement and contended that the construction adopted by the trial court worked a forfeiture of financial interests to which Davis's estate was entitled on the theory that the estate should have continued to receive distributions equal to those made to Roth until the closing of the sale of Davis's membership units in December of 2013. The supreme court rejected this argument, stating it was clear that the operating agreement not only authorized, but required, consideration of the tax law in construing its terms. The court relied on a provision of the operating agreement that stated: "The Members acknowledge that the Company will be treated as a 'partnership' for federal and Georgia state tax purposes. All provisions of this Agreement and the Company's articles of organization are to be construed so as to preserve that status."

The court also rejected challenges by both parties to the trial court's establishment of September 30, 2011, as a reasonable cut-off date for determining financial rights. Roth argued that the financial rights of Davis's estate should have ended on January 31, 2010, the month of Davis's death, or on November 10, 2010, when Roth exercised his option to purchase. Davis's estate, on the other hand, argued that it should have continued to share in profits and losses and distributions beyond September 30, 2011. In response to the argument of Davis's estate, the court pointed out that the buy-out procedure established by the agreement was "a simple and expeditious procedure." The court relied on a Georgia statute requiring that the performance of contractual obligations by a contracting party "be substantially in compliance with the spirit and the letter of the contract and completed within a reasonable time" as well as case law stating that every contract imposes on each party a duty of good faith and fair dealing. Given the delays in closing caused by Davis's estate, the court concluded that the trial court did not err in establishing September 30, 2011, which was more than 20 months after Davis's death, as the cut-off date for allocation of profits and losses and accrual of distribution rights. With respect to Roth's argument in favor of an earlier cut-off date, the court pointed out that the valuation of Davis's membership units was not completed at the time Roth exercised his option. The special master acknowledged that the efforts of Davis's estate to have the CPA replaced hampered the CPA's valuation, but the special master also observed that the LLC had complete control over how quickly the valuation was completed. The court thus found no error in the special master's determination that a reasonable cut-off date for the estate's financial rights was the last day of the month in which the CPA's valuation was completed and presented to the estate.

Lincoln Provision, Inc. v. Puretz, 775 F.3d 1011 (8th Cir. 2015).

In analyzing the fair value of one member's interest for purposes of the statutorily required purchase of the interest by the LLC when the member dissociated from the LLC, the court relied on certain terms agreed upon by the two members in negotiations over the operating agreement although the members were never able to agree to all of the terms of an operating agreement. The trial court had calculated the value of the member's interest based on 50% of the value of the LLC, less the amount the member had agreed to contribute, plus the amount the LLC had contributed to an escrow account for the earnest money deposit for the purchase of property by the LLC. Because the evidence showed that the two members had agreed to a 50-50 split only after the return of their capital contributions, and the dissociating member did not make its agreed capital contribution, the court concluded that the dissociating member was only entitled to the return of the amount it had contributed to the escrow account.

Aron Puretz and Lincoln Provision, Inc. (Lincoln) formed an Illinois LLC for the purpose of acquiring and operating two Nebraska cattle-processing plants. The standard form of articles of organization filed to form the LLC stated that management was vested in the members and listed Lincoln and Puretz as the members. Puretz and Lincoln intended to include the details of the LLC's financing and operations in an operating agreement but were never able to settle on the terms of the operating agreement. To bid on the cattle-processing plants, the LLC was required to make an initial earnest-money deposit of $250,000 to an escrow account. Puretz contributed $150,000 and Lincoln contributed $100,000 to that amount. The LLC then submitted a successful bid of $3,900,000 for the two plants in a bankruptcy auction. Meanwhile Lincoln, Puretz, and their attorneys exchanged emails and draft operating agreements, but they could not agree on several major issues. The members met in a final attempt to resolve their differences, and notes prepared to summarize those discussions described the issues upon which the members apparently agreed, including that the members' capital contributions would be repaid in full before the company's profits and losses were divided equally between the members. Because the members were not able to resolve their disagreements about the financing and operations of the LLC, Lincoln refused to contribute its agreed-upon 30% of the purchase price for the plants. Puretz thus paid the entire $3,900,000 purchase price, except for the $100,000 from Lincoln's contribution to the escrow account that was credited to the purchase price.

About a month after the closing of the purchase of the cattle-processing plants, Lincoln's attorney sent a letter to Puretz's attorney stating that Lincoln was dissociating from the LLC. Under the Illinois LLC statute, if the LLC does not dissolve on the dissociation of a member, the LLC is required to repurchase the dissociating member's interest on the terms agreed to by the members. If the LLC does not purchase the interest, the dissociating member may file suit against the LLC to have the court determine the fair value of the interest. Because Lincoln and Puretz had never executed an operating agreement that described the method for calculating the value of a member's ownership interest in the LLC, Lincoln filed this lawsuit against the LLC (invoking diversity jurisdiction) seeking a determination of the fair value of its interest in the company LLC.

After a four-day bench trial, the district court held that Lincoln and Puretz each held a 50% interest in the LLC and that the value of the LLC on Lincoln's dissociation date was $3,900,000 and that the fair value of Lincoln's interest was $880,00, calculated as follows: 50% of the $3,900,000 value of the LLC ($1,950,000), less the 30% of the $3,900,000 purchase price that Lincoln failed to contribute at closing ($1,170,000), plus a return of the $100,000 Lincoln contributed to the escrow account. The LLC argued the value of Lincoln's interest was $100,000, the amount Lincoln contributed toward the acquisition of the plants. The LLC appealed.

The court of appeals agreed with the LLC that the evidence showed that the members agreed to a proportional return of capital prior to any distribution of profits and losses, even though they never finalized an operating agreement. The court reviewed testimony by Lincoln's president, one of Lincoln's employees, and Lincoln's attorney supporting the conclusion that the members agreed that the 50-50 split would occur only after the members received their capital back in a 70-30 split as invested. Because Lincoln refused to make its initial 30% contribution to capital, Puretz actually contributed 100% of the capital to the LLC, less Lincoln's $100,000 payment to the escrow account. Lincoln presented no evidence indicating that Puretz agreed to contribute 70% of the capital to the LLC in exchange for the right to receive only 50% of the capital in repayment of his investment. The court rejected Lincoln's argument that the district court correctly relied on the LLC's articles of organization as the best evidence that each member had a "50% interest" in the LLC for all purposes, including for purposes of calculating the fair value of a member's distributional interest. The articles merely established that the LLC was to be formed as a member-managed LLC and that management was to be vested in its two members; the articles could not be read to establish the members' economic interests in the LLC. The court also concluded that the district court did not err in assigning no value to Lincoln's business plan, "sweat equity," or unperformed promises to provide management services. The district court correctly concluded that Lincoln's only contribution was the $100,000 paid to the escrow account.

