



THE LLC & PARTNERSHIP REPORTER

(f/k/a The PUBOGRAM)

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Garth Jacobson - Chair
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Peter D. Hutcheon - Editor Emeritus

FROM THE CHAIR

*Garth Jacobson
CT Corporation
Seattle, Washington*

Greetings from the Chair,

First, I want to congratulate Steve Frost the 2017 Lubaroff Award recipient. Steve has in so many ways improved the landscape of LLCs partnerships and unincorporated entries through his many activities related to our committee entities. A few years ago he worked an assignment at the IRS to provide a practitioners perspective to tax laws related to LLCs and partnerships. Steve recently chaired the Uniform Protective Series LLC legislative drafting committee. His professional and personal contributions to our committee are many. But equally important he has been the type of person to exemplify Marty Lubaroff. He truly reflects high levels professionalism with personal charm and affability. Those are characteristics we should all strive. He is truly deserving of the award.

The Lubaroff is our signature committee award. Some awards require head scratching to find worthy candidates. But in our committee we have a stable full of people who are truly worth of this award. The previous recipients stand as giants in our profession and create a tall standard to meet. However, we have many others on our committee who stand worthy to receive this honor in the future. Trust me, the selection of a recipient is difficult because of the many great people associated with our committee. I am very happy to know that as the years continue there is a large group of people who make our committee great and will be

honored. We are blessed with some of the best and brightest people in the country who share our passion for our area of practice and who make great friends that make our lives better.

In case you haven't noticed there have been lots of discussions at the ABA about how to become more relevant to the attorneys. For an organization by and for attorneys it seems the question wouldn't need to be asked. The challenge is that as the baby boomer are turning into living fossils and fading into the sunset will the next generation of lawyers take their place and take up the cause. As the membership of the ABA has decreased in the past decade, leadership has taken to asking the question of what to do to make our organization relevant and worthy of our time. We can get the information from law books, and the many on-line sources. But those sources pale in comparison to live interactions with experts. Books and the internet, don't make the connections to interesting tangents that create the ah-ha moments that live interactions create. Because our committee includes a caste of diverse understanding and intellectual curious people willing to share their wisdom with other members it is an incredible value to attend our meetings and programs just to meet and discuss the relevant topics. I believe it is through these efforts that the next generations of lawyers will find value and continue the promotion of excellence in our profession.

The upcoming LLC Institute, in my opinion, is the greatest value of the ABA. We keep the cost intentionally low to accommodate all comers. Yet we offer the highest level of experienced lawyers and academic giants discussing cutting edge topics. My kudos to Scott Ludwig for getting this institute going and to Christina Houston, Johnny Lyle, Lou Conti and Tom Rutledge for their great contribution of time effort and contacts to make this year's program great. I can't thank them enough. Again it will be a must attend event that I hope to see you there.

Thanks to everyone for their great contributions to our committee.

LLCs, Partnerships and Unincorporated Entities Committee
2017 LLC Institute
November 2 – 3, 2017
Agenda

Thursday, November 2, 2017

7:20 a.m. - 8:00 a.m. Breakfast (included in registration)

8:00 a.m. - 8:15 a.m. Welcome; Housekeeping

8:15 a.m. - 10:15 a.m. **Program (2 hrs.) Case Law Update (Non-Delaware)**

Prof. Elizabeth “Beth” Miller (Baylor Law School Waco, Texas), Dan Sheridan (Stark & Stark – Lawrenceville, New Jersey), Sean Ducharme (Hunton & Williams – Richmond, Virginia), and Kelley Bender (Chapman and Cutler – Chicago, Illinois)

This panel will discuss recent LLC and partnership cases other than from Delaware on various topics of significance, including cases dealing with fiduciary duties and veil piercing and cases illustrating pitfalls in drafting operating agreements.

10:15 a.m. - 10:30 a.m. Break

10:30 a.m. - 12:00 p.m. **Program (1.5 hrs.) Tax**

Moderator: Louis T. M. Conti (Holland & Knight – Tampa, Florida)

Panelists: Robert R. Keatinge (Holland & Hart – Denver, Colorado), Bahar A. Schippel (Snell & Wilmer – Phoenix, Arizona), and James B. Sowell (KPMG – Washington DC)

This panel will discuss the potential impact of the 2017 Tax Reform Proposals and/or provisions (if enacted) which affect pass-through business entities and their equity-holders. The focus will be on partnership tax law changes, as well as disregarded entity and compensation/self-employment changes and planning.

12:15 p.m. - 1:30 p.m. **Luncheon**

Keynote address by J. William Callison (Faegre Baker Daniels – Denver, Colorado)

In 2013, the United Nations Commission on International Trade Law requested that its Working Group I commence deliberations on reducing legal obstacles encountered by micro, small and medium sized

businesses (MSMEs) in entering the formal economy, maximizing their economic potential and, indirectly, assisting with sustainable development and rule of law application. Working Group I has spent several years focusing on legal standards for the organization of MSMEs and may, after more time, prepare some form of model international statute for use in developing countries. Bill Callison is an NGO delegate to the Working Group and is a member of the Secretariat's expert advisory committee. He will discuss the process, politics, perspectives and possibilities of this project which, in some senses, is like the original LC statutory drafting process, with the addition of civil, common and other legal perspectives, entirely different domestic approaches and agendas, pre-NCCUSL and without tax law definition.

1:30 p.m. - 3:30 p.m. **Program (2 hrs.) [Allocations & Substantial Economic Effect](#)**

Prof. Walter D. Schwidetzky (University of Baltimore), Prof. Roberta Mann, Mr. & Mrs. L.L. Stewart Professor of Business Law (University of Oregon), Bahar A. Schippel (Snell & Wilmer – Phoenix, Arizona), and Ross Cohen (Bingham Greenebaum Doll – Louisville, Kentucky)

This panel will lay out the basics of the “substantial economic effect” safe harbor for tax allocations and discuss when business lawyers can, and cannot, dispense with tax allocations provisions in their LLC agreements. The program then will discuss some more advanced topics, including when an LLC might choose not to comply with the substantial economic effect rules.

3:30 p.m. – 3:45p.m. Break

3:45 p.m. - 5:15 p.m. **Program (1.5 hrs.) [USACafes \(Alternative Veil Piercing\)](#)**

Prof. Mohsen Manesh (University of Oregon), Prof. Joshua Fershee (West Virginia University), and Carmen Fonda (Venable – Baltimore, Maryland)

This program will address LLC veil piercing in both the traditional context and the special USACafes context, in which individuals acting on behalf of a legal entity that exercises control over an LLC (arguably) owe a fiduciary duty to that LLCs and its owners.

6:00 p.m. - 7:00 p.m. **Cocktail Hour – Cash Bar**

7:00 p.m. - 9:00 p.m. **[Lubaroff Award Dinner](#)** - (this event is a separately ticketed event - obtain through the registration process)

Friday, November 3, 2017

7:30 a.m. - 8:00 a.m. Breakfast (included in registration)

8:05 a.m. - 10:05 a.m. **Program (2 hrs.) Delaware and Bankruptcy Case Law Update**

Tarik J. Haskins (Morris, Nichols, Arsht & Tunnell – Wilmington, Delaware), Matt O’Toole (Potter, Anderson, Corroon – Wilmington, Delaware), and James J. Wheaton (Chesapeake, Virginia)

This panel will discuss recent LLC and partnership cases from Delaware on various topics of significance, including cases dealing with fiduciary duties and veil piercing and cases illustrating pitfalls in drafting operating agreements. Jim Wheaton will provide an update on recent bankruptcy decisions of interest.

10:05 a.m. - 10:15 a.m. Break

10:15 a.m. – 12:15 p.m. **Program (2 hrs.) Fiduciary Duties**

Moderator: Professor Carter Bishop (Suffolk University – Boston, Massachusetts)

Panelist: Tammy L. Mercer (Young Conaway Stargatt & Taylor – Wilmington, Delaware), Prof. Joan Heminway (University of Tennessee), Prof. Mohsen Manesh (University of Oregon), and Melissa K. Stubenberg (Richards Layton & Finger – Wilmington Delaware)

This panel will discuss the role of fiduciary duties in structuring LLC operating agreements. Topics will include accidental contractual resurrection of a fiduciary duty eliminated, aiding and abetting a fiduciary duty contractually eliminated, and using a majority in interest amendment provision to eliminate a fundamental fiduciary duty of the minority. Time permitting, the panel will also discuss disclosure duties connected to voting decision making.”

12:15 p.m. - 12:45 p.m. **Luncheon: Working Committee Meeting (included in registration)**

12:45 p.m. - 2:15 p.m. **Program (1.5 hrs.) Good Faith**

The Honorable Collins J. Seitz, Jr. (Justice, Delaware Supreme Court), Former Vice Chancellor, Donald F. Parsons, Jr. (Morris, Nichols, Arsht & Tunnell LLP – Wilmington, Delaware), Lisa R. Jacobs (DLA Piper – Philadelphia, Pennsylvania), and Srini Raju (Richards Layton & Finger – Wilmington, Delaware)

This panel will discuss the various concepts of good faith—contractual

good faith, fiduciary good faith, and the implied covenant of good faith and fair dealing—in the context of LLCs and partnerships. The panel will discuss recent case law regarding good faith and various transactional scenarios involving LLCs and partnerships in which issues of good faith may arise.

2:15 p.m. - 2:30 p.m. Break

2:30 p.m. - 4:00 p.m. **Program (1.5 hrs.) State and Local Tax Matters**

Erica L. Horn (Dean Dorton Allen Ford – Lexington, Kentucky), Steven Wlodychak (Ernst & Young – Washington DC), and Marianne Evans (KPMG – Washington DC)

The Bipartisan Budget Act of 2015 enacted a new federal audit regime for partnerships, which gives the IRS the authority to audit partnerships at the entity level AND to assess and collect tax deficiencies directly from the partnership. Full implementation of these new rules is fast approaching. The first IRS audits under the new rules are anticipated to begin as early as 2020 for taxable years beginning after December 31, 2017 (i.e., January 1, 2018 for calendar year filers). The IRS has issued proposed regulations and a technical corrections bill has been widely discussed. While changes from the federal perspective will be significant, those changes may pale in comparison to the problems that may be experienced by the states and thus, state tax liability for the partnership and its partners. The panelists will provide a brief overview of the new federal partnership rules and then turn to the serious implications for the states. The Multistate Tax Commission and state tax authorities are already working with stakeholders such as the Tax Executives Institute, ABA, Tax Section SALT Committee, Council On State Taxation, AICPA, and the Institute of Professional in Taxation to develop model legislation that will help taxing authorities and taxpayers alike with the inevitable state audit complications created by the new federal audit rules.

4:30 p.m. - 5:00 p.m. **Wrap-Up**

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Steven G. Frost to Receive the 2017 Martin I. Lubaroff Award

The 2017 recipient of the Martin I. Lubaroff award is Steven G. Frost of Chicago Illinois.

Steve is a 1982 graduate of the DePaul University College of Law. He received a BA and a BS from the University of Colorado in 1975, and he received an MS in Accountancy from DePaul in 1977. He worked on the audit and tax staffs of Ernst & Ernst before going to law school. In 2016 he retired after a distinguished career with Chapman and Cutler, during which time he practiced principally in tax and investment fund law. From September, 2008 through October, 2009, he was Senior Counsel in the Office of Tax Policy at the Department of the Treasury, where he was responsible for guidance and legislative initiatives for pass-through entities, including the drafting of the proposed series classification regulations. From 2001 through 2012, Steve was an adjunct professor at the Kent College of Law Masters of Taxation program where he taught partnership tax. Steve is a Uniform Law Commissioner from Illinois, and he served as an advisor from the ABA Tax Section or as a Commissioner with respect to the drafting of all of the Uniform Limited Liability Company Act, the Revised Uniform Limited Liability Company Act, the Limited Liability Partnership amendments to the Uniform Partnership Act, the Revised Uniform Limited Partnership Act, and the Model Entities Transactions Act. Most recently, he chaired the drafting committee for the Uniform Protected Series Act. He is an elected member of the American Law Institute. In addition, with great pride, he serves as a member of the school board of Stevenson High School District 125 and on the Chicago regional board of the Anti-Defamation League. He has served as the chair of the ABA Tax Section's Partnership and LLC Committee. He is a fellow of the American College of Tax Counsel and has now endeavored working as an adjunct at the University of Notre Dame College of Law.

Steve has served on several committees of the Chicago Bar Association, including as chair of the Committee on Federal Income Tax and as chair of the CBA's Business Section Committee on Noncorporate Entities. He is also a member of the Illinois Institute of Business Laws, which updates the state's business statutes. He has published in journals including the Business Lawyer, the Journal of Taxation, the Journal of Real Estate Taxation, Taxes Magazine, Tax Notes, the Journal of

Limited Liability Companies, the Illinois Bar Journal and the Journal of Passthrough Entities. He is a member of the Advisory Board of the Journal of Passthrough Entities.

In 2012, Steve received the Lawrence Katz Memorial Service Award from the Partnerships and LLCs Committee of the ABA Section on Taxation.

Steve has served on the Joint Editorial Board for Uniform Unincorporated Business Organization Acts, and has taken a lead in facilitating a cooperative and mutually supportive relationship between the ULC and our Committee.

Lauris G.L. Rall wrote:

I love the guy like a brother. He cannot play golf worth a damn (neither can I). Nor can he hold his liquor (neither can I). Not much of a sense of humor but much more funny than he thinks he is.

Steve has been a stalwart of the alternative entity bar for as long as I can remember. He is the full package given that he knows the tax end of things as well as the partnership and LLC laws. Like all good client centric attorneys he is practical and sensible in his approach. His contributions through his stint in Treasury and as the infamous Commissioner Frosty of the NCCUSL world clearly add to his achievements and make him eminently "Lubaroffesq."

Congrats Big Guy Steve - well deserved!!!

Johnny Lyle wrote:

Steve is one of the most kind, gracious, humble and thoughtful people I have ever met. He is very deserving of this award.

David McBride wrote:

My knowledge of Steve Frost is from his chairmanship of the drafting committee for the Uniform Protected Series Act. He is intelligent, thoughtful, concerned about the development of the law, able to balance competing considerations and, most importantly for our drafting committee, he was patient, he persevered and he was calm and good-natured throughout an often difficult debate. Steve was able to manage the process so that all were able to contribute, often from differing perspectives and with differing priorities. The drafting committee produced a better statute because of

Steven G. Frost to Receive the 2017 Martin I. Lubaroff Award

Steve, and Steve has made a very meaningful contribution to the law by his ability to bring this statute to completion. In short, Steve is just a great guy and a great lawyer. Congratulations to him on this well-deserved honor.

David Walker wrote:

Steve is such a nice guy. Patient, funny, smart, engaged but humble and respectful of others, and he brings so much experience to the table. He's also mischievous, loves a good joke, knows his bourbon, and relishes scouting out and selecting great restaurants! At one of our Limited Partnership Drafting Committee meetings probably 20 years ago, he had blue M & Ms to give to people who made unusually good contributions to the discussion. Steve also enjoyed what happened when Chair Howard Sweibel called a meeting for Saturday morning at 8:00 or 8:30 rather than 9:00 over Marty Lubaroff's protest. Marty much preferred the 9 o'clock time, but he acquiesced and was there the next morning right on time at 8:30. Howard wasn't!

And we waited. And waited. Finally, Marty went off to call Howard or see what the problem was. Soon after he left, Howard appeared and looking about the room, he asked everyone, "Is Marty not here yet?" He was hopeful, but we had to tell him, "Life is not that good, Howard." All of us had a good laugh at that. Marty then appeared, and Howard, sheepish, apologized for being late. Howard did not receive any blue M & Ms that morning.

Beth Miller wrote:

Steve Frost once wrote in a tribute to another Lubaroff Award recipient that each recipient "was a mensch that cared about this Committee and its members." It is quite fitting for Steve to join the ranks of those "mensches." Steve cares deeply about the law of unincorporated entities, as evidenced by his significant contributions to projects of the LPUE Committee and NCCUSL and his service as a CLE warrior and author of numerous thoughtful and thought-provoking articles and papers. Steve also cares about the people around him. His warmth, good humor, and sincerity enrich the process of working with him on any endeavor. As anyone who has the opportunity to

spend any amount of time with Steve has learned, he is devoted to his family, friends, colleagues, and community. He exemplifies the professional and personal qualities we honor in remembering Marty, and I congratulate Steve on this well-deserved recognition.

Christina Houston wrote:

Steve inspires me every day. I smile every time I think about him. He makes me laugh. He makes me think. We all know his brilliance and wisdom. He only knows how to promote others – never himself. His passion for issues that matter not only in the law but more importantly in our community (and for some MLB team – which one is that again??) is unmatched. If we all shared Steve's humility, kindness and genuineness, we would be much better off. Although he is having fun in retirement (-I like the visual of Steve taking horseback riding lessons after having had a bit too much brown liquor...), I personally refuse to let him get too far away for too long because Steve is the heart of who we are and what we what we aspire to do. That is what the Lubaroff Award is about. Thank you, Steve.

Robert Keatinge wrote:

I have known Steve for over twenty years and have come to value his wisdom and good humor. As many of have Steve migrated from tax to business law. He has always tried to work his way through the language to the right answer.

I have travelled with Steve to Aruba and surprised Wendy in London on her 50th birthday. We have visited museums from the Chicago Institute of Art to the Bowling Hall of Fame. But more important than all that we have spent hours trying to grasp the rationality of the law. Steve has always taken the time to care about his friends.

James Reynolds wrote:

Steve is as smart and thoughtful as any lawyer you will ever find in any room you enter during your life. Since the days when both of us served as ABA advisors to the original ULLCA drafting committee, I have benefitted from Steve's knowledge and analysis of difficult LLC issues, both tax and nontax. During the next 25

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years, his contributions to the advancement of LLC laws have been invaluable.

What makes Steve an outstanding lawyer, I have come to believe, is his possession of a double empathy gene. This rare and peculiar genetic mutation accounts for Steve's genuine desire not only to listen to what you say, but to hear what you mean and to offer his help. And did I mention happy and funny? If they ever create a Hall of Fame for Cheerful Lawyers, I suspect it will be located in a rather small building and that Steve will have a prominent place in it.

For all of these reasons, I have forgiven Steve for introducing me to a game that has spoiled many a good walk, and for my humiliation in wearing the world's all-time ugliest Chicago Bulls T shirt. Congratulations to a most deserving recipient of the Lubaroff Award.

Louis T.M. Conti wrote:

Steven G Frost, "Frosty" as I sometimes call him when he is not around, is a Renaissance Man (minus any discernable artistic skills), a Lawyer's Lawyer, a connoisseur of fine wines and spirits, and most importantly, one hell of a nice guy who was lucky enough to find, and smart enough to marry, the exceptional Wendy Frost. Sure, he was an accounting major and tax lawyer early on, and sure he was smart and diligent as a student and young lawyer, but I didn't know him then, so I can't speak to his school days or early years in practice. However, for more than 25 years I have had the great good fortune to be part of the ABA LPUE Committee where I have come to meet and develop friendships with exceptional lawyers, and more importantly, exceptional human beings, like Frosty. Steve has the uncommon ability to make new acquaintances feel like old friends. Steve welcomes, and indeed embraces, everyone he meets. Steve takes time to get to know people, and cares about them and their families. Steve is patient, thoughtful, and deliberate when others want to rush to judgment. Through Uniform Law Commission Drafting sessions, ABA Committee and subcommittee meetings and assignments, and in Adlai Stevenson School Boards meetings, you can always count on Steven G. Frost to be professional, thoughtful, honorable, dependable, and respectful of the opinions of

others – just like Marty Lubaroff was throughout his professional life.

Steven, my friend, Congratulations on this well-deserved recognition and honor. Marty would be happy and proud!

Thomas Geu wrote:

Steve Frost cares. One of his most disarming talents is to make a new acquaintance feel like they've been friends for years. He is thoughtful, inquisitive, and comfortable enough in his own skin to open my visit and inquire about topics that may be unfamiliar to him. One such conversation that I was privileged to be privy to what was between Steve and Marty. Steve was visiting with Marty about the art of the deal, deal making, and rain making, years after Steve had been excepted as a partner "doing tax". His contribution to legal reform, his attempt to bring people together rather than divide them, and the willingness to do the nitty-gritty work to accomplish a task, make him a laudable choice for this award. Marty would be proud.

Scott Ludwig wrote:

When I first met Steve, I thought he was a hard-nosed, tough Chicago lawyer, steeped in tax from his time as a Senior Tax Accountant with Ernest & Young, his time as Senior Counsel at the Treasury Department, his time as a Partner at Chapman Cutler, and his time as an Adjunct Professor at the Chicago Kent College of Law. Steve also appeared to know everything about Uniform entity acts having served as a commissioner now for over 17 years.

However, this tough façade is just that. As a professional, Steve cares deeply about advancing the law and helping others around him to understand the pitfalls that are not readily visible. In this regard, he is tenacious as he is concerned for the welfare of his fellow practitioners.

One his personal side, Steve brings that same passion to his family, his community, and his friendships.

Steve's commitment to his wife, Wendy, and his children is obvious. When he discusses Wendy and his children, Steve's eyes light up with joy and happiness, and after having met

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Wendy, we all can understand why Steve is so happy – as we say in the South, Steve definitely “outkicked his coverage.”

Steve’s service as a school-board member for the past 17 years is just one example of his commitment to his community. He regularly informs many of us of his school’s achievements and holds up the achievements of many of the students in the school system. He does all of this without having any children currently in that school system – he just wants to see children succeed in life.

As to his friends, I can only say from my experience that friendship means a great deal to Steve and that he invests heavily in those friendships. From our first meeting, Steve has always gone out of his way to be kind to me and to teach me the law. He is a born life-long learner and a teacher.

My favorite memory of Steve was after a particularly contentious meeting of our committee, he asked me to dinner so that we could both discuss our views rationally and as adults. While we did discuss committee matters, we actually spent more time talking about our families and our personal experiences -- I suspect that was Steve’s plan all along. After that dinner, I knew that Steve Frost was special. He exemplifies the traits that we all saw and admired in Marty. Steve deserves to be honored by his peers and I am glad that I will be able to celebrate this special occasion with Steve at the LLC Institute. Congratulations Steve!

Tom Rutledge wrote:

I first met Steve at a committee meeting in Chicago. New to the committee, I was invited to come along with the group who were going to lunch. I clearly remember Scott Ludwig having the heirloom tomato and mozzarella salad. As we were walking back from lunch, Steve asked my view on a tax problem. I don’t remember the problem beyond knowing I did not know the answer. But that was Steve, both trying to learn something new even as he graciously tried to bring someone into the group.

Steve is an exceptional attorney, an exceptional teacher and an exceptional colleague it matters involving the law and otherwise. For all that he is professionally and

personally, I know that he views one of his greatest accomplishments as the success of the students at the school for which he serves on the board. Those national merit scholars, scholarship recipients, etc., are a great part of his legacy, one which extends far beyond the confines of our shared Committee.

I consider myself most fortunate to count Steve Frost as a friend.

Lou Hering wrote:

It has been my pleasure and privilege to have known Steve for many years -- too many to count; to have worked with him on many of our Committee projects, to have worked with him on work (paying that is) projects and to have enjoyed his company and companionship when we weren’t working. Throughout this time, I have found Steve to be an excellent lawyer and excellent companion and one of the nicest people I have ever meet. Steve truly loves the law and works to advance it as evidenced by his work at Treasury on the series regulations. He is a most deserving recipient of the Lubaroff award and my only regret is that I won’t be there to see him receive it.

Kelley Bender wrote:

When I received the news that Steve was this year’s recipient of the Lubaroff Award, I put a conference call on mute to explain to the associate in my office what a big deal it was and how Steve was going to be so honored to receive the award. The associate thought for a moment and said, “So this is like his Heisman Trophy?” Indeed. Given his nature, however, I’m sure he probably asked for a recount, not believing his name would be added to the list of distinguished past recipients.

Many members of this committee have known Steve much longer than I have, and will speak much more eloquently to Steve’s contributions to our little corner of the law. I’ll use my allotment of space and ink to reflect on Steve’s passion for learning and teaching. Steve has been and continues to be a phenomenal teacher - generous with his time, quick to praise and patient when he knows someone can do better. He recently offered to spend time with a colleague of mine who needed a primer on partnership allocation and distribution provisions (even though you can

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imagine how difficult it is for him to fit activities like that into his schedule between golf and more golf). He also will be teaching a one-week intensive transactional law course at Notre Dame in the coming year. When a colleague of ours who has been teaching the course for a couple of years began looking for another person to help teach the course, I instinctively suggested Steve, and we both agreed he would love the opportunity to teach this particular course. But true to form, Steve expressed concern to my colleague about whether he really had the background or experience to teach certain parts of the course that dealt with issues outside his main areas of practice. Steve often believes he has more to learn than he has to teach – his humbleness is one of the qualities that makes him a great lawyer.

Steve loves to be a student too, which he is demonstrating quite well in retirement. He has already audited an astronomy class, taken a race car driving course and practiced shooting with a Navy SEAL (among other adventures about which I've probably not yet heard). But many of you witnessed his desire to learn on a pretty frequent basis pre-retirement as well. I've been in the room or copied on emails when Steve has reached out to many of you to ask a "simple" or "quick" question that he has promised will take no more than a few minutes (hours) or a brief email (treatise) to address. Steve is not afraid to ask questions or to show that he still has much to learn, and he values the expertise and brain power of his friends on this Committee very much.

On a personal note, I could not have asked for a better teacher, mentor, cheerleader and friend to guide me at the start of my career. He has been supportive in so many ways, and I'm certain that he probably does not even realize all that he has done for me and for my family. I also cannot let this opportunity go by without recognizing his dedication to the school board that he now serves as the president of (Go Patriots!) and to his family (Go Wendy, Jared and Sloane!). It is possible that Steve and I have spent more time talking about both of those subjects than we have the practice of law.

My two sons refer to Steve only by his full name – "Steve Frost" – and my oldest son recently told me that he was bummed "Steve Frost" retired because Steve wouldn't be at the office to give him treats the next time he visited,

as had become the custom. From the entire Bender family, we offer our congratulations to Steve Frost on this well-deserved recognition!

Jim Wheaton wrote:

One of the extraordinary things about pre-check-the-box LLCs was the way the frantic effort to make LLCs mainstream resulted in long-lasting friendships. That happened at ABA meetings, in a room at the Williamsburg Woodlands hotel over a case or so of cheap beer, and at random CLE programs sponsored by all sorts of people trying to use the relative few who knew anything about LLCs to educate the skeptical masses.

Sometimes those CLE invitations were a bit of a burden, but sometimes they were serendipitous, and that was the case in 1994 when I was asked to speak at a series of programs sponsored by Bill McKee. My wife and three-year old were ecstatic about the first of these, because the venue was the Disney Grand Floridian, but the best part of that experience for me was not proximity to a breakfast with Cinderella, but a couple of lunches with Steve Frost.

It's been 23 years since that seminar, and Steve and I have shared dozens of meals together in probably as many cities, as well as a few visits to concerts at Ravinia outside Chicago, and even a sublime afternoon with Toulouse-Lautrec at the Art Institute with Steve's late father-in-law, he of blessed memory. I call him when I need a Chicago restaurant idea, he pings me for the scoop on South Bend. Steve even let me wander down the hall of the Treasury unescorted one time to eavesdrop on Tim Geithner during the 2009 fiscal crisis. I've heard about his kids growing up, and he has shared in stories about mine, two of whom weren't yet born when we met. In 1994, I was still in the first half of my 10-year service on a local school board, which I stopped doing in 2000. Steve ignored my advice and started on his school board in Buffalo Grove (who knew that Illinois had buffalo?) in 2000, and is still going almost 20 years later -- a public service that we both know is the least appreciated in America. One of my biggest regrets about knowing Steve is that I find myself incompetent to share one of his other passions – golf.

Steven G. Frost to Receive the 2017 Martin I. Lubaroff Award

But none of these attributes of Steve as a friend tell the story of what a great lawyer he is. He is incisive, and unfailingly patient, which I presume is an advantage for leaders in the Uniform Laws community. He cares passionately about getting the right answer, and is willing to acknowledge that sometimes there is more than one right answer. He is curious, and encourages the curiosity of others. He is collegial and manifests a style that many of us remember as among Marty Lubaroff's best features, and he is wholly worthy of receiving this recognition that bears Marty's name.

Heather Jefferson wrote:

Steve Frost - Congratulations on a well-deserved award! You are a worthy recipient, and I am honored to know you.

Kaitlin Wolff wrote:

I cannot think of a more deserving recipient of the Martin I. Lubaroff award than Steve Frost. When I joined the Uniform Law Commission staff in 2015, I, along with my co-worker Brian, was immediately assigned to be the staff attorney on a strange-sounding project referred to as "Series." (The ULC really threw the newcomers into the deep end there!) Neither of us has been a transactional attorney, so we wondered how it was going to be spending time with this committee of business law experts. As it turns out, the committee was exceptional. Over the course of the past two years, we have watched the drafting committee, under Steve's leadership, create the most clear and comprehensive statute on series limited liability companies.

There is no doubt Steve has a brilliant legal mind, but what we've valued most is his kindness and character. He has always made us feel welcomed and part of the group, and we will always be grateful for that. Steve, now that the drafting phase is over, we look forward to working with you on the enactment side!

Brian Lewis wrote:

Steve Frost receiving the Martin I. Lubaroff award is a well-deserved honor. Steve embodies all of the qualities that the Lubaroff award represents. It has been an honor to have the opportunity to work with Steve through his

work with the Uniform Law Commission (ULC). It was an absolute pleasure working under Steve's leadership in the drafting of the Uniform Protected Series Act and I very much look forward to working with him in the future. I cannot thank him enough for his graciousness in being a guiding hand in the work that my fellow colleague, Kaitlin, and I have done at the ULC and his care in our well-being outside of the office. I always enjoy the opportunity to work with Steve as I think of him as being a brilliant mind and having a great sense of humor. He has taught me a great deal and has gracefully demonstrated patience and understanding in working with us young attorneys in an area of law that was initially foreign to us. Not only do I know that I can always depend on Steve as being a champion of the work of the Uniform Law Commission, but he is awesome judge of top-notch dining locations and is the ULC Commissioner who I often refer to as the "ultimate foodie." Congratulations on being awarded the Lubaroff award Steve! Job well done!

Allan Donn Wrote:

The adoption of the Uniform Protected Series Act by the Uniform Law Commission at its 2017 Annual Meeting reflected Steve Frost's scholarship and leadership in the field of unincorporated business organizations. Steve had served as the Chairman of the Study Committee appointed by the ULC to recommend whether or not the ULC should undertake a drafting project, and upon ULC's decision to proceed, Steve was appointed as the Chairman of the Drafting Committee.

The principal objective of the Drafting Committee appears to have been to prepare a statute that may fairly be called a model, to address the issues that were inadequately addressed in acts of the 15 jurisdictions that had series legislation, as distinguished from advocating a new form of business organization.

The first reading of what became the UPSA took place at the ULC's 2014 Annual Meeting. According to the Reporter, "The first reading provoked extensive and spirited discussion, which was at times quite skeptical."

In response to the reactions at the 2014 Annual Meeting, Steve determined that the next draft would take a fundamentally different

Steven G. Frost to Receive the 2017 Martin I. Lubaroff Award

approach. A revised version of the draft was read at the 2015 Annual Meeting. Although no action was taken at the meeting, a number of critical comments about the concept, as distinguished from technical aspects of the draft, were expressed.

Steve spoke with the individual Commissioners who had made negative comments to permit each of them to articulate the basis of the criticism. He reported to the Drafting Committee the result of those discussions and he, together with the Reporter Dan Kleinberger, made recommendations to the Drafting Committee to address the concerns and criticism that had been expressed. Based upon those efforts, a further revised draft was read at the ULC 2016 Annual Meeting. In response to further comments at that meeting, the Drafting Committee had at least 8 internet meetings that led to the final draft submitted to the 2017 Annual Meeting. At that meeting, the UPSA was read and approved by vote of the states, with 47 states voting “yes” and 1 abstention.

Dan Kleinberger wrote:

Those who have worked with Steve on the Protected Series project will understand when I say, “I’m really struggling with how to adequately describe his excellence.”

I have managed the following

- Wendy loves and cherishes him; ergo, he must be (and is) spectacular.
- Steve has a *gutte nshumah*. Steve is a *mensch*.
- Steve is always thoughtful, and, as David Ben Gurion said, “Thought is a strenuous art – few practice it, and then only at rare times.”
- As a lawyer, Steve exemplifies excellence. Of course, advising pension firms on investment vehicles is not a unique activity, but per Booker T. Washington, “Excellence is to do a common thing in an uncommon way.” Which Steve has done.

- Almost finally, two thoughts from Montaigne:

“Don’t take life too seriously. No matter what, you won’t get out alive – no special relevance to Steve, but a great thought nonetheless.

Of special relevance to Steve:

“It is good to rub and polish our brain against that of others.” It has been my good fortune to rub and polish my brain against Steve for many years, beginning with his pronouncement (and explanation) that uniform entity acts should not have profit allocation provisions, and, most recently (for the past four years), in the Protected Series project. For this any many other things, I am grateful to Steve.

- One last thought – I knew and worked with Marty. He had a powerful intellect coupled with a gentleness of character. In this and so many other respects, Steve truly deserves the Lubaroff award.

Steven G. Frost to Receive the 2017 Martin I. Lubaroff Award

The Martin I. Lubaroff Award was established in 2001 to honor the memory of Marty Lubaroff, who untimely passed away on January 1, 2001. Marty was the quintessential lawyer--careful, thorough, exacting, engaging, insightful, precise, provocative and persistent, while gentle, kind and courteous. He was a good friend and mentor to scores of lawyers in Delaware and throughout the United States and was an esteemed Delaware practitioner with the law firm of Richards, Layton & Finger. Marty was a long-time member of, and key participant in, the LLCs, Partnerships and Unincorporated Entities Committee. He chaired the Limited Partnerships Subcommittee at the time of his death.

Past Award Recipients are: 2001, Harry J. Haynsworth IV; 2002, Alan R. Bromberg; 2003, Allan G. Donn; 2004, Gerald V. Niesar; 2005, Peter D. Hutcheon; 2006, Howard N. Lefkowitz; 2007, George W. Coleman; 2008, Robert R. Keatinge; 2009, Michael A. Bamberger; 2010, Lewis R. Kaster; 2011, John H. Small; 2012, Larry E. Ribstein; 2013, Elizabeth S. Miller; 2014, Lauris Rall; 2015, James J. Wheaton; and 2016, Scott E. Ludwig.



Delaware Alternative Entities

Statutory Update

August 2017

**MORRIS
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TUNNELL**

2017 Amendments to Delaware's Alternative Entity Statutes¹

In its last session, the Delaware Legislature passed a number of amendments to the Delaware "alternative entity" statutes—the Delaware Limited Liability Company Act (the "*DLLCA*"), the Delaware Revised Uniform Limited Partnership Act ("*DRULPA*") and the Delaware Revised Uniform Partnership Act ("*DRUPA*"). All of the amendments were effective as of Aug. 1, 2017.

The amendments to the alternative entity statutes include a number of "clean up" changes as well as certain substantive improvements relating to, inter alia, delegation, formation requirements and limited partner safe harbors.

Amendments Common to Multiple Alternative Entity Statutes

Power to Delegate. [DLLCA § 18-407; DRULPA § 17-403(c); DRUPA § 15-401(l)]

Sections 18-407 of the DLLCA, 17-403(c) of the DRULPA and 15-401(l) of the DRUPA provide for the delegation by managers, members, general partners or partners, as applicable, of their rights and powers to manage and control the business and affairs of the applicable entity. These amendments confirm that managers, members, general partners or partners, as applicable, have the power and authority to delegate "any or all" of their rights, powers and duties to manage and control the business and affairs of the applicable entity, including core government functions, notwithstanding any other provision of the applicable act. These amendments are in response to the Delaware Court of Chancery decision in *Obeid v. Hogan*, CA. No. 11900-VCL (Del. Ch. Jun. 10, 2016), which raised questions concerning the scope of delegation authorized under these provisions.

Substantial Compliance with Formation Requirements. [DLLCA § 18-201(e); DRULPA § 17-201(e)]

Sections 18-201(a)(2) of the DLLCA and 17-201(a)(2) of the DRULPA currently provide that in order to form a limited liability company or limited partnership, a certificate of formation or certificate of limited partnership must be filed in the Office of the Secretary of State that sets forth the address of the registered office and the name and address of the registered agent of such entity. These amendments confirm that a certificate that contains the name of the registered agent and the address of the registered office, even if the certificate does not expressly designate such person or address as such, substantially complies with the statutory requirements.

Expansion of Definition of Entities that may Convert, Domesticate, Merge and Consolidate. [DLLCA §§ 18-209(a), 18-212(a), 18-214(a), 18-216(a); DRULPA §§ 17-211(a), 17-215(a), 17-217(a), 17-219(a); DRUPA §§ 15-901(a), 15-902(a), 15-903(a), 15-904(a)]

The conversion, domestication and merger and consolidation provisions of the DLLCA, the DRULPA and the DRUPA provide a broad list of entities that can engage in these transactions, including any unincorporated business or entity. These amendments confirm that any incorporated business or entity (in addition to a corporation) may engage in these transactions.

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Amendments to the DRULPA

Expansion of Limited Partner Safe Harbor. [DRULPA § 17-303(b)(1)]

Section 17-303(a) of the DRULPA provides that a limited partner of a limited partnership is not liable for the obligations of the limited partnership unless such limited partner is also a general partner or participates in the control of the business. Section 17-303(b) of the DRULPA provides a list of safe harbors, e.g., activities that do not constitute participation in the control of the business of a partnership. The amendment to Section 17-301(b)(1) of the DRULPA expands the safe harbor relating to being a stockholder of a corporate general partner, a partner of a partnership general partner, a member of an LLC general partner and a beneficiary of an estate or trust general partner to include holding any type of interest in any such general partner.

NJ-RULLCA Provisions Requiring Unanimous Consent of Members

By: *Gianfranco A. Pietrafesa*
Archer
Hackensack, New Jersey

There are numerous provisions in the New Jersey Revised Uniform Limited Liability Company Act (NJ-RULLCA)¹ requiring the consent of all members of a limited liability company (LLC) regarding certain actions. Fortunately, NJ-RULLCA implicitly authorizes the members of an LLC to agree in the company's operating agreement to require something less than unanimous consent of the members. N.J.S.A. 42:2C-11(c) expressly identifies the provisions an operating agreement may not alter or eliminate (unless done in accordance with NJ-RULLCA). By implication, any other statutory provisions may be altered or even eliminated in the operating agreement. In further support of this principle is the statutory language included in NJ-RULLCA about the freedom of contract and the enforceability of operating agreements.²

The following list identifies the actions requiring the unanimous consent or vote of the members under NJ-RULLCA. As noted, an operating agreement may change the required vote from unanimous to something less than unanimous, such as a simple majority or super-majority vote.

1. After the formation of an LLC, a person may become a member only with the consent of all existing members.³
2. Any action, matter or decision outside the ordinary course of business, regardless of whether the LLC is member-managed or manager-managed⁴ (This includes decisions to (a) sell, lease, exchange or otherwise dispose of all or substantially all of the LLC's property outside the ordinary course of business, (b) mergers, (c) conversions and (d) domestications.)⁵

¹ N.J.S.A. 42:2C-1 *et seq.*

² N.J.S.A. 42:2C-11(i).

³ N.J.S.A. 42:2C-31(c)(3).

⁴ N.J.S.A. 42:2C-37(b)(4) & -37(c)(4)(c).

⁵ See N.J.S.A. 42:2C-37(c)(4), -75(a), -79(a) & -83(a). (Note

3. Amending the operating agreement, regardless of whether the LLC is member-managed or manager-managed⁶
4. Authorizing or ratifying an act or transaction that violates the fiduciary duty of loyalty⁷
5. Expelling a member from the LLC pursuant to the provisions of NJ-RULLCA. However, the vote of the member being expelled is not required (obviously)⁸
6. Dissolving the LLC⁹
7. As noted, merging the LLC with or into another entity, converting the LLC into another type of business entity, and domesticating the New Jersey LLC into another state so that it becomes an LLC of the other state¹⁰
8. With regard to any merger, conversion or domestication, if a member will be subject to personal liability as a result of the merger, conversion or domestication, that member must approve the merger, conversion or domestication. Since almost all members will be similarly situated, any merger, conversion or domestication that will result in personal liability to the members will require the approval of all members.¹¹

that NJ-RULLCA uses the term "activities" instead of "business" because an LLC may be used for nonprofit purposes. See N.J.S.A. 42:2C-4(b); Uniform Law Commission Comment to RULLCA Section 108(b)).

⁶ N.J.S.A. 42:2C-37(b)(5) & (c)(4)(d).

⁷ N.J.S.A. 42:2C-39(f).

⁸ N.J.S.A. 42:2C-46(d).

⁹ N.J.S.A. 42:2C-39(a)(2).

¹⁰ N.J.S.A. 42:2C-75(a); 42:2C-79(a); 42:2C-83(a).

¹¹ N.J.S.A. 42:2C-86.

Do You Really Want To Be The Registered Agent?

By: *Stuart L. Pachman*
Brach Eichler LLC
Roseland, New Jersey

Statutes authorizing artificial entities (corporations and limited liability companies, for example) require the entity to designate a registered agent. The designated registered agent (i) provides the State someone through whom or which it may communicate with the entity and (ii) ensures the State's citizens someone on whom process may be served when the entity is sued.