In sum, the evidence established that Lincoln and Puretz contemplated that any capital they contributed to the LLC would be returned to them in proportion to their respective contributions before any profits or losses generated by the LLC's operations were divided equally. Because Lincoln did not make its agreed-upon 30% contribution to capital, it was not entitled to a 30% distribution. Lincoln's only contribution to the LLC was its $100,000 deposit in the escrow account, and the court of appeals thus remanded with instructions to enter an order awarding Lincoln $100,000.

Dissociation of Member

Northwest Wholesale, Inc. v. PAC Organic Fruit, LLC, 2015 WL 5286198, __ P.3d __ (Wash. 2015).

The Washington Supreme Court held that a debtor in bankruptcy did not have standing to bring a derivative action on behalf of a Washington LLC because the Washington LLC statute provides that a plaintiff in a derivative action must be a member of the LLC, the debtor was dissociated as a member pursuant to the Washington LLC statute when the debtor filed bankruptcy, and the dissociation provision of the Washington LLC statute was not preempted by Section 541 or 365 of the Bankruptcy Code.

Harold and Shirley Ostenson and Greg Holzman formed an LLC in 1998. The Ostensons and Greg Holzman, Inc. ("GHI") became the members of the LLC, and both the Ostensons and GHI were active in the business. GHI owned a majority interest and had management responsibilities under the operating agreement. Holzman fired the Ostensons from their positions with the LLC after the LLC defaulted on its operating line of credit and lease. The Ostensons filed for bankruptcy protection under Chapter 11 in early 2007. Later in 2007, a creditor of the LLC filed this lawsuit in state court against the LLC, GHI, and the Ostensons. The Ostensons filed cross claims and a third-party complaint against Holzman, GHI, and another entity of Holzman's. These claims were a derivative action on behalf of the LLC. After the creditor's claims settled, the only remaining claims were the Ostensons' responsive claims against the LLC and the derivative claims against the Holtzman defendants. This case went to trial in 2011, and the Holzman defendants moved to dismiss the Ostensons' derivative action after the Ostensons rested their case. The Holzman defendants argued that the Ostensons were no longer members of the LLC and lacked authority to bring their derivative action. Eventually, the trial court ruled that the Ostensons relinquished their membership in the LLC when they filed bankruptcy and could not maintain a derivative action on the LLC's behalf. The Ostensons appealed, and the court of appeals agreed with the trial court that the Ostensons did not have standing. The Ostensons appealed to the Washington Supreme Court.

The Ostensons repeated the argument that they made in the court below that Sections 541(c)(1) and 365(c)(1) invalidated or rendered unenforceable ipso facto bankruptcy clauses. Under the Washington LLC statute, a member is dissociated as a member when the member files a voluntary petition in bankruptcy unless the LLC agreement provides otherwise, and a plaintiff in a derivative action must be a member at the time of bringing the action. The Ostensons argued that the dissociation provision of the statute was preempted by federal bankruptcy law.

The court first addressed the interplay between Section 541(a) and (c)(1) and the Washington LLC statute. Under Section 541(a), a bankruptcy filing triggers the creation of a bankruptcy estate into which the debtor's property interest devolves, but the threshold question of how a debtor's interest is determined turns on state law. Applying Ninth Circuit case law, the court concluded that the Ostensons' bankruptcy estate took their interest as defined, determined, and encumbered according to state law, and the interest that devolved to the Ostensons' bankruptcy estate was thus an assignee's interest and not a member's interest in the LLC. The court of appeals had reached the same result applying *In re Garrison-Ashburn, LLC*, a Virginia bankruptcy court decision applying a similar provision of the Virginia LLC statute. The Washington Supreme Court concluded that the court of appeals correctly applied *In re Garrison-Ashburn,* and the supreme court distinguished and declined to follow a portion of *In re First Protection, Inc*. because the court felt that the Ninth Circuit Bankruptcy Appellate Panel in that case did not adhere to Ninth Circuit precedent. The court also distinguished *In re Daugherty Construction, Inc.* and another case because those cases dealt with statutory or contractual provisions that triggered dissolution of the LLC rather than dissociation of a member on the filing of a member's bankruptcy.

The court next addressed the Ostensons' argument that Section 365(e)(1) invalidates or renders unenforceable ipso facto bankruptcy clauses. Section 365 applies to executory contracts. The supreme court explained that the court of appeals analyzed the obligations in the LLC operating agreement and noted that they might suffice to create an executory contract, but the court of appeals found it unnecessary to decide whether the operating agreement was an executory contract because the court concluded that Section 365(e) otherwise excused further performance under the agreement. The court of appeals relied on Washington case law in the partnership context in which the court held that a provision of state law that dissolved a general partnership upon a partner's filing of bankruptcy was not superseded by Section 365(e)(1)'s invalidation of ipso facto provisions because the freedom of the partners to choose with whom they are associated excused the remaining partners from performance under Section 365(e)(2). The supreme court agreed with the court of appeals that the same rights of voluntary association on which the partnership case law rested applied to LLC membership. Thus, if the LLC operating agreement in this case constituted an executory contract, the associational rights of the members found in the Washington LLC statute triggered the Section 365(e)(2) exception rendering the Section 365(e)(1) prohibition on ipso facto clauses inapplicable.

Texas Ear Nose & Throat Consultants, PLLC v. Jones, 2015 WL 3918130, __ S.W.3d __ (Tex. App. 2015).

In this dispute between a departing member of a medical practice organized as a professional limited liability company and the other members, the court of appeals held that the departing member's membership in the LLC did not terminate when he left the medical practice, that the departing member was entitled to recover attorney's fees from the PLLC but not from the individual members in connection with denial of his right to access the PLLC's books and records, and the departing member's oppression claim should be remanded for further proceedings in the interest of justice in light of the Texas Supreme Court's decision in *Ritchie v. Rupe* after the trial of this case.

Jones was a founding member of Texas Ear Nose & Throat Consultants, PLLC ("TENT"), a closely held medical practice. Three basic documents governed the relationship between each member, TENT, and the other members: (1) a member agreement, (2) regulations (i.e., LLC operating agreement), and (3) a physician's employment agreement (one for each member). In November 2009, relations between Jones and the other members became strained, and the member who served as president of TENT accused Jones of undermining the practice and told Jones to leave by January 2010. Jones delivered his notice of retirement two days later on November 19, 2009, and his last day of work for TENT was December 15, 2009, after which he went to work for Baylor College of Medicine. In February 2010, Jones sued TENT and the other members alleging breach of the agreements between them, shareholder oppression, and denial of access to the practice's books and records. TENT and the other members counterclaimed against Jones for breach of contract. Based on an extensive jury verdict, the trial court awarded each side breach-of-contract damages and related attorney's fees, awarded Jones additional attorney's fees on his claim seeking access to books and records, and ordered the other members to buy out Jones's membership as a remedy for shareholder oppression. TENT (and the other members) appealed.

The first several issues addressed by the court of appeals related to the appellants' contentions that the evidence did not support the jury's findings that TENT breached Jones's employment agreement, that Jones was entitled to $374,694.01 in "ancillary income" due to the alleged breach, and that Jones's own breach of the agreement was excused. The court of appeals analyzed the terms of the employment agreement and the evidence and concluded that the evidence supported the jury's findings.

The court of appeals next addressed the appellants' challenge to the jury finding that Jones was still a member of TENT at the time of trial. The appellants' argued that Jones's status was proven as a matter of law and that the trial court thus should have disregarded the jury's finding. The appellants relied on the terms of the LLC operating agreement and the member agreement for their contention that Jones's membership was terminated when he announced his retirement and that his interest was then "involuntarily transferred" back to TENT. According to the appellants, Jones had no membership for the trial court to order to be bought out at the time of trial. The court of appeals concluded that the provision of the operating agreement relied on by the appellants did not exactly provide what the appellants argued it did. The appellants argued that the operating agreement provided that the retirement of a member immediately terminated the member's membership in TENT, but the court noted that the following provision relied upon by the appellants did not say what became of a member's ownership interest on retirement:

> The death, retirement, resignation, or dissolution of a Member, or the period for the duration of the Company [i.e., TENT] as stated in the Articles [i.e., TENT's Articles of Organization] expires, or the occurrence of any other event which terminates the continued membership of a Member in the Company (a "Dissolution Event"), dissolves the Company unless the remaining Member(s) unanimously consent in writing to the continuation of the business of the Company ("Unanimous Consent").

The effect of retirement on a member's interest was covered by the member agreement, which set forth numerous occurrences that could result in the involuntary transfer of a member's ownership interest in TENT as well as procedures for handling those transfers. The occurrences listed included death of the member, termination of the member's employment with the medical group with or without cause, termination of employment by the member with or without cause, and "Total and Permanent Retirement of the Member from the Practice of Medicine and from the Medical Group." Another provision of the member agreement provided various methods of valuation of a member's interest depending on the nature of the termination of membership. The appellants argued that Jones's attempt to retire on November 19, 2009 was ineffective under the member agreement because Jones did not at that time retire from the practice of medicine. They argued that Jones instead simply terminated his employment with TENT without cause, which according to the member agreement would entitle him to $10 as payment for his interest in TENT. However, this argument glossed over the jury's finding that the appellants improperly terminated Jones's employment before his attempted retirement. In any event, the termination of Jones's employment with TENT, whether a retirement, resignation, or termination, did not determine whether he retained his membership interest in TENT. Rather than being automatic on the occurrence of one of these events, specific steps had to be taken under the member agreement before a transfer could be effected. Occurrence of any of the listed events triggered successive rights of first refusal to purchase the departing member's ownership interest. If neither the group nor individual members exercised the right of first refusal, the departing member (or his legal representative) could continue to hold the ownership interest so long as ownership did not violate laws and regulations governing medical practices. In that situation, the member had the right to demand redemption by the medical group. The appellants alternatively contended that the medical group in fact exercised its right of first refusal, pointing to testimony of TENT's bookkeeper that Jones was given a $10 credit in TENT's books for his "stock" in January2010. In support of the jury's finding, Jones cited numerous external communications after January 2010 in which TENT continued to represent that he was a member, including TENT's tax returns and his own K–1s from TENT, emails stating that Jones should be invited to board meetings, and a letter from TENT to its bank listing Jones as a “remaining partner.” Thus, there was evidence to support the jury’s finding that Jones was still a member at the time of trial.

Grants Pass Imaging & Diagnostic Center, LLC v. Marchini, 346 P.3d 644 (Or. App. 2015).

The court of appeals agreed with the trial court that the term “member” as used in an LLC operating agreement included only current members, not former members, and that the noncompetition provision in the agreement thus did not apply to a withdrawn member. The members of the LLC were physicians, and the LLC provided diagnostic testing services. When one of the members started constructing a sleep laboratory, the LLC informed the member that operating the laboratory would violate the operating agreement. The member withdrew from the LLC and began operating the sleep laboratory. The LLC and its members sued the withdrawn member for various causes of action alleging that the withdrawn member’s operation of the sleep laboratory violated the operating agreement. The provision at issue stated:

> 1.8 *Other Business of Members.* Each member shall (i) account to the Company and hold for the Company any property, profit or benefit derived by the member in the conduct and winding up of the Company’s business or derived from a use by the member of any Company property, including appropriation of a Company opportunity; and (ii) refrain from competing with the Company within Josephine County and Jackson County, Oregon, without the consent of all members after full disclosure of all material facts. Each member hereby acknowledges and agrees that a member’s ownership of or other participation in the conduct of any business shall not be considered to be in competition with the Company if the business is not conducted within Josephine and Jackson County, Oregon.

The plaintiffs argued that the term “member” as explained through extrinsic evidence, included former members and that the withdrawn member thus violated the noncompete provision in the agreement. The court of appeals noted that the operating agreement did not define the term “member,” and the court examined the ordinary meaning as well as the definition in the Oregon LLC statute. The court then analyzed the text of the disputed provision using the broadest meaning of the term “member” in the context of the entire agreement. According to the plaintiffs, the noncompetition clause prohibited both current and former members from competing with the LLC without the consent of all the current members. Thus, the term “member” had different meanings in different clauses of the same provision. The court disagreed with this interpretation because the plaintiffs' construction was at odds with the use of the term “member” throughout the remainder of the agreement. The court gave examples of provisions in the agreement that distinguished between a “member,” “additional member,” and “dissociated member.”

Even though the text of paragraph 1.8, considered in the context of the entire agreement, appeared to support only one plausible interpretation of the term “member” (i.e., an active or current member of the LLC), the court stated that case law did not foreclose the use of extrinsic evidence to determine whether a contractual term is ambiguous. The plaintiffs argued that statements made by the members at several planning meetings established that the unambiguous meaning of the term “member” under paragraph 1.8 included both current and former members. However, the court concluded that the extrinsic evidence proffered by the plaintiffs did not aid in establishing the meaning of the term because the evidence showed that discussions at the planning meetings regarding the specific scope of any post-withdrawal, non-competition provision included varying durations, none of which was included in any draft or the signed agreement, and there was no indication that the meaning of the term “member” was ever discussed. The plaintiffs also argued that paragraph 1.8(ii) should be interpreted to include former members because it would otherwise add nothing to paragraph 1.8(i), but the court pointed out that the legislature had clearly differentiated between competition with an LLC and appropriation of an LLC opportunity and that the language of the agreement mirrored the statutory scheme.