There are two schools of thought on whether the lawyer forming a closely held entity should act as registered agent. Some believe it maintains a contact between lawyer and client. Also, by being the agent through which process is served, the opportunity to be engaged to defend the actions is enhanced.

On the other hand, as many lawyers have discovered, the client who calls with the emergent need for an entity to be formed immediately will, a day or two later, tell you that the deal collapsed and the need for an entity has evaporated. Whether or not you receive the courtesy of the second call, the client has no desire to deal with the fact that the entity was formed or the consequence of your being the agent shown on the State's records. The same result follows when a client, without informing you, retires, goes out of business, or for some other reason abandons his or her entity, or changes lawyers. You continue to receive communications from the State as the agent of an entity that is no longer your client. To be removed from the State's records, you must take the steps required by the relevant statute to resign and then hope that your efforts were successful.

Worse than these annoyances is the risk of personal liability. In *Int'l Env'tl. Mgmt., Inc. v. United Corp. Servs., Inc.*, 858 F.3d 1121 (8th Cir. 2017), a large multi-state corporation changed its registered agent, or at least thought it did, as did both the old and new agent. Things went awry, however. The document intended to effect the change in Missouri was misfiled resulting in the agent originally named remaining of record as the corporation's registered agent in

that State. When process was served on it sometime later, delivery to the corporation somehow failed. Much later the corporation learned that a substantial default judgment had been taken against it, which it paid when relief from the judgment was denied by the court. The corporation sued both its original agent and the one it believed had been named as successor. The latter settled. The former moved to dismiss and was successful in the trial court, but in a split decision the Court of Appeals reversed. The majority held that the agent shown on Missouri's records had a continuing duty to the corporation notwithstanding the fact that the corporation had informed it that the corporation was changing registered agents.

The disadvantages of serving as registered agent can be avoided by naming the individual client (or a service company) as such. Nonetheless, when a good client asks you to serve in that capacity, it remains pragmatic to do so.

Overhaul of Illinois LLC Act Provides Modernization, Increased Flexibility

By: *Thomas John "Tom" Kinasz*
Holland & Knight LLP
Chicago, Illinois

HIGHLIGHTS:

- Extensive changes made to the Illinois Limited Liability Company Act (the Act) will impact both existing and new LLCs.
- The changes are designed to adopt a "freedom of contract" approach for Illinois LLCs as well as give business owners and investors increased flexibility in drafting the governing provisions for their LLCs.
- The changes, which took effect on July 1, 2017, bring the Act into closer conformity with the Revised Uniform Limited Liability Company Act adopted by other states.

Significant changes have been made to the Illinois Limited Liability Company Act (the Act) that will impact both existing and new LLCs. These changes, which took effect on July 1, 2017, were designed in part to bring the Act into closer conformity with the Revised Uniform Limited Liability Company Act that has been adopted by numerous other states. The primary intentions of the changes are to adopt a "freedom of contract" approach for Illinois LLCs as well as give business owners and investors increased flexibility in drafting the governing provisions for their LLCs.

Key Highlights

A summary of the more significant changes of interest include the following:

1. Members are not automatically agents of the LLC. A member no longer is an agent of the LLC solely by reason of being a member. (Prior to the change, each member of a member-managed LLC and each manager of a manager-managed LLC was considered an agent of the LLC.) An LLC may file a Statement of Authority with the Illinois Secretary of State to identify a manager or member authorized to execute instruments related to the transfer of

real property or other transactions. Similarly, the LLC may file a Statement of Denial with the Secretary of State to deny any authority granted in the Statement of Authority.

2. Oral and implied operating agreements are now recognized. The Act states that an operating agreement is enforceable "whether or not there is a writing signed or record authenticated by a party against whom enforcement is sought, even if the agreement is not capable of performance within one year of its making."

3. Binding effect of operating agreement. The LLC is automatically bound by its operating agreement, even if does not expressly consent to the agreement. Any individual who becomes a member is deemed to agree to the operating agreement. The operating agreement may be entered into before, after or at the time of the filing of the LLC's Articles of Organization.

4. Presumed member-managed status of LLC. The LLC is deemed to be member-managed unless otherwise expressly stated in the operating agreement. The Articles of Organization filed with the Secretary of State will no longer specify management by members or managers. However, managers and members with manager authority must be reported in the Articles of Organization.

5. Member status. A person may become a member without acquiring an economic interest in the LLC or being obligated to contribute to the capital of the LLC.

6. Fiduciary duties. The operating agreement may eliminate or reduce a member's fiduciary duty of loyalty owed to the LLC by clear and unambiguous language. Also, the fiduciary duty of care may be altered, except to authorize intentional wrongdoing or knowing violations of law. The obligations of good faith and fair dealing may not be restricted or eliminated.

7. Rights to inspect LLC records. The Act changes a member's right to information so that the LLC is no longer required to automatically give the information to a dissociated member unless such member submits a written demand upon the LLC stating the records request and purpose, and the purpose must be proper or it may be denied. The LLC will have 10 days to respond to a member's request for records. Transferees of distributional interests have limited rights to request LLC records.

8. Judgment creditors of members. The rights of a judgment creditor of a member are modified, including limiting the creditor to a lien on a member's distributional rights.

9. Dispute resolution. Courts will now have the authority to resolve disputes between LLC members by ordering a remedy other than dissolution, including the purchase of a separating member's interest.

10. Dissociated members. The LLC is no longer required to purchase the interests held by a dissociated member.

11. Conversion/domestication. The Act provides expanded rights permitting conversion of an LLC into a different entity form (such as a corporation) and vice versa. The Act will now permit

domestication of a foreign LLC whereby it may become an Illinois LLC, and for an Illinois LLC to become an LLC in a foreign state.

12. Documenting the dissolution. Upon completion of the winding-up process in solution, Statement of Termination (replacing the Articles of Dissolution) is filed with the Secretary of State. Other changes apply to events of dissolution and how an LLC continues operation after dissolution.

13. Recognition of electronic records. Greater recognition of electronic records is available. The definition of "record" now reads "information that is inscribed on a tangible medium or that is stored in an electronic or other medium and is retrievable in perceivable form." All "writing" requirements are now subject to the Illinois Electronic Commerce Security Act. The act of signing a document has been expanded to cover electronic records: "sign" with respect to a record means to "adopt a tangible symbol" or "to attach to or logically associate with the record an electronic symbol, sound or process."

The preceding is not an exhaustive list of all changes that took effect on July 1. Because of these changes, amendments to operating agreements and/or the manner in which an LLC conducts business may be necessary.

Non-Waivable Provisions Under the New Jersey Revised Uniform Limited Liability Company Act

By: *Gianfranco A. Pietrafesa*
Archer
Hackensack, New Jersey

Almost all of the default provisions in the New Jersey Revised Uniform Limited Liability Company Act (NJ-RULLCA)¹ may be altered, except as otherwise provided in Section 11 of the statute.² Indeed, NJ-RULLCA provides that it “is to be liberally construed to give the maximum effect to the principle of freedom of contract and to the enforceability of operating agreements.”³ This article identifies and explains the statutory default provisions that may not be altered under Section 11 of the statute, the so-called ‘non-waivable’ provisions.

Litigation

A limited liability company (LLC) has the capacity to sue and be sued in its own name.⁴ An operating agreement may not vary an LLC’s right to engage in litigation.⁵

The Uniform Law Commission (ULC) August 19, 2015 Comments (2015 Comments) to its Revised Uniform Limited Liability Company Act (RULLCA) state that an LLC is an entity distinct from its members and that its members lack the power to alter that characteristic.⁶ This provision is likely a

carryover from the ULC’s general partnership act, which provides that a partnership is distinct from its partners. It is not a controversial provision.

Applicable Law

NJ-RULLCA provides that New Jersey law governs: 1) the internal affairs of a New Jersey LLC, and 2) the liability of a member as member and a manager as manager for the debts, obligations, or other liabilities of an LLC.⁷ An operating agreement may not vary this applicable law.⁸

The ULC 2015 comments state that an operating agreement may lawfully incorporate by reference the provisions of another state’s LLC statute.⁹ For example, an operating agreement of a New Jersey LLC may incorporate by reference Delaware’s LLC statute. New Jersey law would still govern the agreement, but Delaware’s LLC statute and the operating agreement would govern the members of the LLC to the extent not prohibited by NJ-RULLCA. As noted in the ULC 2015 comments, this approach raises complex drafting issues and is rarely, if ever, a good idea.

Court Power

A court has the power to enter orders regarding the signing and filing of records.¹⁰ An operating agreement cannot interfere with the court’s power in this regard.¹¹

Fiduciary Duties

Members of a member-managed LLC and managers of a manager-managed LLC have fiduciary duties of loyalty and care.¹² Although NJ-RULLCA provides that an operating agreement may not eliminate the duty of loyalty, the duty of care, or any other fiduciary

¹ N.J.S.A. 42:2C-1 et seq.

² N.J.S.A. 42:2C-11(C), as modified by N.J.S.A. 42:2C-11(D) Through 42:2C-11(G).

³ N.J.S.A. 42:2C-11(I).

⁴ N.J.S.A. 42:2C-5.

⁵ N.J.S.A. 42:2C-11(C)(1).

⁶ ULC 2015 Comment to Section 105(C)(2). NJ-RULLCA is Based on the ULC’s July 20, 2011 Version of RULLCA. See http://www.Uniformlaws.Org/Shared/Docs/Limited%20liability%20company/Ullca_Final_06rev.Pdf. Since then, the ULC Has Revised RULLCA and its Comments. The current version of RULLCA is dated Aug. 19, 2015. See [Http://www.Uniformlaws.Org/Shared/Docs/Limited%20liability%20company/ULLCA_Final_2014_2015aug19.Pdf](http://www.Uniformlaws.Org/Shared/Docs/Limited%20liability%20company/ULLCA_Final_2014_2015aug19.Pdf). N.J.S.A. 42:2C-11 is based on Section 110 of the 2011 version, which was revised and renumbered as Section 105 in the 2015 version. A table with cross-references of N.J.S.A. 42:2C-11, 2011 RULLCA Section 110 and 2015 RULLCA Section 105 accompanies this article.

⁷ N.J.S.A. 42:2C-6.

⁸ N.J.S.A. 42:2C-11(C)(2).

⁹ ULC 2015 Comment to Section 104(1).

¹⁰ N.J.S.A. 42:2C-21.

¹¹ N.J.S.A. 42:2C-11(C)(3).

¹² N.J.S.A. 42:2C-39(A) & -39(I)(1). See N.J.S.A. 42:2C-39(B) (Duty of Loyalty) and N.J.S.A. 42:2C-39(C) (Duty of Care).

duty,¹³ it further provides that, if not manifestly unreasonable,¹⁴ an operating agreement may restrict or eliminate the duty of loyalty,¹⁵ alter (but not eliminate) the duty of care,¹⁶ and alter or eliminate any other fiduciary duties, meaning fiduciary duties under the common law.¹⁷

Good Faith and Fair Dealing

The members and, if applicable, the managers must discharge their duties and exercise their rights under the operating agreement and NJ-RULLCA consistent with the contractual obligation of good faith and fair dealing.¹⁸ An operating agreement may not eliminate this obligation,¹⁹ but, if not manifestly

¹³ N.J.S.A. 42:2C-11(C)(4).

¹⁴ NJ-RULLCA addresses how a court is to determine whether a term in an operating agreement is manifestly unreasonable, but there is no case law explaining the term or its application. See Gianfranco A. Pietrafesa, The Manifestly Unreasonable Standard Under NJ-RULLCA, NJSBA Business Law Section Newsletter, Vol. 38, No. 1 (July 2014).

¹⁵ N.J.S.A. 42:2C-11(D)(1). In addition to eliminating or altering the duty of loyalty, an operating agreement may identify the specific types or categories of activities that do not violate the duty of loyalty. N.J.S.A. 42:2C-11(D) (2). For example, in a real estate holding company, the operating agreement will often provide that the ownership of other real estate by the members does not violate the aspect of the duty of loyalty prohibiting a member from competing with the LLC. See N.J.S.A. 42:2C-39(B)(3). See Also Gianfranco A. Pietrafesa, The Duty Of Loyalty Under The New Jersey Revised Uniform Limited Liability Company Act, 290 N.J. Lawyer Mag. 12 (Oct. 2014).

¹⁶ N.J.S.A. 42:2C-11(D)(3). Although an operating may alter the duty of care, it cannot authorize intentional misconduct or knowing violations of law, which is not surprising. *Id.*

¹⁷ N.J.S.A. 42:2C-11(D)(4). It is not clear whether there are any other fiduciary duties, but a court may conclude that a member or manager has the duty to maintain the confidentiality of the LLC's confidential information and the duty to make certain disclosures to the LLC, its managers and members.

¹⁸ N.J.S.A. 42:2C-39(D).

¹⁹ Every contract in New Jersey includes an implied covenant of good faith and fair dealing, which is identical to the contractual obligation of good faith and fair dealing; therefore, it makes sense that the contractual obligation of good faith and fair dealing cannot be eliminated. Note that the obligation includes the exercise of rights and the discharge of duties under NJ-RULLCA (in addition to those under the operating agreement), which makes sense since the statute serves as the default operating agreement in the absence of an operating agreement. See N.J.S.A. 42:2C-11(B) ("To The Extent That The Operating Agreement Does Not Otherwise Provide For A Matter Described In Subsection A. Of This Section, This Act Governs The Matter").

unreasonable, it may prescribe standards by which to measure the performance of the obligation.²⁰

Information Rights

Members, managers and even dissociated members have certain rights to receive information about the LLC.²¹ An operating agreement may restrict such rights, or the duties to provide such information, but may not do so unreasonably.²² In addition to restrictions or conditions in an operating agreement, an LLC may impose reasonable restrictions and conditions on access to and use of records and information, including designating information as confidential and imposing nondisclosure and safeguarding obligations on the recipient.²³

The ULC 2015 comments note that in determining whether a restriction is reasonable, a court might consider: 1) the danger or other problem the restriction seeks to avoid, 2) the purpose for which the information is sought, and 3) whether, in light of both the problem and the purpose, the restriction is reasonably tailored.²⁴

Judicial Dissolution

A court has the power and authority to dissolve an LLC on various statutory grounds.²⁵ An operating agreement may not vary the court's power to judicially dissolve a New Jersey LLC under these statutory grounds.²⁶ However,

²⁰ N.J.S.A. 42:2C-11(D)(5). There is no case law explaining the concept of prescribing standards to measure performance of the contractual covenant of good faith and fair dealing. See Gianfranco A. Pietrafesa, Standards To Measure Good Faith And Fair Dealing Under NJ-RULLCA, 216 N.J.L.J. 362 (May 5, 2014). See ULC 2015 Comment to RULLCA §105(C)(6) for examples of contract provisions purporting to create standards to measure performance of the contractual covenant of good faith and fair dealing.

²¹ N.J.S.A. 42:2C-40.

²² N.J.S.A. 42:2C-11(C)(6).

²³ N.J.S.A. 42:2C-40(G).

²⁴ ULC 2015 Comment to RULLCA 105(C)(8).

²⁵ N.J.S.A. 42:2C-48(A)(4) & (5). These statutory grounds include, but are not limited to, it being not reasonably practicable to carry on the LLC's business in conformity with the operating agreement, N.J.S.A. 42:2C-48(A)(4)(B), and oppression of one or more members by the managers or controlling members, N.J.S.A. 42:2C-48(A)(5)(B).

²⁶ N.J.S.A. 42:2C-11(C)(7).

an operating agreement can limit the remedies the court has the power to impose to dissolution only; for example, it can provide that a court cannot enter an order for the sale and purchase of LLC interests.²⁷

Winding Up a Dissolved LLC

An LLC in dissolution must wind up its business as provided in NJ-RULLCA.²⁸ An operating agreement may not vary this requirement.²⁹ For example, an LLC cannot continue its business indefinitely and cannot make distributions to members in lieu of payments to creditors.

Direct or Derivative Action

NJ-RULLCA provides members with the right to maintain direct and derivative actions.³⁰ An operating agreement may not unreasonably restrict such rights.³¹ The ULC 2015 comments note that reasonable provisions in an operating agreement include forum selection, mediation prior to litigation, arbitration of direct and derivative claims, waiver of jury trial and a demand in all derivative cases. By contrast, the ULC 2015 comments note that it would be unreasonable, by way of example, for an operating agreement to require a would-be derivative plaintiff to make demand regardless of futility.³²

Approval of Extraordinary Action

NJ-RULLCA requires the members to unanimously approve extraordinary action, such as a merger, conversion or domestication.³³ Nothing in the statute prevents an operating agreement from altering this unanimity require-

²⁷ ULC 2015 Comment to RULLCA 701(B) (“...[N.J.S.A. 42:2C-48(B)] Can Be Overridden By The Operating Agreement. Thus, The Members May Agree To Restrict Or Eliminate A Court’s Power To Craft A Lesser Remedy, Even To The Extent Of Confining The Court (And Themselves) To The All-Or-Nothing Remedy Of Dissolution.”).

²⁸ N.J.S.A. 42:2C-49(A) & -49(B)(1).

²⁹ N.J.S.A. 42:2C 11(C)(8).

³⁰ N.J.S.A. 42:2C-67 through -72.

³¹ N.J.S.A. 42:2C-11(C)(9).

³² See ULC 2015 Comments to Section 105(C)(11).

³³ N.J.S.A. 42:2C-75(A), -79(A) & -83(A)(1).

ment to a simple majority or supermajority requirement.

However, if a merger, conversion or domestication will result in the members having personal liability as the owners of the surviving, converted or domesticated company, then the members will have the right to unanimously approve the action.³⁴ For example, if an LLC for some reason wants to convert to a general partnership, it must receive the unanimous approval of the members since they would have unlimited personal liability as partners in the general partnership. In such situations, an operating agreement may not restrict a member’s right to approve such a merger, conversion or domestication.³⁵

Rights of Third Parties

An operating agreement may restrict the rights of a member and manager,³⁶ as well as a dissociated person and transferee,³⁷ but not the rights of third parties, such as creditors.³⁸

Indemnification and Exculpation

NJ-RULLCA provides for an LLC’s indemnification of members, managers and others.³⁹ However, an operating agreement may alter and even eliminate such indemnification.⁴⁰ An operating agreement may also eliminate a member or manager’s personal liability to the LLC and its members for money damages.⁴¹ However, under no circumstances may an

³⁴ N.J.S.A. 42:2C-86(A).

³⁵ N.J.S.A. 42:2C-11(C)(10). An operating agreement cannot sidestep such a unanimous vote requirement through a provision allowing an amendment of the agreement with less than the unanimous consent of the members.

³⁶ N.J.S.A. 42:2C-11(C)(11).

³⁷ *Id.*; N.J.S.A. 42:2C-13(B). For example, an operating agreement may restrict a transferee of a transferable interest from becoming a member unless the transferee satisfies certain conditions, such as agreeing to be bound to the terms of the operating agreement.

³⁸ N.J.S.A. 42:2C-11(C)(11). As noted, an operating agreement may limit the power of a court to dissolution of an LLC as opposed to the grant of lesser remedies for oppression. See *Supra* N.27.

³⁹ N.J.S.A. 42:2C-38.

⁴⁰ N.J.S.A. 42:2C-11(G).

⁴¹ *Id.*

operating agreement permit indemnification or exculpation of a member or manager for certain 'bad acts,' such as breaching the duty of loyalty,⁴² receiving an improper personal benefit, making improper distributions,⁴³ intentionally inflicting harm on the LLC or a member,⁴⁴ or intentionally violating criminal law.⁴⁵

Conclusion

Section 11 provides that certain provisions of NJ-RULLCA cannot be altered—the so-called non-waiv-able provisions. However, as noted, many of the non-waivable provisions may, in fact, be altered as provided in NJ-RULLCA.

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Table of Applicable Provisions under NJ-RULLCA v. 2011 RULLCA and 2015

NJ-RULLCA	RULLCA (7-20-	RULLCA
	<i>NJ law based on</i>	
42:2C-11(c)(1)	110(c)(1)	105(c)(2)
42:2C-11(c)(2)	110(c)(2)	105(c)(1)
42:2C-11(c)(3)	110(c)(3)	105(c)(4)
42:2C-11(c)(4)	110(c)(4)	105(c)(5)
42:2C-11(c)(5)	110(c)(5)	105(c)(6)
42:2C-11(c)(6)	110(c)(6)	105(c)(8)
42:2C-11(c)(7)	110(c)(7)	105(c)(9)
42:2C-11(c)(8)	110(c)(8)	105(c)(10)
42:2C-11(c)(9)	110(c)(9)	105(c)(11)
42:2C-11(c)(10)	110(c)(10)	105(c)(13)
42:2C-11(c)(11)	110(c)(11)	105(c)(15)
42:2C-11(g)	110(g)	105(c)(7)

⁴² However, as noted, an operating agreement may eliminate the duty of loyalty. *Supra* n.15.

⁴³ See N.J.S.A. 42:2C-36.

⁴⁴ This prohibition against indemnifying or exculpating a member or manager for intentionally inflicting harm on a member includes oppressive conduct.

⁴⁵ N.J.S.A. 42:2C-11(G).

Indiana Court Addresses, For Purposes of Diversity Jurisdiction, Classification of a Chinese Business Organization

By: Thomas E. Rutledge
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A lawsuit may be brought in or removed to federal court pursuant to “diversity” jurisdiction, which requires, *inter alia*, that none of the defendants have the same citizenship as do any of the plaintiffs. In addition, diversity jurisdiction requires that the amount in dispute exceed \$75,000. The citizenship of a natural person is dependent upon their “domicile.” For business organizations, there are two tests that are applied. If the business organization is a corporation, it has the citizenship of its jurisdiction of organization and that in which it maintains its principal place of business. Alternatively, if the business organization is “unincorporated,” there is attributed to it the citizenship of each of its owners. The application of this test becomes particularly difficult with respect to foreign business organizations as it is necessary to first determine whether they are equivalent to a corporation or, rather, are unincorporated. Recently the Federal District Court for the Northern District of Indiana was presented with this challenge. *Nanshan America Advanced Aluminum Technologies, LLC v. Nemick*, Case No. 4:13-CV-078 JD, 2017 WL3333963 (N.D. Ind. August 4, 2017).

The substance of this dispute involves apparently blatant embezzlement by Nemick against his employer Nanshan. The court, *sua sponte*, in ruling upon a motion for default judgment as to breach of fiduciary duty, considered first whether it had jurisdiction in the matter.

The plaintiff, Nanshan, is an LLC and therefore has the citizenship of each of its members. The only member of Nanshan is a Shandong Nanshan Aluminum Co., Ltd., a Chinese entity. So the question was, would Shandong be treated as a corporation or as an unincorporated association? In determining that it is the former, the court wrote:

According to Nanshan’s supplemental filing, Shandong is organized as a “Gufen Youxian

Gongsi,” which is also referred to as a “company limited by shares.” Such an entity provides limited liability for equity investors and also shares the features of personhood, including the right to contract and litigate in its own name. It also appears that the entity has a perpetual existence unless otherwise specified in its articles of association. Shares are also alienable, as such companies can be listed on a stock exchange, and Shandong is in fact listed on the Shanghai Stock Exchange. The entities are also governed by a board of directors, which employs a manager who is responsible for the company’s operations. Company Law of the People’s Republic of China, art. 108, 113. A Gufen Youxian Gongsi is also required to be treated as a corporation for U.S. tax purposes. 26 C.F.R. § 301.7701-2(b)(8)(i).

The Seventh Circuit has held that entities from other countries that share these characteristics qualify as corporations for the purposes of diversity jurisdiction. *E.g., BouMatic*, 759 F.3d at 791. It has also held that companies “limited by shares” under the laws of other countries are equivalent to corporations for these purposes. *Superl Sequoia Ltd. v. Carlson Co., Inc.*, 615 F.3d 831, 832 (7th Cir. 2010) (holding that a “Hong Kong business organization ‘limited by shares’ “ is “equivalent to a corporation in the United States”); *Lear Corp. v. Johnson Electric Holdings Ltd.*, 353 F.3d 580, 583 (7th Cir. 2003) (“[A] business organization ‘limited by shares’ under Bermuda law is equivalent in all legally material respects to a corporation under state law.”). Thus, the Court finds that Shandong is properly treated as a corporation for purposes of diversity jurisdiction. And because it is incorporated and has its principal place of business in China, Shandong (and thus Nanshan) is a citizen of China, meaning that complete diversity exists and the Court has subject

matter jurisdiction under §
1332(a)(2).

As an aside, I believe this is the first opinion to, in the context of classifying a foreign entity as either incorporated or unincorporated, to have referenced the check-the-box classification regulations; I have previously argued that the courts should make that reference in these determinations. See Rutledge, *Recent Developments in Diversity Jurisdiction for LLCs and Other Unincorporated Forms*, JOURNAL OF PASSTHROUGH ENTITIES (Nov./Dec. 2015) , available at SSRN: <https://ssrn.com/abstract=2697285>.

Direct Versus Derivative Distinction Applied in Single-Member LLC

In a recent decision from the North Carolina Business Court, the direct versus derivative distinction was applied to dismiss claims for breach of fiduciary duty brought by the LLC's sole member. *Timbercreek Land & Timber Co., LLC v. Robbins*, 17 CVS 140, 2017 NCBC 64, 2017 WL 3214427 (Sup. Ct. N.C. July 28, 2017).

Hooper, who had no experience in the timber industry, thought it was a good investment opportunity. In turn, Robbins, who represented that he had extensive experience in the timber industry, needed financing. To that end, Hooper caused Timbercreek Land & Timber Co., LLC to be organized with Hooper as the sole member. It appointed Robbins as the LLCs manager, with authority to oversee all aspects of the LLC's business operations. Ultimately, the trust placed in Robbins was unjustified. Rather, he engaged in a far-reaching program that included embezzlement, kickbacks, misappropriation of company assets, misappropriation of opportunities, etc. When suit was ultimately brought against him by both the Timbercreek LLC and Hooper individually, Robbins sought to dismiss all of the claims for breach of fiduciary duty, claiming he was not subject to any such duties.

With respect to the LLC's claims, the court, applying a provision of the North Carolina LLC Act imposing fiduciary duties upon company officials who are not themselves managers (N.C. Gen. Stat. § 57D-3-21(b)), easily dismissed the allegations that Robbins was not subject to fiduciary obligations. The claims for breach of fiduciary duty brought by Hooper himself were, in contrast, dismissed. Applying the direct versus derivative distinction, the court could not within the pleadings find any special duty owed by Robbins to Hooper; rather, Robbins' obligations were owed to the LLC. This distinction was applied notwithstanding that the Timbercreek LLC was entirely owned by Hooper.

**Delaware Chancery Court Rejects
Naked Assertion That Minority
Member Owes Fiduciary Duties**

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In a decision rendered by the Delaware Court of Chancery (Glasscock, V.C.), there was rejected the naked assertion that the minority member of the Delaware LLC is bound by fiduciary obligations. *Re: Beach To Bay Real Estate Center LLC v. Beach To Bay Realtors Inc.*, Civ. Act. No. 10007-VCG, 2017 WL 2928033 (Del. ch. July 10, 2017).

The facts of this case are rather involved, if only because it involves a number of related companies with nearly indistinguishable names. Still, ultimately, this came down to a dispute with respect to the winding up and termination, with related settling of accounts, of a failed real estate venture to which only one of the parties had made significant capital contributions beyond the original. Also complicating the case was the fact that there was no integrated written operating agreement, but rather a series of alleged oral agreements and one writing, it conflicting in part with the alleged oral contract.

In this decision, the court ruled on motions to dismiss that were filed in 2014. At that time, the parties requested that the court hold off on consideration as they were pursuing settlement discussions. Finally, in 2017, on the court's own motion, consideration was given to those arguments. Vice Chancellor Glasscock's description of this case's history is worth reading, namely:

In Yorknapatawpha County, Faulkner tells us, the "past is never dead. It's not even past." It must be so in Sussex, if this case is any indication. This matter involves a Sussex-centered

real estate sales venture, ultimately unsuccessful and, according to the Plaintiffs, giving rise to a dog's breakfast of claims and accountings, mostly concerning acts taking place during the time of the administration of the second President Bush. The Defendants moved to dismiss three of the counts. Three years ago. The matter was fully briefed in 2014, and oral argument had been schedule. I continued the argument, at the parties' request, because they were "exploring" settlement. Outside the litigation, the world continued to turn. Births and deaths occurred, heartaches were endured, aspirations were pursued, wars were fought. Inside the litigation, in the micro-world of *Beach to Bay v. Beach to Bay*, time stood still. Apart from rousing themselves to answer, in desultory fashion, occasional proddings from this Court (themselves, I admit, less than energetic), the parties were content in a world slowed to the pace of matter chilled to near-absolute zero. Eventually, following a mandatory appearance of counsel at a call of the calendar, sufficient thaw set in to revive consideration of this partial motion to dismiss. The parties consented – that is, impliedly consented by failing to respond to a letter from the Court – to consideration of the briefs without amendment or update, and sans oral argument. Therefore, I have addressed the issues as fixed in the briefs from 2014 like flies in amber.

But back to the merits. The plaintiff, in its complaint, alleged that the defendant owed a fiduciary duty to the plaintiff and failed to appropriately discharge that obligation by means of certain self-dealing transactions. The defendant sought dismissal of this claim on the basis that the plaintiff had not demonstrated that a fiduciary duty existed to begin with. The parties were in agreement that a manager/managing member of a Delaware LLC does owe fiduciary duties, but that did not extend to minority members. Rather, the Chancery Court found:

On the face of the Complaint, minority membership is the sole allegation that purports to create a fiduciary duty. That is insufficient as a matter of law. Thus, the pleading that [the minority member] owed fiduciary duties to [the majority member] falls short.

**From the Most Recent Issue of the
BUSINESS LAWYER**

David L. Bury, Jr. and Thomas T. McClendon, *Planning For The Unexpected: Drafting Operating Agreements To Protect LLC Members From Another Member's Bankruptcy*, 72 BUSINESS LAWYER 981 (Fall 2017)

E. Norman Veasey and Jane M. Simon, *The Conundrum of When Delaware Contract Law Will Allow Evidence Outside The Contract's "Four Corners" In Construing and Unambiguous Contractual Provision*, 72 BUSINESS LAWYER 893 (Fall 2017)

Courts Disagree as to the Standard for Issuing a Charging Order; Is the Judgment-Debtor a Member?

By: Thomas E. Rutledge
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As a vehicle for collecting on a judgment, a charging order may be issued against a judgment-debtor's interest in a partnership, limited partnership or LLC, functioning essentially as a garnishment of whatever distributions that company would otherwise make to the judgment-debtor. Pursuant to the charging order, those amounts are paid to the judgment-creditor. In a pair of recent decisions, courts disagreed as to what level of showing must be made that the judgment-debtor is indeed a member/partner in the LLC/partnership that would be subject to the charging order.

In the first of these decisions, the court held, in effect, that there is a very low threshold for the issuance of a charging order. *Seufret v. Temple Management, LLC*.¹ In this instance, the judgment-creditor asserted that the judgment-debtor, Bergman, was a member in 660 Sherman, LLC, and that his interest therein should be subject to a charging order. An objection thereto was filed on the basis that the plaintiff had not made a showing that of the judgment-debtor held an interest therein. The court overruled that objection, writing:

If 660 Sherman, LLC is served with the charging order and owes no debt to the defendant, 660 Sherman, LLC is under no jeopardy. If a dispute arises about whether Bergman is owed a debt by 660 Sherman, LLC, that dispute can be presented to this court for resolution at a future date with notice to all relevant parties.

In contrast, in a decision out of Missouri, the judgment-creditor seeking a charging order was held to a much higher standard. *St. Louis Bank First v. Kohn*.² Therein, the court of appeals reversed a lower decision granting charging orders with respect to the judgment-debtor's alleged interest in certain partnerships and

LLCs. On the basis that there had not been a sufficient showing that in fact the judgment-debtor was a member/partner in those ventures, the award of the charging orders was reversed.

IMHO, the *Seufret* decision is the better of the two. Vis-a-vie the LLC, the charging order is a passive obligation to direct to the judgment-creditor what would otherwise be paid to the judgment-debtor. For that reason, little proof of the judgment-debtor's interest in the LLC need be shown. Rather, even as the statute is silent as to the point, the judgment-creditor should be awarded a charging order on "information and belief" that the judgment-debtor is a member/assignee. If in fact the judgment-debtor is not in fact a member/assignee of the LLC, it is not obligated to do anything as there are no payments to divert to the judgment-creditor.

¹ 2017 WL 2622347 (Conn. Sup. Ct. May 25, 2017).

² 517 S.W.3d 666 (Mo. Ct. App. 2017).

Recent Changes to Delaware's Alternative Entity Acts as a Result of Obeid v. Hogan

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Delaware has recently revised its Limited Liability Company Act (DLLCA), its Revised Uniform Partnership Act (DRUPA), and its Revised Uniform Limited Partnership Act (DRULPA) to address concerns raised by the Delaware Chancery Court opinion in *Obeid v. Hogan*.¹ The amendments to all three alternative entity acts are effective as of Aug. 1, 2017.

The amendments all address the power of those governing alternative entities to delegate their power and authority, which was called into question in *Obeid* when the Delaware Chancery Court addressed the all too common use of a corporate-like "Board of Directors" for managing an LLC. Although LLCs are beloved for their contractual flexibility, the use of certain "corporate" aspects of governance in LLCs can become problematic, as the *Obeid* case demonstrated.

There were two cases in 2016, which addressed aspects of the "corporification" of LLCs, which raised concerns: *Obeid v. Hogan*² and *Richardson v. Kellar*.³ Since this article is focused on the recent Delaware amendments to its alternative entity statutes, it will examine the *Obeid* opinion and the resulting Delaware amendments to the LLC and partnership statutes. I recommend you also read the *Richardson* opinion by the North Carolina Supreme Court in yet another LLC member dispute.

Obeid involved a dispute among the three owners of two LLCs which owned and managed a successful portfolio of 11 hotel and 22 commercial properties. Both LLCs were owned by the same three members with equal 1/3 interests. All three members were also named as members of the "Board of Directors" of one LLC, and as "Managers" of the other LLC. In its opinion, the Court designated one of the LLCs as the "Corporate LLC" because it utilized

a "board of directors" comprised of the three members for its governance. The second LLC was called the "Manager-Managed LLC" by the Court throughout its opinion because it was managed by the three members but in their capacity as "Managers" as provided in the LLC Agreement.

Prior to the dispute, William Obeid was tasked with managing the portfolio of hotel properties, and his other two co-members were charged with managing the portfolio of commercial properties. That is, until the other two co-members took action to remove Obeid from power.

The other two co-members took action by majority vote to remove Obeid as the President of the Manager-Managed LLC, replacing him with one of his co-members, and they also voted to remove him as a member of the Board of Directors of the Corporate LLC.

Obeid initiated litigation against his co-members in multiple state and federal courts challenging their actions. One of the actions was a derivative action in New York brought by Obeid on behalf of both LLCs. Consequently, the two LLCs acting through the other two co-members as directors in the Corporate LLC and as Managers in the Manager-Managed LLC, retained Michael Hogan, a retired Federal judge, to serve as the special litigation committee for both LLCs to evaluate the claims brought by Obeid in the derivative action. Importantly, Hogan was not named as a "director" of the Corporate LLC, nor was he named as a "Manager" of the Manager-Managed LLC.

Following the appointment of Hogan as the special litigation committee, Obeid filed the lawsuit in Delaware seeking a determination that Hogan was not properly appointed as the special litigation committee for either LLC, because he was not a director of the Corporate LLC, nor a manager of the Manager-Managed LLC. Obeid also contested the actions of his co-owners in removing him as the President of the Manager-Managed LLC.

The Chancery Court in a far reaching opinion by Vice-Chancellor J. Travis Laster addressed the use of a "corporate-like governance structure" for a Delaware LLC. He acknowledged that Delaware approved of the contractual flexibility of LLCs which allowed the

¹ CA No. 11900-VCL (Del. Ch. June 10, 2016).

² CA No. 11900-VCL (Del. Ch. June 10, 2016).

³ 2016 WL 4165887 (Sup. Ct. N.C. Aug. 2, 2016).

owners to create corporate-like governance structures; however, in so doing, he noted that members of an LLC should be aware that there could be unintended consequences. The Vice Chancellor concluded that if an LLC was set up to be governed like a corporation, the parties should expect that a court would draw on corporate law principles when addressing actions by the corporate styled governing body. The court declared that a “derivative suit is a corporate concept grafted onto the LLC form”, and further that case law governing corporate derivative suits is generally applicable to derivative suits on behalf of an LLC.

So the court examined *Zapata Corp. v. Maldonado*,⁴ which held that a properly constituted corporate board committee could serve as a special litigation committee. Vice Chancellor Laster concluded that since a special litigation committee is not an ‘ordinary course’ action in the corporate context, it should be undertaken only by one or more members of the board of directors. The court ignored the fact that the board of directors of the Corporate LLC was comprised of named defendants, therefore they could not be independent and disinterested. The Chancery Court nonetheless ruled that former Judge Hogan could not function as a special litigation committee for either LLC because he was not a director of the Corporate LLC, nor a Manager of the Manager-Managed LLC.

Surprisingly, the Vice Chancellor concluded that a Manager-Managed LLC was sufficiently analogous to a board of directors-managed LLC, to allow the court to apply the same reasoning that it applied in the Corporate LLC context, *i.e.*, that it was enough of a corporate-like governance structure to be controlled by the Zapata case, which would have required that an appointee to a special litigation committee be a member of the Board of Managers of the Manager-Managed LLC. This reasoning was surprising to say the least, and disturbing to many LLC watchers.

The result in Obeid was so disturbing that Delaware has now enacted amendments to its alternative entity statutes, all of which are intended to make it quite clear that managers, members, general partners or partners, as applicable, have the power and authority to

delegate “any or all” of their rights, powers and duties to manage and control the business and affairs of the applicable entity, including core government functions, notwithstanding any other provision of the applicable act. See revised Section 18-407 of the DLLCA, Section 17-403(c) of the DRULPA and Section 15-401(l) of the DRUPA.

Florida lawyers should take note that the Florida Revised LLC Act, Section 605.04071, provides that members or managers of a Florida LLC have:

“the power and authority to delegate to one or more other persons the member’s or manager’s, as the case may be, rights and powers to manage and control the business and affairs of the limited liability company, including the power and authority to delegate to agents, boards of managers, members, or directors, officers and assistant officers, and employees of a member or manager of the limited liability company, and the power and authority to delegate by a management agreement or similar agreement with, or otherwise to other persons.”

Although the broad statutory statement of delegation in the Florida Revised LLC Act should be sufficient to preclude a result like the one in Obeid, it may be prudent for Florida to consider a tweak to the statutory language to be doubly certain that anyone may be appropriately delegated “any or all” right or power to act, including serving as a special litigation committee, without the necessity of being a member, manager, or director (if a “board of directors” is utilized as the governing body of the LLC).

⁴ 43 A.2d 779 (Del. 1981).

Fun and Games and Diversity Jurisdictions; and Now the Rest of the Story

In a recent case out of Louisiana, the court considered the evidence necessary to demonstrate that a now former member had indeed been bought out of an LLC, with the effect that diversity jurisdiction would thereafter exist. An illuminating footnote discussed the back story of this transaction and how diversity jurisdiction had, from at least one perspective, been manufactured. *HomeLife in the Gardens, LLC v. Landry*, Civ. Act. No. 16-15549, 2017 WL 3189220 (E.D. La. July 27, 2017).

Relying upon federal diversity jurisdiction i.e., that none of the defendants shared the same citizenship as any of the plaintiffs and the amount in controversy exceeded \$75,000, HomeLife in the Gardens LLC brought this action in federal court against Landry. Landry's basis for seeking dismissal of the complaint was that diversity did not exist because one of the members of the plaintiff, Schmidt, was a citizen of Louisiana, as was she, thereby precluding diversity jurisdiction. Schmidt admitted that he had been a member of the LLC, but that his interest therein had been bought out. In support of this assertion, there were tendered to the court bank records documenting the transfer of funds pursuant to which the transaction took place, it happening on October 7, 2016. Schmidt as well file what was apparently an affidavit ("Schmidt declared under penalty of perjury") explaining that he sold his interest in the company on October 7, 2016. In that this complaint was filed after that October 7 date on which Schmidt ceased to be a member of the plaintiff, diversity jurisdiction was present.

But then, the rest of the story. In a footnote, the court explained how this complaint followed on one voluntarily dismissed when the plaintiffs apparently recognized that diversity jurisdiction was lacking, leading to the Schmidt buyout so that the suit could be refiled. Specifically, at footnote 8, the court wrote:

The Court notes that the present case is not the first case to feature a dispute between these parties. On September 27, 2016, these same plaintiffs filed suit against Landry in this Court asserting substantially the same claims as in the present case. See *Rankey et al. v. Landry*, No. 16-14968, Dkt. 1 (E.D. La. 2016). This first case was voluntarily dismissed by the plaintiffs on October 7, 2016-the same day that Schmidt sold his stake in HomeLife. See *id.*, Dkt. 11. Schmidt represents to the Court that the dismissal of the first case was to permit "additional time" to "investigate the citizenship of the parties." Case No. 16-15549, R. Doc. No. 43-1, ¶ 9. Schmidt stretches the term "investigate" to its breaking point: Schmidt did not want time to "investigate the citizenship of the parties," but rather wanted time to refile the case after changing HomeLife's citizenship. By first selling off his interest in HomeLife and then refiling the case, Schmidt created the complete diversity that – it is now obvious – was lacking in the first case. While Schmidt and HomeLife should have been more forthright with the Court, current law permitted them to act as they did. See *Grupo Dataflux v. Atlas Global Group, L.P.*, 541 U.S. 567, 581 (2004).