The court also rejected the plaintiffs' alternative argument that the term "member" was ambiguous. The plaintiffs argued that the term "member" must include former members under paragraph 5.3 of the agreement, thus creating an internal inconsistency that would require the court to conclude that the term is ambiguous. Paragraph 5.3 required the LLC to furnish "a statement suitable for use in the preparation of the member's income tax return" within 90 days of the end of the fiscal year. The court characterized this provision as "[s]imply ... reflect[ing] the external legal obligation of all business entities to provide tax statements to owners and employees," and not creating an internal inconsistency that would render the term "member" ambiguous.

In sum, the court held that "[t]he specific context of the term 'member' within paragraph 1.8 and the other provisions in the agreement allowed for only one reasonable interpretation of the term 'member,' that is a current, or active, member."

Lincoln Provision, Inc. v. Puretz, 775 F.3d 1011 (8th Cir. 2015).

In analyzing the fair value of one member's interest for purposes of the statutorily required purchase of the interest by the LLC when the member dissociated from the LLC, the court relied on certain terms agreed upon by the two members in negotiations over the operating agreement although the members were never able to agree to all of the terms of an operating agreement. The trial court had calculated the value of the member's interest based on 50% of the value of the LLC, less the amount the member had agreed to contribute, plus the amount the LLC had contributed to an escrow account for the earnest money deposit for the purchase of property by the LLC. Because the evidence showed that the two members had agreed to a 50-50 split only after the return of their capital contributions, and the dissociating member did not make its agreed capital contribution, the court concluded that the dissociating member was only entitled to the return of the amount it had contributed to the escrow account.

Aron Puretz and Lincoln Provision, Inc. (Lincoln) formed an Illinois LLC for the purpose of acquiring and operating two Nebraska cattle-processing plants. The standard form of articles of organization filed to form the LLC stated that management was vested in the members and listed Lincoln and Puretz as the members. Puretz and Lincoln intended to include the details of the LLC's financing and operations in an operating agreement but were never able to settle on the terms of the operating agreement. To bid on the cattle-processing plants, the LLC was required to make an initial earnest-money deposit of $250,000 to an escrow account. Puretz contributed $150,000 and Lincoln contributed $100,000 to that amount. The LLC then submitted a successful bid of $3,900,000 for the two plants in a bankruptcy auction. Meanwhile Lincoln, Puretz, and their attorneys exchanged emails and draft operating agreements, but they could not agree on several major issues. The members met in a final attempt to resolve their differences, and notes prepared to summarize those discussions described the issues upon which the members apparently agreed, including that the members' capital contributions would be repaid in full before the company's profits and losses were divided equally between the members. Because the members were not able to resolve their disagreements about the financing and operations of the LLC, Lincoln refused to contribute its agreed-upon 30% of the purchase price for the plants. Puretz thus paid the entire $3,900,000 purchase price, except for the $100,000 from Lincoln's contribution to the escrow account that was credited to the purchase price.

About a month after the closing of the purchase of the cattle-processing plants, Lincoln's attorney sent a letter to Puretz's attorney stating that Lincoln was dissociating from the LLC. Under the Illinois LLC statute, if the LLC does not dissolve on the dissociation of a member, the LLC is required to repurchase the dissociating member's interest on the terms agreed to by the members. If the LLC does not purchase the interest, the dissociating member may file suit against the LLC to have the court determine the fair value of the interest. Because Lincoln and Puretz had never executed an operating agreement that described the method for calculating the value of a member's ownership interest in the LLC, Lincoln filed this lawsuit against the LLC (invoking diversity jurisdiction) seeking a determination of the fair value of its interest in the company LLC.

After a four-day bench trial, the district court held that Lincoln and Puretz each held a 50% interest in the LLC and that the value of the LLC on Lincoln's dissociation date was $3,900,000 and that the fair value of Lincoln's interest was $880,00, calculated as follows: 50% of the $3,900,000 value of the LLC ($1,950,000), less the 30% of the $3,900,000 purchase price that Lincoln failed to contribute at closing ($1,170,000), plus a return of the $100,000 Lincoln contributed to the escrow account. The LLC argued the value of Lincoln's interest was $100,000, the amount Lincoln contributed toward the acquisition of the plants. The LLC appealed.

The court of appeals agreed with the LLC that the evidence showed that the members agreed to a proportional return of capital prior to any distribution of profits and losses, even though they never finalized an operating agreement. The court reviewed testimony by Lincoln's president, one of Lincoln's employees, and Lincoln's attorney supporting the conclusion that the members agreed that the 50-50 split would occur only after the members received their capital back in a 70-30 split as invested. Because Lincoln refused to make its initial 30% contribution to capital, Puretz actually contributed 100% of the capital to the LLC, less Lincoln's $100,000 payment to the escrow account. Lincoln presented no evidence indicating that Puretz agreed to contribute 70% of the capital to the LLC in exchange for the right to receive only 50% of the capital in repayment of his investment. The court rejected Lincoln's argument that the district court correctly relied on the LLC's articles of organization as the best evidence that each member had a "50% interest" in the LLC for all purposes, including for purposes of calculating the fair value of a member's distributional interest. The articles merely established that the LLC was to be formed as a member-managed LLC and that management was to be vested in its two members; the articles could not be read to establish the members' economic interests in the LLC. The court also concluded that the district court did not err in assigning no value to Lincoln's business plan, "sweat equity," or unperformed promises to provide management services. The district court correctly concluded that Lincoln's only contribution was the $100,000 paid to the escrow account.

In sum, the evidence established that Lincoln and Puretz contemplated that any capital they contributed to the LLC would be returned to them in proportion to their respective contributions before any profits or losses generated by the LLC's operations were divided equally. Because Lincoln did not make its agreed-upon 30% contribution to capital, it was not entitled to a 30% distribution. Lincoln's only contribution to the LLC was its $100,000 deposit in the escrow account, and the court of appeals thus remanded with instructions to enter an order awarding Lincoln $100,000.

Foreign LLCs: Governing Law

Volvo Construction Equipment Rents, Inc. v. NRL Rentals, LLC, 2015 WL 3620708, __ Fed. App'x __ (9th Cir. 2015).

The plaintiff sought to hold Dwight and Marcel Bosworth personally liable under an alter-ego theory for a $10 million judgment against a Nevada LLC and a $10 million judgment against a Texas LLC and Texas limited partnership. Although the trial court had proceeded under the assumption that the plaintiff's alter-ego claim against the Bosworths with respect to the Texas LLC and Texas limited partnership should be decided under Nevada law, and that there were no substantive differences between Nevada and Texas law concerning alter-ego liability, the court of appeals held that Texas law applied to the claims because the entities were organized under Texas law. The court stated that this result was required under the Restatement (Second) of Conflict of Laws, which is followed by Nevada, as well as the governing-law provisions of the Nevada limited partnership and LLC statutes.

Charging Order

McClure v. JP Morgan Chase Bank, NA, 2015 WL4760275, __P.3d__ (Colo. App. 2015).

The court resolved a dispute about the priority of competing charging orders based on a first-in-time service rule. Charging orders that were served on a Colorado LLC after another creditors' charging orders nevertheless took priority because the earlier served charging orders were obtained in Arizona and had not been domesticated in Colorado. Thus, the earlier served charging orders were not enforceable at the time they were served, and the later served charging orders were the first enforceable charging orders to be served on the LLC.

Chase Bank obtained charging orders against a debtor's membership interests in Colorado LLCs in Arizona under the Arizona charging order statute, and Doug and Nancy McClure later obtained charging orders from a Colorado court against the same debtor's interests. Chase served its charging orders on the LLCs before the McClures did, but Chase failed to domesticate its charging orders in Colorado before serving them. (Chase eventually domesticated the charging orders but had not done so at the time the McClures served their charging orders.)

The court of appeals held as a matter of first impression that the priority of charging orders issued against Colorado LLCs is determined by first-in-time service of charging orders enforceable in Colorado. Charging orders that are enforceable in Colorado include both those issued by Colorado courts as well as foreign charging orders that have been domesticated in Colorado courts. Chase argued that its Arizona-issued charging orders were enforceable in Colorado because the Arizona court was a "court of competent jurisdiction" under the Colorado charging order statute, and the Arizona charging orders complied with Colorado law. However, Colorado case law has established the primary methods available to foreign judgment creditors seeking to enforce foreign-state judgments in Colorado: (1) filing a complaint in a Colorado court asserting the existence, details, and enforceability of the foreign judgment; or (2) domesticating the foreign judgment in a Colorado court under the Uniform Enforcement of Foreign Judgments Act. Unless one of these procedures is complied with, foreign charging orders are not enforceable in Colorado. To enforce a foreign charging order against a Colorado LLC based on domestication, the creditor would have to domesticate the charging order and not merely the judgment on which the charging order is based because the charging order—unlike the judgment on which it is based—requires the Colorado LLC to take action, i.e., to pay LLC distributions to the judgment creditor.

The court stated that the rule it announced in this case furthers the interest that Colorado has in LLCs organized in Colorado as demonstrated by the Colorado Limited Liability Company Act. Chase argued that the court's rule conflicted with the first-in-time service rule applied by a division of the court of appeals in a case involving competing charging orders against a partnership interest. The court distinguished that case on the basis that both charging orders were issued by Colorado courts, and the rule as applied in this case had to take into account the rules regarding enforceability of foreign judgments. The court stated that its holding would not unfairly burden foreign judgment creditors because Colorado has a simplified procedure for rendering foreign judgments enforceable in Colorado: domestication under the Enforcement Act. The court also rejected Chase's argument that giving the McClures' charging order priority was a collateral attack on Chase's Arizona charging orders in violation of the Full Faith and Credit Clause. The Full Faith and Credit Clause protects the final judgments of one state from collateral attack in another state, and application of the rule announced in this case simply determines the enforceability and priority of the competing states' charging orders, applying the elements described in Colorado case law. Because the McClures were the first to serve charging orders that were enforceable in Colorado, the trial court was correct to declare that the McClures' charging orders had priority over the Chase charging orders.

Mahalo Investments III, LLC v. First Citizens Bank & Trust Company, Inc., 769 S.E.2d 154 (Ga. App. 2015).

The members of an LLC argued that the trial court erred by entering a charging order against their interests in several LLCs as part of the same action in which the original judgment was entered and without first establishing that venue and jurisdiction over the LLCs was proper. The court of appeals held that the LLC statute does not require that a separate action against the LLC be initiated to obtain an order charging a member's interest in the LLC with payment of an unsatisfied judgment.

After learning in discovery conducted in post-judgment collection efforts that two judgment debtors owned interests in several LLCs, the judgment creditor filed an application seeking a charging order in the same court under the same file number as the original action in which the judgment was entered. The trial court entered the charging order, and the members argued on appeal that the Georgia LLC statute requires the judgment creditor to initiate a proceeding separate and apart from the suit in which the judgment was entered. The members relied on the statutory text and structure of the charging order statutes in the LLC and partnership contexts and a Georgia

Supreme Court decision addressing the charging order remedy in the partnership context.

The court of appeals focused on the statutory requirement that an application for an order charging a membership interest must be filed with a "court of competent jurisdiction." The court could discern no basis for not permitting the court that entered the underlying judgment to enter the charging order so long as that court is a "court of competent jurisdiction." The members pointed to slightly different language in the Georgia Uniform Partnership Act's charging order provision to support their argument that the judgment creditor must initiate an action in a separate court to obtain a charging order, but the court of appeals disagreed that the charging order provision in the partnership statute had any bearing on construing the plain and unambiguous language in the LLC statute. The court also did not agree with the members' argument that the Georgia Supreme Court's reference in another case to a judgment creditor's initiation of a "collateral proceeding" to obtain a charging order meant that the application for a charging order must be filed in a separate action. First, the question of whether an entirely new proceeding must be initiated by a judgment creditor to obtain a charging order against a member's interests in a limited liability entity was not at issue in that case. Second, the members' argument contradicted its argument about the manner in which the partnership statutes were worded compared to the LLC statute. The Georgia Supreme Court's language relied on by the members merely confirmed that a judgment creditor must, in addition to obtaining a judgment, initiate another proceeding collateral to the one establishing the debt, and request a separate order from the court to charge a debtor's interests in an LLC or partnership. This conclusion merely leads to the question of what is meant by a "court of competent jurisdiction" in the LLC statute–more specifically, whether jurisdiction and venue over the judgment debtor and member of the LLC is sufficient or whether a court is competent to issue a charging order only if jurisdiction and venue over the LLC is proper.

The Georgia LLC statute is silent as to whether the LLC must be made a party to the proceeding initiated by the judgment creditor filing an application for a charging order. Based on the language of the charging order provision of the LLC statute, the court gleaned that the charging order is a mechanism by which a judgment creditor can attach a member's LLC interest to satisfy an unpaid judgment, but the charging order does not permit the judgment creditor to replace the member or otherwise interfere in the governance of the LLC. It is the judgment debtor's right to possession of distributions in the future that is essentially being levied or charged, and it is "business as usual" from the LLC's standpoint except that any distributions to the member subject to the charging order are diverted to the judgment creditor. Because the LLC has no right or direct interest that is affected by the charging order, the court saw no reason why the LLC must be added as a party to the proceeding to obtain the charging order. Thus, the court held that the Georgia LLC statute only requires that a court have jurisdiction over the judgment debtor to have authority to enter a charging order against the judgment debtor's interest.

Regions Bank v. Alverne Associates, LLC, 456 S.W.3d 52 (Mo. App. 2014).