Curci (?)

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The bottom line is that LLCs (and partnerships) are not meant to be asset protection devices to protect the assets of a member from his or her own creditors. Instead, they are meant to be vehicles for bona fide commercial enterprises, and not just -- as with Baldwin and his wife -- somebody's personal piggy bank. However, LLCs and partnerships are commonly misused for this latter purpose, and so it should surprise nobody that the courts will employ an equitable remedy such as reverse veil piercing to cut through this misuse.

Alter ego cases, including reverse veil piercing cases, are fundamentally Cases of 'No'. Creditor rights attorneys will ask debtors whether an LLC or partnership has any employees, any customers, any vendors, conducts any marketing, or does any of the numerous other things that bona fide commercial enterprises do. Get enough 'No' answers, and you've proved alter ego. For a debtor to simply say that the entity is a "holding company" isn't enough. Here, Baldwin answered more than enough questions in the negative for the trial court to find (if it desired on remand) that JPBI was simply his personal piggy-bank, and little more. That, in a nutshell, is what makes for reverse veil piercing.

EXECUTIVE SUMMARY

In *Postal Instant Press, Inc. v. Kaswa Corporation*, the California Court of Appeals held that the concept of reverse veil piercing would not be recognized to pierce the veil of a corporation so as to allow creditors of a shareholder to take the assets of the corporation. This decision has been widely interpreted to mean that reverse veil piercing doesn't exist in California at all. But in a recent opinion, *Curci Investments, LLC v. Baldwin*, the California Court of Appeals stated that while disallowing reverse veil piercing for a corporation makes sense because a creditor has the ability to levy upon the debtor's shares, it makes little sense as applied to a debtor's LLC where the creditor is restricted to a charging order, and thus distinguished *Postal Instant*

Press. Further, the California Court of Appeals applied California law to determine the issue of reverse veil piercing, and not Delaware law although the debtor's LLC was formed in Delaware.

FACTS

California real estate developer James P. Baldwin formed a Delaware LLC called JPBI Investments LLC ("JPBI"), with Baldwin himself owning a 99% membership interest and his wife owning the other 1%, for the exclusive purpose of "holding and investment Baldwin and his wife's cash balances". Baldwin was the manager and CEO of JPBI, and makes all the determinations as to when he makes distributions to the members, i.e., to himself and his wife.

JPBI was formed in 2004, and in 2006, Baldwin individually borrowed \$5.5 million from a lender, with the promissory note eventually being owned by Curci Investments, LLC. Baldwin promised to pay back the note, with interest, by January 2009.

One month after signing the promissory note, Baldwin created eight family trusts for the benefit of his grandchildren, with Baldwin's children as the trustees. (Curiously, at least one of Baldwin's sons was unaware that he was a trustee of one such trust, even though he signed the trust document.) Then, Baldwin caused JPBI to loan \$42.6 million to three family partnerships that were formed by Baldwin for ostensible estate planning purposes. These loans were documented by promissory notes to JPBI that were to be repaid by January, 2015.

January 2009 came and went without Baldwin paying on its note owed to Curci, so Curci filed suit and, in 2012, won a judgment against Baldwin for \$7.2 million.

Meanwhile the three family partnerships were also not making payments on their notes to JPBI, and Baldwin caused JPBI to extend the terms of repayments of those notes to 2020. So far, no payments have been made on those notes.

Curci then obtained charging orders against Baldwin's interest in 36 entities in which he had an interest. The charging orders established liens on Baldwin's interests, and

required that distributions be re-routed to Curci until its judgment was paid. Probably not surprisingly, none of these entities made distributions, despite the fact that between 2006 and 2012 they had previously distributed about \$178 million to Baldwin and his wife.

California decisional law allows for a procedure under California Code of Civil Procedure 187 by which a creditor may add an alter ego of the debtor to the judgment, such that the alter ego itself becomes a judgment debtor. Curci filed such a motion to add JPBI to its judgment against Baldwin.

It is here that I must digress. In 2008, the California Court of Appeals decided in *Postal Instant Press, Inc. v. Kaswa*, 162 Cal.App.4th, 77 Cal.Rptr.3 96 (2008), that so-called "reverse veil piercing" (the piercing of the legal separateness of an entity to satisfy the judgment against an owner) did not apply to allow a creditor to reverse-pierce the veil of a corporation. This was largely because the creditor had another remedy, which was to levy on the debtor's shares in the corporation:

The judgment creditor can enforce the judgment against the shareholder's assets, including shares in the corporation. Upon acquiring the shares, the judgment creditor will have whatever rights the shareholder had in the corporation.

Although *Postal Instant Press* applied only to a corporation, that opinion has been widely overstated by some litigants and commentators as holding that "reverse veil piercing does not exist in California".

That presumption will now be tested as we return to our case. The trial court ruled against Curci, holding that *Postal Instant Press* meant that reverse veil piercing was not viable in California, even as applied to an LLC instead of to a corporation. Curci appealed.

After a lengthy discussion of the section 187 procedure, alter ego and veil piercing, and what constitutes reverse veil piercing, the Court of Appeals went directly to the heart of the issue: Did *Postal Instant Press* create a blanket prohibition in California against reverse veil piercing, or was it limited to reverse veil piercing against a corporation?

The Court of Appeals noted that allowing reverse veil piercing as to a corporation upset the normal scheme of California's enforcement of judgment laws, as it allowed a creditor to by-pass the traditional remedy of levying on a debtor's shares in a corporation and then using those shares to get at the corporation's assets by voting, etc. Thus, *Postal Instant Press* was correctly decided as it related to corporations.

However, the Court of Appeals noted that the *Postal Instant Press* decision was limited to corporations, and did not go so far as to say that there would be no reverse veil piercing as to LLCs. But LLCs are not corporations, and are treated differently for judgment enforcement purposes. Unlike corporate shares, a debtor's interest in an LLC may not be levied upon, but instead is subject to a charging order, which simply places a lien on the debtor's economic rights to distributions, *i.e.*, a creditor who obtains a charging order doesn't also acquire any voting rights in the LLC, as opposed to a creditor that levies on corporate shares, who does. Apples and oranges.

The Court also distinguished the facts of *Postal Instant Press* because the corporation there had other non-debtor shareholders who would have been adversely affected by reverse veil piercing, but here it was only Baldwin and his wife who owned the interests in JPBI, and even the wife's 1% interest was available to creditors as community property. In other words, there were no "innocent" parties which would be adversely affected by reverse veil piercing JPBI. But reverse veil piercing should remain a remedy of last resort, said the Court of Appeals, and should only be granted if a creditor can show that all other remedies were unavailable or impractical;

We are equally unconcerned about reverse veil piercing being used when legal remedies are available. Although legal remedies—e.g., conversion, fraudulent transfer—may be available in many cases, thereby precluding reverse veil piercing, it is precisely the rare situations in which they are not that reverse piercing should deliver justice. Plus, requiring a creditor wishing to invoke the doctrine to demonstrate the absence of a plain, speedy, and adequate remedy at law would protect against reverse piercing being used to bypass legal remedies.

Baldwin also argued that California's LLC law made charging orders the exclusive remedy available to creditors. The Court of Appeals pointed out the limitation of that exclusivity, which was only as to the debtor's transferable interest, meaning that other remedies not against the transferable interest -- but against the LLC itself -- were also available to creditors. The Court of Appeals also pointed to the Legislative Assembly comments to California's LLC law which expressly noted that making the charging order the exclusive remedy was not meant to prevent a court from employing reverse veil piercing in appropriate cases.

Here, Baldwin had complete control over JPBI, almost a complete interest, and was manipulating that entity so that it was not requiring the loans from the three family partnerships to be repaid to JPBI. These made for good facts for reverse veil piercing, but the Court of Appeals shopped short of holding that JPBI should be reverse veil pierced, but instead remanded the case back to the trial court for further evaluation of the issue.

ANALYSIS

A preliminary note must be made that this a Court of Appeals decision which may be appealed to the California Supreme Court, and who knows how that might turn out. If I had to bet, however, I'd bet on this decision being affirmed since it makes perfect sense: Corporations and LLCs should be treated differently for purposes of reverse veil piercing, since corporate shares can be levied by a creditor, but interests in an LLC cannot.

The Court of Appeals did not touch upon an alternative ground for its opinion, which is that to now allow reverse veil piercing against a single-member, or predominantly single-member, LLC would have the effect of creating what would amount to an "unlimited exemption bucket" that folks could put their personal assets into and have those assets protected from creditors, far beyond the normal exemptions stated by the California Legislative Assembly, i.e., immunizing single-member LLCs to all enforcement remedies by a charging order would do substantial harm to California's exemption scheme, since assets that were otherwise available to creditors under that scheme could instead be protected in an LLC. Since it is not

the purpose of LLCs to be unlimited and exempt personal piggy banks, allowing such immunity to reverse veil piercing would be to violate the California Corporations Code relating to LLCs as well.

It is also very important to note that the Court of Appeals took this action in regard to a Delaware LLC, which is simply further cumulative evidence that courts will almost always apply local law to determine judgment enforcement issues, particularly involving debtors who are locally resident. It doesn't make any sense whatsoever that a debtor could, just by spending a few hundred bucks in Delaware, Wyoming, Nevada or other debtor-haven states, turn upside the local laws for collecting judgments, particularly when the creditor had no say at all in whose law should be applied. Folks who think that they are getting some great advantage by forming their LLCs in another state are apt to be deeply disappointed if a day of challenge ever comes.

In particular, it seems that the purveyors of Delaware trusts and LLCs are the most aggressive in urging in their marketing that the local court not engage in a conflicts-of-law analysis but will mechanically apply Delaware law in every situation involving a Delaware entity. As we see in opinion-after-opinion in creditor-debtor law, this is simply not true. Sometimes in alter ego cases involving corporations this is the case, but even that application varies between the states. Here, the California court gave the application of Delaware law the thumbs down.

The greater problem is that it is almost incapable of discernment in advance whether Delaware law will apply or not, just as it is whether the courts of a particular state will enunciate a broad rule -- as California did in the *Postal Instant Press* decision -- and then, as in *Curci*, start to chip away at the general rule by finding exceptions and distinguishing facts. A week ago, California didn't recognize reverse veil piercing, today it does to no small degree. That is how quickly things can change in creditor-debtor law.

All of this recalls the "General Rule" to which most law students catch on in the first two weeks of law school, i.e., "General Rules Are Generally Inapplicable". It is therefore suggested that those who aggressively market Delaware

trusts and entities for consumption outside of Delaware should include a OUIJA board and chicken bones to assist their customers in determining whether or not Delaware law will apply.

Otherwise stated, despite an aura that has come up over the decades, mainly because of corporate law, that other states will frequently look to Delaware law to resolve certain issues, outside of corporate law the truth is that Delaware law has no special exportability, and this carries even more weight as Delaware has since gained a reputation as "race to the bottom" state which enacts laws to the detriment of legitimate creditors.

Changing gears, it is also worthy of note that the Court looked through the form of the Baldwins' 99% and 1% ownership, and determined that in substance the LLC was a *de facto* single-member LLC ("SMLLC") which involved no non-debtor members. This is consistent with the decision in *In re Albright*, 291 B.R. 538 (Bankr.D.Colo.2003) which suggested that a mere "peppercorn" interest would not break up the membership interests sufficiently to defeat that a determination that an LLC was a single-member LLC.

It is this latter issue which is likely to cause planners some considerable angst, as it is increasingly unclear what form of a minority interest, and how much of a minority interest, is necessary to keep an LLC from being considered a single-member LLC. The only thing that we know with certainty now is that it is some number which in a given case can be between 0% and 50%.

Frankly, it is unlikely that there will ever be a hard-and-certain rule as to what constitutes a single-member LLC, but rather the courts will continue to examine this issue in like of all the facts and circumstances of a particular case. Just adding a spouse, living trust, or corporation controlled by the debtor as a 1% or 2% member? Good luck with that.

The bottom line is that LLCs (and partnerships) are not meant to be asset protection devices to protect the assets of a member from his or her own creditors. Instead, they are meant to be vehicles for *bona fide* commercial enterprises, and not just -- as with Baldwin and his wife -- somebody's personal

piggy bank. However, LLCs and partnerships are commonly misused for this latter purpose, and so it should surprise nobody that the courts will employ an equitable remedy such as reverse veil piercing to cut through this misuse.

Alter ego cases, including reverse veil piercing cases, are fundamentally Cases of 'No'. Creditor rights attorneys will ask debtors whether an LLC or partnership has any employees, any customers, any vendors, conducts any marketing, or does any of the numerous other things that *bona fide* commercial enterprises do. Get enough 'No' answers, and you've proved alter ego. For a debtor to simply say that the entity is a "holding company" isn't enough. Here, Baldwin answered more than enough questions in the negative for the trial court to find (if it desired on remand) that JPBI was simply his personal piggy-bank, and little more. That, in a nutshell, is what makes for reverse veil piercing.

As California tends to a be a leader among the states on judgment enforcement issues, it will be interesting to see if the opinion in *Curci* will get traction elsewhere. Stay tuned.

CITE AS

Curci Investments, LLC v. Baldwin, 2017 WL 3431457 (Cal.App., Distr. 4, August 10, 2017). Full Opinion at <https://goo.gl/eQx5N3>

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Notes from Colorado

By: Allen Sparkman
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Denver, Colorado

- A. Effective September 1, 2017, S.B. 1518 provides that a limited liability company that refuses a member's written request that complies with TBOC § 101.502(a) to examine and copy records or other information described by such section is liable to the member for any cost or expense, including attorney's fees, incurred in enforcing the member's rights under § 101.502. The same rule is applied to limited partnerships with respect to written requests that comply with BOC § 153.552(a), except that the limited partnership provision also applies to requests by assignees.
- B. S.B. 1518 also provides, effective September 1, 2017, that, in the case of a series LLC, the registered agent for the LLC is also the registered agent for each series. S.B. 1518 also provides that each governing person of a series (Texas or foreign) "is an agent of the series for the purpose of service of process, notice, or demand required or permitted by law to be served on the series.

Charging Order Receiver Could Not Exercise Control Over LLCs

In a recent decision from Florida, the court held that a receiver appointed pursuant to the charging order statute could not exercise managerial control over the LLCs. *McClendon v. Dakem & Associates, LLC*, 42 Fla. L. Weekly D1189, 2017 WL 2298443 (Fla. 5th Dist. Ct. App. May 26, 2017).

Dakem was successful in receiving charging orders against McClendon's interest in numerous LLCs, those charging orders in furtherance of judgments in favor of Dakem. In four instances, with respect to LLCs controlled by McClendon, the receiver was charged to exercise managerial control over the companies. McClendon challenged the receiver's exercise of those rights, asserting they were outside the scope of the statute. The Court agreed with that determination, writing:

[T]he charging order should only have divested [McClendon] of her economic opportunity to obtain profits and distributions from the LLC, charging only her membership interest, not her managerial rights. To the extent that the order appointing the receiver authorized the receiver to exercise managerial control over the LLCs, it exceeded the permissible scope and is reversed. In sum, the order granting the charging order and appointing a receiver is affirmed; however, the portions of the order permitting the receiver to be the financial officer of the LLC and exercise managerial control is reversed.

Does Your LLC Agreement Have a Purposeless Purpose Clause?

By: Peter Mahler
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WARNING: Contractarians may find the following post disturbing. Reader discretion is advised.

Now that I've got your attention, consider this:

- Under the standard for judicial dissolution of a New York LLC prescribed in the landmark 1545 Ocean Avenue case, the primary, contract-based inquiry is whether the LLC's managers are unable or unwilling to permit or promote the stated purpose of the entity, as found in the LLC's operating agreement or articles of formation, to be realized or achieved.
- The typical, broad purpose clause found in untold thousands of standardized and customized LLC agreements provides that the LLC's purpose is "any lawful business," mirroring Section 201 of the LLC Law ("A limited liability company may be formed under this chapter for any lawful business purpose or purposes").
- When a fully integrated operating agreement states that the LLC's purpose is "any lawful business," may a minority member of an LLC nonetheless seek judicial dissolution based on extrinsic (parol) evidence that those in control of the LLC are operating it for a lawful business purpose that departs from the LLC's alleged original lawful business purpose?

Until last week's decision by the Brooklyn-based Appellate Division, Second Department — the same court that gave us *1545 Ocean Avenue* — in *Mace v. Tunick*, 2017 NY Slip Op 06170 [2d Dept Aug. 16, 2017], I would have answered that question "no" with support from a number of case precedents in New York and other jurisdictions including that hotbed of contractarian jurisprudence known as Delaware. After *Mace*, it appears that the "any lawful business" purpose clause may be as good as no purpose clause.

Background

Mace fits within a recurrent fact pattern in which the owners of an operating business form a separate entity — in this case, an LLC — to acquire real property to house the operating business. In 2007, the owners of Ceres Chemical Co., in which the plaintiff had a 20% interest, formed Pedani Realty Services, LLC to acquire for \$1.25 million a building in Westchester, New York, to serve as headquarters for Ceres. The plaintiff contributed 20% of the purchase price and received a 20% membership interest in Pedani.

At the time of its formation, Pedani's members filled in the blanks and executed what appears to be an off-the-shelf, pre-printed form of operating agreement with the following purpose clause:

"The purpose of the Company is to conduct any lawful business for which limited liability companies may be organized and to do all things necessary or useful in connection with the foregoing."

The agreement also has an integration clause disavowing all "representations, agreements, arrangements or understandings, oral or written, between or among the parties relating to the subject matter of this Agreement which are not fully expressed in this Agreement."

Ceres occupied the building for the next 6 or 7 years, paying rent to Pedani at the monthly rate of \$13,000. In 2013, the plaintiff retired and sold his 20% interest in Ceres to the defendant 80% shareholder, allegedly with the understanding that Ceres would continue paying rent to Pedani in which the plaintiff continued to hold a 20% interest and defendant the remaining 80%.

In 2014, the defendant moved Ceres's operations to South Carolina, vacated Pedani's building, and stopped paying rent to Pedani. The defendant subsequently made himself Pedani's managing member and issued a capital call over plaintiff's objection. In 2015, the defendant leased Pedani's building to an unrelated third party at a monthly rent of about \$3,600 which plaintiff alleged was below fair market value.

The Dissolution Complaint

The plaintiff filed suit in October 2015. The first cause of action in his amended complaint sought judicial dissolution of Pedani under LLC Law § 702, alleging that upon Ceres's departure from the property "the purpose for which Pedani was formed had ceased," and that the defendant had rejected plaintiff's request to sell the property and dissolve the LLC.

The plaintiff alleged as additional cause for dissolution defendant's breach of fiduciary duty and breach of the operating agreement in connection with leasing the property at less than fair market rent and making an unauthorized capital call, all of which created "fundamental and intractable" disagreement between the LLC's two members "as to make it unfeasible for Pedani to carry on its business as originally intended."

The Trial Court's Decision

The defendant filed a motion to dismiss the complaint, contending that Pedani continued to carry on its business consistent with the operating agreement's broad purpose clause ("any lawful business") and that the plaintiff as 20% member had no right under the agreement to force a sale of the property.

The plaintiff argued that Pedani's purpose no longer existed following Ceres's departure, and that the operating agreement's "generic" purpose clause did not preclude a finding that Pedani was formed for the more limited purpose of purchasing and holding the property to serve as Ceres's headquarters.

In a Decision and Order dated May 23, 2016, the presiding judge, Westchester Commercial Division Justice Alan D. Scheinkman, agreed with the plaintiff that the operating agreement's purpose clause was not dispositive of the issue — indeed, that the clause contains "no stated purpose" — but nonetheless granted the defendant's motion based on evidence that Pedani's ongoing and viable purpose was to acquire title to, and manage, the property. Here's how it played out, in the judge's own words:

"Here, Pedani has no stated purpose. Rather, Section 2.1 of the Operating

Agreement contains broad, boiler-plate language that the purpose of the Company is to conduct any lawful business for which a limited liability company may be organized and to do all things necessary or useful in such regard. Defendants' argument is, essentially, that because Pedani's stated purpose is to do any lawful business, it is impossible to conclude that the management of the entity is unable or unwilling to permit or promote any lawful business from being achieved. This argument is far too facile as, if accepted, it would preclude judicial dissolution on every occasion in which such common, boiler-plate purpose language is used in an Operating Agreement. Indeed such broad language may be invoked, not because the company lacks a specific purpose but to avoid hamstringing company operations, or shifts in business, through more restrictive language.

More important, the Court cannot ignore the fact . . . that Pedani was formed on July 9, 2007 and, by deed dated September 26, 2007, Pedani took title to the Property. Hence, the contemporaneous real estate documents, read together with the Operating Agreement, indicate that the initial purpose of Pedani was to acquire title to, and manage, the Property. However, Plaintiff has failed to allege facts which, if proven true, would establish that the purpose of Pedani changed or that the management of Pedani is unable or unwilling to reasonably permit or promote Pedani's achievement of its purpose to acquire and maintain the Property."

The Appellate Court's Ruling

The plaintiff appealed from Justice Scheinkman's dismissal of the dissolution claim. In its unsigned memorandum opinion last week, the Appellate Division agreed with Justice Scheinkman that the operating agreement's purpose clause "did not set forth any particular purpose for Pedani," but it then labeled as "an impermissible factual finding" Justice Schienkman's conclusion that Pedani's purpose "was simply to acquire and manage property."

The defendant was not entitled to dismissal of the dissolution claim, the court wrote, because:

“Neither the operating agreement nor the leases of the property to Ceres and, upon Ceres’ relocation, a third party, utterly refuted the plaintiff’s allegation as to Pedani’s purpose so as to conclusively establish a defense as a matter of law to the plaintiff’s dissolution cause of action.”

Mace’s Impact

As I mentioned above, a number of prior court rulings have dismissed LLC dissolution claims based on alleged failure of purpose in the face of operating agreements with broad purpose clauses like the one in *Mace*. Examples include Justice Driscoll’s decision in *Matter of Ross* and the Delaware Chancery Court’s decision in *In re Seneca Investments, LLC*.

Is it necessarily so that “any lawful business” purpose is the equivalent of no stated purpose? Why must its “boiler-plate” character and its unlimited scope render it useless under the contract-centric approach endorsed in 1545 Ocean Avenue, especially when, as is usually the case, the operating agreement has a merger clause precluding reliance on any extrinsic representations and understandings of purpose or anything else outside the written agreement? Could not Justice Scheinkman’s astute observation, that a purpose clause more restrictive than “any lawful business” could “hamstring” company operations, equally serve a valid objective to make it harder for a member to seek judicial dissolution?

Unfortunately, the Appellate Division’s sparsely worded decision in *Mace* did not address any of these questions.

One thing’s for certain. There are countless operating agreements in existence with “any lawful business” purpose clauses. If “any lawful business” is a purposeless purpose clause, the primary focus of the judicial dissolution standard under *1545 Ocean Avenue* — whether the LLC’s managers are willing or able to achieve its stated purpose under the operating agreement — merely becomes a waystation on the road to more protracted litigation proceedings requiring discovery and

evidentiary hearings. Good for business divorce lawyers like me. Not so good for business owners.

**California Court Of Appeal Holds LLC's
Former Counsel May Represent Insider
Defendants In Derivative Suit**

By: Keith Paul Bishop
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Derivative actions can be somewhat confusing. Although the entity is essentially the plaintiff, it is named as a defendant. Initially, one might question why must the corporation be named as a party? I can think of at least two reasons. First, the litigation involves the rights of the entity directly. Second, including the entity as a party helps to ensure that the defendants will enjoy the protection of res judicata should they prevail. Those are reasons for naming the entity as a party, but why name the entity as a defendant rather than as a plaintiff? In California, this seemingly odd result follows from Section 382 of the Code of Civil Procedure: "If the consent of any one who should have been joined as plaintiff cannot be obtained, he may be made a defendant, the reason thereof being stated in the complaint . . .".

In the case of a limited liability company, a lawyer may at times represent the company and the manager of the company. When a derivative suit is brought by a member, does the attorney's prior representation of the company disqualify the attorney from representing the company's manager? That was the question before the California Court of Appeal in *Beachcomber Management Crystal Cove, LLC v. Superior Court*, 2017 Cal. App. LEXIS 664 (Cal. App. 4th Dist. June 28, 2017).

Writing for the Court, Justice Richard M. Aronson concluded that an attorney may represent the insiders in a derivative lawsuit despite the attorney's previous representation of the company regarding issues raised in the suit. In reaching this conclusion, the Court focused on a line of cases that govern governing successive representation in derivative lawsuits brought by small or closely held companies (*Forrest v. Baeza*, 58 Cal. App. 4th 65 (1997) and following cases). The *raison d'être* for disqualification in successive representation cases is to prevent the attorney from using confidential information gained from the representation of the entity. This rationale breaks down when the insider defendants

essentially had access to the same information. Thus, that becomes the "critical inquiry".

Securitization Trust has Citizenship of the Trustee, and not the Certificate Holders, for Purposes of Diversity Jurisdiction

In a recent decision out of Texas, it was necessary that the court characterize a securitization trust as either a traditional trust or a business trust in order to determine whether diversity jurisdiction existed. In this instance, based upon the characteristics of this particular trust, it was found to be a traditional trust. On that basis, it was afforded the citizenship of only its trustee. *DHI Holdings, LP v. Mortgageit, Inc.*, Civ. Act. No. H-17-0960, 2017 WL 3116152 (S.D. Texas July 21, 2017).

The court characterized the question as follows:

The motion to remand presents a narrow issue. One of the defendants in the case is US Bank, as trustee of the Terwin Mortgage Trust 2006-3 Asset-Backed Certificates, Series 2006-3 (referred to in the briefs, and this opinion, as the “2006-3 Trust” or the “Trust”). The issue is whether US Bank as trustee, or instead the 2006-3 Trust itself, is the real party in interest in the suit. If US Bank is the real party in interest, the court looks only to US Bank’s Ohio citizenship, and there is complete diversity. If it is not, the court must look to the citizenship of all of the Trust’s member certificate holders. Because there is no record evidence of the certificate holders’ citizenship, the presumption against jurisdiction requires remand if the trust itself is the real party in interest.

Assessing the terms of the trust, pursuant to which the trustee had legal title to the assets and managed same (sometimes through agents), as well as the provision that U.S. Bank could sue and be sued in its capacity as trustee, it was determined that it was the real party in interest under *Navarro Savings Association v. Lee*, 446 U.S. 458, 460-61 (1980). The court considered and rejected arguments to the contrary such as the ability of the certificate holders to compel certain actions, including the removal of the trustee, finding they were not sufficient to remove the trust from classification as a traditional trust in contrast to a business trust. Therefore, diversity jurisdiction existed.

NY Court Defines When LLCs Can Use Special Litigation Committees

By: Jason Grant
New York Law Journal
New York, New York

A special litigation committee cannot be used to determine the fate or direction of derivative claims brought on behalf of a New York limited liability company, unless its use is expressly written into the operating agreement, a Manhattan appeals court has ruled in an important decision of first impression.

"Article IV of the New York LLC Act makes clear that the operating agreement of an LLC governs the relationships among members and [their] powers and authority," wrote a unanimous panel of the Appellate Division, First Department, in a ruling that has changed the course of a legal battle, begun in 2011, over revenues springing from a luxury condominium development found in Manhattan's opulent Tribeca neighborhood.

Sallie Manzanet-Daniels

"One attraction of the LLC form of entity is the statutory freedom granted to members to shape, by contract, their own approach to common business relationship problems," the panel wrote, quoting *Obeid v. Hogan*, a 2016 Delaware Court of Chancery opinion.

The ruling, penned by Justice Sallie Manzanet-Daniels, is important because it draws a line between how New York corporations, governed by the Business Corporation Law, may resolve derivative claims, and how LLCs may work through the same types of claims when an operating agreement is silent on special litigation committees.

At the same time, the opinion in *LNYC Loft LLC v. Hudson Opportunity Fund I LLC*, 650969/11, helps further define parameters surrounding the court-created right of New York LLC members to lodge derivative actions in the first place.

That right—set forth in state Business Corporation Law but conspicuously absent from the LLC Act—was created by the Court of

Appeals in its 2008 *Tzolis v. Wolff* decision.

Since then, according to Manzanet-Daniels, "courts have looked to New York statutory and common law on partnerships and corporations in determining certain questions arising in the LLC context."

She added, "Tzolis encouraged courts to fashion remedies to speak to the omissions in the LLC statute." But "nonetheless," she wrote, "we decline to uphold the appointment of an SLC [special litigation committee] where the relevant operating agreements do not delegate managerial authority to nonmembers or nonmanagers or otherwise provide for the appointment of an outsider to serve as an SLC."

Still, Manzanet-Daniels' Aug. 15 opinion could ultimately face scrutiny in the Court of Appeals.

Steven Shore, of Ganfer & Shore in Manhattan, the defendants' counsel, said on Aug. 17 that he and his clients will seek leave to appeal.

"It's a case of first impression," he said in an interview, and "our view is that the Court of Appeals in *Tzolis* indicated that LLCs should be treated similar to corporations. We think if you're going to treat LLCs and corporations in a similar manner that LLCs should have an ability to have a special litigation committee."

Moreover, he said, "unless the decision is reversed by the high court, it will have an adverse impact on LLCs in New York. Also the result is going to be that our courts, which are already busy enough, are going to have to resolve all of these LLC cases, which are much better handled by special litigation committees."

How It Began

The dispute in the long-running case is complicated, involving entities and shareholder members that could be more cleanly described using a chart.

Plaintiff LNYC Loft LLC brought direct claims in the lawsuit. And later it was able to amend the suit to add derivative claims on behalf of two New York companies, HRC-NYC Development LLC and One York Street Associates LLC.

One York Street Associates LLC is the sole owner of a high-end residential and commercial condominium at 1 York Street in Tribeca. The fight over 1 York Street's revenues, fueled by sales of multimillion-dollar units, is at the heart of the struggle.

One York Street Associates LLC, meanwhile, is 75 percent owned by derivative plaintiff HRC-NYC Development LLC, and 25 percent owned by defendant Jani Development II LLC.

And HRC-NYC Development LLC is 56 owned by defendant Hudson Opportunity Fund I LLC (and affiliates), and 44 percent by the original, direct plaintiff, LNYC Loft LLC.

LYNC Loft contends in its suit that Hudson Opportunity Fund I, while acting as managing member of One York Street Associates in 2010, entered into an illegal amendment to reduce distributions by One York Street to members, including to LYNC.

It says Hudson Opportunity Fund I was induced to do so—against its own financial interest —by Jani, in a backdoor deal. Hudson Opportunity Fund's actions, LYNC contends, were a breach of HRC-NYC Development's operating agreement because, under that agreement, it needed LNYC's consent before it could make any such move.

After five years of motion practice and discovery, LNYC added the derivative claims on behalf of HRC-NYC Development and One York Street Associates in 2016.

Soon after, managing members of those two closely held LLCs decided to engage an independent person to serve as a special litigation committee (SLC). The SLC's role would be to determine whether the derivative claims should go forward and, if so, how.

After some dispute with LYNC over who the SLC should be, the two LLCs' managing members decided to select a one-person, outside committee: Mark Zauderer, senior partner at the Manhattan litigation boutique Flemming Zulack Williamson Zauderer.

LYNC, in turn, objected, leading to more litigation. And in September 2016, Manhattan

Supreme Court Justice Carol Edmead, the presiding judge in the lawsuit, declared as part of a 15-page ruling that Zauderer could remain in his role.

Edmead found in part that, despite LYNC's contentions otherwise, Article 6 of the HRC-NYC Development operating agreement did not bar appointment of an SLC.

She wrote that the agreement did require "operating members," including LYNC, to approve of any "major [company] decision"—but ruled that appointment of an SLC did not qualify as a major decision.

"The court finds that the retention of Mr. Zauderer, in and of itself, does not rise to the level of prosecuting or settling this legal action, so as to require plaintiff's [LYNC's] written consent," Edmead wrote.

The Reversal

On Aug. 15, Manzanet-Daniels, joined by Justices Rolando Acosta, Dianne Renwick, Angela Mazzaelli and Richard Andrias, disagreed, reversing Edmead.

"Neither operating agreement [for either derivative plaintiff HRC-NYC Development or derivative plaintiff One York Associates] provides for the delegation of decision-making authority to other than a member, or to an outsider like Mr. Zauderer to serve as SLC," Manzanet-Daniels wrote.

"The agreements are explicit that while day-to-day management is vested in the manager, 'major decisions' need the consent of the other members. We reject the argument that the appointment of the SLC (as opposed to the ultimate decision as to whether to proceed with the derivative litigation) was not a 'major decision' within the meaning of the agreements," she continued, writing, "The SLC [Zauderer] was specifically granted the authority to 'determine the positions and actions that the companies should take with respect to the claims, considering, among other things, whether the claims have merit, whether they are likely to prevail, and whether it is in the companies' best interests to pursue them.'"

However, the panel also made clear that if New York LLCs want to write special litigation committees and outsiders into their operating agreements, they can do so.

"That is not to say that the appointment of an SLC would in all cases be improper," Manzanet-Daniels said. "Indeed, the [LLC] members may so provide in the operating agreement, and such provision will be enforced in accordance with those same principles concerning the parties' freedom to contract."

Steven Kaplan, of Rosenfeld & Kaplan in Manhattan and representing LNYC Loft, said on Aug. 17 that he believes the unanimous panel got it right. And he's prepared to oppose any motion by the defendants for leave to appeal, he said.

"This has clarified the law that, at least in the First Department, derivative claims on behalf of an LLC cannot be delegated to a committee, unless the operating agreement calls for it," Kaplan said.

Of the ongoing litigation, he added, "The ruling affords my client the opportunity to fully vindicate its rights." He did not specify how much money may be at issue.

Marcel Kahan, a corporate law professor at New York University, said that he believed the First Department decision's was reasonable, and he pointed out that the parties to the two LLC operating agreements could have written into their agreements—before a dispute arose—an SLC who they both chose as neutral and independent.

In the case of Zauderer, Kahan said, while the panel made clear that "no one suggests [he] is in any way biased," he was still selected by only HRC-NYC Development and One York Street Associates, not by LNYC Loft.

"There is some question about who was chosen and why the defendants chose Zauderer," he said. "The defendants picked him. They selected him unilaterally."

The panel's opinion, while directed largely at reversing Edmead's September 2016 decision that included her approval using Zauderer, also had the effect of throwing out a 14-page decision issued by Edmead earlier this

month. In part of that decision, Edmead had approved of Zauderer's settlement for the derivative claims, settlement terms that LNYC had opposed.

"The SLC's investigation was independent and sufficiently thorough, the SLC's determinations, including that the derivative claims should be dismissed pursuant to the terms of its recommended settlement are entitled to deference," the judge had written, adding, "To rule otherwise, would be to subject these companies to further litigation when they have already decided, through the mechanism of an SLC, to settle the derivative claims on terms that are fair and sensible."

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Developments at the Joint Editorial Board

As you know, the Committee participates in a Joint Editorial Board ("JEB") with representatives of the Uniform Laws Commission with respect to developments in the Uniform Unincorporated Organization Acts.

After several years of serving on the JEB, Paul Altman's tenure on the JEB has come to an end. We thank Paul for yet another aspect of his tireless service on Committee business. Lou Conti has been appointed to what was Paul's position, joining Scott Ludwig and Tom Rutledge as the Committee's representatives.

Stop Delaying: The Need for An Operating Agreement Under the Revised MN LLC Act

By: *Janel Dressen*
Anthony Ostlund Baer & Louwagie P.A.
Minneapolis, Minnesota

There is effectively only four months (effective January 1, 2018) before the Minnesota Revised Limited Liability Company Act is in full force and effect for all existing Minnesota limited liability companies. The Operating Agreement, which can be written, verbal, implied or a combination of all three,¹ is the centerpiece of a member's rights under Minnesota Chapter 322C (the "Revised LLC Act"). There are many important "rules" under the Revised LLC Act that can be addressed upfront and agreed upon by the members in an Operating Agreement. Some would argue that without a written Operating Agreement, an LLC with more than a single member is taking unnecessary and undue risk. Thus, it would be well-advised to prepare an Operating Agreement for all existing Minnesota LLCs with more than a single member prior to January 1, 2018.

For example, under the Revised LLC Act, unless the Operating Agreement expressly provides otherwise, newly formed LLCs are considered member-managed.² In a member-managed LLC, the LLC is to be managed by the members equally, again, unless the Operating Agreement provides otherwise. In other words, each member has one vote, regardless of the ownership percentage of that member. "A difference arising among members as to a matter in the ordinary course of the activities of the company may be decided by a majority of the members."³

As a second example, the Operating Agreement governs the relations among members, and can vary the rights and duties owed greatly, adding additional protections provided by statute or limiting protections provided by statute. Minn. Stat. § 322C.0110, subd. 2 provides that where the Operating Agreement is silent with respect to the relations among the members as members and between the members and the limited

liability company (among other matters described in subd. 1), the statute governs.

Section 322C.0110, subd. 3 places restrictions on what an Operating Agreement can and cannot do. Among other things, the Operating Agreement cannot be read to:

- Be governed by another state's laws;⁴
- Generally eliminate the duty of loyalty, the duty of care, or any other fiduciary duty;⁵
- Eliminate the contractual obligation of good faith and fair dealing;⁶
- Vary the power of a court to order dissolution where appropriate for member oppression;⁷
- Unreasonably restrict a member's right to bring a direct or a derivative action.⁸

Certain other terms of an Operating Agreement are allowed if not "manifestly unreasonable."⁹ The court shall make its determination of whether an Operating Agreement term is manifestly unreasonable "as of the time the challenged term became part of the operating agreement and by considering only circumstances existing at that time."¹⁰ Further, the court may invalidate the term only if, in light of the purposes and activities of the LLC, it is readily apparent that the objective of the term is unreasonable or the term is an unreasonable means to achieve its objective. *Id.*

At least for purposes of evaluating the conduct of members (in any LLC under the Revised LLC Act), the Operating Agreement expressly includes an obligation of good faith and fair dealing, including a requirement that members act in a manner, in light of the

¹ Minn. Stat. 322C.0701, subd. 17.

² Minn. Stat. § 322C.0407, subd. 1.

³ Minn. Stat. § 322C.0407, subd 2(2) and 2(3).

⁴ subd. 3(2).

⁵ subd. 3(4).

⁶ subd. 3(5).

⁷ subd. 3(7).

⁸ 3(9).

⁹ Minn. Stat. § 322C.0110, subd. 4.

¹⁰ *Id.* at subd. 8.

Operating Agreement, that is honest, fair, and reasonable. This obligation cannot be eliminated.

Importantly, for Minnesota LLCs formed prior to August 1, 2015, the LLC's existing articles of organization, any bylaws, and operating or member control agreement will operate as if the language in those governing documents were in the "Operating Agreement" under the Revised LLC Act effective on January 1, 2018.¹¹ Moreover, subject to the specific terms of the "Operating Agreement," certain protections and rights set forth in Chapter 322B will carry over to Minnesota LLCs that were formed prior to August 1, 2015 after January 1, 2018, such as company information retention, dissenters' rights and allocation of profits and losses, among other rights and obligations.

Because of the significance of the Operating Agreement under the Revised LLC Act, LLCs should be communicating with experienced counsel, carefully considering the operations and governance of the LLC and ensuring that they are protected from unfair terms and/or that the terms of the "Operating Agreement" are consistent with the member's expectations.

Janel Dressen is a shareholder of Anthony Ostlund Baer & Louwagie P.A. where she represents businesses and individuals in all aspects of litigation and dispute resolution, with an emphasis on director and officer, governance, shareholder, LLC member, partnership, employment and contract disputes. Ms. Dressen also counsels businesses regarding risk management and avoidance, governance, and employment matters. Ms. Dressen has been and continues to be recognized as a Super Lawyer by Minnesota's "Super Lawyers."

Fear and Loathing and Warning Labels

Recently I came across the enclosed "warning" label on, of all things, a doormat. It provides:

Important things you should know about your new doormat. Warning:

Do not use mat as a projectile. Sudden acceleration to dangerous speeds may cause injury. When using mat follow directions: Put your right foot in, put your right foot out, put your right foot in and shake it all about. This mat is not designed to sustain gross weight exceeding 12,000 lbs. If mat begins to smoke, immediately seek shelter and cover head. Caution: If coffee spills on mat, assume that it is very hot. This mat is not intended to be used as a placemat. Small food particles trapped in fibers may attract rodents and other vermin. Do not glue mat to porous surfaces, such as pregnant women, pets and heavy machinery. When not in use, mat should be kept out of reach of children diagnosed with CFED (Compulsive Fiber Eating Disorder). Do not taunt mat. Failure to comply relieves the makers of this doormat, Simply Precious Home Décor, and its parent company, High Cotton, Inc., of any and all liability.

¹¹ Minn. Stat. § 322C.1204, subd. 3.

**Select Recent (Non-Delaware) Cases:
Personal Liability of LLC Members and
Managers**

By: *Sean Ducharme*
Hunton & Williams LLP
Richmond, Virginia

1. *Fulmer v. Hurt*, 515 S.W.3d 129 (Ark. Ct. App. 2017).

The plaintiffs held a judgment against an Arkansas LLC and sought to pierce the veil of the LLC to reach the assets of the LLC's two members. The judgment related to unpaid promissory notes issued by the LLC to the plaintiffs as a major portion of the consideration paid by the LLC for its purchase of the plaintiffs' business. The trial court granted summary judgment for the defendants. The plaintiffs appealed the trial court's decision, arguing that the trial court required the plaintiffs to show evidence of a higher standard of misconduct by the defendants to support the plaintiffs' piercing claim (*i.e.*, fraud or illegal conduct) than is required by Arkansas law.

The appellate court examined applicable Arkansas case law, noting that it supports the proposition that, in order to pierce the veil in Arkansas, a plaintiff must prove fraud, illegal conduct, or abuse of an entity for the specific purpose of injuring a third party. The appellate court held that the trial court applied the correct legal standard for piercing the veil and appropriately granted summary judgment because the plaintiffs failed to meet their burden of proof. The plaintiffs offered no evidence that the defendants illegally abused the LLC or engaged in fraud, deception or conduct sufficient to justify piercing the veil. The evidence showed that the defendants: (1) contributed capital to the LLC each year, (2) did not dissolve the LLC or form another entity to avoid paying the judgment, (3) did not take assets from the business, either personally or for the benefit of any third party, and (4) followed the requisite business formalities under Arkansas law. The appellate court affirmed the trial court's grant of summary judgment for the defendants.

2. *Fausse Riviere, L.L.C. v. Snyder*, 211 So.3d 1188 (La. Ct. App. 2017).

The plaintiff lessor sued an LLC lessee and its president for back rent and restoration costs. The president was also the controlling member of the LLC. The trial court entered a judgment against the LLC and its president, finding that the LLC was the president's alter ego and holding him personally liable for the debts of the LLC. The president appealed the decision, arguing that the trial court erred in piercing the LLC's veil.

The appellate court examined applicable Louisiana case law. The Louisiana supreme court has acknowledged that an LLC member can be held liable for the debts of the LLC under a piercing the veil theory. The appellate court has stated that the same policy considerations apply to piercing the veils of corporations and LLCs. The court may pierce the corporate veil under two exceptional circumstances where the shareholders either: (1) commit fraud or deceit acting through the corporation or (2) are indistinguishable from the corporation because either corporate formalities are disregarded or the corporation is operated as the "alter ego" of the shareholder. The court must consider the totality of the circumstances when deciding whether to allow piercing the veil. Some circumstances that may weigh in favor of piercing are: (a) commingling of funds, (b) failure to follow corporate formalities, (c) undercapitalization, (d) failure to have separate bank accounts and bookkeeping records and (e) failure to hold regular shareholder and director meetings. A controlling shareholder's involvement in the business, by itself, is insufficient to pierce the veil. In the current appeal, the appellate court noted that the evidence clearly supported a finding that the LLC was not operated as a separate entity from its president/controlling member and that there was significant commingling of assets. The appellate court concluded that the trial court had a reasonable basis for finding that exceptional circumstances existed to pierce the LLC's veil and affirmed the trial court's decision to pierce the veil.

3. *Benzakry v. Patel*, 77 N.E.3d 1116 (Ill. App. Ct. 2017).

The plaintiffs purchased a gas station from an Illinois LLC. The gas station was leased to a

third party tenant pursuant to a triple net lease. The lease was assigned to the plaintiff buyer as part of the transaction. Shortly after the acquisition transaction was completed, the third party tenant stopped paying rent, and the gas station closed. The plaintiffs sued the LLC for various misrepresentations made to the plaintiffs prior to closing concerning the lease and the tenant's ability to pay the rent. The plaintiffs obtained a default judgment against the LLC.

The plaintiffs also sued the LLC's sole member and her husband, the sole manager of the LLC, claiming breach of contract, deceptive practices and common law fraud. The plaintiffs sought to pierce the veil of the LLC to hold its sole member liable for its debts. Finally, the plaintiffs moved to amend their pleadings to add a principal-agent claim against the sole member to hold her responsible for misrepresentations made by her husband in his capacity as the LLC's manager.

The trial court dismissed the breach of contract claims against the sole member and the manager because they were not parties to the purchase agreement. As for the deceptive practices claims, the trial court issued a directed verdict in favor of the sole member and the manager because the court concluded that the misrepresentations in question were not subject to the Illinois consumer protection act. The trial court denied the plaintiffs' motion to add a principal-agent claim against the sole member. The remaining counts (common law fraud and piercing the veil) went to the jury, which found in favor of the plaintiffs on the common law fraud count against the manager and the piercing the veil count against the sole member. The jury awarded the plaintiffs damages. The defendants appealed the jury verdict, and the plaintiffs appealed the trial court's directed verdict on their deceptive practices claims and the trial court's denial of the plaintiffs' addition of a principal-agent claim.

The defendants argued that the plaintiffs' piercing the veil claim should have been decided by the court, not the jury. The appellate court noted that this was an issue of first impression as no Illinois cases have discussed this issue. The court examined two federal circuit court cases, which were split on the issue, but ultimately looked to substantive Illinois law for the answer. The court noted that Illinois courts have established that piercing claims are

equitable in nature, and that there is no right to a jury trial in equitable claims. Citing the Illinois code of civil procedure, the court stated that a court does have the discretion to direct equitable claims to be heard by a jury. The court held that the plaintiffs' piercing claim was properly tried before a jury.

The defendants argued that the plaintiffs provided no evidence to pierce the veil of the LLC and hold its sole member liable for the LLC's default judgment. The appellate court noted that there are two requirements to pierce the corporate veil under Illinois law: (1) a unity of interest and ownership that causes the separate personalities of the corporation and the individual to no longer exist, and (2) the presence of circumstances under which adherence to the fiction of a separate corporate existence would sanction a fraud, promote injustice or promote inequitable consequences. The court also noted that Illinois courts are reluctant to pierce the corporate veil, and a party seeking to pierce the veil has a substantial burden to overcome. Illinois courts look at various factors in determining whether to pierce the veil, including: (a) inadequate capitalization, (b) failure to issue stock, (c) failure to observe corporate formalities, (d) nonpayment of dividends, (e) insolvency of the debtor corporation, (f) nonfunctioning of the other officers or directors, (g) absence of corporate records, (h) commingling of funds, (i) diversion of assets from the corporation by or to a shareholder, (j) failure to maintain arm's length relationships among related entities and (k) whether the corporation is a mere facade for the operation of the dominant shareholders. The appellate court examined the trial court's record and noted that it showed evidence of three piercing factors: (i) the LLC was inadequately capitalized, (ii) the sole member was a "nonfunctioning shareholder" who was the sole member of the LLC but was not involved with the LLC's activities and (iii) the sole member commingled the LLC's funds with her other business ventures and her personal funds. The appellate court concluded that the jury's piercing verdict was not against the manifest weight of the evidence.

As for the plaintiffs' common law fraud claim against the LLC's manager, the defendants argued that the plaintiffs could not rely on the manager's misrepresentations made outside the purchase agreement because the purchase

agreement contained an “entire agreement” clause, which the defendants argued was tantamount to a non-reliance agreement. The plaintiffs argued that the clause was a standard merger or integration clause, not a non-reliance clause. The appellate court examined applicable Illinois case law directly on point and concluded that, since the “entire agreement” clause in the purchase agreement did not contain non-reliance language or even the word “reliance” or any associated term, the purchase agreement did not defeat the plaintiffs’ common law fraud claim.

The appellate court engaged in an exercise of statutory interpretation to address the plaintiffs’ appeal of the trial court’s directed verdict ruling against the plaintiffs’ deceptive practices claims under the Illinois consumer fraud act. The trial court concluded that the plaintiffs did not show that the defendants’ misrepresentations resulted in public injury, which is a requirement to make a deceptive practices claim under the consumer protection statute. After examining the legislative history and public policy behind the statute and the trial court’s record, the court held that the plaintiffs did not have to prove public injury and could bring a deceptive practices claim under the statute. The court granted judgment in favor of the plaintiffs against both the sole member and the manager. Because the plaintiffs were eligible for attorneys’ fees under the statute, the appellate court remanded this claim to the trial court for the sole purpose of assessing attorneys’ fees.

Regarding the plaintiffs’ principal-agent claim, the plaintiffs argued that the LLC’s manager was acting as the agent of his wife, the LLC’s sole member, and that the trial court should have allowed the plaintiffs to amend their complaint to include the principal-agent claim. The appellate court noted that the record shows evidence of a principal-agent relationship since the manager kept the business records and handled the LLC’s day-to-day transactions, and the sole member relied “heavily and almost exclusively” to maintain the LLC. Under the doctrine of *respondeat superior*, a principal may be held liable for the negligent actions of an agent. The appellate court concluded that the trial court erred when it denied the plaintiffs the opportunity to amend their complaint to include a principal-agent claim. Based on the record, the appellate court also granted judgment in favor of the plaintiffs and against the defendants on the

principal-agent claim.

The appellate court remanded the case to the trial court for a new calculation of damages and costs, including an assessment of attorneys’ fees and any damages relating to the plaintiffs’ principal-agent claim.

4. *Southern Shores Realty Services, Inc. v. Miller*, 796 S.E.2d 340 (N.C. Ct. App. 2017).

The plaintiff, a rental management company, had entered into contracts to manage vacation rental properties in the Outer Banks, North Carolina owned by various North Carolina LLCs. The members of each LLC were an individual, his wife and their sons. No single member owned a majority interest in any one LLC. The husband was active in the business, while the wife and sons were passive investors.

Pursuant to the terms of the rental management contracts, the plaintiff collected advance deposits from tenants and remitted the advance payments to the LLCs. Eleven rental properties became subject to foreclosure proceedings. The plaintiff used its own funds to return deposits to tenants for these foreclosed properties and then sued each of the LLCs that owned the foreclosed properties to recover these amounts based on theories of breach of contract and deceptive trade practices. The plaintiff also sued the husband to hold him personally liable for the LLCs’ debts under the theory of piercing the veil. The trial court issued a directed verdict against the plaintiff for its deceptive trade practices claims. The trial court allowed the breach of contract and veil piercing claims to be submitted to the jury, and the jury returned verdicts in favor of the plaintiff on these claims. The defendants filed a motion asking the trial court to set aside the jury’s verdicts and to enter judgment in the husband’s favor with respect to the veil piercing claim or, in the alternative, to award the defendants a new trial. The trial court denied the defendants’ motions, and the defendants appealed.

As to the breach of contract claims, the appellate court concluded that the plaintiff presented sufficient evidence to support its breach of contract claims and that the trial court did not err by denying the defendants’ motions. The court affirmed the trial court’s order in accordance with the jury’s verdict.

As to the veil piercing claim, the appellate court examined applicable North Carolina case law. Citing North Carolina supreme court precedent, the appellate court noted that North Carolina courts will pierce the veil whenever necessary to prevent fraud or achieve equity and that veil piercing is a “strong step: Like lightning, it is rare and severe.” The appellate court then noted that North Carolina’s appellate courts have generally pierced the veil of an LLC under the same circumstances that support piercing the veil of a corporation by applying the “instrumentality rule” adopted by the North Carolina supreme court for piercing the corporate veil. The three elements necessary to pierce the corporate veil under the instrumentality rule are: (1) control in the form of complete domination of finances, policy and business practice with respect to the transaction attacked by the plaintiff, (2) use of control to commit fraud or wrong, to perpetrate the violation of a statutory or other positive legal duty, or a dishonest and unjust act in contravention of plaintiff’s legal rights, and (3) proximate cause of plaintiff’s injury. The North Carolina supreme court also set forth factors to be considered in deciding whether to pierce the corporate veil including: (a) inadequate capitalization, (b) non-compliance with corporate formalities, (c) complete domination and control of the corporation so that it has no independent identity and (d) excessive fragmentation of a single enterprise into separate corporations. The appellate court stated that these factors may be weighed differently in the context of piercing the veil of an LLC. For example, the appellate court noted that, since the default rule under the North Carolina LLC Act is that all members of an LLC are deemed to be managers, “the fact that an individual has a management role in an LLC cannot, standing alone, justify imposing personal liability upon the manager on the grounds that he or she exercised ‘control’ over the LLC.” The appellate court further concluded that non-compliance with corporate formalities is of less relevance for LLCs since they are subject to far fewer formal statutory requirements than a corporation.

The appellate court examined the trial court’s record. The court concluded that the plaintiff offered sufficient evidence to support the jury’s findings that the husband exercised complete control over the finances, policies and business practices of the LLCs as their “alter ego” and used his control to cause the LLCs to disregard

their contractual obligations to return the rental deposits to the plaintiff, and that the husband’s actions were the proximate cause of the plaintiff’s injury. The court also concluded that the LLCs were inadequately capitalized and that the business was excessively fragmented.

The appellate court also addressed two additional arguments made by the defendants on the issue of piercing the veil. First, the defendants argued that the LLCs were properly formed and the husband did not have a majority ownership of any of them. The court noted that the defendants conceded that “an individual may be ‘held personally liable’ when an individual’s exercise of control is used to violate a duty owed to a plaintiff.” The court then noted that the evidence indicated that (1) the defendants *owed a duty* to return to plaintiff the rental deposits, (2) the husband made the substantive decisions for the LLCs and was known as the “decision maker,” (3) the husband refused to comply with *this contractual obligation* and (4) the plaintiff’s damages were proximately caused by the husband’s refusal to return the rental deposits. Second, the defendants made a policy argument that the concept of limited liability of members of a North Carolina LLC for the LLC’s contractual obligations would be undermined by the trial court’s decision since any member of an LLC with whom a contract counterparty deals on a day-to-day basis would be subject to personal liability for the LLC’s contract. The appellate court disagreed, distinguishing the “exercise of ordinary daily management of the LLCs” from the husband’s “decision to intentionally breach the [LLCs’] contracts without input from the other LLC members and [attempt] to use the LLCs to achieve an unjust result.”

The appellate court concluded that the plaintiff presented sufficient evidence to pierce the veil of the LLCs and that the trial court did not err by denying the defendants’ motions. The court affirmed the trial court’s order piercing the veil of the LLCs in accordance with the jury’s verdict.

5. *Roscoe v. Angelucci Acoustical, Inc.*, 512 S.W.3d 730 (Ky. Ct. App. 2017).

The plaintiff was a subcontractor who held a trial court judgment for unpaid fees against two Kentucky LLCs – the owner of the construction project, and the general contractor for the project – and an individual who was a managing member of both LLCs. The plaintiff had made

claims for breach of contract, unjust enrichment, a mechanic's lien, and fraudulent misrepresentation and concealment. The trial court granted a partial summary judgment for unpaid fees plus interest in favor of the plaintiff against the general contractor. In a ruling almost two years later, the trial court granted the plaintiff's motion to pierce the corporate veil of the general contractor, taking into consideration an intervening Kentucky supreme court ruling on the subject, and found that the managing member and the project owner were liable as well. The managing member appealed the trial court's ruling.

The appellate court affirmed the trial court's grant of partial summary judgment on the breach of contract claim, noting that the defendant failed to produce any evidence upon which the trier of fact might reasonably find judgment in its favor.

The appellate court next addressed the plaintiff's piercing the corporate veil claim. In granting partial summary judgment in favor of the plaintiff, the trial court analyzed a recent Kentucky supreme court decision that set forth the elements for piercing the corporate veil. The supreme court stated that the traditional alter ego formulation and the instrumentality theory are essentially interchangeable because, under either theory, the two dispositive elements are: (1) domination of the corporation resulting in loss of corporate separateness and (2) circumstances under which continued recognition of the corporation would sanction fraud or promote injustice. The supreme court listed 11 factors for courts to consider in assessing the first element (instead of just five factors identified in an appellate court decision more than 30 years earlier), with emphasis on "the four factors that are most critical": (a) grossly inadequate capitalization, (b) egregious failure to observe legal formalities, (c) disregard of distinctions between parent and subsidiary and (d) a high degree of control by the parent over the subsidiary's operations and decisions, particularly those of a day-to-day nature.

In analyzing the piercing claim, the appellate court applied the supreme court's piercing elements and factors to the trial court's findings of fact. As to the first piercing element, the appellate court noted that the trial court had enumerated the total lack of corporate separateness with painstaking effort for four pages of its decision. The two managing

members of the project owner were the same two managing members of the general contractor, which had been formed for the sole purpose of serving as the general contractor for the project. The only asset of the general contractor was its contract with the project owner to provide general contracting services for the project. The appellate court concluded that it was clear from its review of the trial court record that the project owner and/or the managing member exercised complete dominion and control over the general contractor.

As to the second piercing element, the appellate court noted that the trial court stated specific reasons why fraud or injustice would be sanctioned if the court declined to pierce the veil. The project owner caused the general contractor to be obligated to pay the subcontractor for work performed on the project and then rendered the general contractor unable to pay. All assets that could or should have been part of the general contractor were moved beyond the reach of creditors and were mostly held by the project owner. The managing member admitted that the general contractor was formed for the sole purpose of escaping the hassles and liabilities of the project owner being a general contractor and was a "pass-through." The project owner derived all of the benefit of improvements to the property from the rent paid by its tenant. The trial court stated that to allow the property owner and the managing member to escape liability under these circumstances would sanction fraud and promote injustice.

The appellate court affirmed the trial court's decision to pierce the corporate veil, noting that the defendant failed to show that the trial court erred in ruling that the Kentucky supreme court's piercing tests had been satisfied under the facts and circumstances of this case.

6. *Curci Investments, LLC v. Baldwin*, 14 Cal.App.5th 214 (Cal. Ct. App. 2017).

The plaintiff held a multi-million dollar judgment against the defendant, an individual. The defendant was a member of a Delaware LLC who held a 99% interest in the LLC and was also the manager and CEO of the LLC. The defendant's wife was the only other member of the LLC, and she held the remaining 1% interest in the LLC. The plaintiff had previously obtained a charging order against the defendant's LLC interest. However, the LLC had not made a

single distribution since the entry of the judgment in favor of the plaintiff. So the plaintiff moved, pursuant to the trial court's authority under the California's civil procedure rules, to add the LLC as a judgment debtor on a reverse veil piercing theory. The trial court denied the plaintiff's motion, citing California appellate court case law precedent holding that reverse veil piercing is not available in California. The plaintiff appealed, arguing that the appellate court precedent cited by the trial court was distinguishable from this case and that reverse veil piercing is available in California and appropriate under the facts and circumstances of this case.

The appellate court first discussed traditional veil piercing concepts under California law to provide the framework for analysis of reverse piercing. (The court was silent about why it chose to apply California law to the piercing analysis, rather than the law of the state in which the LLC was organized (Delaware) under the internal affairs doctrine applicable to foreign LLCs under the California LLC Act.) Citing California appellate court precedent, the court noted that the "well-established alter ego doctrine" will hold a stockholder of a corporation personally liable for the debts of the corporation when the corporation is used to perpetrate a fraud, circumvent a statute or accomplish some other wrongful or inequitable purpose. The court also cited the California LLC Act section that expressly provides that the common law governing alter ego liability applies to members of LLCs to the same extent it applies to stockholders of corporations, except that failure to observe corporate formalities is not a factor in establishing alter ego liability for members of LLCs except to the extent such formalities are expressly required by the LLC's organizational documents. Citing California case law precedent, the court noted that two conditions must be met to invoke the alter ego doctrine in California ("...unity of interest and ownership between the corporation and its equitable owner that the separate personalities of the corporation and the shareholder do not in reality exist...", and "inequitable result if the acts in question are treated as those of the corporation alone") and that "there is no litmus test to determine when the corporate veil will be pierced; rather the result will depend on the circumstances of each particular case."

The appellate court then discussed the concept of reverse veil piercing and distinguished it from traditional veil piercing. The court noted that "a growing majority of courts across the country" have adopted outside reverse veil piercing (*i.e.*, reverse piercing by a third party, and not an insider) as a potential equitable remedy, and that in addition to the traditional veil piercing factors, some courts have added additional factors to address concerns unique to reverse piercing. In a prior case cited by the defendant, the California appellate court held that "a third party creditor may not pierce the corporate veil to reach to reach corporate assets to satisfy a shareholder's personal liability." That court expressed concerns about allowing judgment creditors to bypass standard judgment collection procedures, harming innocent shareholders and creditors of the corporation, and using an equitable remedy in situations where legal remedies were available.

The appellate court distinguished the current case from the prior case cited by the defendant on several counts, stating that the prior case was expressly limited to corporations and did not apply to LLCs. The court noted that the facts and circumstances of the current case, as well as the nature of LLCs compared to corporations, did not present the same concerns identified in the prior case. First, there are no innocent members of the LLC since the defendant's wife is the only other member of the LLC and she is liable for the debt to the plaintiff. Second, unlike a creditor of a shareholder of a corporation, a creditor of a member of an LLC is limited to obtaining a charging order against distributions made to the member from the LLC and cannot vote, obtain ownership of, or sell the member's interest in the LLC (the court noted that the comments to the charging order provision of the Revised Uniform LLC Act, from which the correlating provision of the California LLC Act was adopted without substantive change, state that the exclusive remedy provision is "not intended to prevent a court from effecting a 'reverse pierce' where appropriate"). Third, in this case, the plaintiff may not have an adequate remedy at law. (The appellate court was silent on whether treating LLCs differently than corporations for purposes of veil piercing was consistent with the California LLC Act section that expressly provides that the common law governing alter ego liability applies to members of LLCs to the same extent it applies to stockholders of corporations.)

The appellate court concluded that the facts of this case may support reverse piercing the LLC's veil. The defendant effectively had complete control over the LLC, including whether it makes distributions to its two members. Since the judgment was entered in favor of the plaintiff, the LLC has made no distributions to its members, despite having made millions of dollars of distributions in the six years before the judgment, and extended the payback period for loans made by the LLC to family partnerships that benefit the defendant's grandchildren. The plaintiff has been trying to collect its judgment against the defendant for more than five years, and the defendant has been uncooperative and claimed lack of knowledge of his own personal assets and the "web of business entities in which he has an interest." For all of these reasons, the appellate court reversed the trial court's denial of the plaintiff's motion to amend the judgment to add the LLC as a judgment debtor to the judgment against the defendant and remanded the case to the trial court to consider whether the facts of this case justify reverse piercing the LLC's veil and adding the LLC as a judgment debtor.

7. *Chico Auto Parts & Services, Inc. v. Crockett*, 512 S.W.3d 560 (Tex. App. 2017).

The plaintiff contracted to perform hazardous material remediation services on an oil well operated by a Texas LLC that was managed by an individual managing member, who was also part owner of the oil and gas interests in the well. The LLC did not pay the plaintiff for remediation services performed on the well, and the plaintiff sued the LLC and its managing member as co-defendants for breach of contract, quantum meruit and fraud, seeking reimbursement for the cleanup work performed. The trial court granted the managing member's motion for summary judgment on all three claims, citing, among other reasons, that there was no privity of contract between the plaintiff and the managing member and that the managing member was immune from liability under the Texas Business Organizations Code. The plaintiff appealed.

The appellate court first examined the plaintiff's breach of contract claim. The plaintiff argued that the managing member was personally liable for the LLC's breach of contract, both in his capacity as owner of the well under the Texas Natural Resources Code, as well as in his

capacity as managing member of the LLC.

The appellate court first addressed the plaintiff's reliance on the Texas Natural Resources Code to hold the managing member liable for the LLC's breach of contract as owner of the well and concluded that such reliance was misplaced. While the statute gave the Texas Railroad Commission the authority to take action against a "responsible person" such as the owner of a well, it did not allow the plaintiff to hold the owner liable for breach of a contract to perform remediation services to which the owner was not a party.

The appellate court next addressed whether the managing member could be held liable for the LLC's breach of contract in his capacity as the LLC's managing member. The court noted the general statutory principle that a member of an LLC is not liable for the debts of the LLC. Although the plaintiff did not argue that the managing member could be held liable under a piercing the corporate veil theory, the court examined the applicable statutory and common law anyway. At the time the plaintiff performed remediation services for the LLC in July 2011, the court noted that virtually all Texas courts uniformly applied the same common law principles to pierce the veil of an LLC that were previously used to pierce the veil of a corporation prior to the Texas legislature's adoption of the statutory "actual fraud" requirement for corporations in 2006. (Effective September 1, 2011, the Texas legislature adopted the same statutory "actual fraud" requirement for piercing the veil of LLCs that had been applicable to piercing the veil of corporations since 2006, *i.e.*, a corporate affiliate may be held liable for a corporation's contractual obligations only if it caused the corporation to be used to perpetrate an actual fraud for its own personal benefit.) Since the plaintiff failed to argue or produce any evidence that the managing member could be held liable for the LLC's debts under the "alter ego" theory or any other common law veil piercing theory, the court concluded that the plaintiff waived veil piercing as a ground for holding the managing member personally liable for the LLC's breach of contract.

The plaintiff also argued that its fraud claim against the managing member should be sufficient to hold the managing member personally liable for the LLC's breach of

contract, citing Texas case law holding that a corporate officer can be sued for the officer's tortious or fraudulent acts without the need for piercing the corporate veil. The appellate court distinguished the facts of this case, stating that the plaintiff's fraud allegations have nothing to do with its breach of contract claim because they relate to the managing member's conduct after the contract was formed. The court further stated that when a plaintiff's claim "sounds in contract, rather than tort, the cases holding a corporate affiliate personally responsible for his tortious or fraudulent acts simply do not apply." For these reasons, the appellate court concluded that the trial court properly granted summary judgment to the managing member on the plaintiff's breach of contract claims.

The appellate court next addressed the plaintiff's argument that the trial court erred in granting summary judgment to the managing member on the plaintiff's claim for quantum meruit, an equitable remedy based on an implied promise to pay for benefits received. Citing relevant case law, the court explained that "quantum meruit implies a contract in circumstances where the parties neglected to form one, but equity nonetheless requires payment for beneficial services rendered and knowingly accepted." The court further explained that, in circumstances where a valid contract already exists, a party cannot recover under a "contract implied by law." This rule applies not only to express contracts, but also to "implied-in-fact contracts that arise from the acts and conduct of the parties" (the appellate court cited another appellate court decision "explaining in detail how an implied-in-fact contract is distinct from an implied-in-law contract, and concluding that an implied-in-fact contract, like an express contract, bars recovery in quantum meruit"). This rule also prevents a plaintiff from seeking to recover in quantum meruit against a third party who benefited from the plaintiff's performance of the contract. The appellate court concluded that, since an implied-in-fact contract for remediation services existed between the plaintiff and the LLC (there was no written contract), the plaintiff was barred from recovery under a quantum meruit theory for the same services.

The appellate court next addressed the plaintiff's contention that the trial court erred in granting the managing member's motion for summary judgment on the plaintiff's fraud claim. The court acknowledged the plaintiff's argument that a

plaintiff may sue a corporation's affiliate for the affiliate's own torts, including fraud, without piercing the corporate veil. To establish actionable fraud, the plaintiff must demonstrate, among other things, that the alleged misrepresentation was material and that the plaintiff justifiably relied on it. In this case, the plaintiff alleged that the managing member misrepresented to the plaintiff that another entity affiliated with the managing member, not the LLC, was the operator of the oil well, and the plaintiff relied on this representation in billing this affiliated entity for the remediation services. (The plaintiff had obtained a prior judgment against this affiliated entity for the same services, but the entity filed for bankruptcy before making any payment to the plaintiff on the judgment.) The court stated that the issue of which party is the operator of the well had no bearing on which party contracted with the plaintiff, agreed to be responsible for the services that the plaintiff performed, or should have been billed by the plaintiff. The plaintiff did not allege that the managing member misled the plaintiff about who the contracting parties were, who should be charged for the plaintiff's services, or the LLC's role in the matter. In fact, the plaintiff had previously accepted two partial payments from the LLC for the remediation services rendered by the plaintiff. The court concluded that the alleged misrepresentation by the managing member was neither material nor justifiably relied upon by the plaintiff, and therefore the trial court properly granted summary judgment to the managing member on the plaintiff's fraud claim.

8. *Grigsby v. Francabandiero*, 152 A.D.3d 1195 (N.Y. App. Div. 2017).

The plaintiff held a judgment against a New York LLC in an action under the Fair Debt Collection Practices Act. The judgment was obtained in Illinois federal district court and domesticated in New York state court. In the New York state court proceeding, the plaintiff also sought to pierce the LLC's veil and hold the two individual defendants liable for the judgment. At the time the conduct that was the subject of the judgment against the LLC occurred, one of the defendants was the sole member and officer of the LLC, and the other defendant was a former member and officer of the LLC who the plaintiff alleged was still an "equitable owner" of the LLC. The plaintiff alleged that the defendants undercapitalized the LLC, failed to adhere to

LLC formalities, and wound down the LLC's business and transferred its assets and operations to a newly-formed entity without providing for payment of the LLC's liabilities, including the plaintiff's judgment. Both defendants moved to dismiss the plaintiff's claims against them, and the trial court granted the defendants' motions. The plaintiff appealed.

The appellate court examined the facts alleged by the plaintiff against defendant who was the sole member and officer of the LLC. The plaintiff asserted that the defendant dominated the LLC and abused its privilege of doing business in the corporate form to perpetrate a wrong or injustice against the plaintiff. The plaintiff alleged that the defendant undercapitalized the LLC, and then dissolved the LLC and transferred its assets to a new entity without reserving funds to satisfy the plaintiff's judgment against the LLC. The appellate court concluded that the plaintiff pled sufficient facts to survive the defendant's motion to dismiss and modified the trial court's order accordingly.

The appellate court separately examined the facts alleged by the plaintiff against the other defendant, who was the former member and officer of the LLC. The appellate court concluded that the plaintiff alleged no facts that, if proved, would establish that the defendant, after relinquishing his status as a member and an officer of the LLC, "dominated and controlled the LLC to such an extent that he may be considered its equitable owner." The appellate agreed with the trial court's conclusion that the plaintiff's "bare-bones allegations" of equitable ownership, without more, were insufficient to survive the defendant's motion to dismiss.

In a concurring opinion, one of the appellate judges emphasized what he described as an "underdeveloped issue" in the law – *i.e.*, piercing the entity veil to hold an "equitable owner" liable for the debts of the entity. The judge cited the general rule under New York law for piercing the corporate veil: "a plaintiff must show that (1) the owners exercised complete domination and control of the corporation in respect of the transaction attacked and (2) such domination was used to commit a fraud or wrong against the plaintiff which resulted in the plaintiff's injury." The judge noted that, in this case, the plaintiff's allegations against both defendants were the same, except that one defendant was a legal

owner and member of the LLC while the other defendant was alleged to be an "equitable owner." The judge concurred with the majority's result of dismissing the claim against the "equitable owner" defendant because "it is not enough to allege the elements of a claim to pierce the corporate veil premised on an alter ego theory and merely state that the defendant is an 'equitable' owner." Rather, specific facts must be alleged demonstrating that the "non-owner has so dominated and controlled the business such that the non-owner may be considered an 'equitable owner' of the business." The judge noted that New York state's highest court has not ruled on whether the concept of an "equitable owner" fits within the alter ego theory of piercing the corporate veil. The judge stated that public policy considerations would need to be taken into account, because the pool of potential defendants would be expanded and the limited liability protections afforded when forming a business entity could be reduced. The judge concluded that the policy concerns of holding an "equitable owner" liable for the debts of an entity may be more significant to an LLC that is controlled by a manager, rather and its members.

9. *State ex rel. Family Support Division v. Steak'm Take'm LLC*, 2017 WL 3136424 (Mo. Ct. App. 2017).

A single-member Missouri LLC operated a drive-through restaurant. The LLC employed an individual who owed child support. The State of Missouri served several withholding orders on the LLC requiring the LLC to withhold child support payments from the employee's paycheck and remit them to the state. The LLC failed to do so and, as a result, became statutorily liable to the state for such amounts. The LLC subsequently transferred the restaurant for nominal consideration to a second, newly-formed single-member Missouri LLC. The sole member of the second LLC managed the restaurant both before and after the transfer, and he was also the sister of the first LLC's sole member and the father of the individual who owed child support. After the transfer of the restaurant, the second LLC operated the restaurant and employed the individual who owed child support. The State of Missouri filed a lawsuit against the first LLC to collect the child support payments that were not withheld, as well as the second LLC under a successor liability

theory and the second LLC's sole member under a veil-piercing theory. Following a bench trial, the trial court entered a judgment against both LLCs and the sole member of the second LLC, holding them jointly and severally liable for child support payments not withheld and remitted to the state. The second LLC and its sole member appealed the trial court's judgment against them.

The appellate court examined the second LLC's argument that the trial court erred in holding the second LLC liable for the debts and liabilities of the first LLC under a successor liability theory. The appellate court noted that, under Missouri law, the general rule is that the transferee of assets is not liable for the transferor's debts and liabilities, except when (1) the transferee expressly or impliedly assumes such liabilities, (2) the transaction is a merger or consolidation, (3) the transferee is a "mere continuation" of the transferor or (4) the transaction is entered into fraudulently to escape liability. Based on the trial court's record, the appellate court agreed with the trial court's conclusions that the second LLC was a mere continuation of the first LLC and was therefore liable for the first LLC's debts, and that the first LLC fraudulently transferred the restaurant to the second LLC to avoid paying the child support payments.

The appellate court next examined the argument of the sole member of the second LLC that he should not be held personally liable for the second LLC's debts and liabilities. The appellate court noted that, under Missouri law, the general rule is that a member of an LLC is not liable for the LLC's debts unless the member is using the LLC for an improper purpose such as avoiding legal obligations, in which case a court may pierce the LLC's veil. Under Missouri law, the following three factors must be shown to pierce the veil: (1) complete domination of finances, policy and business practice in respect to the transaction attacked such that the LLC had no separate mind, will or existence of its own, (2) such control must have been used to commit fraud or wrong, to perpetrate the violation of statutory or other positive legal duty, or dishonest and unjust act in contravention of plaintiff's legal rights, and (3) the act must have proximately caused the plaintiff's injury. The trial court's record showed that the sole member of the second LLC had complete control over the finances and management of the LLC, that he knew about the child support debt when the LLC

took ownership of the restaurant from his sister's LLC for nominal consideration, and that he used his control over the LLC to escape liability for child support debt. The appellate court concluded that all three prongs of the veil-piercing test were satisfied, and that the trial court did not err in holding the sole member of the second LLC personally liable for the LLC's debts.

10. *Torstenson v. Birchwood Estate, L.L.C.*, 2017 WL 1086222 (Iowa Ct. App. 2017).

An Iowa LLC purchased real estate to develop lots for sale. The purchase price for the real estate was funded by \$25,000 capital contributions from each of the LLC's two members and a \$1.7 million bank loan secured by the real estate. The bank loan was guaranteed by each of the LLC's two members, both of which were also Iowa LLCs (hereinafter LLC Member #1 and LLC Member #2), as well as their respective individual owners. Lot sales slowed to the point where the LLC borrower could no longer continue making payments on the bank loan. So LLC Member #1 and LLC Member #2 decided to make alternating voluntary capital contributions to the LLC borrower to enable the LLC borrower to satisfy its loan payment obligations. Eventually, LLC Member #1 stopped making voluntary capital contributions at a time when LLC Member #1 had made fewer total capital contributions to the LLC borrower than LLC Member #2. One of the owners of LLC Member #2 purchased the note from the lender to prevent a default and then called the personal guaranties of the two owners of LLC Member #1, who thereafter made guaranty payments to the note holder and sued the LLC borrower for reimbursement. The trial court ruled that the two owners of LLC Member #1 were not entitled to reimbursement because their payments were more like capital contributions than guaranty payments, that LLC Member #1 was responsible for reimbursement or equalization of excess capital contributions made by LLC Member #2 to the LLC borrower, and that the two owners of LLC Member #1 were personally liable for these amounts under a veil-piercing theory. The two owners of LLC Member #1 appealed.

The appellate court first addressed the claim by the two owners of LLC Member #1 that, under Iowa law, they were entitled to reimbursement from the LLC borrower for the guaranty

payments made by them on the LLC borrower's behalf. Citing Iowa supreme court precedent, the appellate court noted that Iowa law requires a principal obligor to reimburse a secondary obligor to the extent the secondary obligor satisfies the underlying obligation. The appellate court ruled that the trial court erred in treating the guaranty payments as capital contributions and that the two owners of LLC Member #1 were entitled to reimbursement from the LLC borrower.

The appellate court next considered whether the trial court improperly considered the law of contribution among co-guarantors in requiring the two owners of LLC Member #1 to make payments to LLC Member #2 and its owners to equalize the excess capital contributions made by LLC Member #2 to the LLC borrower. The appellate court ruled that the trial court erred in considering contribution in this case since neither LLC Member #2 nor any of its owners was a party to the lawsuit.

The appellate court next examined the trial court's ruling that the two owners of LLC Member #1 were personally liable under a veil-piercing theory and for breach of fiduciary duty owed to the LLC borrower. The trial court held that the failure of LLC Member #1 to continue making capital contributions to the LLC borrower was a breach of the fiduciary duty of care of LLC Member #1 and its two owners to the LLC borrower. The appellate court ruled that the trial court erred in reaching this conclusion. The appellate court concluded that the two owners of LLC Member #1 were not members of the LLC borrower and therefore had no fiduciary duties to the LLC borrower or obligations under the LLC borrower's operating agreement. Rather, LLC Member #1 was a member of the LLC borrower and had fiduciary duties to the LLC borrower and obligations under the LLC borrower's operating agreement. The LLC borrower's operating agreement did not require LLC Member #1 to make any additional capital contributions after its initial \$25,000 capital contribution or to equalize capital accounts. The appellate court also stated in somewhat conclusory fashion that the failure of LLC Member #1 to continue making capital contributions to the LLC borrower did not constitute a breach of fiduciary duty (the Iowa LLC Act has a statutory "reasonable person" duty of care).

The appellate court next addressed the trial court's decision to pierce the veil of LLC Member #1 (a non-party to the litigation) and hold its two owners personally liable for LLC Member #1's debts. Citing Iowa case law, the appellate court noted that the corporate veil may be pierced under exceptional circumstances, such as when a shell corporation serving no legitimate business purpose is used to perpetuate fraud or promote injustice. Factors to be considered include: (1) undercapitalization, (2) lack of separate books, (3) commingling of finances or obligations, (4) promotion of fraud or illegality, (5) failure to follow corporate formalities and (6) corporation is a mere sham. The trial court held that piercing was appropriate because LLC Member #1 was formed for the purpose of investing in the LLC borrower, was undercapitalized, and did not follow corporate formalities or maintain separate books. The appellate court noted that the doctrine of piercing the corporate veil is an equitable remedy to protect creditors, and since there was no judgment against LLC Member #1, there was no reason to pierce the veil. The appellate court concluded that piercing was not warranted in this case based on undercapitalization because the adequacy of capitalization is determined at or near the time of formation, and at the time the LLC borrower was formed, LLC Member #1 made a capital contribution of \$25,000 and no further capital contributions were expected or required. The appellate court ruled that, under the facts of this case, there was no legal ground to pierce the veil of LLC Member #1.

Lastly, the appellate addressed the trial court's determination that the two owners of LLC Member #1 would be unjustly enriched if they were allowed to make fewer capital contributions to the LLC borrower than LLC Member #2. The appellate court concluded that it could not affirm the trial court's ruling against the owners of LLC Member #1 based on an unjust enrichment theory because the owners of LLC Member #1 were seeking reimbursement from the LLC borrower for their guaranty payments, and it was LLC Member #1 (and not its owners) that was alleged not to have made capital contributions to the LLC borrower. In other words, LLC Member #1 may have been unjustly enriched, but its owners were not.

The appellate court concluded that the two owners of LLC Member #1 were entitled to reimbursement by the LLC borrower for the

guaranty payments they made for the LLC borrower's obligations, and the appellate court reversed the trial court's order and remanded the case for entry of a judgment in favor of the owners of LLC Member #1.

Current Status of Bankruptcy Issues

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Applying Bankruptcy Law to LLCs.

Eligibility of an LLC to File a Bankruptcy Petition.

Title 11 of the United States Code (the “Bankruptcy Code”) permits “persons” to file bankruptcy petitions, and the statutory definition of “person” includes “individual, partnership, and corporation.” Bankruptcy Code § 101(41). Although an LLC is not a “partnership” in a state law sense, the Bankruptcy Code defines “corporation” to include:

- (ii) partnership association organized under a law that makes only the capital subscribed responsible for the debts of such association; [or]
- (iv) unincorporated company or association;

Bankruptcy Code § 101(9)(A). For the purposes of determining an LLC’s eligibility to file a bankruptcy petition, an LLC should be able to fit within either of the subsections cited above. It might be possible to argue with the characterization of an LLC as a corporation because § 101(9)(B) specifically excludes limited partnerships from the definition of corporations, but this distinction is unlikely to matter in any event. The definition of “person” lists individuals, partnerships and corporations as entities “included” within the definition, but is not so exclusive as to prevent another type of entity not listed in the statute from also being characterized by a court as a “person.”

It is also worth observing that the classification of an LLC as a partnership or as a corporation for purposes of determining the applicability of the Bankruptcy Code should have little other effect on the disposition of a bankruptcy proceeding. Most of the provisions of the Bankruptcy Code that apply specifically to partnerships relate to issues, such as the

liabilities of general partners, that are not likely to apply in an LLC context.