A judgment creditor's application for a charging order was found to be insufficient to establish entitlement to the charging order because it was based solely on allegations in the application, and the application was not verified nor did it support an inference that the allegations were based on personal knowledge.

The assignee of a bank payee of two promissory notes and deeds of trust was substituted for the bank as party plaintiff and obtained a judgment against the promissor and guarantor of the notes. The judgment creditor filed its "Verified Application for Charging Order" pursuant to the Missouri charging order statute. In the notarized application, the judgment creditor alleged that the trial court entered a judgment against the guarantor, the amount of the judgment, and the amount remaining unsatisfied. The judgment creditor requested that the court "issue a Charging Order requiring any limited liability company in which [the guarantor] has an interest to pay Plaintiff the amounts up to the unsatisfied amount of the above judgment with interest from [the guarantor's] interest in said limited liability company...." The application was signed by a representative of the judgment creditor on behalf of the judgment creditor, and there were two charts ("Exhibit B") attached showing the alleged outstanding balances on each promissory note and calculations of interest. It appeared that the trial court entered a charging order based solely on allegations contained in the application, and the court of appeals held that the record contained insufficient evidence to support the charging order.

The court explained that a charging order is a post-judgment remedy that allows the judgment creditor of an individual debtor-member of a limited liability company (or a partnership) to enforce a judgment by charging the individual member's distributional interest with the unsatisfied amount of a judgment. To obtain a charging order, the LLC statute requires a judgment creditor to file an "application to a court of competent jurisdiction." Under the rules of civil procedure, "[a]n application to the court for an order shall be by motion which ... shall be in writing, shall state with particularity the grounds therefor, and shall set forth the relief or order sought." A motion is not self-proving, and the movant has the burden of proving the allegations in the motion. An after-trial motion that is based on facts not appearing in the record may be supported by proof of facts in the form of affidavits, depositions, and oral testimony, but "exhibits attached to motions filed with the trial court are not evidence and are not self-proving." The relief sought in the application required resolution of factual matters not appearing in the record—most importantly, the amount of the outstanding judgment and interest the guarantor owed the judgment creditor. Although the application purported to be "verified," it failed to allege that the facts it contained were asserted on the personal knowledge of the representative of the judgment creditor that signed the application. The representative neither declared that he had personal knowledge of the facts pleaded in the application nor identified the source of the information he used to calculate the amount of the outstanding judgment. Because he did not define his relationship with the judgment creditor or provide a job title, the court could not infer personal knowledge. Exhibit B was not in the form of an affidavit, was never offered and admitted into evidence, and was not stipulated to but instead was challenged by the guarantor. In sum, the court's review of the record revealed nothing that provided sufficient facts to determine with any degree of certainty the amount of the outstanding judgment.

The court of appeals rejected the judgment creditor's argument that rules applying to execution applied to charging orders and did not require proof of the amount of the judgment. The court stated that the rules indicated that the charging order statute, and not the rules for execution, govern the procedure for obtaining a charging order, and the court pointed out that it had previously held that the charging order is the exclusive remedy for a judgment creditor of a partner and that the charging order has replaced levies of execution for reaching partnership interests. Based on the purpose of the charging order and the statutory requirement of judicial oversight, the court declined to extend the rules governing executions to charging orders issued under the LLC statute.

Fraudulent Transfer

A.G. Cullen Construction, Inc. v. Burnham Partners, LLC, 29 N.E.3d 579 (Ill. App. 2015).

The court of appeals concluded that a Delaware LLC's payments to the LLC's parent member and the member's owner, which left the LLC unable to pay an arbitration award entered against the LLC after the payments were made, were fraudulent transfers and provided a basis to pierce the veil of the LLC. The court also held that the LLC's manager breached a fiduciary duty owed to the creditor in the context of the LLC's insolvency.

An LLC hired a construction firm to build a facility in Pennsylvania, and the LLC and the construction firm had a disagreement as the project neared completion. The LLC stopped paying the construction firm, and the firm sought relief through arbitration. Before the arbitration award was entered, the LLC began to liquidate its assets and windup. After paying off a secured loan, most of the remaining cash was disbursed to the LLC's member as a development fee and to repay a loan made to the individual owner of the LLC's member. The LLC had no funds remaining to pay the arbitration award, and the construction firm sued the LLC, its member, and the manager (who was also the owner of the LLC's parent member) in Illinois to recover the amount of the arbitration award, alleging claims based on fraudulent transfer, veil piercing, and breach of fiduciary duty.

The court concluded that the payments of a development fee to the parent of the LLC and the repayment of a loan made to the parent's sole owner were fraudulent transfers based on the fact that 9 of the 11 badges of fraud were present in connection with the payments. Although the parent and its owner claimed that they did not think the construction firm would be awarded damages in the arbitration, the court pointed out that they were insiders who were on notice of a threatened lawsuit and the real possibility of a judgment. The court concluded that reasonably equivalent value was not received by the LLC in exchange for the transfers. According to the court, there was no consideration for the development fee because the parent was obligated to perform those functions as the majority owner, and the parent was not able to produce invoices showing what services were performed beyond what it was already obligated to perform (claiming that the records were probably lost). The LLC's repayment of a loan that had been made to the owner of the parent was not supported by consideration because the loan proceeds had in turn been lent to the parent by its owner in order to allow the parent to make its capital contribution to the LLC. The LLC was thus in essence repaying a capital contribution that its parent was obligated to pay. The assets transferred comprised substantially all of the LLC's assets. Further, by its transfers, the court stated that the LLC became insolvent and concealed its assets from the construction firm, all of which occurred just two months after the arbitration award and 10 months after the demand for arbitration. The court stated that a debtor may prefer one creditor over another so long as the debtor acts without fraudulent intent, but the court concluded that these transfers were fraudulent in violation of Section 5 of the Illinois Uniform Fraudulent Transfer Act.

Securities Laws

Wen v. Willis, 2015 WL 4611903, __ F.Supp.3d __ (E.D. Penn. 2015).

Wen, an undergraduate student from China who was enrolled at Temple University, sued Foxcode, Inc. ("Foxcode"), an investment and merchant banking firm, and Foxcode's principal, Robert Willis, for common-law fraud, conversion, breach of fiduciary duty, and federal and state securities fraud. Wen alleged that Willis represented that the defendants would manage $4 million invested by Wen with the defendants for Wen's benefit, deliver a return on the investment, and guarantee the full return of the $4 million principal when the investment concluded. The defendants created two Delaware LLCs to carry out the plan to invest Wen's funds—Foxcode Far East, LLC ("FFE"), and Foxcode Capital Markets, LLC ("Foxcode Capital"). The LLC agreement of FFE ("FFE Agreement") provided that Wen would contribute $4 million in exchange for a 99.9% membership interest in FFE, and Foxcode Capital would contribute $4,000 for a 0.1% membership interest. Foxcode would also provide all financial advisory services to generate earnings for FFE and would be paid management and performance fees. The FFE Agreement provided that the LLC was managed by its members, and both members had the ability to bind the LLC, call a meeting, demand access to the books and records, and withdraw and dissolve the LLC after 24 months. Numerous business decisions required unanimous consent of both members. Wen alleged that the defendants drained the funds from FFE's account, transferring nearly all the funds to their own accounts. After Wen became suspicious and was not provided satisfactory reports and information, he brought this suit. In this opinion, the court addressed the defendants' motion to dismiss the claims.