The distinction between a “partnership” and a “partnership association” that fits within the Bankruptcy Code definition of “corporation” arose in *In re Rambo Imaging, L.L.P.*¹ In that case, the bankrupt entity was a Texas general partnership that had elected limited liability partnership status. Although the partnership agreement described numerous actions that could be taken only with the approval of two-thirds of the holders of partnership units, and delegated other actions to the “Managing Partners,” the agreement did not specifically address the power to put the partnership into bankruptcy. The partnership was clearly a general partnership, but the court engaged in an analysis of the limited liability of the partners, and relied on a treatise reference in Collier’s, to conclude that an LLP should be treated as a “partnership association,” and therefore a “corporation” for Bankruptcy Code definitional purposes. On that basis, the court held that a dissident general partner did not have the power to commence an involuntary bankruptcy proceeding on behalf of the partnership.

The court in *In re Midpoint Development, L.L.C.*² noted the omission of LLCs from the Bankruptcy Code, and analogized to corporations and partnerships. In that case, the court held that even a limited liability company in dissolution is entitled to make a bankruptcy filing, because a dissolved LLC is still in the process of winding up, and the winding up process may be conducted through bankruptcy. However, this case was ultimately reversed by the Tenth Circuit because the bankrupt LLC had not only dissolved, but had actually filed articles of dissolution that became effective prior to the bankruptcy filing. On the effective date of the articles of dissolution, the Oklahoma LLC ceased to exist, and so could not later file for bankruptcy. See *In re Midpoint Development, L.L.C.*³

Authority to File a Bankruptcy Petition.

As a general proposition, state law determines who has the legal right to file a

¹ 2008 Bankr. LEXIS 2311 (Bankr. W.D. Tex. July 15, 2008).

² 313 B.R. 486 (Bankr. W.D. Okla. 2004).

³ 466 F.3d 1201 (10th Cir. 2006).

bankruptcy petition.⁴ With respect to general partnerships, the federal bankruptcy rules once provided that a bankruptcy petition could be filed by any general partner, provided that all general partners consented,⁵ but that rule was deleted because it was inappropriate for the bankruptcy rules to attempt to define what is essentially a state law governance rule. In the corporate context, the power to file a petition will usually rest with a corporation's board of directors, but in an LLC setting, the authority of managers is not as clear. State LLC statutes generally do not prescribe whether members or managers have the power to file federal bankruptcy petitions, and this determination will require an analysis of the terms of the LLC's governing documents. If the articles of organization and the operating agreement do not describe the authority of members or managers to file for bankruptcy, the answer to this question will depend on whether the LLC is member-managed or manager-managed, and the extent to which the articles and operating agreement otherwise delegate actions to managers and reserve actions to members. For example, if an LLC's managers are given relatively broad authority to take significant business actions on behalf of the LLC, it might be appropriate for a bankruptcy court to conclude that the managers also have authority to file a bankruptcy petition. By contrast, if an operating agreement reserves almost all significant business decisions to the members collectively (by whatever voting rule), the members will probably be deemed to have the authority to make the bankruptcy filing decision. The risk that a bankruptcy court will be vested with the power to determine which managers or members have the power to file a bankruptcy petition should provide sufficient justification for careful drafting of an operating agreement provision.

Most of the cases addressing the power to file a bankruptcy petition are divided into two categories: those that deal with the statutory power to initiate bankruptcy, and others that address whether a bankruptcy has been appropriately commenced given the terms of an LLC's governing documents or other agreements.

⁴ See *Price v. Gurney* 324 U.S. 100 (1945).

⁵ See former Fed. Bankr. R. § 1004(a).

Statutory Power to File.

In *In re A-Z Electronics LLC*,⁶ a bankruptcy proceeding on behalf of an LLC had been commenced by the LLC's sole member, but the member was himself a debtor in a Chapter 7 bankruptcy case. On that basis, the court concluded that the member's bankruptcy trustee had the statutory status of the member, and therefore was the only person entitled to commence the bankruptcy proceeding on behalf of the LLC. In *In re Delta Starr Broadcasting, L.L.C.*,⁷ the court analyzed the Louisiana LLC statute and concluded that a bankruptcy petition should be likened to other major actions requiring majority approval of an LLC's members under that statute. Although the LLC had not undertaken formal procedures (including resolutions or a meeting) before initiating the LLC's bankruptcy, the court concluded that a majority of the members had unambiguously approved the filing, and that Louisiana law did not require "corporate" formalities in order for an LLC to take valid member action.

Two 2010 cases address the status of persons as members authorized to participate in the bankruptcy filing decision. In *In re Wyatt & McAlister, PLLC*,⁸ a member resigned as an employee of a professional limited liability company but preserved her ownership interest in the LLC. The court held that because she had not resigned and therefore remained a member, she was entitled to vote on whether to put the LLC into bankruptcy, and because she was a 50% member, the other member did not have authority to file the bankruptcy petition without her approval. In *In re Lake County Grapevine Nursery Operations*,⁹ a member that had pledged his entire membership interest and was in default on the underlying loan was found to have authority as a member because the pledge did not have the effect of acting to defease the member of his status as such without further action to confer membership status on the creditor.

A 2013 Virginia case applied the *ipso facto* provision of § 365 of the Bankruptcy Code

⁶ 350 B.R. 886 (Bankr. D. Idaho 2006).

⁷ 2006 WL 285974 (E.D. La. Feb. 3, 2006).

⁸ 2010 WL 1709920 (Bankr. S.D. Miss. Apr. 23, 2010).

⁹ 441 B.R. 653 (Bankr. N.D. Cal. 2010).

to declare ineffective the Virginia LLC Act's bankruptcy dissociation provision and give effect to a filing, but this case dealt with the status of a member at the time of the filing, rather than the member's statutory power. In this case, the debtor's personal bankruptcy case had been dismissed, and the question was whether the LLC of which he was a member had a properly authorized bankruptcy petition, given that he may have ceased to be a member when his petition was filed. The court concluded that the debtor's approval of the LLC filing was valid because the debtor's non-economic interest in the LLC was the property of the estate because the *ipso facto* clause invalidated the effect of the operating agreement and the Virginia LLC act. However, having said that the *ipso facto* clause rendered those provisions invalid, as if the rights were never divested, the court then spoke of the rights as "revesting" in the debtor.¹⁰

Contractual Power to File.

The value of a contractual provision limiting the authority of managers or members to file a bankruptcy petition was made clear in *In re Avalon Hotel Partners, LLC*.¹¹ In this case, the operating agreement required 75% member approval for certain "Major Decisions." Although bankruptcy was not specifically listed as an event triggering the "Major Decision" clause, the court reached the conclusion that a bankruptcy filing was analogous to a conversion into another type of entity, and imposed the 75% requirement. However, it is preferable to anticipate bankruptcy more explicitly.

Courts have generally enforced explicit contractual provisions governing the right to file a bankruptcy case, including provisions that have been drafted to protect creditors. In *In re Orchard at Hansen Park, LLC*,¹² the operating agreement required unanimous member consent for the filing of a voluntary bankruptcy case, and the court allowed a creditor to intervene and contest the authority of one of the

members to file the petition. The court concluded that a creditor had standing to make that challenge, reviewed an operating agreement provision that required unanimous member vote, and concluded that without evidence of that vote, the filing member was without authority to file the bankruptcy petition on behalf of the LLC.¹³

A Virginia bankruptcy case reached a similar result. In *In Re Loudoun Heights, LLC*,¹⁴ the bankrupt LLC had two members, including another LLC with a 93% membership interest. However, prior to the bankruptcy filing, that LLC had been administratively terminated for failure to file its annual report and pay its annual fee, and therefore was deemed under the Virginia LLC Act to have dissociated as a member of the bankrupt LLC. The bankruptcy filing was authorized by the sole remaining member, and even though the other member LLC had been reinstated subsequent to the bankruptcy filing, the court refused to give that reinstatement effect for the purposes of determining whether the bankruptcy filing had been properly authorized at the time of the filing several months before.

Two cases also emphasize the importance of providing more explicitly for the possibility of an LLC's bankruptcy. In both cases, had the operating agreements been more explicit, the court's analysis would have been unnecessary.¹⁵

In two other cases, courts have enforced provisions that give lenders an explicit voice in

¹⁰ See *In re Virginia Broadband, LLC*, 498 B.R. 90 (Bankr. W.D. Va. 2013). Contrast this case with *In re B&M Land and Livestock, LLC*, 498 B.R. 262 (Bankr. D. Nev. 2013) (Chapter 7 debtor as the sole member of an LLC did not have power to file a Chapter 11 petition for the LLC).

¹¹ 302 B.R. 377 (Bankr. D. Or. 2003).

¹² 347 B.R. 822 (Bankr. N.D. Tex. 2006).

¹³ Compare *In re Telluride Income Growth Limited Partnership*, 311 B.R. 585 (Bankr. D. Colo. 2004) (dissolved LLC serving as general partner of limited partnership was not eligible to initiate bankruptcy on behalf of limited partnership because limited partnership agreement provided for the termination of the LLC's status as general partner upon dissolution).

¹⁴ 2014 Bankr. LEXIS 2085 (Bankr. E.D. Va. June 26, 2014).

¹⁵ See *In re 210 West Liberty Holdings, LLC*, 2009 WL 1522047 (Bankr. N.D.W. Va. May 29, 2009) (provision that "all decisions" be made by majority vote is sufficient to allow bankruptcy filing over member objection because the objecting member's approval was not necessary to constitute majority); *In re Ice Oasis, LLC*, 2008 WL 5753355 (Bankr. N.D. Cal. Nov. 7, 2008) (in two member LLC with 50/50 ownership, both members were required to approve the bankruptcy filing because the operating agreement provided for "all decisions" to be approved by a majority, and bankruptcy is not an ordinary course decision that may be approved by the managing member).

the filing of a bankruptcy petition. In *In re Global Ship Systems, LLC*,¹⁶ the operating agreement established the creditor as a “Class B shareholder,” and the filing of a voluntary bankruptcy by the LLC required the consent of the Class B shareholder. This case actually involved the ruse of the LLC soliciting the filing of an involuntary case that it then failed to contest, but the court concluded that that end-run around the creditor’s contractual rights as a member was inappropriate, and granted the creditor relief from the stay because the bankruptcy had been filed without its consent. In *In re Green Power Kenansville, LLC*,¹⁷ an LLC’s sole member had assigned its interest in the LLC to a third party, which then commenced a bankruptcy petition on behalf of the LLC. The assignment violated a loan agreement, the voting of the interest by the assignee was contrary to a pledge agreement provision that allowed the creditor to vote all of the original member’s interests upon a loan default, and the assertion of authority by the assignee apparently attempted to override an independent manager provision that effectively required lender consent to a bankruptcy filing by the LLC. The court enforced the independent manager provision, despite the fact that the assignee may not have had knowledge of the provision, on the basis that the assignee member was governed by the written operating agreement irrespective of knowledge. Because the assignee lacked power to file the petition, the court dismissed the bankruptcy case.

In *In re Quad-C Funding LLC*,¹⁸ a dissident LLC member challenged the filing of a Chapter 11 petition for the LLC on the basis that the requisite supermajority vote of members had not approved the filing. The other members of the LLC had circumvented the dissident member’s effective veto right by raising additional capital and issuing additional LLC units that eliminated the dissident member’s ability to block the filing. The dissident member asked the court to consider the validity of the issuance of the additional units (based on the lack of accredited investor status of the new investors), but the court concluded that in bankruptcy, it was not obligated to investigate the non-bankruptcy

legal status of the voting rights of each LLC member.

Effect of Non-Bankruptcy Law.

State receivership law and other state remedies can also affect the way in which LLC laws interact with bankruptcy.

The court in *In re Orchard Village Investments, LLC*,¹⁹ was required to consider whether non-bankruptcy state receivership law could be used to prevent the filing of a bankruptcy petition. Following the creation of the state receivership, the receiver was granted broad authority that arguably divested the members of the authority to file a bankruptcy petition. The LLC’s operating agreement specifically denied the LLC’s manager the authority to file a bankruptcy petition, and reserved that power to the members by majority consent. In this case, the disputed bankruptcy petition was filed by the manager, and ratified post-petition by the members. The court held the post-ratification approval sufficient under the operating agreement, and held that the state receivership proceeding could not trump the ability to file the federal bankruptcy petition.

Using Bankruptcy-Remote Techniques.

The effectiveness of creditor efforts to utilize bankruptcy-remote single purpose entities (SPEs) and contractual restrictions on bankruptcy filings to limit the ability of an LLC to file for bankruptcy requires careful drafting, and these techniques may not always be honored by courts confronted with them.

The creditors involved in *In re Crossover Financial I, LLC*,²⁰ had extracted an agreement by the debtor LLC and its sole member pledging the member’s interest and providing the creditors with voting rights by proxy in the event of default. However, the court concluded that the creditors exercising these rights simply became assignees or transferees under the Colorado LLC statute, and did not have the right to participate in management or otherwise to divest the sole member of his status as a member. For that reason, the sole member’s adoption of a unanimous consent directing the filing of the

¹⁶ 391 B.R. 193 (Bankr. S.D. Ga. 2007).

¹⁷ 2004 WL 5413067 (Bankr. E.D.N.C. Nov. 18, 2004).

¹⁸ 498 B.R. 135 (S.D.N.Y. 2013).

¹⁹ 405 B.R. 341 (D. Ore. 2009).

²⁰ 477 B.R. 196 (Bankr. D. Colo. 2012).

LLC's bankruptcy petition was within the member's legal power.

Another case emphasizes the importance to creditors of carefully drafting provisions intended to cover bankruptcy filings. In *In re General Growth Properties, Inc.*,²¹ several hundred SPEs had been established with "independent managers" who had the power to consent or withhold consent to a bankruptcy filing by each SPE. Before the bankruptcy petitions were filed against the ultimate parent and the numerous subsidiaries, the independent managers were discharged and replaced, in a manner that apparently complied with the provisions of the SPEs' operating agreements. Because the new independent managers arguably had more expertise than the prior independent managers, the court concluded that this maneuver could not be deemed to be in bad faith, and refused to dismiss the bankruptcy petitions on that basis.

The practical effect of a unanimity requirement was at issue in a dispute over the bankruptcy of a regional sports network, *In re Houston Regional Sports Network, L.P.*²² In that case, the bankrupt limited partnership had an LLC general partner, and the general partner was controlled by four "directors". The directors represented differing interests and owners of the LLC, and certain decisions, including bankruptcy reorganization, required director unanimity. One of the directors argued that the bankruptcy petition should be dismissed because its unwillingness to reorganize the partnership rendered the proceeding fatal, but the court concluded that despite disclaimers of fiduciary duties in the limited partnership agreement, and the fact that the directors were one step removed as directors of a general partner, the directors all owed fiduciary duties to the limited partnership bankruptcy estate. Accordingly, the court refused to dismiss the proceeding because of its expectation that all the directors would take future actions consistent with their fiduciary duties to the debtor.

Two different bankruptcy courts rendered decisions in 2016 that had the effect of overriding operating agreement provisions that

empowered a creditor or a nominee of a creditor to utilize a bankruptcy approval requirement to block a bankruptcy filing by a debtor LLC. In *In re Lake Michigan Beach Pottawattamie Resort LLC*,²³ the operating agreement had been amended, following a loan default by the Michigan LLC, to permit the lender to designate a "special member" of the LLC. The special member's consent was required in order to take certain actions, including the filing of a bankruptcy petition, and the amendment also purported to absolve the special member from considering any interests other than those of the creditor. In a somewhat convoluted decision, the court determined that the waiver of fiduciary duties was not valid under Michigan law, but nevertheless held that the purported elimination of fiduciary duties was fatal to the creditor's contractual approval right. On public policy grounds, the court upheld the validity of the bankruptcy filing. In *In re Intervention Energy Holdings, LLC*,²⁴ the court conducted a more extensive analysis of the public policy disfavoring waivers of the right to file bankruptcy, and treated as invalid an operating agreement provision that required unanimous member consent, where the Delaware LLC's lender had been admitted to the LLC and issued a single ownership unit. Without discussing whether the operating agreement at issue actually contained a waiver of fiduciary duties, the court focused on the absence of fiduciary duties as the basis for finding, again on public policy grounds, that the bankruptcy filing was valid. Interestingly, in both cases, the LLCs and their non-creditor members had failed even to consult the creditor members regarding the bankruptcy filings, so that the creditor members were not even given the opportunity to demonstrate that their participation in the bankruptcy filing decision was conducted in accordance with the kinds of fiduciary duties that would typically be expected to apply.

Similar issues have arisen in two 2017 cases. One recent case to weigh a bankruptcy blocking mechanism is *Squire Court Partners L.P. v. Centerline Credit Enhanced Partners LP*.²⁵ In this partnership case, the limited partnership consisted of three partners, and the

²¹ 409 B.R. 43 (Bankr. S.D.N.Y. 2009).

²² 2014 WL 554824 (Bankr. S.D. Tex. Feb. 12, 2014).

²³ 547 B.R. 899 (Bankr. D. Ill. 2016).

²⁴ 2016 WL 3185576 (Bankr. D. Del. 2016).

²⁵ Case No. 4:16CV00935 JLH, 2017 U.S. Dist. LEXIS 105032 (E.D. Ark. Jul. 7, 2017).

sole general partner filed a voluntary petition. That partner held a 0.01 percent interest in the partnership, while the interests of the two limited partners were 99.98 percent and 0.01 percent. The partnership contained a provision that required unanimous partner (including the limited partners) consent for a bankruptcy filing, and the general partner, which was also the guarantor of the partnership's indebtedness, attempted to obtain the limited partners' approval. They did not agree, and in fact were in the process of invoking the guaranty in another proceeding to ensure that the partnership's indebtedness did not remain in default.

The general partner invoked the outcomes in both *Intervention Energy Holdings* and *Lake Michigan Beach* to challenge the validity of the unanimous approval requirement. The partner asserted that the fact that limited partners do not owe fiduciary duties to the limited partnership rendered their right to veto a bankruptcy proceeding void. The general partner also claimed that the sole general partner had inherent power to act for the partnership in filing the petition. The court rejected both arguments. As to the fiduciary duties claim, the court distinguished *Lake Michigan Beach* by noting that no external parties, and particularly no creditor, were involved. Nothing in state law prohibited a limited partnership from giving limited partners an approval right over major decisions such as bankruptcy. With respect to the general partner's attempt to liken itself to a corporate board of directors with inherent governance authority, the court acknowledged that the usual situation would give a general partner that power, but that the partners had agreed among themselves to order things differently. The court concluded that it "is one thing for the courts to overrule a creditor that seeks to block a debtor from filing bankruptcy; it is quite another for the courts to overrule the owners of the entity."

The most recent decision balancing the jurisdictional prerequisite with public policy concerns is *In re Lexington Hospitality Group, LLC*.²⁶ The debtor was a Kentucky LLC subject to a voluntary bankruptcy petition filed by its largest percentage member, which was also the primary manager of the LLC. However, when

the LLC borrowed the funds needed to acquire a hotel property from what appears to have been a non-institutional lender – PCG Credit Partners (PCG) – the lender apparently required that its affiliate 5532 Athens LLC (5532) be given a thirty percent interest in the LLC in what was labeled an "equity kicker." At the time of the loan the operating agreement was also amended to add a requirement for an independent manager, who was named in the agreement and given the sole duty to act as a manager with the power to approve or disapprove a proposed bankruptcy petition. The independent manager and its replacements could be appointed by the majority member, subject to what seem to be reasonably strong independence standards, and not subject to lender approval. However, the operating agreement (though an addendum added at the time of the loan) provided that the independent manager would have fiduciary duties to the creditors and the company, but not the other members, and must consider the interests of 5532 (the lender-affiliated member) when exercising its sole bankruptcy-related duty.

The voting requirements for bankruptcy approval added at the time of loan origination evinced a belt-and-suspenders approach, with overlapping and somewhat conflicting standards:

- A requirement that the Independent Manager approve any bankruptcy,
- A negative covenant in the operating agreement addendum that prohibited the LLC from filing for bankruptcy without the consent of PCG (the lender, not 5532, its representative member) and *unanimous* member consent, and
- A provision in the addendum stating that the company could declare bankruptcy only if the Independent Manager authorized it, "and then only upon a 75% vote of the Members" (with 5532 as a 30% member).

In connection with a post-default forbearance, a second addendum to the

²⁶ Case No. 17-51568, 2017 Bankr. LEXIS 3129 (Bankr. E.D. Ky. Sept. 15, 2017).

operating agreement may have been entered into, and that addendum purported to transfer an additional 20% interest to 5532.

The debtor's non-independent manager filed the LLC's bankruptcy petition without obtaining or even seeking the independent manager or supermajority member approvals, and PCG objected that the petition had been filed without authorization. The court held that the various bankruptcy-remote provisions constituted a void bankruptcy waiver, and assessed the manager's authority to file as if the offending provisions had been excised from the operating agreement. The court did not cite *Price*, nor did the word "jurisdiction" appear anywhere in the opinion. The court treated the key question as whether insufficient authority existed for the filing, because without finding authority the court would be compelled to dismiss the petition under Section 1112 of the Bankruptcy Code. By characterizing the set of bankruptcy-remote provisions as an attempt to extract a complete bankruptcy waiver, rather than viewing the provisions individually, the court reached a debtor-friendly result by concluding that it could ignore all of the special approval provisions as void. That result might not have been foreordained had the provisions been better drafted. First, 5532 apparently held a bona fide equity interest of at least 30 percent of the total equity value (net of the loan) of the hotel project. The original interest was granted concurrently with the loan origination, but also represented a real equity investment by the lender affiliate, and was presumably part of the bargain by which the lender assessed the risk of the loan it was making. The provisions governing the interest did not provide for it to disappear once the loan was repaid, but only after both loan repayment and redemption of the interest by the LLC. Second, the value of the interest, as equity, was necessarily lower in priority than any indebtedness of the hotel project, including trade debt or any other obligations other than the lender's mortgage. Third, the independent manager requirement did not give the lender, or 5532, any voice in the appointment of that manager, and so there was no expectation that the independent manager would be affiliated with or otherwise beholden to either the lender or 5532. Fourth, that independent manager, in making the bankruptcy filing decision, would have been obligated to take into account the interests of *both* the LLC and the LLCs creditors, and the consideration of

creditors requirement did not limit that consideration to the mortgage holder alone. In sum, nothing about establishing this bankruptcy-remote structure, which gave a truly independent manager the right to consent to any bankruptcy filing, comes across as sufficient basis for ignoring either the jurisdictional prerequisite or the contractual bargain among the lender, its affiliate, and the borrower.

Venue

In re Blixseth,²⁷ involved an involuntary bankruptcy petition brought by a state department of revenue. The debtor resided in the state of Washington, and owned interests in a Nevada LLC and a Nevada LLLP. The assets of these entities were in turn located outside Nevada. The question arose whether Nevada was the state in which the debtor's principal assets were located. The lower court concluded that the intangible entity interests should be deemed located in the debtor's state of residence (Washington), but the appeals court reversed that decision, concluding that having elected the benefit of Nevada's laws in establishing the entities, the interests in which constituted the principal bankruptcy assets, venue was proper in the state of formation of those entities. A dissent in the case asserted that the case was wrongly decided because it ignored the effect of Article 9 in specifying the situs of intangible property rights.

Effects of an LLC Bankruptcy Filing.

LLC Bankruptcy Filing as a Dissolution Event.

The LLC statutes do not define a bankruptcy filing by an LLC as an event of dissolution or dissociation, and so it is unnecessary to determine whether the winding-up process will be triggered by such a bankruptcy as a matter of state law.

Composition of the Bankruptcy Estate.

The "estate" of a bankrupt LLC will include "all legal or equitable interests" of the LLC as of the time of filing. Bankruptcy Code § 541(a). In addition to the LLC's property, these interests will include all rights of the LLC under

²⁷ 484 B.R. 360 (Bankr. App. 9th Cir. 2012).

an operating agreement to additional member contributions or required member loans.

In *In re KRSM Properties, LLC*,²⁸ the court was confronted with a claim by the member-owners of a bankrupt LLC that they were entitled to challenge a creditor's attempt to recover tax payments made by the LLC on behalf of the individual owners. The members took the position that they were synonymous with the LLC, that their tax obligations were those of the LLC, and that the prior tax payments were properly made. The court correctly concluded that the status of the LLC as a pass-through entity did not vitiate the separateness of the LLC from its members, and concluded that the LLC's bankruptcy estate could attempt to claw back the prior tax payments.

In *In re Ealy*,²⁹ the court observed the general rule that the assets of an LLC are not equitably owned by its members, so that the bankruptcy estate of a member does not include the LLC's assets. However, in that case, the court found other equitable circumstances for treating the individual member as having an equitable interest in real estate nominally owned by the LLC.

Preferences.

Under Bankruptcy Code § 547(b)(4), the "insiders" of a debtor are subject to a one year preference period. Managers of an LLC are likely to be considered insiders of the LLC, and members in a member-managed LLC will probably have the same status. It is possible that investor members of an LLC that do not otherwise participate in the LLC's business might fall outside the "insider" preference period.

Although Section 101(31) of the Bankruptcy Code does not explicitly define managers and others in positions of management responsibility of an LLC as "insiders," the court in *In re CEP Holdings, LLC*,³⁰ concluded that the statutory definition of officers of a corporation as corporate insiders should be "transferred" to determine insider status for an LLC. The court concluded that the

title bestowed upon a potential insider would not be determinative, but that the appropriate test was the actual position and responsibility of the insider. Because managers and members with significant responsibilities may have the kind of relationship with an bankrupt LLC that would make their dealings with the LLC subject to scrutiny because of the possibility of non-arms-length transactions, it is likely that such persons will be presumed to have insider status for the purposes of evaluating potential preferences.

In *In re Carr & Porter, LLC*,³¹ an attorney who owned the debtor law practice organized as an LLC sold his interest back to the Company. The debtor agreed to pay Porter \$1 million in multiple payments over several years and accordingly made regular installment payments to Porter until the debtor LLC filed for bankruptcy. Trustee claimed that these payments were transfers to an insider in violation of Section 547(b) of the Bankruptcy Code and that Porter was required to turn over assets he received from the debtor. The court held that as a former member, Porter was not an insider within the meaning of Section 547(b) and granted summary judgment in his favor. Even though after the sale of his interest, Porter remained an important attorney with the debtor, was responsible for the debtor's most significant client and helped obtain a loan for the debtor, Porter relinquished all of his executive authority and no longer functioned in a managerial capacity. Therefore, payments made to Porter were not transfers to an insider and did not have to be turned over to the trustee. Interestingly, the trustee failed to pursue what should have been a more viable claim – that the debt was incurred and/or the payments made by the LLC "in respect of" an LLC interest at a time when such distributions were wrongful under Virginia's LLC statute.

Member or Creditor?

The court in *In re Cybersight, LLC*,³² addressed the status of a former member's claim to payment in respect of a membership interest. The former member had arbitrated the amount of his claim for the former interest, and reduced the arbitration award to judgment. The court concluded that notwithstanding the fact

²⁸ 318 B.R. 712 (Bankr. App. 9th Cir. 2004).

²⁹ 307 B.R. 653 (Bankr. E.D. Ark. 2004).

³⁰ 2006 WL 3422665 (Bankr. N.D. Ohio Nov. 28, 2006).

³¹ 416 B.R. 239 (Bankr. E.D. Va. 2009).

³² 2004 WL 2713098 (D. Del. Nov. 17, 2004).

that the award related back to a prior equity interest in the LLC, the interest was properly viewed as a debt obligation of the debtor LLC, so that the former member was entitled to be treated as a general unsecured creditor.

A different result was reached by the court in *In re Tristar Esperanza Properties, LLC*.³³ In that case, the court concluded that the former member's arbitration award in respect of the former member's interest was required to be treated for bankruptcy purposes as a claim for damages arising from the purchase or sale of a security of the debtor or an affiliate of the debtor. Thus, the former member's claim was required to be subordinated to those of other creditors. This result was applied even though the former member had withdrawn three years prior to bankruptcy.

Applicability of Stay to Members.

In contrast to the partnership context, where a stay that extends to the property of individual partners may be appropriate in order to protect creditor access to the assets of the partners, it would not be appropriate for a stay to be made applicable to the members of an LLC. As a general proposition, the members and managers of an LLC are not liable, by reason of their status as such, for the obligations of the entity.

Courts have generally recognized the distinction between an LLC's assets and the assets of members, and have held that when one or the other files bankruptcy, the bankruptcy stay does not include the assets of the other. In *In re Calhoun*,³⁴ the court noted that in a case involving an individual member bankruptcy, LLCs in which the debtor had an interest would not be subject to or protected by the provisions of the automatic stay. Similarly, in *In re Resource Energy Technologies, LLC*,³⁵ the court concluded that discovery orders against the member of a bankrupt LLC did not violate the stay because the stay did not extend to the members, even though the orders obligated the members to obtain information from the LLC.

³³ 488 B.R. 394 (Bankr. App. 9th Cir. 2013).

³⁴ 312 B.R. 380 (Bankr. N.D. Iowa 2004).

³⁵ 419 B.R. 746 (Bankr. W. D. Ky. 2010).

By contrast, in *In re Saxby's Coffee Worldwide, LLC*,³⁶ the court issued an injunction to bar actions against the owners of the debtor LLC. At the time of its bankruptcy filing, seven lawsuits were pending against the debtor's members and entities owned by the debtor's members. The members filed a motion for preliminary injunction under Section 105 of the Bankruptcy Code to stop the defendants from prosecuting these actions. Although an automatic stay generally may not be invoked to protect non-debtors, Section 105 provides that "[t]he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." 11 U.S.C. § 105(a). Accordingly, the court held that in this case an injunction was warranted to stop actions against members of the LLC because their time, energy and commitment were necessary for the formulation of a reorganization plan, which would be jeopardized if the debtor's members had to defend themselves from pending lawsuits. However, the court refused to issue an injunction with respect to actions against entities owned by the debtor's members because these entities did not play a significant role in the operation of the debtor. See also *In re Gander Partners LLC*.³⁷

Agreement to Issue LLC Interest as an Executory Contract.

In *In re Sandman Associates, L.L.C.*,³⁸ a prospective member of an LLC entered into a letter agreement with the LLC to make a capital contribution in exchange for an interest. The letter contemplated that the new member would sign the operating agreement, but even though the contribution was made, the operating agreement was never signed. After the parties engaged in series of disputes, the LLC filed for bankruptcy in an effort to shed itself of the dissident contributor. The court concluded that the failure to sign the operating agreement was a technical matter that did not alter the fact that the performance obligations of the contributor under the letter agreement (i.e. the making of the contribution) had been satisfied. Because the performance had already occurred and the

³⁶ 440 B.R. 369 (Bankr. E.D. Pa. 2009).

³⁷ 432 B.R. 721 (Bankr. N.D. Ill. 2010) (issuance of stay involving state law proceeding against guarantor in interest of the bankruptcy estate).

³⁸ 251 B.R. 473 (W.D. Va. 2000).

letter agreement did not contemplate any unperformed future acts, the letter was not an executory contract capable of being rejected by the bankrupt LLC.

Substantive Consolidation.

Two courts addressed the equitable doctrine of substantive consolidation in 2005. Substantive consolidation is often sought by bankrupt debtors that wish to include the assets of legally separate but related entities in the bankruptcy estate, or by creditors wishing to gain access to the assets of non-bankrupt but affiliated entities.

In *In Re Brentwood Golf Club, LLC*,³⁹ the LLC operator of a golf course was the bankrupt, and its lender sought to be able to reach the assets of a separate LLC that operated the restaurant at the golf course. The court found that the bank could reach the assets of the restaurant LLC on both a piercing the corporate veil basis and under the doctrine of substantive consolidation. The court considered evidence that ownership of the restaurant assets had never been transferred from the golf course LLC to the restaurant LLC, that the two LLCs did not maintain separate bank accounts until after the bankruptcy petition was filed, that the lease to the restaurant LLC was at a substantially below-market rate (less than approximately fifty cents per square foot), that the restaurant LLC had failed to make rent payments or other payments required under the lease, that the financial records of the entities were “inextricably” intertwined, and that the reality of operations of the golf course made the restaurant and the course interdependent. The court found that the two entities met the requirements of Michigan’s common law alter ego test. Although it was unnecessary to its decision, the court then proceeded to evaluate the substantive consolidation issue, and separately went through the substantive consolidation analysis under the second circuit’s *Augie/Restivo* and the D.C. Circuit’s *Auto-Train* tests. The court noted that substantive consolidation did not necessarily require it to find facts as plain as those that enabled it to apply the state law alter ego test, and concluded that substantive consolidation was appropriate under both standards.

³⁹ 329 B.R. 802 (Bankr. E.D. Mich. 2005).

In Re Owens Corning,⁴⁰ involved an attempt by bankrupt Owens Corning to force the substantive consolidation of its non-bankruptcy subsidiaries. One of the principal lenders had extended financing that was based on separate guaranties received from, among others, certain of Owens Corning’s non-consolidated subsidiaries. The Third Circuit reversed the district court’s holding that the entities should be substantively consolidated. The non-consolidated subsidiaries (both LLCs and corporations) had been maintained separately before the filing of the bankruptcy petition, and the evidence of commingling and lack of separateness was minimal. The court concluded that consolidation would be appropriate only if separateness of the entities had been disregarded prior to the filing of the bankruptcy petition, such that Owens Corning’s creditors knew the separation of the entities had broken down, or if the assets of the entities were so commingled that separating them after the filing of the petition would be prohibitive. The Third Circuit found that neither factor was present and also seemed troubled by the fact that substantive consolidation was being used “offensively” by the debtor in order to prefer certain creditors over others.

Bankruptcy of a Member.

Nature of a Bankrupt Member’s Bankruptcy Estate.

As observed above, the bankruptcy estate of a debtor includes all of the debtor’s legal or equitable interests as of the filing of the bankruptcy petition. In the many cases that have addressed the bankruptcy of a partnership’s general partner, it has been observed that the partner’s interest in the partnership consists of the partner’s economic rights, the partner’s management rights, and the partner’s rights as a co-owner of partnership property. *In re Cardinal Industries, Inc.*⁴¹ The concept of co-ownership of partnership property flows from sections 24 and 25 of the original Uniform Partnership Act, which specify that a partner holds partnership property as a tenant in partnership with the other partners.

⁴⁰ 419 F.3d 195 (3d Cir. 2005).

⁴¹ 116 B.R. 964, 970-71 (Bankr. S.D. Ohio 1990).

Because the members of an LLC do not have any interest in an LLC's property, a member's bankruptcy estate will consist of the member's economic rights in the LLC (referred to in some statutes as the member's "distributional interest"), and the member's management rights in the LLC. See *In re Garrison-Ashburn, L.C.*⁴² A more extensive discussion of the distinction between economic and non-economic rights, and the extent to which they are affected by provisions of state law and operating agreements, is contained in subsections C and D below.

A different result was reached in *In re Campbell*,⁴³ where the court found that although the rights of members of a member-managed LLC became part of the bankruptcy estate based on Illinois state law defining property rights, the status of one of the bankruptcy members as the manager (as opposed to member-manager) of a manager-managed LLC was not a property right, so that the management rights could not be exercised by the trustee unless and until the trustee removed and replaced the manager in accordance with the operating agreement.

A unique situation was presented by *In re Lee*,⁴⁴ where the bankrupt member had no economic interest in the LLC, but had majority voting rights. The court concluded that the voting rights constituted property of the estate, because the effect of that result would be to protect other economic benefits available to the debtor, including his continued status as the employed manager of the LLC, and his ability to award himself (by virtue of his majority vote) incentive and bonus payments.

Scope of Estate.

The contents of a bankrupt member's bankruptcy estate are also affected by pre-bankruptcy agreements and by the distinction between a member's rights in the member's membership interest from a possible interest in the underlying assets of the LLC.

⁴² 253 B.R. 700, 707-708 (E.D. Va. 2000) (bankruptcy estate includes both economic and non-economic rights in the LLC).

⁴³ 475 B.R. 622 (Bankr. N.D. Ill. 2012).

⁴⁴ 2015 WL 4724944 (S.D. Ind. Aug. 10, 2015).

Pre-Bankruptcy Restrictive Contracts.

In *In re Weiss*,⁴⁵ the debtor member was subject to operating agreements that prohibited a pledge or assignment of the member's interests without the consent of the LLCs' managers. Notwithstanding this restriction, the debtor pledged his interests in the LLCs to his creditors, and the creditors sought relief from the bankruptcy stay in the member's case on the basis that they were secured creditors. The court concluded that the interests were not subject to the security interests because the member had no legal right to make the pledges, and concluded that the security interests in the LLC interests were therefore unperfected because they could not attach to collateral that the debtor had no right to transfer.

Debtor's Interest in the LLC.

The separateness of an individual debtor from a related LLC, even where an LLC is a single-member LLC, was emphasized by the court in *In re McCormick*.⁴⁶ In that case, the debtor filed for individual relief under Chapter 13 of the Bankruptcy Code, and attempted to draw the single-member LLC of which he was the sole member into his individual bankruptcy case. The court concluded that the automatic stay that applied to the individual debtor would not apply to the LLC, and concluded that because an entity was not an eligible debtor under Chapter 13, the LLC could not be a co- or joint debtor with the bankrupt member under Chapter 13. A similar result occurred in *In re Knefel*,⁴⁷ in which the court concluded that a single-member LLC owned by the member debtor was not subject to the automatic stay that applied to the individual debtor.

Several other cases yielded similar results. In *In re Aldape Telford Glazier, Inc.*,⁴⁸ a bankrupt corporation was the sole member of the non-bankrupt LLC and listed the assets of the LLC as its own assets in the corporation's bankruptcy petition schedules. The court held that the winding up of the LLC had not been completed (which would have involved the

⁴⁵ 376 B.R. 867 (N.D. Ill. 2007).

⁴⁶ 381 B.R. 594 (Bankr. S.D.N.Y. 2008).

⁴⁷ 2007 WL 2416535 (Bankr. E.D. Va. Aug. 17, 2007).

⁴⁸ 410 B.R. 60 (Bankr. D. Ida. Jul. 23, 2009).

payment of the LLC's creditors and evidence of actual distribution to the member). The assets of the LLC could not be deemed to be the assets of the debtor because they had not been distributed to the debtor. Similarly, in *In re Harder*,⁴⁹ the debtor requested that the court issue an injunction barring the creditors of numerous LLCs, in which the debtor was a member, from pursuing lawsuits against the LLCs. The debtor argued that an injunction was warranted under Section 105 of the Bankruptcy Code because without it, any plan of reorganization would be jeopardized. The court declined to order the injunction. First, the court emphasized that the real estate holdings of the LLCs were property of LLCs that were not in bankruptcy. They were not the debtor's property and the court needed to evaluate any prejudice to the debtor's reorganization, not to the LLCs' reorganization. Additionally, even though the debtor's rights in the LLCs would generally be a part of his estate and would be affected by any lawsuits against the LLCs, this was not such a case because the debtor had assigned his ownership interests in the LLC to a workout expert. Finally, issuing an injunction would unnecessarily prejudice the LLCs' creditors and would result in a greater harm to them than to the debtor. Substantially the same result was reached in *In re Campbell*,⁵⁰ where the primary assets of an LLC owned by two bankrupt members were interests in other LLCs and a limited partnership. In this case, the court concluded that the interests of those entities were owned by the LLC, and not by the members, and therefore were not property of the bankruptcy estate.

Many cases involving an attempt to ignore the separateness of an LLC by drawing a non-bankrupt LLC's assets into a bankrupt member's LLC estate constitute efforts by the bankrupt to enlarge the bankruptcy estate, but *In re Goreham*,⁵¹ involved a case in which a member successfully transferred assets away from his non-bankrupt LLC, to the detriment of creditors. The debtor was the sole member of an LLC that owned a piece of real estate. Within ninety days before the bankruptcy filing, the debtor caused the LLC to transfer the real estate to a corporation owned by the debtor's son. The

⁴⁹ 413 B.R. 827 (Bankr. D. Ore. 2009).

⁵⁰ 475 B.R. 622 (Bankr. N.D. Ill. 2012).

⁵¹ 2009 Bankr. LEXIS 2995 (Bankr. D. Neb. Sept. 16, 2009).

court refused to set aside this transfer, holding that although the debtor's interest in the LLC was his personal property and thus property of his bankruptcy estate, the LLC's underlying property was not. The transfer made by the LLC could not be avoided as a preferential transfer under Section 547(b) because it was not attributable to the debtor.

Winding Up an LLC In Which a Bankrupt Member Owns an Interest.

As discussed below, there are a number of decisions surrounding the extent to which a bankrupt member can continue to participate in the management activities of an LLC. However, once an LLC is dissolved and is in the process of winding up, the outcome may be different. In *In re LaHood*,⁵² the court concluded that a non-bankrupt member of a dissolved LLC continued to have the right to participate in the winding up process. Michael and Richard Lahood each owned 50% membership interest in an LLC. Michael filed for bankruptcy, and Richard (also a creditor of Michael's) declared the LLC dissolved pursuant to a provision of the operating agreement that provided for member bankruptcy as a dissolution event. Without seeking relief from stay, Richard then caused the LLC to wind up by conveying the LLC's real property to himself and Michael in equal shares. The court held that the distribution of the real estate was invalid because it violated the LLC statutory provision that prescribes that creditors of the LLC should be paid first when winding up the LLC's affairs.

The trustee also asserted that Michael had the right to participate in the LLC's winding up of its affairs under Illinois law because Michael's dissociation was not wrongful. The court agreed and found that Michael's dissociation was not in breach of any provision of the LLC's operating agreement.