Wen's claim for securities fraud under federal law was dismissed because the plaintiff had powers as a managing member of the LLC that precluded characterizing his interest in the LLC as a "security" under federal law. The court applied the United States Supreme Court's definition of an investment contract in *Howey* as interpreted by the Third Circuit. The three elements for showing an investment contract as articulated by the Third Circuit are: (1) "an investment of money"; (2) "in a common enterprise"; (3) "with profits to come solely from the efforts of others." The defendants did not dispute the first two elements but disagreed with Wen that his interest in FFE met the third requirement, i.e., that his profits were to come solely from the efforts of others. The court stated that the inquiry with regard to the third element began and ended with the operating agreement. The court listed the powers enjoyed by Wen as a member under the FFE Agreement and discussed case law in the Third Circuit in the partnership and LLC context, and the court concluded that the weight of authority dictated that Wen's membership interest in FFE was not a security because Wen was granted significant control over FFE as a manager by the terms of the FFE Agreement. Wen attempted to distinguish the cases relied on by the court by arguing that the cases involved plaintiffs who had in fact been actively involved in management. Wen argued that, unlike those cases, he was not a sophisticated investor and did not in fact exercise any control over the investment. But the court concluded that “a variance, even a significant one, between the powers enjoyed by a plaintiff-investor in an agreement and the operation of those powers in reality does not *per se* convert an interest from a nonsecurity into a security.” Wen tried to convince the court to adopt the Fifth Circuit’s reasoning in *Williamson v. Tucker,* in which the Fifth Circuit held that an investor in a partnership could have an interest that constituted an investment contract, despite the powers afforded by agreement, “if he could show he was ‘so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers.’” The court was not persuaded to adopt the *Williamson* rule and apply it to Wen’s case when the Third Circuit would not do so under its existing jurisprudence. The court stated that Wen enjoyed a “plethora of powers” as a managing member of FFE and had significant control over the management of the company. The fact that he did not exercise those powers, or even the fact that the defendants thwarted his attempts to exercise those powers, did not make his membership interest in FFE a security for purposes of the federal securities laws. Thus, the court granted the defendants’ motion to dismiss Wen’s federal securities fraud claim.

Because an LLC interest is presumptively a security under Pennsylvania securities law and Wen did not participate actively and completely in the management of the LLC as required for Wen’s membership interest to meet an exclusion from the definition of a security, Wen established that his membership interest was a security under the Pennsylvania Securities Act (PSA). The PSA provides that a “security” presumptively includes any membership interest in a limited liability company, but the definition does not include an LLC membership interest where all of the following conditions are satisfied: (1) the membership interest is in an LLC that is not managed by managers; (2) the purchaser of the membership interest enters into a written commitment to be engaged actively and directly in the management of the LLC; and (3) the purchaser of the membership interest, in fact, does participate actively and directly in the management of the LLC. The first condition was met because the FFE Agreement provided that FFE was managed by its members, but the parties disagreed with regard to the second and third conditions. The court noted a dearth of case law defining what exactly is meant by “engaged actively and directly” for purposes of the second condition. The affirmative responsibilities of the day-to-day management of FFE were assigned solely to Foxcode Capital, but both Wen and Foxcode Capital were required to devote “time and attention” to the business of FFE, and numerous transactions required unanimous consent of Foxcode Capital and Wen. The court stated that the statutory language does not require that a certain quantum of active and direct engagement in the management of the company be defined, but rather suggests that any amount will do. The court thus concluded that Wen did enter into a written commitment to be engaged actively and directly in the management of FFE so that the second condition was satisfied. However, the court concluded that the third condition was not satisfied. That condition calls for a factual inquiry—whether Wen did, in fact, participate actively and directly in the management of the FFE. Wen pointed to allegations in his complaint that the defendants transferred almost all of his $4 million investment out of the FFE account and into their own accounts and kept Wen in the dark and then froze him out when he made inquiries about the dissipation of the investment. Viewing the inferences drawn from these allegations in the light most favorable to Wen, the court found that Wen had sufficiently pleaded that this third condition did not apply. Because not all three conditions were satisfied, Wen established that his membership interest in FFE was a security for the purposes of stating a PSA securities fraud claim. The court also concluded that Wen had sufficiently pled scienter so as to survive the motion to dismiss his claim for securities fraud under the PSA.

Sun RiverEnergy, Inc. v. McMillan, Civil Action No. 3:13-CV-2456-D, 2015 WL 1378713 (N.D. Tex. Mar. 25, 2015).

The plaintiff sued to recover short-swing profits under Section 16(b) of the Securities and Exchange Act of 1934 based on numerous transactions involving shares in the plaintiff owned by an LLC. The court held that the “pecuniary interest” of a 50% member for purposes of determining the member’s beneficial ownership of shares sold by the LLC in a buyout of the other member was 50% even though after the transaction at issue the member owned 100% of the LLC.