A second case emphasizes the power of even a bankrupt member to manage the winding up process. In *In re Greeson*,⁵³ the court allowed the distribution of the bankrupt LLC's assets to the member, even though the bankrupt member had sold and distributed the assets of

⁵² 2009 WL 803558 (Bankr. C.D. Ill. Mar. 19, 2009), *aff'd in part*, 437 B.R. 330 (C.D. Ill. 2010).

⁵³ 2009 Bankr. LEXIS 1732 (Bankr. D. Kan. Jun. 2, 2009).

the LLCs to the bankruptcy estate without satisfying the statutory requirement that creditors be paid first. The debtors dissolved the LLC before bankruptcy. They then filed for bankruptcy and took the position that upon the dissolution of the LLC, the LLC's assets became their property and part of their bankruptcy estate. To strengthen their position, the debtors effectuated formal transfers, pursuant to which the LLC conveyed its equipment and accounts receivables to the debtors. Creditors objected to the debtors' position because under Kansas statutory scheme of distribution priorities when winding up an LLC, an LLC's property must first be used to satisfy creditors' claims. The court declined to apply the "trust fund doctrine" and found that even though the debtors violated the Kansas LLC act, the creditors could vindicate their rights against the assets in the bankruptcy process. But see *In re Williams*,⁵⁴ where the court confronted the issue of how to wind up and liquidate an LLC when both of the LLC's members had filed individual bankruptcy petitions. The court concluded that under the Virginia LLC statute, both members had dissociated as members upon their bankruptcy, and therefore had only the rights of assignees. Because there were no remaining members, the court concluded that it had the authority to appoint a liquidating trustee.

Provisions of State Law and Operating Agreements that Apply in Bankruptcy.

Most LLC acts provide, as a default rule, that unless otherwise agreed by an LLC's members, the bankruptcy of a member will be an event of dissociation. Most operating agreements will address the extent to which a bankruptcy filing by a member will trigger dissociation or dissolution, but this contractual language will often be co-extensive with the statutory default rules.

To the extent that the remaining members of an LLC elect to continue the business of an LLC following an event of dissociation or dissolution, both statutory law and operating agreements will generally provide that the bankrupt member loses status as a member and thereby ceases to have any management rights in the LLC. At that point, the member's rights in the LLC will typically be

limited to economic or "distributional" rights. The bankrupt member will have the status of a transferee or assignee of an LLC interest, and cannot again take on the status of a member unless admitted to membership by the requisite vote of the remaining members. The effect of these general statutory and contractual rules in the bankruptcy context is addressed in subsection D below. Some more general issues are also addressed by the following cases:

Forfeiture of an Interest May Be Treated as a Preference in Favor of Non-Debtor Members.

In *In re Lull*,⁵⁵ the bankrupt member had been removed from his status as a member of the LLC. There was a dispute as to whether the removal (which the court denoted as a "transfer") took place before or after the filing of the petition, but in any event, the court analyzed the automatic dissociation of the bankrupt member under the Hawaii LLC statute, and concluded that whether the forfeiture took place under the terms of that statute or the operating agreement, the consequent benefit to the other members might be treated as a preference. The court concluded that the non-bankrupt member was a statutory insider (and therefore subject to the one-year preference), found that the non-bankrupt member received more because of the bankrupt member's removal/forfeiture than he would have as an unsecured creditor, and reserved for later judgment a determination of the actual amount of the preference. This kind of preference analysis, if applied more widely by the courts, could have a significant impact on the ability of LLCs and non-bankrupt members to effectively enforce contractual and statutory restrictions that might otherwise be enforceable, because a court could potentially treat every forfeiture or reduction of a bankrupt member's economic interest as a preference directly recoverable from the LLC's other members (even where the non-bankrupt members may not have liquidity in the LLC sufficient to pay the amount of the preference into the bankruptcy estate).

Exercise of Rights as Member or Manager.

Without substantive discussion of the question, a North Carolina bankruptcy court held that a bankrupt member had standing to seek

⁵⁴ 455 B.R. 485 (Bankr. E.D. Va. 2011).

⁵⁵ 2008 WL 3895561 (Bankr. D. Hawaii Aug. 22, 2008).

judicial dissolution of a non-bankrupt LLC notwithstanding the fact that the North Carolina LLC Act and the operating agreement caused the bankrupt member to cease to be a member upon the filing of his bankruptcy petition. Under the dissolution provisions of the North Carolina statute, absence of status as a member should have defeated the bankrupt member's subsequent attempt to pursue judicial dissolution, but the court treated the prohibition as an invalid *ipso facto* clause (see the further discussion below), and without further analysis, proceeded to analyze the requested dissolution on its substantive merits in later proceedings. See *In re Klingerman*.⁵⁶ The continuing rights of a bankrupt member (or that bankrupt member's personal representative) to exercise management rights can also arise in a context where the bankrupt member may object to the assertion of management rights, because those rights will be exercised by the debtor's bankruptcy trustee. In *In re Modano*,⁵⁷ the bankrupt member objected to actions proposed to be taken by his bankruptcy trustee. The trustee had designated himself as the manager of a single-member LLC controlled by the bankrupt, and the court analyzed Delaware law and concluded that the personal representative had the statutory power to continue a single-member LLC following a dissolution caused by the bankruptcy of its sole member. Having continued the LLC in its status as personal representative of the sole member, the trustee therefore had the power to designate itself as the manager.

By contrast, in *In re Hickory Ridge, LLC*,⁵⁸ the court simultaneously gave effect to state law provisions regarding the dissociation of a member upon bankruptcy but then held that the bankruptcy trustee succeeded to the dissociated member's management rights, and therefore had the right to control the LLC's actions in its own bankruptcy.

⁵⁶ 388 B.R. 677 (Bankr. E.D.N.C. 2008).

⁵⁷ 412 B.R. 715 (Bankr. D. Md. 2006).

⁵⁸ 2010 WL 1727968 (Bankr. N.D.W. Va. Apr. 27, 2010).

Enforceability of Statutory and Operating Agreement Provisions in the Bankruptcy Context.

Operating Agreement as an Executory Contract.

It is generally established that partnership agreements, to the extent they delineate material unperformed obligations of the partners, are executory contracts within the meaning of the Bankruptcy Code. Almost all of the cases that have thus far addressed bankruptcy issues in the LLC context have likewise held that operating agreements are executory contracts.⁵⁹ Operating agreements will contain numerous provisions relating to ongoing agreements and covenants of the parties, and for this reason, it is often appropriate that they also be classified as executory contracts for purposes of the Bankruptcy Code. For example, in *Allentown Ambassadors, Inc.*,⁶⁰ the court concluded that an operating agreement relating to the operation of an independent professional baseball league was an executory contract because the members had continuing duties, including duties to manage the LLC (*i.e.*, the baseball league), and the duty to make additional cash contributions as needed for the operation of the LLC.

An operating agreement was found to be an executory contract in *In re DeVries*.⁶¹ The operating agreement related to the operation of a business that operated a dairy farm, and among the obligations of the members were the obligations to make additional capital contributions and to provide loan guarantees. The court concluded that those obligations were executory, because the debtor member's obligations to contribute capital and to execute guarantees were not hypothetical, given both the volatile nature of the dairy industry and the fact that loan guarantees had been required in the past. The court went further to find that a separate cross-purchase agreement to which the members were parties was not severable from the operating agreement, and that the two

⁵⁹ See *In re Daugherty Construction, Inc.*, 118 B.R. 607 (Bankr. D. Neb. 1995), ("*Daugherty*"); *In re DeLuca*, 194 B.R. 65 (Bankr. E. D. Va. 1996) ("*DeLuca I*"); *In re DeLuca*, 194 B.R. 79 (Bankr. E. D. Va. 1996) ("*DeLuca II*").

⁶⁰ 361 B.R. 422 (Bankr. E.D. Pa. 2007).

⁶¹ 2014 WL 4294540 (Bankr. N.D. Tex. Sept. 27, 2014).

would need to be treated as a single indivisible agreement. Having found that the operating agreement was an executory contract, the court found that by failing to assume either of the agreements, the trustee was deemed to have rejected them under § 365. Under § 365(g), the rejection of an executory contract constitutes a breach, and the operating agreement provided that a breaching member would have the status of a mere assignee. Accordingly, the court held that the trustee had no ability to exercise the non-economic rights available under the operating agreement, because those were reserved for “active” members of the LLC. The court concluded that it did not need to address the effect of the *ipso facto* clause prohibition because of the deemed rejection of the agreement.

Notwithstanding the trend of cases holding that partnership agreements and operating agreements are executory contracts, several courts have determined that operating agreements did not contain sufficient unperformed obligations to be treated as executory contracts. The court in *In re Garrison-Ashburn, L.C.*,⁶² found that the operating agreement did not contemplate future performance by the members, but merely served to establish the framework under which the LLC would be managed. Because the court concluded that the operating agreement was not an executory contract, the court gave effect to the current Virginia LLC act provision that makes the bankruptcy of a member an event of dissociation, and concluded that the prohibitions on *ipso facto* clauses that apply to executory contracts did not apply to this LLC. The court’s reasoning appeared to be affected both by a Virginia statutory change since the date of the cases cited above, which changed the bankruptcy of a member from an event causing the dissolution of the LLC itself to one that causes the dissociation of the member, and by the fact that the LLC’s operating agreement did not include the kinds of provisions that would have created the possibility of future performance obligations (such as provisions related to future capital contributions or loans, requiring active participation in management or imposing negative restrictions on the ability of members to compete or otherwise take actions contrary to the interests of the LLC).

⁶² 253 B.R. 700 (E.D. Va. 2000).

Another court held that because an operating agreement did not contain any current obligations or continuing management role for an LLC’s member, the operating agreement was not an executory contract capable of being assumed, assigned or rejected. See *In re Capital Acquisitions & Management Corp.*⁶³ In that case, the court permitted the non-bankrupt members to utilize a right of first refusal found in the operating agreement. A court’s analysis of operating agreement obligations (or the lack thereof) yielded the same result in *In re Warner*.⁶⁴ However, by contrast, the court in *In re Strata Title, LLC*,⁶⁵ held both that an operating agreement that contained a purchase option was an executory contract, and that the exercise of that option, which was triggered by the bankrupt member’s filing, was an invalid *ipso facto* clause. The *Strata Title* court did not engage in an extensive analysis of § 365. The executory contract determination was based in large part on the fact that the LLC owned property that was being actively marketed, and that the participation of the members (including the debtor) was necessary to address a variety of issues, including approval of a sale.

In *In re Tsiaoushis*,⁶⁶ both the district court and the bankruptcy court in a previous decision found that the operating agreement was not an executory contract because there were no material, continuing obligations of the members. The bankrupt debtor had no managerial duties in a manager capacity, and had no unperformed duties as a member. Because the agreement imposed no additional duties or responsibilities, the court found that the agreement was not an executory contract, that it was therefore not subject to the Bankruptcy Code Section 365 analysis discussed further below, and that the trustee would be entitled to enforce the provisions of the operating agreement requiring the dissolution and winding up of the LLC as a result of the debtor member’s bankruptcy filing.

A similar result was reached in *In re Ehmann*.⁶⁷ In *Ehmann*, the LLC had been

⁶³ 341 B.R. 632 (Bankr. N.D. Ill. 2006).

⁶⁴ 480 B.R. 641 (Bankr. N.D.W. Va. 2012).

⁶⁵ 2013 WL 1773619 (Bankr. D. Ariz. Apr. 25, 2013).

⁶⁶ 2007 WL 2156132 (E.D. Va. July 19, 2007).

⁶⁷ 319 B.R. 200 (Bankr. D. Ariz. 2005).

formed by an individual debtor's parents, apparently for estate planning purposes. Ehmann's bankruptcy trustee pursued various claims against the LLC, asserting that it had the right to make those claims because it was stepping into the shoes of Ehmann as a member. In its defense, the LLC attempted to rely on some of the bankruptcy provisions discussed in the following sections of this outline, and claimed that the trustee did not have the power to assume the debtor member's rights under the operating agreement, which it alleged to be an executory contract. The court concluded, however, that the operating agreement of the LLC contained no unperformed obligations of the type that would cause it to be deemed an executory contract, and that in fact, the debtor member had no "obligations" to be performed that would trigger the bankruptcy law provisions sought to be applied by the LLC. Those substantive bankruptcy law issues were not reached because the court concluded that no executory contract was involved.

A second decision was issued in *Ehmann* in late 2005.⁶⁸ In this decision, a bankruptcy court permitted the bankruptcy trustee to exercise a member's rights to seek remedies for breaches of the operating agreement by the non-bankrupt manager, who was apparently authorizing loans and other insider transactions in a manner that was contrary to the operating agreement. The transactions appeared to be designed to avoid distributing to the bankrupt Ehmann his share of the proceeds of a prior transaction which resulted in significant cash being available to the LLC. The court concluded that an injunctive remedy would not be effective against this misbehavior, and ordered the appointment of a receiver. Note, however, that this opinion was withdrawn by the bankruptcy court in late January 2006.

In re Wilson,⁶⁹ similarly found an operating agreement not to be an executory contract. The court, citing *Ehmann*, noted that neither the bankruptcy trustee nor any member of the LLC considered the agreement an executory contract (the argument was being advanced by a creditor), and found that the

absence of obligations to make additional capital contributions as well as the fact that the management powers of the members were rights but not obligations meant that the rights under the operating agreement were not executory duties of the type found in an executory contract.

The analysis utilized by a number of courts that have found LLC operating agreements to be executory contracts was directly rejected in *In re Denman*.⁷⁰ In that case, the debtor was a 70% owner of an LLC, and the operating agreement provided that any other member would have the option to purchase another member's interest upon a "triggering event" that included member bankruptcy. When the debtor member filed for bankruptcy, another member sought to enforce that provision. The court discussed the Countryman standard and several cases concluding that LLC operating agreements are not per se executory contracts, and conducted a relatively extensive analysis of the Tennessee LLC act on the way to determining that operating agreements under the Tennessee statute are distinct from typical executory contracts. The court noted that obligations under a Tennessee LLC operating agreement are not bilateral because a member's failure to perform does not excuse performance of the other members, because Tennessee LLC operating agreements may be entered into in connection with single member LLCs, when there is no mutual assent or consideration, because operating agreements may be amended without the approval of all members, and because operating agreements can bind new members without their explicit assent. The court then considered the operating agreement at issue, and finding that the membership interests were analogous to corporate securities and that the agreement did not contain any material member obligations, concluded that the agreement was not an executory contract. The court went further to determine that the purchase right was an invalid *ipso facto* clause because it created a right that was triggered only upon the bankruptcy.

A 2015 bankruptcy case involving a general partnership distinguished the *Denman* result. In *Sullivan v. Mathew*,⁷¹ the court was

⁶⁸ 334 B.R. 437 (Bankr. D. Ariz. 2005).

⁶⁹ 2014 WL 3700634 (Bankr. N. D. Tex. July 24, 2014).

⁷⁰ 513 B.R. 720 (W.D. Tenn. 2014).

⁷¹ 2015 WL 1509794 (N.D. Ill. Mar. 30, 2015).

confronted with a situation in which the exercise of certain rights under the partnership agreement depended upon the bankruptcy trustee's having properly assumed a partnership agreement that the court determined to be an executory contract. The trustee had not assumed the partnership agreement within 60 days after the order for relief, which under the Bankruptcy Code causes a deemed rejection. See §365(d)(1). The court considered the Countryman definition of executory contracts, and determined that there were sufficient additional duties under the partnership agreement that were "significant, ongoing obligations." The court found that the failure to perform those obligations would be a material breach, and concluded that an executory contract existed, and that the agreement had been deemed rejected because it had not been timely assumed. The court indicated its belief that "the *Denman* decision is tethered to the particular qualities of Tennessee LLC agreements," that the *Denman* reasoning was not applicable to partnerships, and that the *Denman* result was therefore unpersuasive.

A 2009 case addressed, in relatively summary fashion, the executory contract status of an operating agreement provision designating a member as "Vice President" of an LLC. The court concluded that an operating agreement provision that terminated the member's status as an officer upon the filing of his personal bankruptcy petition was not an invalid "*ipso facto*" clause because the member's service as an officer should be thought of as a personal service contract, not an assignable executory contract.⁷²

Applicable Bankruptcy Law Provisions.

Section 365(a) of the Bankruptcy Code provides that the bankruptcy trustee, subject to court approval, may assume or reject any of the debtor's executory contracts. Section 365(f) further provides that except as provided in § 365(c), the trustee may assign an executory contract notwithstanding any contrary provision in any contract or under applicable law. Note that for the purposes of Chapter 11 of the Bankruptcy Code, references to the "trustee" should be considered to refer also to a debtor in possession. Bankruptcy Code § 1107.

⁷² See *JD Factors, LLC, v. Freightco, LLC*, 2009 WL 3401965 (N.D. Ind. Oct. 16, 2009).

The general rule is that the trustee or debtor in possession is permitted to assume an executory contract even if nonbankruptcy law or the contract itself would forbid such an assumption. Section 541(c) of the Bankruptcy Code overrides any restriction on the transferability of an asset in the bankruptcy estate that may be imposed by an agreement or nonbankruptcy law, and Section 365(e)(1) permits the avoidance of so-called "*ipso facto*" clauses that would otherwise provide for the termination or modification of a contract or contract right that might be triggered by the debtor's commencement of the bankruptcy case or insolvency or financial condition prior to the termination of the bankruptcy case. Two other sections of the Bankruptcy Code, however, hold out the possibility that it might still be possible to enforce statutory and agreement provisions that are triggered by a partner's or member's bankruptcy.

Section 365(c) of the Bankruptcy Code provides that the trustee or debtor in possession may not assume or assign an executory contract if:

(1)(A) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and

(B) such party does not consent to such assumption or assignment;

Bankruptcy Code § 365(c). This section is consistent with similar language in § 365(e)(2), which exempts the same categories of executory contracts from the provisions cited above that would otherwise override *ipso facto* clauses.

Paragraph (1) of this subsection does not apply to an executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or

delegation of duties, if (A)(i) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to the trustee or to an assignee of such contract or lease, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and (ii) such party does not consent to such assumption or assignment.

Based on a strict construction of the statutory language, therefore, it would seem that a trustee (including even the debtor in possession) will not be permitted to assume an operating agreement if it can be determined that the agreement is of a type as to which state law excuses a nonbankrupt member from accepting performance from or rendering performance to any party other than the debtor or the debtor in possession.

A 2015 case decided by the Supreme Court of Washington addressed the interplay between these Bankruptcy Code provisions and state law. In *Northwest Wholesale, Inc. v. PAC Organic Fruit, LLC*,⁷³ the court was tasked with determining whether a former member could assert a derivative claim on behalf of the company. The case turned on the state law and bankruptcy law effect of language in the Washington LLC statute that treated the debtor-member as dissociated as a member of the LLC at the time of the bankruptcy filing, so that the interest succeeded to would be deemed the interest of an assignee, rather than the interest of a member (only members have standing to bring in derivative suit). The court concluded, relying on *Garrison-Ashburn*, that the bankruptcy estate received the interest as defined by state law. The court went further and determined that it was unnecessary to decide whether §365(e)(1) would invalidate that clause because §365 applies to executory contracts, and even if the operating agreement at issue was an executory contract, §365(e)(2) would excuse performance because the remaining member would not be required to accept performance from a former member or his or her successor in bankruptcy.

⁷³ 357 P.3d 650 (Wash. 2015).

The Right Of A Debtor Member To Assume An Operating Agreement.

Two courts have addressed in detail whether a debtor in possession or trustee may assume an operating agreement, notwithstanding state law provisions that would provide for bankruptcy as a disassociation or dissolution event. In the absence of bankruptcy law provisions that override state law, the bankruptcy of a member would, at least in member-managed LLCs, trigger an opportunity for the remaining members to vote whether to continue the LLC. In any event, the bankruptcy would cause the bankrupt member's status as a member to cease.

a. Daugherty.

In *Daugherty*, which was decided in October 1995, the bankruptcy court concluded that the provisions of the Nebraska Limited Liability Company Act were overridden by the Bankruptcy Code, and that the bankruptcy of a member did not trigger a dissolution of the LLC. The court held that even under an operating agreement, Section 365(c)(1) does not permit a party to avoid accepting from or rendering performance to a debtor in possession. 188 B.R. at 614. This analysis is consistent with the majority rule in partnership cases, and the leading case in partnership area is *In re Cardinal Industries, Inc.*⁷⁴ The *Daugherty* court specifically rejected a separate line of cases which have held that a partnership dissolves, and a partner's status as such ceases, upon a partner's bankruptcy filing.

b. The DeLuca Cases.

Both of the DeLuca cases arose from the bankruptcy filings of a husband and wife who are involved in numerous entities, including several LLCs. In *DeLuca I*, the principal question was whether the remaining members of the LLC could remove the DeLucas as managers of the LLC and insert a new manager, when the underlying operating agreement required unanimous member consent for the appointment of a new manager. The court concluded that the pre-petition removal of the DeLucas as managers was valid because the operating agreement was silent on

⁷⁴ 116 B.R. 964 (Bankr. S.D. Ohio 1990).

removal but state law permitted removal upon a majority vote of the members. The court also found that a new manager could be appointed by the remaining members after the bankruptcy petition because the bankruptcy petition of the DeLucas had the effect of terminating the DeLucas' status as members.

In *DeLuca II*, the DeLucas were members of an LLC that was itself one of two members of a second LLC. The other member of the second LLC sought the court's determination that the DeLucas' bankruptcy caused a dissolution of the first LLC (because there were no non-bankrupt members of that LLC who could vote to continue), and that the dissolution of the first LLC therefore triggered the dissolution of the second LLC. Again, the court gave effect to state law provisions and agreed that the second LLC had dissolved as a result of the DeLucas' Chapter 11 filing. However, without reaching the question whether the DeLucas had unlawfully dissolved the second LLC, the court concluded that it would not disturb the prior appointment of a bankruptcy trustee in favor of allowing the remaining member of the second LLC to wind up the LLC's business. The applicable Virginia statute would have permitted all members (presumably including the first LLC) that had not "wrongfully dissolved" the LLC to participate in the winding up.

In both of the *DeLuca* cases, the court relied primarily on *Breeden v. Catron*,⁷⁵ a general partnership case in which the lower courts and in the Fourth Circuit concluded that the language of Section 365(c) should be read literally to prevent the debtor in possession's assumption of a partnership agreement because applicable state law would not require the remaining partners to perform their obligations under the partnership agreement or to accept the performance of the bankrupt partner's obligations from any party other than the bankrupt partner. In such circumstances, the *Catron* court concluded, neither the trustee nor the debtor in possession could assume the contract. In the *DeLuca* cases, the court likened the partnership agreement at issue in *Catron* to the operating agreements involved in the *DeLuca* cases, and concluded that the state law provisions governing dissolution and the status

⁷⁵ 158 B.R. 624 (Bankr. E. D. Va. 1992), *aff'd*, 158 B.R. 629 (E. D. Va. 1993), *aff'd*, 25 F.3d 1038 (4th Cir. 1994).

of a bankrupt member should be given effect notwithstanding the Bankruptcy Code's general preference toward permitting the assumption of executory contracts.

As noted elsewhere in this outline, a more recent case from the bankruptcy court in the Western District of Virginia reached a different result than the *DeLuca* cases. That court held that the noneconomic management rights in the LLC were property of the bankrupt member, and without mentioning or even analyzing the *DeLuca* cases, held that the statutory provision that would otherwise have deemed the bankrupt member a mere assignee was an invalid *ipso facto* provision under Bankruptcy Code §541(c)(1)(B).⁷⁶

Enforcement of Membership Interest Purchase Options in Bankruptcy.

Several cases have addressed situations in which non-bankrupt members have attempted to claim the benefit of purchase options that would allow the redemption or acquisition of a bankrupt member's interest. For example, in *In re Capital Acquisitions & Management Corp.*,⁷⁷ the court found that an operating agreement was not an executory contract, and on that basis, that the provisions of § 365 were not applicable to render a right of first refusal to purchase an LLC interest an invalid *ipso facto* provision. However, the court also noted that even if the operating agreement were an executory contract, the right of first refusal would still not apply. The right was not actually triggered by the bankruptcy filing itself, or the appointment of a trustee or receiver, but by the election to sell the bankrupt member's interest. This seems to be a bit of hair-splitting, but the court concluded that because the provision at issue was not itself triggered by the bankruptcy filing, but by a subsequent action during the bankruptcy proceeding, the sale provision did not constitute an invalid *ipso facto* clause. Other cases involving rights of first refusal and purchase options discussed elsewhere in this outline include *In re Denman*,⁷⁸

⁷⁶ For a complete discussion of the *DeLuca* cases and the underlying legal issues, see Wheaton, *Dumping Deadbeats: Enforcing Limited Liability Company Agreements in Bankruptcy*, JOURNAL OF LIMITED LIABILITY COMPANIES, Fall 1996, at 60.

⁷⁷ 341 B.R. 632 (Bankr. N.D. Ill. 2006).

⁷⁸ 513 B.R. 720 (W.D. Tenn. 2014).

and *In re Strata Title, LLC*.⁷⁹

Other Cases Addressing Assumption and *Ipsa Facto* Issues.

Several other cases have addressed the relationship of the bankruptcy law provisions to single-member LLCs. In *In re Desmond*,⁸⁰ an individual debtor sought to prevent a creditor of a wholly-owned LLC from taking action against the LLC by asserting that obligations entered into by the LLC were invalid because the authorization of the obligations by the debtor in his manager capacity was invalid because the management rights were an asset of his individual bankruptcy estate. The court found that because the LLC was not in bankruptcy, nothing about the debtor's individual bankruptcy deprived him of the right to take action on behalf of the LLC. The court distinguished *In re Albright*.⁸¹ In *Albright*, the court concluded that it could disregard statutory provisions requiring approval for the admission of an assignee as a member because the LLC at issue was a single-member LLC, and there were no other members whose approval was required before the chapter 7 trustee could be substituted as a member for the bankrupt debtor-member. In *In re Pickel*,⁸² the court followed the logic of the *Albright* case in concluding that § 541(c)(1) trumped a provision of the Virgin Islands LLC statute that caused a bankrupt member to be dissociated. The LLC was a single-member LLC, and the court noted that giving effect to the LLC provision would leave the company without a member or manager.

Two Delaware cases have also addressed the *ipso facto* clause issue and the status of and distinction between economic and management rights in an LLC. In *Milford Power Company, LLC v. PDC Milford Power, LLC*,⁸³ the court analyzed the appropriate bankruptcy law sections and concluded that bankruptcy law preempted any provisions of the LLC operating agreement that would deprive a debtor of making its economic rights available to assignee, but would allow the

enforcement of the agreement to the extent it restricted the assignment of the debtor's management rights. A similar result was reached by another Delaware court in *In Re IT Group, Inc.*⁸⁴

The court in the *Allentown* case also conducted an extensive analysis of the Section 365 and *ipso facto* clause issues. Having concluded that the operating agreement relating to the operation of a professional baseball league constituted an executory contract, the court concluded that the debtor member's interest in the LLC was not terminated as a result of the member's bankruptcy. The court synthesized the partnership and LLC cases addressing the tension between the various Section 365 subsections, and concluded that the North Carolina statutory provisions that restrict assignments of membership interests are sufficiently ambiguous that they do not constitute applicable non-bankruptcy law prohibiting assignment. The court also concluded on the facts that the operation of the LLC did not demonstrate that a member's duties were the kinds of non-delegable duties that should render the membership interest non-assignable.

In the *JD Factors* case noted above, the court also concluded that under § 365(c)(1), an Indiana law provision to the effect that a person cannot become a member without the consent of all the other members would be likely to be given effect.

LLC as Insider of Member Debtor.

In *In re Barman*,⁸⁵ the court held that for the purposes of defining the "insiders" of an individual Chapter 7 debtor, an LLC is sufficiently close to a corporation to apply the bankruptcy principles that apply to corporations. Under the Bankruptcy Code, a corporation of which the debtor is a director, officer or control

⁷⁹ 2013 WL 1773619 (Bankr. D. Ariz. Apr. 25, 2013).

⁸⁰ 316 B.R. 593 (Bankr. D.N.H. 2004).

⁸¹ 291 B.R. 538 (Bankr. D. Colo. 2003).

⁸² 487 B.R. 289 (Bankr. D.N.M. 2013).

⁸³ 866 A. 2d 738 (Del. Ch. 2004).

⁸⁴ 302 B.R. 483 (D. Del. 2003). See also *In re Soderstrom*, 484 B.R. 874 (M.D. Fla. 2013), where the court held that a non-bankrupt member of an LLC could object to a trustee's proposed sale of the bankrupt debtor's interest in the LLC because that sale purported to include the bankrupt member's management rights. The court briefly analyzed the interplay of § 365 with an operating agreement that constituted an executory contract, and upheld a bankruptcy court determination that § 365 should be applied to prevent the estate's ability to assume the debtor's management interest in the LLC.

⁸⁵ 237 B.R. 342 (Bankr. E.D. Mich. 1999).

person, or an affiliate or insider of an affiliate, constitutes an insider. A corporation is an affiliate if the debtor controls 20% or more of its "voting securities." In this case, which involved a South Carolina LLC, the court found that the LLC was an insider of the member debtor because the debtor was one of three of the LLC's members and owned or controlled one-third of the voting rights in the LLCs.

**Miscellaneous Recent (Non-Delaware)
Partnership and LLC Cases**

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Veil Piercing

Curci Invs., LLC v. Baldwin, 14 Cal.App.5th 214 (Cal. App. 4th Dist. 2017).

A judgment creditor of an individual sought to add the individual's LLC as a judgment debtor, i.e., to reverse pierce the veil of the LLC. The trial court held that reverse veil piercing is not available in California. The court of appeals distinguished the case relied on by the trial court and held that reverse veil piercing is available in California. Thus, the court remanded the case for a factual determination of whether the LLC's veil should be pierced.

In 2004, James Baldwin formed JPBI Investments LLC (JPBI), a Delaware LLC, for the sole purpose of hold[ing] and invest[ing] [Baldwin and his wife's] cash balances. Baldwin and his wife were JPBI's two members, with Baldwin owning a 99% membership interest and his wife owning a 1% membership interest. Baldwin was a manager and the chief executive officer of JPBI. Baldwin thus controlled when or if JPBI made distributions to the members.

A couple years after establishing JPBI, Baldwin borrowed \$5.5 million from the predecessor of Curci Investments, LLC (Curci). Not long after that loan, Baldwin settled eight family trusts for his grandchildren with Baldwin's children as trustees. For estate planning reasons, Baldwin also established three family partnerships, the partners of which were various combinations of the family trusts. JPBI loaned more than \$42 million to the three general partnerships.

When the Curci note came due in 2009, Baldwin had made no payments, and Curci filed suit to recover the amount owed. The parties entered into a court-approved stipulation establishing a payment schedule to avoid a judgment, but Baldwin failed to make the agreed payments, and the court entered a \$7.2 million judgment against Baldwin in 2012. By 2014, no payments had been made to Baldwin on the notes from the partnerships, and Baldwin

extended the due dates to 2020 for unexplained reasons and no consideration. Curci obtained charging orders against 36 entities in which Baldwin had an interest, including JPBI. Although JPBI had distributed about \$178 million to Baldwin and his wife between 2006 and 2012, no distributions had been made since the 2012 judgment on the Curci note.

In 2015, Curci filed a motion to add JPBI as a judgment debtor on the judgment against Baldwin. Curci based its motion on the doctrine of outsider reverse piercing, arguing that the doctrine should be applied to JPBI as Baldwin's alter ego because Baldwin was using JPBI to avoid paying the judgment and injustice would result if JPBI's assets could not be used to satisfy Baldwin's personal debt.

The trial court denied Curci's motion to add JPBI as a judgment debtor based on *Postal Instant Press, Inc. v. Kaswa Corp.*, 162 Cal.App.4th 1510, 77 Cal.Rptr.3d 96 (2008), in which a judgment creditor sought to add a corporation as a judgment debtor on a judgment against an individual who had been a shareholder of the corporation. In that case, the court of appeals refused to apply reverse veil piercing based on concerns about allowing judgment creditors to bypass standard collection procedures, harming innocent shareholders and corporate creditors, and using an equitable remedy where legal remedies were available. Ultimately, the court of appeals in Curci distinguished *Postal Instant Press* and held that reverse veil piercing of JPBI might be appropriate.

In its discussion of whether reverse veil piercing of JPBI may be applied in this case, the court of appeals first provided background and framework for its discussion of reverse piercing by reviewing basic principles associated with traditional veil piercing under the well-established alter-ego doctrine. [Author's Note: Although JPBI was a Delaware LLC, the court confined its discussion to California law. The court apparently did not consider the possibility that Delaware law should control the issue before the court. Even when specifically confronting the issue, California courts have not always followed the internal affairs doctrine in veil piercing cases. See *Butler v. Adoption Media, LLC*, 486 F.Supp.2d 1022 (N.D. Cal. 2007). The governing law provision of the current LLC statute that calls for application of

the law of the state of formation applies to “[t]he organization of the limited liability company, its internal affairs, and the authority of its members and managers” and “[t]he liability of a member as member and a manager as manager for the debts, obligations, or other liabilities of the limited liability company.” Cal. Corp. Code § 17708.01. Thus, the provision encompasses internal affairs and traditional veil piercing but does not explicitly address reverse veil piercing.]

After reviewing the basic principles and policies associated with traditional veil piercing, the court described the two conditions that must generally be met in California to invoke the alter-ego doctrine: (1) unity of interest and ownership between the corporation and its equitable owner such that the separate existence of the corporation and shareholder do not in reality exist, and (2) an inequitable result if the acts in question are treated as those of only the corporation. Although courts list factors that may be analyzed to make an alter-ego determination, there is no “litmus test,” and each case depends on its own facts.

The court described reverse veil piercing as similar to traditional veil piercing in that both disregard the separate existence of an individual and business entity when the ends of justice require, but the doctrines differ in that reverse veil piercing seeks to satisfy the debt of an individual through the assets of the entity rather than holding an individual responsible for the acts of the entity. The court stated that a majority of jurisdictions have adopted outsider reverse piercing as an equitable remedy, and some of those jurisdictions apply the same “test” applied in traditional piercing while others include additional factors to address concerns unique to reverse piercing.

The court discussed the California appellate court’s decision in *Postal Instant Press* and concluded that it did not preclude reverse piercing in this case for several reasons. First, *Postal Instant Press* involved a corporation rather than an LLC, and the decision was expressly limited to corporations. Additionally, the facts of the instant case as well as the nature of LLCs do not present the concerns raised in *Postal Instant Press*. Here there was no “innocent” member of JPBI that could be affected by reverse piercing inasmuch as the other 1% of JPBI was owned by Baldwin’s wife, who was also liable for the debt owed to Curci

because the community estate is generally liable for any debt incurred by either spouse before or during marriage. As for the concern about bypassing normal collection procedures, a creditor of an LLC member does not have the same options as a creditor of a shareholder. A shareholder’s creditor may use collection procedures that will enable it to step into the shoes of the shareholder and exercise the shareholder’s rights to vote and sell the shares, whereas an LLC member’s creditor may only obtain a charging order. The LLC member retains the rights to control and manage the LLC, including, in this case, Baldwin’s right to decide when or if distributions will be made. As for the availability of legal remedies, such as conversion and fraudulent transfer, the court acknowledged that legal remedies may be available in many cases and thereby preclude piercing, but the court stated that reverse piercing was needed to deliver justice in precisely those rare cases where legal remedies are not available. Requiring a creditor who wishes to invoke reverse piercing to demonstrate the absence of “a plain, speedy, and adequate remedy at law would protect against reverse piercing being used to bypass legal remedies.”

Baldwin argued that the California charging order statute precluded reverse piercing because the statute provides the sole remedy for creditors of an LLC member. However, the court pointed out that the statute states that the charging order is the exclusive remedy by which a judgment creditor may “satisfy the judgment from the judgment debtor’s transferable interest,” whereas reverse piercing is a means of reaching the LLC’s assets, not the debtor’s transferable interest. The court also noted the comments to RULLCA—on which the California statute is based—that the charging order provisions are not intended to preclude reverse piercing where appropriate. [Again, the court did not address Delaware law, which provides in the charging order context that a creditor of an LLC member has no “right to obtain possession of, or otherwise exercise any legal or equitable remedies with respect to,” the LLC’s property. 6 Del. C. § 18-703.]

In conclusion, the court stated that the instant case may present a situation where reverse veil piercing would be appropriate, noting “Baldwin’s nonresponsiveness and claimed lack of knowledge concerning his own

personal assets and the web of business entities in which he has an interest,” and his complete control over JPBI and the use of that power to extend the repayment of loans made to benefit his grandchildren and to cease making distributions to himself and his wife despite having distributed \$178 million in the six years predating the judgment.

Ultimately, the court expressed no opinion as to whether JPBI’s veil should be pierced but remanded the case to the trial court for further consideration. The court stated that there was no litmus test, as in the case of traditional veil piercing, and “the key is whether the ends of justice require disregarding the separate nature of JPBI under the circumstances,” taking into account “at minimum,...the same factors as are employed in a traditional veil piercing case, as well as whether Curci has any plain, speedy, and adequate remedy at law.”

A.V.E.L.A., Inc. v. Estate of Marilyn Monroe, LLC, 241 F.Supp.3d 461 (S.D.N.Y. 2017).

The court in this protracted multi-party, multi-claim, intellectual-property dispute granted summary judgment against a party that was seeking to impose liability for alleged wrongdoing of The Estate of Marilyn Monroe, LLC (a Delaware LLC that is not actually Monroe’s estate) on a related LLC based on the alter-ego theory of liability.

This dispute revolved around the rights to twelve registered trademarks involving Marilyn Monroe. In this opinion, the court addressed, inter alia, a third-party defendant’s assertion that defendant Authentic Brands Group LLC (ABG) should be held liable for alleged wrongdoing of The Estate of Marilyn Monroe, LLC (Estate LLC) on the basis that ABG was the alter ego of Estate LLC. Applying Delaware law to the veil piercing claim, the court concluded that the claimant’s allegations fell far short of alleging that Estate LLC was ABG’s alter ego.

The court looked to Delaware law to address the alter-ego argument because “New York’s choice of law rules provide that the law of the state of incorporation determines when the corporate form will be disregarded and liability will be imposed on shareholders. The court

stated that an LLC provides limited liability similar to that in the corporate form under Delaware law, and persuading a Delaware court to disregard an LLC’s corporate structure is a “difficult task.” The court stated that Delaware law permits a court to pierce an LLC’s veil where there is “fraud” or the LLC is “in fact a mere instrumentality or alter ego of its owner. A showing that one entity is the alter ego of another requires a showing “that ‘the entities in question operated as a single economic entity,’ and (ii) that ‘there [is] an overall element of injustice or unfairness. The court listed a number of factors that are relevant to the “single economic entity” showing and noted that somewhat less emphasis is placed on the observance of formalities in the LLC context than in the corporate context because fewer formalities are required in the LLC context. With regard to the showing of “injustice or unfairness,” the court stated that a claimant must establish that the LLC was a “sham or shell through which the parent... perpetrates injustice.” The injustice or unfairness must result from abuse of the corporate form and must be more than merely the cause of action that is the basis of the claimant’s lawsuit.

In this case, the court found virtually no factual allegations to substantiate the alter-ego claim. The claimant alleged that the two LLCs shared senior employees, offices, and letterhead, but those facts did not speak to the factors considered under Delaware law with regard to alter ego. The claimant’s allegations that Estate LLC was “‘a mere corporate shell over which ABG maintains ownership’ and that it ‘functions as a mere facade or instrumentality for ABG were legal conclusions rather than factual allegations. The allegation that affording Estate LLC limited liability would promote injustice by permitting ABG to insulate itself from the wrongdoing of Estate LLC did not allege how respecting Estate LLC’s form would promote injustice beyond the causes of action asserted by the claimant. Although the court recognized that an alter-ego inquiry is usually a fact-intensive process and is ordinarily a question for the jury, the court rejected the alter-ego claim in this case because the claimant’s factual allegations in support of the claim were “scant and irrelevant.”

Spradlin v. Beads and Steeds Inns, LLC (In re Howland), 674 Fed. App'x 482 (6th Cir. 2017).

The court rejected the trustee's attempt to rely on reverse veil piercing in order to characterize a transfer of property by a non-debtor as a fraudulent transfer of the debtors' property. The court found it unnecessary to reach the question of whether the Kentucky Supreme Court would recognize reverse piercing because—even assuming Kentucky would recognize reverse piercing—the court concluded that veil piercing in Kentucky is a form of vicarious liability and not a means to consolidate two entities into one as the trustee was attempting to do.

The bankruptcy trustee sought to set aside a transfer of real property by an LLC owned by the debtors on the basis that the transfer of the property was a fraudulent transfer. Recognizing that the provisions of the Bankruptcy Code on which she relied applied to a transfer of an interest in a debtor's property, the trustee argued that she could pierce the veil of the LLC in reverse and treat the LLC and the debtors as a single entity. The bankruptcy court rejected the trustee's argument, and the district court affirmed the bankruptcy court. The trustee appealed to the Sixth Circuit.

The court of appeals stated that veil piercing falls into two camps as it relates to whether a litigant may consolidate a debtor and its alter ego into a single entity. The first camp is the "identity approach," under which a corporation and its alter ego are deemed to be a single entity such that piercing the veil "expands the debtor's estate to include the property of its alter ego." However, the court found that Kentucky falls into the second camp, in which veil piercing is employed as a form of vicarious liability, based on statements by the Kentucky Supreme Court describing veil piercing as a means to impose liability on the shareholders for a debt of the corporation. The trustee argued that Kentucky would allow the use of veil piercing to consolidate entities, but the court examined the cases relied on by the trustee and concluded that they were not inconsistent with Kentucky's adherence to the vicarious liability approach to veil piercing. The court explained that "the vicarious liability approach...does not give the pierced entity (i.e., the debtor) an interest in its alter ego's assets it gives the

pierced entity's creditor (i.e., the trustee) an interest in the alter ego's assets in order to satisfy its judgment against the pierced debtor." In sum, "[b]ecause Kentucky veil piercing does not transform the alter ego's property into the property of the debtor, but rather simply allows a creditor to pursue the alter ego under a vicarious liability theory, the trustee has not stated a claim under [Bankruptcy Code] § 544 and § 548, both of which require that the debtor have an interest in the transferred property."

Rocklon, LLC v. Paris, No. 09-16-00070-CV, 2016 WL 6110911 (Tex. App. Oct. 20, 2016).

Relying on reverse veil piercing, the court held that the trial court properly enjoined an LLC from accessing, distributing, or disbursing the proceeds of the sale of the LLC's property based on evidence that the member had used the LLC as his alter ego and had fraudulently transferred the LLC's bank account to his son.

The surviving spouse and estate of Kristin Paris (collectively, "the plaintiff") brought a wrongful death suit against Rocklon, L.L.C. ("Rocklon"), Rockal, Inc. ("Rockal"), and Rockline George Kennedy, among others, after Kristin Paris died in a car accident with Kennedy. A key point of dispute in the lawsuit was Kennedy's relationship to his co-defendant entities. The plaintiff alleged that the two entities were the alter egos of Kennedy, while Kennedy alleged that he had no ownership interest in the entities.

According to the plaintiff's pleadings, Kennedy had been drinking at the bar and strip club that was operated by Rockal on real property owned by Rocklon. Kennedy then left the club in his vehicle, crossed the median of a highway and struck Kristin Paris's vehicle head on. Kennedy was arrested shortly after the incident and released a few days later. Upon his release from jail, Kennedy accompanied his son to Rocklon's bank and transferred full control of Rocklon's account to the son. Eight days after Kennedy filed his answer in the suit, Rocklon sold its primary asset, the real estate where the club was located, for approximately \$1 million. The trial court entered a temporary injunction preventing the proceeds of the real estate sale from being accessed by Rocklon, and Rocklon

filed a notice of interlocutory appeal challenging the temporary injunction.

On appeal, Rocklon argued that there was no evidence that Rocklon was liable to the plaintiff on the underlying claims because the evidence did not establish that Rocklon was the alter ego of Kennedy and there was no evidence of a fraudulent transfer. In a fraudulent transfer action under the Texas Uniform Fraudulent Transfer Act (TUFTA), the statute provides that a creditor may obtain “an injunction against further disposition by the debtor or a transferee, or both, of the asset transferred or of other property.” In this case, the plaintiff alleged TUFTA claims against all defendants, including Rocklon. The plaintiff alleged that Rocklon was an alter ego of Kennedy and thus a debtor under TUFTA, and that Rocklon had fraudulently transferred or was likely to fraudulently transfer its property with actual intent to hinder, delay, or defraud the plaintiff.

Turning first to Rocklon’s challenge to the plaintiff’s veil-piercing theory, the court noted that Texas intermediate courts of appeal and other jurisdictions have applied to LLCs the same state-law principles for piercing the veil as they have applied to corporations. Rocklon did not challenge the plaintiff’s contention that veil piercing theories are applicable to LLCs, but rather argued that the plaintiff failed to present evidence to support the plaintiff’s reverse piercing theory. The court explained that a creditor who relies on reverse veil piercing seeks to apply the alter-ego doctrine in reverse, i.e., “to hold a corporation’s assets accountable for the liability of individuals who treated the corporation as their alter ego.” To determine whether an alter-ego relationship exists, a court looks at the total dealings of a corporation and the individual and considers the degree to which corporate and individual property have been kept separately, the amount of financial interest, ownership, and control the individual maintains over the corporation, and whether the individual used the corporation for personal purposes. Other relevant factors include whether corporate debts were paid with personal checks or other evidence of the commingling of funds. An individual’s representations that he would financially back the corporation and diversion of company profits to the individual for personal use is also evidence tending to support a finding of an alter-ego relationship. Finally, the court may also consider inadequate capitalization of

the corporation. The applicable standard of review in this case was for abuse of discretion. This standard required the court of appeals to examine the evidence in the record to see if it reasonably supported the trial court’s decision. The court organized its discussion of the evidence of alter ego around three issues: (1) ownership interest and control of Rocklon; (2) commingling of funds; and (3) Kennedy’s representations.

With regard to the issue of ownership and control, Rocklon argued that it was merely a real estate business that leased property to Rockal, the company that owned and operated the club, and that Rocklon was owned solely by Kennedy’s son and not Kennedy. The court reviewed basic statutory concepts relating to an LLC, such as the certificate of formation, company agreement, members, membership interests, and assignees. Rocklon’s certificate of formation filed with the Secretary of State on February 1, 2006, indicated that it was a member-managed LLC whose registered agent and only member was Kennedy. Two nearly identical company agreements were produced by Rocklon’s bank. One version, which was unexecuted, indicated that Kennedy was the sole and initial member. The other version, which was executed, indicated that Kennedy’s son was the sole and initial member. Both company agreements were dated February 1, 2006. The record also contained an assignment of membership interest in Rocklon from Kennedy to Kennedy’s son dated February 1, 2006, but the court of appeals concluded that the trial court could have reasonably determined that the assignment was void due to its failure to meet the requirements of the company agreements for a valid assignment.

Both of the Rocklon company agreements contained in the record defined an assignee as “a person who receives a Transfer of all or a portion of the Membership Interest of a Member, but who has not been admitted to the Company as a Member.” Another provision of the company agreement stated that “[a]ny attempted Transfer by a person of an interest or right, or any part thereof, in or in respect of the Company other than as specifically provided by this Agreement shall be, and is hereby declared, null and void ab initio.” The company agreements also stated that an assignee did not have any voting right or right to participate in the operations or management of the company until

admitted as a substituted member. Further, an assignee was admitted as a substituted member only when the member making the transfer granted the assignee the right to be admitted and the instrument assigning the membership interest contained an agreement by the assignee that the assignee agreed to be bound by all of the terms and provisions of the company agreement. The assignment purporting to transfer Kennedy's interest in Rocklon to his son was only signed by Kennedy and did not contain any agreement by the son as an assignee. Thus, the court concluded that the trial court could reasonably have determined the assignment failed and was void based on the provisions of Rocklon's company agreement. Further, the record contained an apparent transmittal letter from an attorney to Kennedy dated June 5, 2006, in which the attorney instructed Kennedy to execute the assignment of interest to his son and have his son execute the company agreement. When questioned in the trial, Kennedy's son stated that he was not sure when the assignment was executed and refused to confirm or deny that it was executed on February 1, 2006. Based on the conflicting documents, the court held that the trial court could properly have found that neither the assignment nor the executed version of the company agreement were reliable to show the true membership or ownership of Rocklon.

The court continued its review of the documents in the record by looking at franchise tax and bank records, finding that they too were inconclusive as to ownership of Rocklon. In the franchise tax reports for 2010, 2012, and 2013, Kennedy was identified as the only officer, director, or member of Rocklon. Although the Tax Code does not require all members to be listed, the court found that the documents, interpreted reasonably, could lead to the conclusion that Kennedy was at least the managing member of Rocklon. The court of appeals described the testimony of Kennedy's son as conflicting with the documents relating to Rocklon's formation in that Kennedy's son testified that he was the owner from the very beginning and that his father's only role was in guaranteeing the real estate loan to Rocklon to purchase its property. On appeal, Rocklon acknowledged that Kennedy was identified as the initial member in the certificate of formation, but argued that Kennedy's son executed the company agreement as its sole member and accepted an assignment of his father's

membership interest. Given the conflicting evidence, the court of appeals said that the trial court could have discredited the son's testimony.

Bank records also supported the contention that Kennedy was the sole member of Rocklon and had sole control of its bank account. Kennedy's signature was the only signature on the signature card, he was identified as president of Rocklon, and his personal address was listed as the address of the company. Also, in June of 2006, after the purported transfer to his son, Kennedy applied for a real estate loan on behalf of Rocklon, and the loan worksheet identified Kennedy as a member of Rocklon. Kennedy pledged his personal life insurance policy to secure the loan. Despite these records, the bank records relating to this loan also contained a resolution signed by Kennedy's son in which he represented that he was the sole member of Rocklon. Kennedy's son testified that his father was only the "land manager" of Rocklon.

Before reaching its ultimate conclusion on the issue of ownership and control, the court also mentioned Rocklon's income tax return forms for two years (which were signed by Kennedy's son as the sole "stockholder"), statements of emergency personnel at the scene of the car accident (reporting that Kennedy represented that he owned the bar and strip club), and statements of employees of the club (who were uncertain about the ownership of the club but described involvement by Kennedy in its operations). After noting that alternative conclusions could be drawn from the evidence, the court ultimately concluded that the record contained some evidence to show that Kennedy had full, seemingly unchecked control over every aspect of Rocklon's business until shortly after his release from jail.

The court next discussed evidence of commingling of funds of Kennedy, Rockal, and Rocklon. Under its lease of the premises from Rocklon, Rockal was to pay monthly rent to Rocklon as well as real estate taxes. However, evidence showed that Kennedy used Rocklon's assets to pay the real estate taxes and that Rocklon received substantially less than it was entitled to receive in rent payments. Additionally, there was evidence that Kennedy wrote checks from Rocklon's account for his personal benefit. This commingling led the court to conclude that "[g]iven all the evidence, the trial court could

have found that Kennedy was at the heart of both of these entities and that he commingled funds from Rocklon, Rockal, and his personal account in disregard of the corporate fictions.”

Finally, the court of appeals noted that Kennedy personally represented to the bank that he was a member of Rocklon, and he guaranteed its loan. He took out a life insurance policy to support his representations to the bank. The court stated that the trial court could have reasonably considered this as some evidence of Kennedy’s use of the corporate fiction as his alter ego.

Based on all of the evidence before the trial court concerning Kennedy’s total dealings with Rocklon, and viewing the evidence in a light most favorable to the trial court’s finding, the court of appeals concluded that the evidence reasonably supported a probable right of recovery at trial based on an alter-ego relationship between Kennedy and Rocklon.

The court then turned its attention to whether Kennedy’s transfer of Rocklon’s bank account to his son was a fraudulent transfer. Based on the evidence that Rocklon was the alter ego of Kennedy, the court stated that it could consider a transfer by Rocklon as a transfer by Kennedy. After Kennedy was released from jail he passed control of Rocklon’s account to his son. Further, Kennedy and his son executed corporate resolutions authorizing the son to communicate with the bank regarding payoff of the loan on the property and to pay off the promissory note to the bank, thus allowing the son to sell the real estate owned by Rocklon. This resolution also gave the son authority to transfer any proceeds from Rocklon’s bank account. The court found this evidence was sufficient to be a transfer of an asset under TUFTA.

The court then examined whether “badges of fraud” were present in the transfer. The facts the court found persuasive were that the transfer was to Kennedy’s son, an insider, that the real estate was substantially all of the assets of Rocklon, that there was some evidence that Kennedy tried to conceal the transfer by going to an out-of-town branch of the bank, that Kennedy received no value in return for the transfer, and finally that the transfer was only made after Kennedy had been charged with

intoxication manslaughter and could have known that the civil lawsuit was likely imminent.

The last TUFTA requirement of imminent and irreparable harm was satisfied by evidence that following the sale of the real estate, Kennedy’s son had begun writing checks to himself out of the Rocklon account. The court agreed with the plaintiff that should the temporary injunction not be in place, the proceeds of the sale of Rocklon’s asset could be gone before completion of a trial. The court thus held that the temporary injunction was properly granted and affirmed the order of the trial court.

Fiduciary Duties

CBIF Ltd. P’ship v. TGI Friday’s Inc., No. 05–15–00157–CV, 2017 WL 1455407 (Tex. App. Apr. 21, 2017).

The court of appeals held that the evidence supported the jury’s findings that an entity that was a partner in a joint venture and a controlling limited partner in a limited partnership breached its fiduciary duties to the joint venture, the limited partnership, and the other partners notwithstanding that the actions taken were within the contractual rights provided by the joint venture agreement and limited partnership agreement because “contractual rights must be exercised in a manner consistent with fiduciary duties” when the two overlap. The court also discussed the contours of a cause of action for knowing participation in a breach of fiduciary duty and concluded that the evidence supported the jury’s findings that an individual knowingly participated in breaches of fiduciary duty by entities he controlled.

In 1995, TGI Friday’s submitted a bid for a concession space at DFW Airport. The bid proposed a joint venture in which disadvantaged business enterprise (DBE) partners would have 35% ownership interest, as was required by government regulations. After DFW approved the proposal, Friday’s formed TGIF/DFW Restaurant Joint Venture (TGIFJV) with three other partners—two DBE partners and a corporation owned by Steve Flory, which ultimately assigned its interest to CBIF Limited Partnership (CBIF), another entity controlled by Flory. Each of the four partners was required to make a capital contribution of \$1.55 million in exchange for a 25% ownership interest in TGIFJV. Both of the original DBE partners had

trouble making their required capital contributions. The interest of one of these DBE partners was acquired by a newly formed limited partnership, TSQF Limited Partnership (TSQF). TSQF's limited partners were CBIF and three individuals (the RSH Group) who comprised the ownership group of the defaulting DBE partner whose interest TSQF acquired. The general partner of TSQF was Texas Star Quality Foods, LLC (Texas Star). Texas Star was managed by Columbia Airport LLC (Columbia), owned by Flory and one of the members of the RSH Group. The RSH Group owned 51% of TSQF, but TSQF was structured so that the RSH Group could not cause TSQF to act without Flory's consent. The interest of the other original DBE partner was acquired by Friday's and CBIF. As a result, TSQF, with a 25% interest, became the only remaining DBE partner in TGIFJV, but the agreement between Friday's and DFW Airport required DBE partners to own 35% of the joint venture. Flory refused to allow CBIF to sell 5% out of its 37.5% interest to help make up for the 10% difference. Therefore, Friday's sold 10% out of its 37.5% interest to Domain Enterprises, Inc. (Domain), a DBE. Ultimately, TGIFJV had four partners—LBD Corporation, a subsidiary of Friday's, with 27.5%; CBIF, controlled by Flory, with 37.5%; Domain with 10%; and TSQF Limited Partnership, owned by the RSH Group, CBIF, and Texas Star, with 25%.

In 1996, TGIFJV entered into a lease agreement with DFW Airport for an initial term of 10 years with two renewal options of 5 years. In 2004, DFW Airport accepted bidding for concession spaces with the requirement that a DBE own 35% interest. Flory failed to meet capital contributions on time and changed his mind multiple times as to whether he wanted to move forward with another lease. This flip-flopping left TSQF with only 25%, rather than the 40% the RSH Group wanted to acquire.

In 2009, DFW Airport began to renovate the airport and required restaurants to enter a new lease. Under new federal requirements, a DBE not only had to own a certain percentage of the venture but also maintain a degree of control at both the DBE partner level and the joint venture level. After a review, DFW Airport and the FAA found TGIFJV's agreement failed to comply with these new control requirements. Friday's and the RSH Group proposed amendments to the joint venture agreement that would give the DBE partners, Domain and

TSQF, greater control, but Flory refused to agree to the changes. Ultimately, Friday's and the RSH Group created a new joint venture and secured the lease. Friday's and RSH Group entered a side agreement with Domain and CBIF to maintain their interests.

In 2011, Friday's sued CBIF, Columbia, and Flory (the CBIF parties). The CBIF parties filed crossclaims against Friday's and third-party claims against TSQF, the RSH Group, and others. TSQF and the RSH Group asserted claims against the CBIF parties. On appeal, the CBIF parties appealed a judgment in favor of the other parties on claims including judicial dissolution of TGIFJV and breach of fiduciary duty.

The court of appeals found that there was sufficient evidence to support the jury's finding that CBIF breached its fiduciary duty to Friday's by unreasonably withholding consent to a new lease with DFW Airport and acting in its own self-interest. CBIF argued it could not be held liable for breach of fiduciary duty because it was merely exercising its contractual right to vote against proposed changes to the venture's governing documents. The court of appeals rejected this argument, stating that contracts "do not exist in a vacuum" and that "contractual rights, such as those claimed by CBIF, do not 'operate to the exclusion of fiduciary duties. Where contractual rights and fiduciary duties 'overlap, contractual rights must be exercised in a manner consistent with fiduciary duties.'" The joint venture agreement of TGIFJV could not be amended or changed without unanimous consent of the partners, but the agreement had to comply with laws and regulations or TGIFJV risked losing its lease. By refusing to agree to the amendments giving the DBE partners the level of control required by federal law, CBIF put TGIFJV in default and at risk of losing the entire venture. CBIF also demonstrated its pursuit of self-interest at the expense of TGIFJV and its partners when CBIF refused to waive its right of first refusal when Friday's sold a 10% interest to Domain to comply with the 35% DBE requirement, and CBIF only agreed to waive its right when Friday's paid CBIF \$109,000. Based on this evidence, the court of appeals concluded there was sufficient evidence to support the finding that CBIF breached its fiduciary duty to Friday's.

Next, the court of appeals concluded that there was sufficient evidence for the jury to find Flory individually liable for CBIF's breach of fiduciary duty because Flory knowingly participated in CBIF's breach. Under Texas law, a person is liable as a joint tortfeasor when the person "knowingly participates in a breach of fiduciary duty." To prevail on this claim, a plaintiff must prove a third party breached its fiduciary duty and that the defendant knew of the fiduciary relationship and was aware of his participation in the third party's breach of duty. Flory argued that he could not be held individually liable for CBIF's breach of fiduciary duty because he acted only in his capacity as manager of Columbia, the general partner of CBIF, and acted in good faith, believing that what he did was for the best interest of CBIF and Columbia. However, the case law relied on by Flory was a breach of contract and tortious interference case, not a breach of fiduciary duty case, and the court stated that Flory's reliance on it was misplaced. The court also rejected the argument that an agent cannot be held liable for aiding and abetting breach of a fiduciary duty by the principal. The court stated that the case on which Flory and Columbia relied for this proposition did not reach the question of whether an agent might be held liable for aiding and abetting a principal's breach of fiduciary duty.

When instructing the jury in this case on knowing participation in a breach of fiduciary duty, the court defined "knowingly" as "actual awareness, at the time of the conduct, that a fiduciary duty was owed and that the fiduciary was breaching that fiduciary duty." The court further instructed the jury that "[a]ctual awareness may be inferred where objective manifestations indicate that a person acted with actual awareness." CBIF was a partner in TGIFJV, and the court of appeals characterized the relationship between partners as "fiduciary in character, and impos[ing] on all the participants the obligation of loyalty to the joint concern and of the utmost good faith, fairness, and honesty in their dealings with each other with respect to matters pertaining to the enterprise." Flory's testimony established that he knew of the fiduciary relationship between CBIF and its partners, but Flory argued that there was no evidence that he actually knew CBIF's actions were breaches of fiduciary duty owed to Friday's and that his testimony showed that he did not know CBIF was acting in breach of a fiduciary duty.

According to the court, however, the jurors could have inferred Flory's actual awareness based on objective manifestations, such as Flory's management of CBIF, knowledge of the airport's DBE requirements, and actions preventing TGIFJV from complying with these requirements. In sum, Flory knew of CBIF's fiduciary relationship with the partners and it could be inferred that Flory had actual awareness of CBIF's breach of fiduciary duty, making Flory individually liable. The court also held that the trial court did not err in refusing to submit a jury question inquiring as to whether Columbia and Flory had a good-faith belief that they were entitled to take their actions based on the joint venture agreement. The court acknowledged that good faith is a defense to tortious interference but stated that it had found no authority extending this defense to a claim of knowing participation in a breach of fiduciary duty.

Flory and Columbia next challenged the sufficiency of the evidence supporting the jury's findings that they breached their fiduciary duties to TSQF. TSQF argued that CBIF and Columbia breached their fiduciary duties by using TSQF's money to fund a lawsuit against the RSH Group, by preventing TSQF from participating in a portion of CBIF's defaulted interest in one of the airport restaurants, by complicating TSQF's compliance with requirements of the DBE program, and by refusing to cooperate in adjusting TGIFJV to allow it to proceed at the airport for its purpose of operating Friday's restaurants. Columbia argued it could not be held liable for using TSQF funds to pay legal fees because the TSQF management services agreement authorized Columbia to obtain certain legal services and to pay for them with TSQF funds. However, the court pointed out that TSQF was managed by Texas Star as general partner, and Columbia's role in TSQF's management was very limited and administrative in nature. Despite this limited control, Columbia caused funds of TSQF to be used to pay legal fees incurred in a lawsuit Columbia and CBIF brought against the RSH Group. In doing so, Columbia "usurped Texas Star's general management role." CBIF was responsible for Columbia's actions because CBIF was a party to the lawsuit and acted through Columbia, its general partner. CBIF and Columbia also breached their fiduciary duties through Flory's lack of cooperation regarding TSQF's participation in a portion of CBIF's

defaulted interest in one of the airport restaurants. CBIF and Columbia argued that they were not liable for breach of a fiduciary duty to TSQF because TSQF could not have participated in the new restaurant without a super majority vote of its partners, which was not requested and would not have occurred because Columbia would not have voted in favor of the participation. The court stated that the argument that Columbia could not breach a fiduciary duty by exercising a contractual right was an argument already rejected by the court earlier in its opinion. Columbia and Flory also argued that the trial court erred in refusing to instruct the jury that contractual rights supplant fiduciary duties. The court rejected this argument because “contractual rights do not ‘operate to the exclusion of fiduciary duties.’” Thus, the court of appeals concluded that the trial court did not err in refusing to submit the requested instruction that contractual rights supplant fiduciary duties, and there was sufficient evidence to support the jury’s finding that CBIF and Columbia breached their fiduciary duties to TSQF.

CBIF and Columbia also challenged the sufficiency of the evidence supporting the jury’s findings that they breached a fiduciary duty to the RSH Group. The RSH Group alleged CBIF and Columbia breached their fiduciary duties by refusing to agree to changes to the governing documents required to bring TSQF and TGIFJV into compliance with federal requirements regarding DBEs. Columbia argued it had no duty to agree to the proposed changes in the governing documents because the governing documents required unanimous consent to amend or modify them. Once again, the court stated that contractual rights do not operate to the exclusion of fiduciary duties and that contractual rights must be exercised in a manner consistent with fiduciary duties. The evidence showed that the airport required TGIFJV and TSQF to meet FAA guidelines for compliance or risk losing TGIFJV’s right to operate restaurants and café bars at the airport. The evidence also showed that CBIF and Columbia refused to amend the governing documents to give the DBEs the requisite levels of control over the venture and the partnership, which resulted in the airport condemning the lease as to one of the restaurants. Thus, the evidence was sufficient to support the jury’s findings of a breach of fiduciary duty to the RSH Group.

The court of appeals also rejected Flory’s challenge to the sufficiency of the evidence supporting the jury’s findings that he knowingly participated in CBIF’s and Columbia’s breach of fiduciary duty to TSQF and the RSH Group. CBIF was a limited partner in TSQF, and a limited partner owes a fiduciary duty to the partners and the partnership if the limited partner exercises control over the operation of the business. CBIF did not challenge findings by the jury that it exercised dominance and control over TSQF. Thus, CBIF owed TSQF and the RSH Group a fiduciary duty. Flory managed Columbia, and Columbia was the general partner of CBIF and a manager of TSQF. Thus, Columbia owed TSQF and the RSH Group a fiduciary duty. Flory knew of these fiduciary relationships, and the court concluded that the jury could have inferred Flory’s actual awareness of the breach based on Flory’s actions. Thus, the court held there was sufficient evidence to support the jury’s finding that Flory knowingly participated in CBIF’s and Columbia’s breach of fiduciary duties. Consistent with its earlier holding regarding Flory’s knowing participation in CBIF’s breach of fiduciary duty to Friday’s, the court held that the trial court did not err in refusing to submit an instruction on good-faith belief as a justification because justification is not a defense to knowing participation.

Beninati v. Borghi, 61 N.E.3d 476 (Mass. App. 2016).

The appellate court held that outsiders who participated in breaches of fiduciary duty by managers and employees of LLCs could be liable under the state unfair trade practices statute even though the statute does not apply to intracorporate disputes arising out of employment contract disputes or disputes between members of the organization arising out of the employment relationship.

Over a period of years, Anthony Beninati (Tony), Steven Borghi, and Joseph Masotta opened twelve health clubs (collectively, WOW New England), each of which was owned and operated through a separate LLC. Eight of the clubs were operated without written operating agreements. While Tony was alive, his wife Elizabeth did not actively participate in the management of the clubs. Tony became ill with an incurable disease, and the accountant for WOW New England drafted written operating agreements

for the eight LLCs that had no written operating agreement a month before Tony's death. The eight new agreements referred to "Anthony (Elizabeth) Beninati" as one of the members. After Tony's death in 2005, Elizabeth began to play a more active role. In 2010, Elizabeth, Borghi, and Masotta began to disagree about the direction of the business. Borghi wanted to expand moreso than the others, and Borghi met another businessman, Dixon, with whom he formed a new business that eventually owned and operated thirteen health clubs in direct competition with WOW New England. Borghi arranged for Dixon to get access to proprietary information of WOW New England, which they used in running their new clubs. Borghi's wife, who was employed by WOW New England, also worked for the new clubs and funneled information from WOW New England to the new business. Without the knowledge of Elizabeth and Masotta, Borghi took various actions involving the use of the name licensed by WOW New England and its assets to further the business of the competing clubs. In 2011, the parties hired attorneys to look into the disputes that were brewing and to attempt to negotiate revised operating agreements to resolve the disputes. Eventually, Masotta, Borghi, and Dixon signed a side agreement, and Masotta, Borghi, and some minority owners of WOW New England—but not Elizabeth—signed revised operating agreements for the existing WOW New England clubs.

In 2012, Elizabeth sued Borghi and his wife, Dixon, Masotta, and the competing entities formed by Borghi and Dixon. In 2013, at a meeting of the WOW New England entities, there was a vote to remove the Borghis as managers, but the Borghis refused to acknowledge their removal, claiming that Elizabeth did not hold a voting interest. Elizabeth filed another action seeking to enforce the vote, and that action was consolidated with the first action. After trial, the trial court ruled that Elizabeth was a full voting member of the WOW New England companies and the 2011 amended and restated operating agreements were void. On Elizabeth's derivative claims, the trial court found that the Borghis, aided and abetted by Dixon, breached their fiduciary duties, and the court awarded damages and equitable relief. The trial court found no liability for unfair trade practices, reasoning that the statute does not apply to internal corporate disputes.

The appellate court found no error in the trial court's findings and relief regarding Elizabeth's status as a voting member and the meaning and effect of the operating agreements. However, the appellate court concluded that the trial court erred in concluding that Dixon and the competing entities formed by Borghi and Dixon could not be liable under the state unfair trade practices statute. The court explained that the Massachusetts unfair trade practices statute "was intended to refer to individuals acting in a business context in their dealings with other business persons and not to every commercial transaction whatsoever and provides a cause of action for those "engaged in the conduct of any trade or commerce" who suffer damages "as a result of the use or employment by another person who engages in any trade or commerce of an unfair method of competition or an unfair or deceptive act or practice." The statute does not extend to employment contract disputes between an employer and employee or disputes between members of an organization arising out of the employment relationship. The plaintiffs did not challenge the trial court's ruling that Borghi and his wife could not be liable under the unfair trade practices statute because the statute does not apply to intracorporate disputes. However, the plaintiffs argued that the trial court erred in finding that Dixon and the entities that were formed to compete with WOW New England could not be liable under the statute. The trial court did not believe Dixon and the competing entities could be liable [b]ecause any wrongdoing by Dixon is only as a result of his aiding and assisting the Borghis in breaching their fiduciary and contractual obligations that they owed WOW New England. The appellate court disagreed with the trial court. Although the unfair trade practices statute is inapplicable to employee employer disputes, the appellate court pointed out that Dixon and the competing entities were never employees of WOW New England. Additionally, the court stated that case law has "explicitly rejected the suggestion that, because an employee cannot be held liable to the company under [the unfair trade practices statute], outsiders who participate with the employee 'in a violation of his duty of loyalty' may not be liable under [the unfair trade practices statute]." The court discussed a case in which a corporate officer formed a competing corporation and diverted a corporate opportunity. In that case, the competing corporation was held liable under the unfair trade practices statute based on the competing

corporation's aiding and abetting of the officer's breach of fiduciary duty to the plaintiff corporation. Similarly, the status of Borghi and his wife within WOW New England did not bar the plaintiffs' unfair trade practices claims against Dixon and the competing entities. Because the trial judge believed that the unfair trade practices statute was inapplicable, she did not attempt to assess Dixon or the competing entities' culpability under the statute. Whether the defendants violated the statute and whether they did so in a manner that would support multiplying the damages were matters to be determined by the trial court, and the appellate court thus remanded these matters for a determination by the trial court.

Interpretation of Operating Agreement

Han v. Official Committee of Unsecured Creditors (In re Kang), 664 Fed. App'x 336 (4th Cir. 2016).

The court of appeals agreed with the district court and bankruptcy court that transfers of direct and indirect interests in an LLC were void (not merely voidable and subject to equitable defenses) because the transfers violated the terms of the LLC's operating agreement. The court rejected the argument that the failure of an individual named as a member in the operating agreement to sign the agreement precluded the operating agreement from becoming effective.

In 2004, an LLC was formed to acquire, develop, and manage a shopping center. When it was formed, the LLC was wholly owned and managed by Grand Equity, LLC (Grand Equity), which was in turn wholly owned and managed by Grand Development, LLC (Grand Development). Grand Development was wholly owned and managed by the debtors, Min and Mik Kang. In 2005, the LLC refinanced its property, and a newly formed entity, Grand Formation, Inc. (Grand Formation) became the managing member of the LLC and acquired a .5% interest. Grand Equity's interest decreased from 100% to 99.5%. Grand Formation and Grand Equity executed a new operating agreement, which listed an individual as the "Independent Member." The individual never signed the agreement and testified that he was never a member. The operating agreement contained restrictions on transfer by the LLC's direct and indirect owners of more than 49% of

the LLC's ownership. The transfer restrictions tracked restrictions contained in the deed of trust executed in the refinancing. In 2008, the Virginia Corporation Commission cancelled the existence of both Grand Equity and Grand Development for nonpayment of annual registration fees, and the property of those entities passed to the Kangs under the Virginia LLC statute. In 2009, the Kangs effectively agreed to sell 60% of their interests in the LLC and Grand Formation to two individuals, Yeon Han and John Sohn, in violation of the terms of the 2005 operating agreement.

The bankruptcy trustee sought and obtained from the bankruptcy court a declaration that the 2009 sale was null and void. Sohn settled with the trustee after the bankruptcy court's ruling, but Han appealed, and the district court affirmed that ruling. On appeal to the court of appeals, Han argued that: (1) the trustee lacked standing; (2) the 2005 operating agreement never became effective and did not govern the 2009 sale of interests; and (3) even if the 2005 operating agreement governed, the 2009 sale was not null and void.

With regard to the threshold issue of standing, Han contended that the trustee lacked standing to assert his claim because the Kangs, in whose shoes the trustee stood, did not have a direct interest in the LLC, but only an interest in the LLCs that controlled it. However, the court pointed out that a Chapter 11 trustee has the power to assert the rights of the debtor and creditors under state law, and the property of the cancelled LLCs passed "automatically under Virginia law to the managers, members, or interest holders, as trustees in liquidation to distribute the LLC's assets after winding up. When Grand Equity and Grand Development were cancelled in 2008, their interests in the LLC were held in trust by the Kangs. As the LLCs were only "pass through entities with no business to wind up or outstanding debts to pay," the interests they held in the LLC passed directly to the Kangs. Stepping into the Kangs' shoes, the trustee thus had standing to pursue the claim that the 2009 sale was null and void.

Han next argued that the 2005 operating agreement never became effective because one of the members never agreed to the agreement. The court acknowledged that the agreement named Ronnie Kim, along with Grand Formation and Grand Equity, as a

member of the LLC, but the court stated that a person cannot become a member without agreeing to do so. Kim testified that he had never been a member of the LLC and had not seen the 2005 operating agreement or even heard of the LLC before preparing for his deposition. Because Kim was never a member of the LLC, the 2005 operating agreement became effective without his agreement.

Finally, Han argued that the violations of the 2005 operating agreement only rendered the 2009 sale voidable, rather than null and void, thus allowing her to raise equitable defenses such as estoppel. Specifically, Han argued that an operating agreement is merely an agreement among its members, and that the trustee could be estopped to deny that the debtors had the power to consummate the sale just as the debtors could be estopped. The court rejected this argument, explaining that an operating agreement binds the parties to the agreement under Virginia law. Further, under the Virginia LLC statute, the parties can “provide rights to any person, including a person who is not a party to the operating agreement, to the extent set forth in the operating agreement. Han admitted that the restrictions in the 2005 operating agreement were designed to benefit the lender and that the transfer violated the control provisions of the 2005 operating agreement. The court stated that few courts appear to have spoken on the issue of whether a prohibited transfer such as this is void or voidable, but the court cited a Florida case as an example of the tendency of courts to conclude that actions that violate an LLC’s operating agreement are null and void. The court here likewise concluded “that such actions are without legal effect because they exceed the scope of authority conferred by the operating agreement.” The court agreed with the district court that “operating agreements define the authority of LLCs, and companies that engage in transactions with an LLC appropriately look to these agreements during the due diligence process to determine such authority. Actions taken outside the authority conferred by the operating agreement are thus ultra vires and without legal effect.” Because the 2009 sale violated the 2005 operating agreement, it was null and void.

Adweiss, LLLP v. Daum, 208 So.3d 760 (Fla. App. 2016).

The court held that, under Delaware law, a provision of an LLC’s operating agreement requiring the LLC to “indemnify, defend, and hold harmless” required advancement of attorney’s fees and costs.

A Florida limited liability limited partnership and its general partner, a Delaware LLC, appealed from an order awarding the defendants advancement of fees and costs based on a provision of the LLC’s limited liability company agreement that provided as follows:

6.6. Indemnity. The Company shall indemnify, defend and hold harmless (i) the Managers, (ii) any person designated to act on behalf of the Managers, ... (severally, the Indemnitee and collectively, the Indemnitees), from and against any claims, losses, liabilities, damages, fines, penalties, costs and expenses (including, without limitations, fees and disbursements of counsel and other professionals) arising out of or in connection with any act or failure to act by an Indemnitee pursuant to this Agreement, or the business and affairs of the Company, to the fullest extent permitted by law; provided, however, that the Company shall not be required to indemnify an Indemnitee for any loss or damage which the Indemnitee may incur as a result of such Indemnitee’s willful misconduct or gross negligence. (emphasis added).

The principal issue on appeal was whether inclusion of the term defend in the phrase indemnify, defend and hold harmless in the paragraph above provides for the advancement of attorney’s fees and costs to the defendants for their defense of the action filed by the plaintiffs. The plaintiffs argued that the provision provides for indemnification, but not advancement. Relying on Delaware case law, the court disagreed with the plaintiffs. According to the court, the plaintiffs’ interpretation would render inclusion of the term defend meaningless and would run afoul of the Delaware Supreme Court’s instruction that the court “give each provision and term effect, so as not to render

any part of the contract mere surplusage. Even though the terms “advancement” and “advance” are not used in the provision at issue, the court stated that Delaware courts have suggested that the term “defend” means something more than indemnify. The court pointed out that the Delaware Court of Chancery in *Majkowski v. American Imaging Management Services, Inc.*, 913 A.2d 572 (Del. Ch. 2006), rejected Majkowski’s argument that he was entitled to advancement based on a provision in an LLC agreement that provided the company shall indemnify and hold harmless” the members and their affiliates. Although the court referred to the provision as “a standard, straight forward indemnification provision, devoid of any advancement rights” the court indicated that Majkowski would have had a stronger argument if the agreement “used the word “defend,”...because the obligation to “defend” comes closer to suggesting the active employment of attorneys and continual payment as the attorneys’ fees are incurred. The court also relied on a Delaware Supreme Court decision discussing a provision in a merger agreement that imposed a duty to “indemnify” but not a duty to “defend.” Based on these Delaware cases, the court affirmed the trial court’s determination that the phrase indemnify, defend and hold harmless entitled the defendants to advancement of attorney’s fees and costs to defend the action filed against them by the plaintiffs. The court stated that “[a]ny other holding would render the term ‘defend’ meaningless.”

Beninati v. Borghi, 61 N.E.3d 476 (Mass. App. 2016).

The appellate court agreed with the trial court’s determination that numerous LLC operating agreements were ambiguous regarding the status of a deceased member’s wife, and the appellate court found no error in the trial court’s factual finding that the parties intended for the deceased member’s wife to take the place of the deceased member on his death. The appellate court also found no error in the trial court’s finding that two other operating agreements were amended by the conduct of the parties to substitute the wife of the deceased member as a member on the death of her husband. Finally, the appellate court held that the trial court did not err in setting aside amendments of the operating agreements, on the basis that “manifest justice and fairness”

required that the amendments not be binding, where the amendments stripped the wife of her voting membership without her consent.

Over a period of years, Anthony Beninati (Tony), Steven Borghi, and Joseph Masotta opened twelve health clubs (collectively, WOW New England), each of which was owned and operated through a separate LLC. Eight of the clubs were operated without written operating agreements. While Tony was alive, his wife Elizabeth did not actively participate in the management of the clubs. Tony became ill with an incurable disease, and the accountant for WOW New England drafted written operating agreements for the eight LLCs that had no written operating agreement a month before Tony’s death. The eight new agreements referred to “Anthony (Elizabeth) Beninati” as one of the members. After Tony’s death in 2005, Elizabeth began to play a more active role. In 2010, Elizabeth, Borghi, and Masotta began to disagree about the direction of the business. Borghi wanted to expand moreso than the others, and Borghi met another businessman, Dixon, with whom he formed a new business that eventually owned and operated thirteen health clubs in direct competition with WOW New England. Borghi arranged for Dixon to get access to proprietary information of WOW New England, which they used in running their new clubs. Borghi’s wife, who was employed by WOW New England, also worked for the new clubs and funneled information from WOW New England to the new business. Without the knowledge of Elizabeth and Masotta, Borghi took various actions involving the use of the name licensed by WOW New England and its assets to further the business of the competing clubs. In 2011, the parties hired attorneys to look into the disputes that were brewing and to attempt to negotiate revised operating agreements to resolve the disputes. Eventually, Masotta, Borghi, and Dixon signed a side agreement, and Masotta, Borghi, and some minority owners of WOW New England—but not Elizabeth—signed revised operating agreements for the existing WOW New England clubs.

In 2012, Elizabeth sued Borghi and his wife, Dixon, Masotta, and the competing entities formed by Borghi and Dixon. In 2013, at a meeting of the WOW New England entities, there was a vote to remove the Borghis as managers, but the Borghis refused to

acknowledge their removal, claiming that Elizabeth did not hold a voting interest. Elizabeth filed another action seeking to enforce the vote, and that action was consolidated with the first action. After trial, the trial court ruled that Elizabeth was a full voting member of the WOW New England companies and the 2011 amended and restated operating agreements were void. On Elizabeth's derivative claims, the trial court found that the Borghis, aided and abetted by Dixon, breached their fiduciary duties, and the court awarded damages and equitable relief. The trial court found no liability for unfair trade practices, reasoning that the statute does not apply to internal corporate disputes.

As a threshold matter, the appellate court agreed with the trial court's determination that the eight operating agreements referring to Anthony (Elizabeth) Beninati as a member were facially ambiguous. The meaning of the insertion of (Elizabeth) in the listing of Anthony (Elizabeth) Beninati as a member at the beginning of the agreements created an ambiguity because the agreements then apportioned a percentage share to Anthony Beninati and were signed only by Anthony Beninati. Considering the extrinsic evidence that was presented, the appellate court could find no clear error in the trial court's factual determination that the parties meant for Elizabeth to have a voting membership in the eight clubs governed by these operating agreements upon Tony's death. The evidence indicated that Tony instructed WOW New England's accountant, in anticipation of his death from a terminal illness, to draft operating agreements to reflect that he held his interests jointly with Elizabeth. Borghi and Masotta decided not to hold their interests jointly with their spouses. After Tony's death, the others treated Elizabeth as a full voting member and did not question her status until litigation appeared imminent. The trial court considered conflicting evidence, such as estate tax returns treating Tony's WOW New England ownership interests as being held individually rather than jointly with Elizabeth, but determined, on balance, that the parties intended the agreements to reflect that Elizabeth would step into Tony's place after his death. In view of the differing inferences that could be drawn from the evidence, the appellate court deferred to the trial court on this matter.

The appellate court also upheld the trial court's conclusion that the two operating agreements that did not refer to Elizabeth were amended by the conduct of the parties to substitute Elizabeth for Tony. There was ample testimony and documentary evidence that the parties treated Elizabeth as a full participant in these two companies and did not adhere to the provisions differentiating between voting and nonvoting membership.