An LLC and one of its members, McMillan, entered into an agreement with the other member, Pingel, under which Pingel agreed to sell all of his interest in the LLC in exchange for consideration that included 350,000 shares of stock in the plaintiff owned by the LLC. In a previous opinion, the court held that this transaction was a "sale" of the stock for purposes of short-swing profit liability under Section 16(b) of the Securities and Exchange Act. In this opinion, the court addressed a dispute as to the amount of McMillan's beneficial ownership in the shares deemed to be sold by the LLC in the buyout of Pingel. McMillan and the LLC maintained that McMillan's beneficial interest in the deemed sale of the shares to Pingel was limited to 175,000 shares based on McMillan's pecuniary interest, i.e., his 50% ownership interest, in the LLC at the time of the sale. The plaintiff argued that McMillan had a pecuniary interest in all 350,000 of the shares sold in the Pingel transaction, reasoning that the pecuniary interest in the sale belonged entirely to McMillan because only he, as the sole remaining investor in the LLC, would have enjoyed the risks and rewards of owning these shares had the LLC not sold them, and only he had the opportunity to profit from the sale because he was the sole remaining investor in the LLC and stood to enjoy 100% of the benefits that it received from the transaction. The plaintiff also asserted that the 50% ownership interest of Pingel in the LLC should not be counted because he had no opportunity to profit from the sale. The court disagreed with the plaintiff's reasoning. The plaintiff relied on a definition of "pecuniary interest"—"the opportunity, directly or indirectly, to profit or share in any profit derived from a transaction"—to determine the *extent* of that interest. However, that provision specifies what is necessary *to have* a pecuniary interest rather than *the extent of* that interest. A person has a "pecuniary interest" if he has *any* direct or indirect opportunity to profit or share in any profit derived from a transaction. 17 C.F.R. § 240.16a–1(a)(2)(i). The regulations contain a standard of measurement, or *extent* of pecuniary interest, in another context. Under 17 C.F.R. § 240.16a–1(a)(2)(ii)(B), a general partner's indirect pecuniary interest in the portfolio securities held by a general or limited partnership is the general partner's proportionate interest, as evidenced by the partnership agreement in effect at the time of the transaction and the partnership's most recent financial statements. The regulations define the *extent* of a person's pecuniary interest (here, an indirect pecuniary interest) based on the interest "in effect at the time of the transaction," and there is no indication in the regulations that the interests of owners in an LLC's portfolio securities should be treated differently. The court also disagreed with the plaintiff's assertion that the 50% ownership interest of Pingel in the LLC should not be counted. Pingel had a pecuniary interest in the transaction, even though he was the purchaser of the shares, because they were being sold by the LLC, in which Pingel had an ownership interest at the time of the sale. Although the transaction itself extinguished that ownership interest, it did not deprive Pingel of the opportunity, directly or indirectly, to profit or share in any profit from the transaction. Thus, the court held that McMillan's pecuniary interest in the LLC was determined according to what it was at the time of the transaction, which was 50%.

Bankruptcy

Northwest Wholesale, Inc. v. PAC Organic Fruit, LLC, 2015 WL 5286198, __ P.3d __ (Wash. 2015).

The Washington Supreme Court held that a debtor in bankruptcy did not have standing to bring a derivative action on behalf of a Washington LLC because the Washington LLC statute provides that a plaintiff in a derivative action must be a member of the LLC, the debtor was dissociated as a member pursuant to the Washington LLC statute when the debtor filed bankruptcy, and the dissociation provision of the Washington LLC statute was not preempted by Section 541 or 365 of the Bankruptcy Code.

Harold and Shirley Ostenson and Greg Holzman formed an LLC in 1998. The Ostensons and Greg Holzman, Inc. ("GHI") became the members of the LLC, and both the Ostensons and GHI were active in the business. GHI owned a majority interest and had management responsibilities under the operating agreement. Holzman fired the Ostensons from their positions with the LLC after the LLC defaulted on its operating line of credit and lease. The Ostensons filed for bankruptcy protection under Chapter 11 in early 2007. Later in 2007, a creditor of the LLC filed this lawsuit in state court against the LLC, GHI, and the Ostensons. The Ostensons filed cross claims and a third-party complaint against Holzman, GHI, and another entity of Holzman's. These claims were a derivative action on behalf of the LLC. After the creditor's claims settled, the only remaining claims were the Ostensons' responsive claims against the LLC and the derivative claims against the Holtzman defendants. This case went to trial in 2011, and the Holzman defendants moved to dismiss the Ostensons' derivative action after the Ostensons rested their case. The Holzman defendants argued that the Ostensons were no longer members of the LLC and lacked authority to bring their derivative action. Eventually, the trial court ruled that the Ostensons relinquished their membership in the LLC when they filed bankruptcy and could not maintain a derivative action on the LLC's behalf. The Ostensons appealed, and the court of appeals agreed with the trial court that the Ostensons did not have standing. The Ostensons appealed to the Washington Supreme Court.

The Ostensons repeated the argument that they made in the court below that Sections 541(c)(1) and 365(c)(1) invalidated or rendered unenforceable ipso facto bankruptcy clauses. Under the Washington LLC statute, a member is dissociated as a member when the member files a voluntary petition in bankruptcy unless the LLC agreement provides otherwise, and a plaintiff in a derivative action must be a member at the time of bringing the action. The Ostensons argued that the dissociation provision of the statute was preempted by federal bankruptcy law.

The court first addressed the interplay between Section 541(a) and (c)(1) and the Washington LLC statute. Under Section 541(a), a bankruptcy filing triggers the creation of a bankruptcy estate into which the debtor's property interest devolves, but the threshold question of how a debtor's interest is determined turns on state law. Applying Ninth Circuit case law, the court concluded that the Ostensons' bankruptcy estate took their interest as defined, determined, and encumbered according to state law, and the interest that devolved to the Ostensons' bankruptcy estate was thus an assignee's interest and not a member's interest in the LLC. The court of appeals had reached the same result applying *In re Garrison-Ashburn, LLC*, a Virginia bankruptcy court decision applying a similar provision of the Virginia LLC statute. The Washington Supreme Court concluded that the court of appeals correctly applied *In re Garrison-Ashburn,* and the supreme court distinguished and declined to follow a portion of *In re First Protection, Inc*. because the court felt that the Ninth Circuit Bankruptcy Appellate Panel in that case did not adhere to Ninth Circuit precedent. The court also distinguished *In re Daugherty Construction, Inc.* and another case because those cases dealt with statutory or contractual provisions that triggered dissolution of the LLC rather than dissociation of a member on the filing of a member's bankruptcy.

The court next addressed the Ostensons' argument that Section 365(e)(1) invalidates or renders unenforceable ipso facto bankruptcy clauses. Section 365 applies to executory contracts. The supreme court explained that the court of appeals analyzed the obligations in the LLC operating agreement and noted that they might suffice to create an executory contract, but the court of appeals found it unnecessary to decide whether the operating agreement was an executory contract because the court concluded that Section 365(e) otherwise excused further performance under the agreement. The court of appeals relied on Washington case law in the partnership context in which the court held that a provision of state law that dissolved a general partnership upon a partner's filing of bankruptcy was not superseded by Section 365(e)(1)'s invalidation of ipso facto provisions because the freedom of the partners to choose with whom they are associated excused the remaining partners from performance under Section 365(e)(2). The supreme court agreed with the court of appeals that the same rights of voluntary association on which the partnership case law rested applied to LLC membership. Thus, if the LLC operating agreement in this case constituted an executory contract, the associational rights of the members found in the Washington LLC statute triggered the Section 365(e)(2) exception rendering the Section 365(e)(1) prohibition on ipso facto clauses inapplicable.

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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 Spring Meeting Montreal, Canada	April 7-9, 2016
2016 ABA BLS Annual Meeting Boston, Massachusetts	September 8-10, 2016
2016 LLC Institute	TBD
2017 ABA BLS Spring Meeting New Orleans, Louisiana	April 6-8, 2017
2017 ABA BLS Annual Meeting Chicago, Illionois	March 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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