Finally, the appellate court concluded that the trial court also did not err in setting aside the 2011 amended operating agreements that stripped Elizabeth of her voting membership without her consent. The trial court "determined that '[m]anifest justice and fairness require that this Court not recognize [the June 2011 operating agreements] as binding. These amended agreements were entered into after Borghi and Dixon partnered to launch a competing business, usurped the WOW trade name, and used proprietary and other confidential WOW New England information. When the agreements were signed, Masotta was unaware of all of the actions of Borghi and Dixon, and the trial court found Masotta's consent to the operating agreements was essentially paid for by a side agreement pursuant to which he was to receive a \$10,000 payoff. The trial court determined Borghi and Masotta had conflicts of interest disqualifying them from voting to amend the operating agreements and found that the 2011 amended agreements could not stand. The appellate court "discern[ed] no clear error of fact or abuse of discretion" on the part of the trial court in this regard.

Since Elizabeth became a full voting member in the LLCs when Tony died, and the 2011 amended operating agreements were invalid, Elizabeth had the status of a full voting member when she and Masotta called the 2013 meeting of the WOW New England membership and voted to remove the Borghis as managers, and the trial court did not err in enforcing the vote to remove the Borghis.

Demir v. Schollmeier, 199 So.3d 442 (Fla. App. 2016).

The court held that an LLC member was not personally liable to a withdrawing member for the return of the withdrawing member's capital contribution under a contribution

agreement entered into by the members. The court discussed the nature of an LLC operating agreement and concluded that the contribution agreement constituted an operating agreement within the meaning of the Florida LLC statute even though the agreement at issue was not called an “operating agreement.” The court determined that the obligation to return the withdrawing member’s capital contribution set forth in the agreement (which provided that the withdrawing member’s capital contribution “shall be reimbursed” but did not explicitly provide by whom) was the obligation of the LLC rather than the obligation of the other members.

After Demir formed Avrupa, LLC for the purpose of operating a night club, Demir, Schollmeier, and Demir’s brother entered into an agreement entitled “Avrupa, LLC Contribution Agreement.” The agreement provided that Schollmeier was contributing \$400,000 to the LLC for a 20% interest, and the other two members were contributing \$1,000,000 for 40% interests in the LLC. The agreement also provided that “Schollmeier may decide to withdraw from ownership of [Avrupa], in which case Schollmeier’s contribution of \$400,000.00 U.S. shall be reimbursed. The night club operated for only a short time, and Schollmeier elected to withdraw from the LLC and demanded return of his capital contribution. When the funds were not returned, Schollmeier sued Demir seeking \$400,000 in damages for breach of contract. The trial court entered summary judgment in favor of Schollmeier against Demir for breach of the agreement, and Demir appealed.

The court of appeals disagreed with the trial court’s determination that the agreement between Demir, Schollmeier, and Demir’s brother was not an operating agreement under the Florida Limited Liability Company Act, but rather a personal contract solely governing the terms of Schollmeier’s contribution to the LLC. Based on the statutory definition of an operating agreement (an agreement that may be entered into by all of the members to regulate the affairs of the LLC and the conduct of its business, to establish duties, and to govern the relations among the members, managers, and company), the court of appeals concluded that the agreement in this case was an operating agreement even though it was not called an “operating agreement” and was not entered into until after the LLC was formed as an LLC. The

court noted that the agreement even stated that it was “a limited liability company agreement under and as provided by the [Florida Limited Liability Company] Act.” Drawing on its decision in *Dinuro Investments, LLC v. Camacho*, 141 So.3d 731, 742 (Fla. 3d DCA 2014), the court explained that an operating agreement is a contract, but that, “unlike a typical bilateral contract, where both signing parties owe duties to one another, operating agreements establish a more complicated and nuanced set of contractual rights and duties. The court further explained that “[o]perating agreements govern the relations among the members, the managers, and the limited liability company itself, as well as the effect of these relations with third parties,” which the court stated is an important distinction “because the signing parties to an operating agreement may very well decide that no individual member owes the other members any duties whatsoever, and that those duties are owed only to the company. The court also stated “that ‘the precise terms of the agreement are critical’ in determining whether a party has breached a contractual duty.”

Schollmeier argued that he was entitled to recover his capital contribution from Demir personally because the agreement provided that Schollmeier may decide to withdraw from ownership of [Avrupa], in which case Schollmeier’s contribution of \$400,000.00 U.S. shall be reimbursed. However, the court pointed out provisions of the agreement that stated that the contributions were being made to the LLC by wiring funds to the LLC’s bank account as well as provisions addressing the effect of potential increases and decreases of contributions on each member’s interest in the LLC and a provision that the LLC would not pay interest on capital contributions. These provisions led the court to conclude that Schollmeier’s contribution was to be reimbursed to him by the LLC when he withdrew from ownership of the LLC. “To read these provisions to mean that the individual Members of Avrupa are required to reimburse a capital contribution explicitly made to only the company is to read more into the Agreement than what its Members agreed upon.” Emphasizing the liability protection provided to participants in an LLC, the court again quoted its opinion in *Dinuro*:

Conspicuously missing from the operating agreement is any provision stating that the members shall be directly liable to each

other for breaches of the terms of the operating agreement. Absent such a stipulation, we presume individual members are not liable for obligations or decisions of the company, as limited liability is one of the paramount reasons for forming an LLC. Section 608.4227 of the Florida Statutes specifically provides that members are typically shielded from individual liability for their involvement with an LLC unless the terms of the articles of organization or the operating agreement provide otherwise.

If the parties intended to provide that a member would be personally liable for any of the LLC's obligations, including the obligation to reimburse a member's capital contribution, the court said that the member's obligation needed to be explicit. Because the agreement did "not authorize a Member to bring a direct action against another Member for a breach of its terms," the court held that Schollmeier was not entitled to reimbursement of his capital contribution to the LLC from Demir.

Capacity of Dissolved LLC

Midwest Renewable Energy, LLC v. Am. Eng'g Testing, Inc., 894 N.W.2d 221 (Neb. 2017).

The plaintiff brought this quiet title action against a Nevada LLC that obtained a judgment lien against the plaintiff's property based on a judgment obtained in California. Before the plaintiff filed its quiet title action, the LLC dissolved and transferred its assets to its members. On appeal, the Nebraska Supreme Court determined that Nevada law, rather than Nebraska law, governed the question of whether the dissolved LLC was amenable to suit, and the court held that the LLC was amenable to suit under Nevada law.

The court began by noting that the amenability of a dissolved LLC to suit was a matter of first impression, but the court stated that it had considered the issue in the corporate context and has looked at principles of corporate law when addressing similar functions of LLCs because an LLC is "a hybrid of the partnership and corporate forms." The court explained that amenability of the dissolved LLC to suit in Nebraska depended on whether Nebraska or Nevada law applied because the survival statutes applicable to LLCs in Nebraska and Nevada differ. The Nebraska statute extends a

dissolved LLC's ability to sue and be sued during the winding up process, whereas the Nevada statute permits an LLC to sue and be sued for two years after it has filed articles of dissolution if the suit could have been initiated before the filing. The LLC filed its articles of dissolution in November of 2013 with an effective date of December 31, 2013. The court characterized the winding up process as beginning when the articles of dissolution were filed and completed on December 31, 2013, thus precluding the LLC from defending or enforcing its rights under Nebraska law because the action was brought in September of 2014. However, because the LLC's judgment lien was created before the LLC's dissolution, and the quiet title action was brought within 2 years of the filing of the articles of dissolution, the court stated that the dissolved LLC was able to defend itself under Nevada law.

To determine whether Nebraska or Nevada law applied in this case, the court considered the internal affairs doctrine. The court explained that the internal affairs doctrine "recognized that only one state should have authority to regulate a corporation's internal affairs—matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholder—because otherwise, a corporation could be faced with conflicting demands." The court noted that the internal affairs doctrine is codified in the Nebraska corporate statute as well as the Nebraska LLC statute, which is based on the Revised Uniform Limited Liability Company Act. The court pointed out that the comments to RULLCA (adopted by the Nebraska legislature) reference Restatement (Second) Conflict of Laws § 302. The court also looked to Section 299 of the Restatement, which specifically addresses choice of law in the context of deciding what law applies to a dissolved corporation's continued existence for purposes of suing or being sued. Relying on these provisions of the Restatement and case law in other jurisdictions applying the internal affairs doctrine to fully dissolved corporations, the court concluded that Nevada's statute governed the dissolved LLC's capacity to sue or be sued. Because the suit was brought against the dissolved LLC within two years of its dissolution, the dissolved LLC could defend itself in this action. The court went on to address the plaintiff's argument that the dissolved LLC could only be defended in the name of its trustees.

The court acknowledged that the Nevada statute confers on the trustees of a dissolved LLC the full power to defend suits on behalf of the dissolved LLC, but the court did not interpret the provision to be exclusive of the dissolved LLC's power to defend itself in its own name. Ultimately, however, the court determined that disputes regarding the ownership, validity, and subsistence of the judgment and judgment lien could not be litigated without the joinder of the managing member, who was an indispensable party because of his claim that the LLC transferred the judgment and judgment lien to him.

Effect of Dissolution and Reinstatement

In re Reinstatement of S&D Roofing, LLC, 202 So.3d 177 (La. Ct. App. 2016).

The court of appeals reviewed the provisions of the Louisiana LLC statute providing for dissolution of an LLC by filing an affidavit and reinstatement of such an LLC, and the court held that the trial court did not err in reinstating the LLC prospectively, rather than retroactively, in view of the silence of the statute regarding the retroactive effect and public policy considerations in this case.

After a judgment creditor of a voluntarily dissolved LLC sought to seize the personal assets of the members to satisfy the creditor's default judgment against the LLC, the LLC's two members filed a petition to reinstate the LLC. The provision under which the LLC dissolved in this case provides for dissolution of an LLC that is no longer doing business and has no debts by the filing of an affidavit of its members. After dissolution, the members are personally liable for any debts of the LLC in proportion to their membership interests. A court may order reinstatement of an LLC previously dissolved by affidavit, but the statute is silent as to whether the reinstatement has a retroactive effect. The trial court ordered reinstatement of the LLC prospectively, and the members appealed, arguing that the reinstatement should be given retroactive effect in order to perfect service of the notice of default judgment on the LLC and to facilitate proper representation of the LLC.

In the absence of Louisiana case law directly addressing the issue, the appellate court considered the statutory reinstatement provision in its broader context and noted that several

other reinstatement provisions applicable to LLCs (e.g., reinstatement after revocation of an LLC's articles of organization after failure to file an annual report for three years and reinstatement after failure to maintain a registered office or registered agent) expressly provide for retroactive effect. The court interpreted the legislature's silence regarding retroactive effect of a reinstatement after dissolution by affidavit to reflect the legislature's intent that such a reinstatement not be given retroactive effect. The court also looked by analogy to cases addressing the analogous matter of reinstatement of corporations dissolved by affidavit. In the absence of express statutory guidance on the matter of retroactive reinstatement of corporations, the court explained that Louisiana courts have primarily relied on considerations of public policy, emphasizing what the shareholders knew prior to dissolution and what purpose motivated dissolution and reinstatement. The court noted that, throughout the various contexts in which courts have addressed corporate reinstatements, Louisiana courts have consistently applied the principle that reinstatement, retroactive or not, cannot operate to shield shareholders from personal liability. The court found the corporate cases instructive in this context and concluded that public policy considerations did not weigh in favor of retroactive effect of the reinstatement of the LLC at issue. When the members dissolved the LLC, they exposed themselves to "any debts and claims against it" under the statute, and the only apparent purpose served by retroactive reinstatement of the LLC's status would be to shield the members from personal liability. With no statutory authority permitting retroactive reinstatement and public policy considerations disfavoring it in this case, the court found no error in the district court's prospective reinstatement of the LLC.

CF SBC Pledgor 1 2012-1 Trust v. Clark/School, LLC, 78 N.E.3d 381 (Ill. App. 2016).

The court held that the relation-back effect of the reinstatement provision of the Illinois LLC statute did not operate to continue an administratively dissolved and reinstated LLC's existence without interruption for purposes of avoiding default under a loan agreement that required the LLC to maintain its existence. Although the LLC had been

administratively dissolved before the plaintiff filed its action for foreclosure against the LLC, the LLC later reinstated and sought to avoid foreclosure by relying on the reinstatement provision of the Illinois LLC statute, which provided that the LLC's "existence shall be deemed continued without interruption from the date of the issuance of the notice of dissolution" and that the LLC was "revived...as if it had not been dissolved," and that "all acts and proceedings of its members or managers, acting or purporting to act in that capacity, that would have been legal and valid but for the dissolution, shall stand ratified and confirmed." In the absence of case law in the LLC context addressing this provision, the court considered corporate cases interpreting a similar relation-back provision in the Illinois corporate statute. The court concluded that the LLC statute's relation-back provision did not operate to prevent the LLC's dissolution from constituting an event of default under the loan agreement. According to the court, "[t]he relation-back provision allows a reinstated LLC to ratify actions taken on its behalf while it was dissolved but, like the relation-back provision in the Business Corporation Act, cannot impose a legal fiction that belies actual, real-world, facts." The loan agreement did not address the effect of reinstatement, and the court concluded that the LLC's failure to maintain its status triggered a default under the plain language of the agreement, which was voluntarily and freely entered into by the LLC.

Ivey Brookside, LLC v. White (In re White), 556 B.R. 489 (Bankr. N.D. Ok. 2016).

The court dismissed this adversary proceeding (in which the plaintiff sought to establish nondischargeability of the debtor's debt to the plaintiff) because the plaintiff LLC filed the proceeding after the LLC's articles of organization were cancelled (due to the LLC's failure to file the annual certificate required to be filed under the Oklahoma LLC statute) and before the LLC reinstated its articles of organization. The court held that the reinstatement did not "relate back" to ratify actions taken in the name of the LLC while it was a nonentity. The court discussed the LLC statute and numerous cases in the corporate and LLC context in reaching its conclusion that the LLC statute did not provide for retroactive effect of the reinstatement. The statute was silent as to whether a reinstatement has

retroactive effect and the court found nothing in the statutory language suggesting that a reinstatement has any retroactive effect. The plaintiff argued that failure to file its annual certificate and fees was a technical oversight and that dismissal would be an inequitable and unfair result given that the oversight had been cured and that dismissal would effectively be with prejudice since the deadline to file a nondischargeability complaint had passed. The court acknowledged that the result was "unfortunate" for the plaintiff, but the court did not view the result as inequitable or unfair. According to the court, the plain language of the statute indicated that the result was consistent with the intent of the Oklahoma legislature. [In 2017, the Oklahoma LLC statute was amended to provide that reinstatement "relates back" to the cancellation and "takes effect as if its articles of organization had never been canceled."]

Charging Order

JPMorgan Chase Bank, N.A. v. McClure, 393 P.3d 955 (Col. 2017).

The Colorado Supreme Court addressed the relative priority of competing charging orders against a foreign judgment debtor's membership interests in several Colorado LLCs. The court held that the membership interest of a non-Colorado citizen in a Colorado LLC is located in Colorado and that a foreign charging order that compels action by a Colorado LLC is ineffective against the LLC until the judgment creditor has taken sufficient steps in Colorado to obligate the LLC to comply with the order. In this case, the Colorado charging orders obtained by the respondents after domestication of a foreign judgment took priority over the petitioner's foreign charging orders (even though the petitioner obtained and domesticated its foreign judgment and served its foreign charging orders on the Colorado LLCs before the respondents obtained and domesticated their foreign judgment and obtained Colorado charging orders) because the petitioner did not obtain Colorado charging orders and did not domesticate its foreign charging orders until after the respondent obtained and served Colorado charging orders.

The court first reviewed and explained the statutory remedy of a charging order and stated that, under Colorado law, the lien created by a charging order generally attaches at the

time the order is served on the LLC. That order of service ordinarily determines the order of priority of competing charging orders regardless of the order in which the competing creditors' judgments were entered.

Next the court addressed the location of a membership interest in a Colorado LLC. The court acknowledged that the case law is divided as to whether a membership interest (intangible personal property) is located where the member is located or where the LLC was formed. The court agreed with the Washington Supreme Court in *Koh v. Inno-Pacific Holdings, Ltd.*, 54 P.3d 1270 (Wash. 2002) that a member's membership interest is located where the LLC was formed for purposes of determining the enforceability of a charging order. The court identified two reasons supporting this conclusion. First, the charging order is, as a practical matter, a mechanism that requires an LLC to take action, i.e., to redirect the debtor member's distributions to the creditor. Thus, the court deemed it more appropriate to place the membership interest in the state where the LLC, and thus the membership interest, was created, rather than the state where the debtor member happens to be domiciled at the time. Second, in the court's view, justice and convenience weigh in favor of locating the membership interest in the state of formation of the LLC because substantial uncertainty and confusion could result from deeming the interest to be located wherever the member is domiciled inasmuch as multiple jurisdictions might be involved in the litigation and an LLC could face the burden of determining which of several orders are binding on it.

The court next turned to the priority of the charging orders at issue in this case. After obtaining a judgment in Arizona against an Arizona resident, JPMorgan Chase Bank, N.A. (Chase) obtained charging orders from the Arizona court against the debtor's membership interests in several Colorado LLCs. The charging orders were sought and obtained under the Arizona LLC statute. The McClures, holders of competing charging orders obtained in Colorado after domesticating their own Arizona judgment against the debtor, argued that Chase's charging orders were invalid because the Arizona charging order statute applies only to LLCs organized under Arizona law. The court found it unnecessary to address this question because, even assuming Arizona law authorizes

charging orders against interests in foreign LLCs, the court ultimately concluded that Chase's charging orders were not entitled to priority over the McClures' charging orders.

In analyzing the priority question, the court placed significance on the fact that the charging orders at issue were not only liens, but also specifically ordered the LLCs to act, i.e., to pay Chase any distributions to which the judgment debtor would be entitled. To be effective, a charging order that compels an LLC to act must bind the LLC, and the question thus becomes what action a judgment creditor must take to make a charging order enforceable against the LLC from which the order requires action. The court noted that its analysis of this question was based on its understanding that the Colorado LLCs involved in this case were not registered to do business in Arizona nor did they have any other connection with Arizona other than the fact that one of their members was sued in Arizona and had judgments against him entered there. Assuming without deciding that the court's analysis should be based on the trial court's personal jurisdiction over the judgment debtor, the court did not see how the exercise of such jurisdiction by the Arizona trial court could force the Colorado LLCs to act, and the court knew of no authority that would support the Arizona trial court's in rem jurisdiction over the membership interests located in Colorado. Thus, approaching the analysis as involving in rem jurisdiction over the membership interest, a charging order in this case would not be enforceable unless it was issued by a Colorado court—i.e., the state in which the LLCs, and thus the membership interests, were formed and are located. Chase domesticated its Arizona judgment in Colorado and then domesticated its Arizona charging orders, and the court stated that it was unclear whether Chase's actions could be deemed the equivalent of obtaining Colorado charging orders based on a domesticated judgment (which is what the McClures did). However, even assuming Chase's actions could be considered the equivalent of obtaining Colorado charging orders, Chase did not obtain enforceable charging orders until it domesticated the Arizona charging orders, which it did not do until after the McClures had obtained and served enforceable Colorado charging orders on the LLCs. Assuming without deciding that the court's analysis must be predicated on the trial court's personal jurisdiction over the LLC, a judgment

creditor who obtains a judgment against a member in a state in which the LLC is not subject to personal jurisdiction will need to domesticate the judgment in the LLC's state of formation and seek a charging order from a competent court in that state. Again assuming without deciding that domesticating the Arizona charging orders was the equivalent of obtaining Colorado charging orders, Chase did not domesticate its charging orders in Colorado until after the McClures had obtained and served effective charging orders on the LLC. Thus, approaching the analysis as implicating either in rem jurisdiction over the judgment debtor's membership interest or personal jurisdiction over the LLCs, Chase did not obtain enforceable charging orders, if at all, until after the McClures had already obtained and served effective charging orders, and the McClures' charging orders thus had priority.

Gillet v. ZUPT, LLC, 523 S.W.3d 749 (Tex. App. 2017).

In a case of first impression in Texas, the court of appeals held that a charging order was not the exclusive remedy of an LLC judgment creditor where the LLC judgment creditor sought to reach the membership interest of one of its own members to enforce a judgment obtained by the LLC against its member. Under the circumstances in this case, the court held that the trial court did not err in granting a turnover order in favor of the LLC against the member's membership interest.

A 45% member sued an LLC to enforce a buy-out of the member's interest under a buy-sell agreement, and the LLC counterclaimed for misappropriation of trade secrets of the LLC. An arbitrator awarded each party damages and declined to offset the damages. The arbitrator determined that the LLC owed the member \$499,050 for the value of his 45% interest plus attorney's fees. The arbitration award stated that the member's ownership interest would cease upon receipt of payment and the member was ordered to surrender all indicia of ownership on receipt of payment. The arbitrator also determined that the member breached his fiduciary duty to the LLC and that the LLC was entitled to damages in the amount of \$1,870,164 plus attorney's fees. The trial court confirmed the arbitration award and granted the LLC a turnover order and appointment of a receiver to collect non-exempt property to apply to the

judgments. The member appealed, arguing that the trial court erred in granting a turnover order because a charging order was the exclusive remedy available against his membership interest. The court of appeals noted that the question of whether a charging order is the exclusive remedy when the judgment creditor is the LLC in which the judgment debtor owns a membership interest was an apparent case of first impression. The court held that requiring turnover of a membership interest in these circumstances was proper for two reasons. First, the reasoning behind the exclusivity of the charging order (to prevent the creditor of an owner from disrupting the business by a forced sale of the owner's interest and causing injustice to the other owners) is inapposite when the judgment creditor seeking the membership interest is the same entity from which the membership derives. Second, unlike a case in which a judgment creditor is seeking to collect on a money judgment by forcing a sale of a membership interest, this case involved an explicit award of the interest from one party to the other as part of the judgment.

Pajooch v. Royal W. Inv. LLC, Series E, 518 S.W.3d 557 (Tex. App. 2017).

The court of appeals analyzed the exclusivity provisions of the LLC and limited partnership charging order provisions of the Texas Business Organizations Code and concluded that the trial court erred in permitting a receiver to assume control of assets of a limited partnership, but the court upheld the trial court's turnover and receivership order against the LLC general partner pursuant to the turnover provision of the Texas Civil Practice and Remedies Code, as well as its order of receivership over the LLC and the individual who owned 99% of the LLC and the limited partnership under the receivership provision of the Texas Civil Practice and Remedies Code, concluding that these orders were appropriate measures to effectuate the charging orders issued with respect to the ownership interests in those entities.

A judgment creditor sought to enforce a judgment against two judgment debtors, Pajooch and U.S. Capital Investments, LLC ("US Capital"). Pajooch was the 99% limited partner of County Investment, LP ("County Investment"), and Pajooch also owned 99% of U.S. Capital, the 1% general partner of County Investment.

County Investment held assets valued at approximately \$4 million, including commercial real estate, the Lexus SUV driven by Pajoo, antique cars, antique rugs, oil paintings, and other investments. The judgment creditor obtained a charging order against Pajoo's membership interest in U.S. Capital and a charging order against the partnership interests of Pajoo and U.S. Capital in County Investment. The trial court also entered a turnover order and appointed a receiver under the Texas Civil Practice and Remedies Code. Although the trial court originally entered a receivership order that expressly excepted the partnership and membership interests of the judgment debtors from the receiver's powers over the judgment debtors' assets, the trial court entered an amended order that appointed a receiver over all nonexempt assets of Pajoo and U.S. Capital, "including (but not limited to) their interest in County Investment L.P." A portion of the receivership order authorized the receiver to take control of assets of County Investment. On appeal, Pajoo and U.S. Capital argued that the trial court erred in appointing a receiver.

The court of appeals analyzed the exclusivity provisions of the limited partnership and limited liability company charging order provisions of the Texas Business Organizations Code and concluded that the trial court erred in permitting the receiver to assume control of assets of County Investment. The Texas Business Organizations Code provides that a charging order is the exclusive remedy by which a creditor of a partner, member, or other owner of an interest in a partnership or LLC may satisfy a judgment out of the judgment debtor's interest in the partnership or LLC. In the course of its discussion, the court distinguished and refused to follow opinions in other jurisdictions in which courts did not confine relief to a charging order in the context of single-member LLCs. The court also rejected the argument that the plain text of the statute vitiated fraudulent transfer laws, stating that "to the extent that a debtor is shown to have fraudulently transferred an asset to a partnership in which the debtor has a partnership interest, the creditor's remedies are not limited to the debtor's partnership interest. Instead, the creditor is authorized to obtain an avoidance of the fraudulent transfer to the extent necessary to satisfy the creditor's claim, as well as other remedies under the Uniform Fraudulent Transfer Act." The court commented that there

was no apparent conflict in this case between fraudulent transfer laws and the exclusivity provision since the judgment creditor did not allege any fraudulent transfer. Based on the plain statutory text of the exclusivity provision, the court of appeals held that the trial court erred by imposing a receivership and turnover order as to County Investment and as to Pajoo's U.S. Capital membership interest.

The court of appeals upheld the trial court's turnover and receivership order against U.S. Capital pursuant to the turnover provisions of the Texas Civil Practice and Remedies Code, as well as its order of receivership over U.S. Capital and Pajoo under the receivership provision, concluding that these orders were appropriate measures to effectuate the charging orders. While acknowledging that the charging order is the exclusive remedy by which a judgment creditor of a partner may satisfy a judgment from the judgment debtor's partnership interest, the court stated that a judgment creditor is not deprived of procedures to put the charging order into effect. A turnover order and receivership may be used to reach both present and future rights to nonexempt property that cannot be readily attached or levied on by ordinary legal process, and the court thus concluded that a turnover and receivership order may be used to monitor distributions and effectuate a charging order. Here the court viewed the turnover and receivership order against U.S. Capital as an appropriate measure to monitor distributions from County Investment and effectuate the existing charging order in favor of the judgment creditor. Likewise, the court of appeals concluded that receivership over U.S. Capital and Pajoo (under a receivership provision in the Texas Civil Practice and Remedies Code permitting a court to appoint a receiver in any case in which a receiver may be appointed under the rules of equity) was appropriate based on a threat of serious injury to the judgment creditor. The parties disputed whether money Pajoo had been receiving from County Investment was salary or a distribution subject to the charging order, and the court stated that Pajoo's de facto domination of County Investment could obstruct the enforcement of the charging orders. The court noted that the judgment creditor may never collect on the judgment because it could not compel a distribution by County Investment, but the court of appeals recognized that the trial court could have found a threat that County

Investment's assets could dissipate into the hands of the judgment debtors without the judgment creditor's knowledge or a meaningful opportunity to seek to have distributions remitted to the judgment creditor.

See *Curci Invs., LLC v. Baldwin*, 14 Cal.App.5th 214 (Cal. App. 4th Dist. 2017), under the heading "Veil Piercing" above, in which the California court held that the California charging order statute did not preclude the equitable remedy of reverse veil piercing.

Governing Law

See *Midwest Renewable Energy, LLC v. Am. Eng'g Testing, Inc.*, 894 N.W.2d 221 (Neb. 2017), under the heading "Capacity of Dissolved LLC" above, in which the Nebraska Supreme Court determined that Nevada law, rather than Nebraska law, governed the question of whether the dissolved LLC was amenable to suit.

See *A.V.E.L.A., Inc. v. Estate of Marilyn Monroe, LLC*, 241 F.Supp.3d 461 (S.D.N.Y. 2017), under the heading "Veil Piercing" above, in which the court looked to Delaware law to address the issue of whether the liability of a Delaware LLC could be imposed on another LLC based on the alter-ego theory because "New York's choice of law rules provide that the law of the state of incorporation determines when the corporate form will be disregarded and liability will be imposed on shareholders.

See *JPMorgan Chase Bank, N.A. v. McClure*, 393 P.3d 955 (Col. 2017), under the heading "Charging Order" above, in which the Colorado Supreme Court addressed the relative priority of competing charging orders against an Arizona judgment debtor's membership interests in several Colorado LLCs. One judgment creditor argued that the charging orders obtained by the other judgment creditor from an Arizona court under the Arizona LLC statute were invalid because the Arizona charging order statute applies only to LLCs organized under Arizona law. The court found it unnecessary to address this question because, even assuming Arizona law authorizes charging orders against interests in foreign LLCs, the court ultimately concluded that the charging orders issued in Arizona were not entitled to priority over charging orders issued in Colorado before the Arizona charging orders were domesticated in Colorado.

Hamburger Hell for a Celebrity Chef: Another LLC Deadlock Takes Its Toll

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There are numerous examples of why deadlock-breaking mechanisms are critical in closely held businesses, particularly limited liability companies (LLCs). Perhaps a celebrity chef will spread the word more effectively than the many previous articles and CLE programs that have illuminated this common problem.

Celebrity chef Gordon Ramsay (Ramsay or GR) has found fame and fortune in the restaurant business through his many commercial successes and media exposure around the world. Yet even he was not immune from the misery of a failed business venture caused by a 50-50 LLC ownership and management structure, shockingly, with no deadlock-breaking mechanism built into the LLC Agreement.

Case Background

The Delaware Court of Chancery decided the case, *In Re: GR BURGR, LLC v. Rowen Seibel*, Case No. 12825-VCS, on Aug. 25, 2017. This article provides a synopsis of the Memorandum Opinion of Vice Chancellor Joseph R. Slights III.

In December 2012, Ramsay partnered with Rowen Seibel (Seibel or RS) to form GR BURGR LLC (GRB), a Delaware LLC, to develop a first-class burger themed restaurant concept. Ramsay held his 50 percent membership interest through GRUS Licensing LP (GRUS), which was majority owned and controlled by Ramsay. Seibel owned and personally held the remaining 50 percent membership interest in GRB.

GRUS and GRB entered into a License Agreement for certain trademarks and other intellectual property (IP) owned by GRUS (GRUS IP License) that was integral to the planned operations of GRB, including the right to use Gordon Ramsay's name in association with BurGR restaurants.

The LLC Agreement provided that GRB was a manager-managed LLC, with two managers, each of whom were to be appointed by the

respective two members. RS appointed himself as a manager, while GRUS appointed a third-party individual as its designated manager. The LLC Agreement explicitly provided that the managers had "full and exclusive right, power and authority to manage all of the business and affairs of the Company".

The LLC Agreement required a majority vote of the two managers (i.e., unanimity) for an action of the managers to be effective. If the two managers could not act unanimously, there was no LLC agreement provision addressing what was to happen. A classic formula for a deadlock.

The LLC Agreement failed to include any deadlock-breaking mechanism – also something that happens all too frequently, but which was surprising given the parties involved in this case.

The LLC Agreement included as one of the four triggers for dissolution the rather common recitation that GRB would be dissolved upon "the entry of a judicial decree for dissolution".

The first and only GRB restaurant was opened under the name BurGR restaurant (the association with Gordon Ramsay was prominently displayed) in the Planet Hollywood Resort & Casino in Las Vegas (Planet Hollywood), through a Development, Operation and License Agreement (Caesar's Agreement), with an affiliate of Caesar's Entertainment Corp. (Caesars).

As frequently happens when two people have equal control over a business, a deadlock arose between Ramsay and Seibel, which came to a head on April 18, 2016, when Seibel pled guilty to a felony violation of the Internal Revenue Code.

From the Chancery court record, it appears that the relationship between Ramsay and Seibel had gotten so bad that they were not on speaking terms by the time the felony conviction was entered against Seibel.

That felony conviction rendered Seibel an "Unsuitable Person" as defined in the Caesar's Agreement, as determined in the "sole and exclusive judgment" of Caesar's, a determination that was explicitly left to Caesar's under the terms of the Caesar's Agreement.

As a result of the felony conviction, shortly after Seibel was sentenced, Caesar's gave written notice to GRB, Ramsay and Seibel on Sept. 2, 2016, that it would terminate the Caesar's Agreement to operate the BurGR restaurant in Planet Hollywood, unless Seibel completely dissociated from GRB. Seibel contested that determination in a separate lawsuit filed in Nevada and refused to dissociate from GRB.

In the meantime, GRUS and its manager appointee could not resolve the inevitable dispute that developed with Seibel, since GRUS wanted Seibel to exit the venture so GRB could maintain its BurGR restaurant operations in Planet Hollywood. Seibel refused.

On Sept. 21, 2016, Caesar's terminated the Caesar's Agreement with GRB.

As a result of the termination letter from Caesar's, GRUS then sent its own termination letter to GRB on Sept. 22, 2016, terminating the GRUS License Agreement between GRUS and GRB for use of the GRUS IP, including the use of the Gordon Ramsay name in connection with BurGR restaurant operations.

On Oct. 13, 2016, GRUS filed an action in the Court of Chancery seeking judicial dissolution of GRB based on the management deadlock.

Seibel answered and counterclaimed on Nov. 23, 2016, and alleged in its answer that "GRUS, through its controller Ramsay, prevented GRB from engaging in any other business as part of a concerted effort to oust Seibel from the Company and to self-interestedly secure the value of the Company and its assets for the sole benefit of Ramsay." See, Answer paragraph 24.

Seibel's counterclaims alleged misappropriation and unjust enrichment by GRUS, brought derivatively on behalf of GRB; breach of fiduciary duty by GRUS brought directly by RS, as well as derivatively on behalf of GRB; and also alleged, derivatively, that GRUS breached its License Agreement with GRB.

On Dec. 13, 2016, GRUS filed a Motion for Judgment on the Pleadings based on what it considered were undisputed facts. There were subsequent proceedings in both the Nevada litigation and the Chancery court proceedings, but the parties could not resolve their dispute.

The Court of Chancery Decision

On Aug. 25, 2017, the Court of Chancery, in a memorandum opinion by Vice Chancellor Slight, decided, as a matter of law, that it was no longer reasonably practicable for GRB to carry on its business in conformity with its operating agreement and, therefore, dissolution was appropriate under Delaware law. The Court granted the Motion for Judgment on the Pleadings by GRUS and ordered the dissolution of GRB.

Delaware's LLC Act, Section 18-802 provides "[on] application by or for a member or manager the Court of Chancery may decree dissolution of an LLC whenever it is not reasonably practicable to carry on the business in conformity with a limited liability company agreement".

In addressing the "not unreasonably practicable" standard, the Vice Chancellor noted that standard does not require a petitioner to show that the purpose of the LLC has been "completely" frustrated. Rather, "the standard is whether it is reasonably practicable for the company to continue to operate its business in conformity with its LLC Agreement", citing *Fisk Ventures LLC v. Segal*, 2009 WL 73957 (Del. Chan. 2009), *aff'd* 984 A.2d 124 (Del. 2009).

The Vice Chancellor held that the analysis is based on the relevant facts and circumstances, with no "blueprint" for determining what is reasonably practicable. However the court summarized "several convincing factual circumstances that have pervaded the case law":

1. the members vote is deadlocked at the Board level
2. the operating agreement gives no means of navigating around the deadlock
3. due to the financial condition of the company, there is effectively no business to operate

None of the factors were individually dispositive, nor must they all exist to find that it is not reasonably practicable to carry on business in accordance with the operating agreement.

The court conceded that judicial dissolution is an "extreme remedy" of "last resort", but it was clear that the court had statutory and common law authority to order dissolution when the facts and circumstances established a basis for the court to conclude that the "not reasonably practicable" standard had been satisfied in the court's judgment.

The court relied heavily on the facts that "... he [Seibel] and Ramsay no longer speak and no longer make decisions for GRB. This dysfunction and voting deadlock has left the Company in a petrified state with no means in the LLC Agreement to break free."

The court went on to address the meaning of "deadlock" by stating, "In the context of judicial dissolution, deadlock refers to the inability to make decisions and take action, such as when an LLC agreement requires an unattainable voting threshold."

The court also addressed the circumstances where judicial dissolution was appropriate, even though the business was continuing to operate despite the deadlock, citing *Haley v. Talcott*, 864 A.2d 86 (Del. Ch. 2004), *Phillips v. Hove*, 2011 WL 4404034 (Del. Ch., 2011) and *Vila v. BVWebTies LLC*, 2010 WL 3866098 (Del. Ch. 2010).

The court also took notice of previous court decisions involving LLCs and partnerships, which analogized to the Delaware General Corporation Code (8 Del. C. Section 273) that addresses judicial dissolution of joint venture corporations with two 50 percent stockholders and sets forth three prerequisites for a judicial order of dissolution of a joint venture corporation: 1) there are two equal 50 percent stockholders, 2) those two stockholders must be engaged in a joint venture, and 3) they must be unable to agree upon whether to discontinue the business or how to dispose of the corporation's assets.

The Court looked at the following undisputed facts as dispositive in finding that the deadlock at GRB met the "not reasonably practicable to carry on its business in conformity with its LLC Agreement" standard for judicial dissolution, for the following reasons:

1. The relationship between the two 50/50 members (GRB and RS) was, at

best, acrimonious, as evidenced by the counterclaims pled by RS, the Nevada lawsuit and litigation between the parties in New York stemming back to 2014.

2. The felony conviction of RS in 2016, along with the facts admitted in the pleadings, show clearly that whatever deadlock may have arisen prior to the conviction, the deadlock "solidified into igneous rock thereafter".

3. Caesar's written demand requiring RS' dissociation from GRB, which RS refused but with which GRUS wanted to find a way to comply to keep the Caesar's Agreement in place, evidenced the inability of the two members to agree or find a compromise to keep the company's only restaurant business operating at Caesar's.

4. The Termination of the Caesar's Agreement that foreclosed the possibility of continued operations of the sole BurGR restaurant at Caesar's was caused by Seibel's felony conviction, not by actions of GRUS or GR.

As the court stated: "It is difficult to imagine how GRB could be any more dysfunctional or deadlocked".

The court contrasted these facts with the facts in *Lola Cars Int'l Ltd. v. Krohn Racing LLC*, 2010 WL 3314484 (Del. Ch. 2010), where the Chancery court found that judicial dissolution was not warranted "where the petitioner's frustration amounts to little more than disappointment with how [the company] is structured and managed" because "unfortunately for [the petitioner] it agreed to this arrangement" and "emphasizing that a party to a limited liability company agreement may not seek judicial dissolution simply as a means of freeing itself from what it considers a bad deal".

Vice Chancellor Slight's concluded: "GRUS finds itself in a lifeless joint venture that does not resemble the one it bargained for. The undisputed facts reveal that the parties will remain deadlocked without a mechanism in the LLC agreement to break through. It is therefore "not reasonably practicable" for GRUS and Seibel to carry on GRB in conformity with the limited liability company agreement."

Finally, the court addressed Seibel's claims that even if GRUS satisfied the "not reasonably practicable" standard, equitable principles should override to deny the requested judicial dissolution because GRUS was seeking to usurp the company opportunity and disenfranchise Seibel as a 50 percent owner for Ramsay's personal benefit. Essentially, Seibel was arguing that the request for judicial dissolution was brought in bad faith, or because of bad faith conduct, and that equity should not reward bad faith conduct.

Seibel argued that Ramsay colluded with Caesar's to terminate the Caesar's Agreement and to deprive GRB of two of its three principal assets: 1) the Caesar's Agreement to operate at Planet Hollywood and 2) the License Agreement from GRUS under which the BurGR restaurant was marketed under the Gordon Ramsay name. Seibel pointed out that Ramsay has continued to operate the BurGR restaurant at Planet Hollywood during the pendency of the lawsuit and that the BurGR restaurant was profitable notwithstanding the deadlock.

The court examined the cases which addressed equitable principles as trumping judicial dissolution, but it concluded that those cases were distinguishable from the facts of the instant case, most notably because there had been no evidence to support a desire by GRUS to dissolve GRB or to walk away from the joint venture with Seibel prior to Seibel's felony conviction and Caesar's termination of its Agreement with GRB. That felony conviction, and the problems which flowed from it, were of Seibel's own doing. As the court noted: "The deadlock here is temporally related to a series of events caused by Seibel, that have rendered GRB no longer able to function."

The court also noted that Seibel failed to point out any future business opportunity that rightfully belonged to GRB that GRUS or Ramsay was seeking to exploit for themselves, nor any specific harm that would arise from the dissolution of GRB since it could no longer operate its sole restaurant in Planet Hollywood as a result of the termination of the Caesar's Agreement.

The court concluded that, based on the facts, it would be the "antithesis of equitable" to lock Ramsay into a failed joint venture and thereby preclude Ramsay from ever engaging in a

restaurant business that bears his name or one that resembles the burger business operated by GRB.

In closing, it should be noted that the former BurGR restaurant at Planet Hollywood Resort & Casino in Las Vegas was rebranded in April 2017 as Gordon Ramsay Burger and continues to operate there under the new name as of the writing of this article.

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2017 SUMMARY OF DELAWARE CASE LAW RELATING TO ALTERNATIVE ENTITIES

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*LVI Group Invs., LLC v. NCM Group Holdings, LLC*¹

This case arose from the combination of two demolition firms (“LVI” and “NCM”), each a Delaware limited liability company. LVI sued NCM and accused NCM of fraud in the inducement. NCM countersued with mirror allegations and also attempted to state a claim of fraud against Paul Cutrone, the former Chief Financial Officer of LVI (“Cutrone”). Cutrone, who is not a Delaware resident, moved to dismiss the action against him citing lack of personal jurisdiction, and the court granted his motion.

The court began its analysis by determining whether there was a statutory basis to assert personal jurisdiction over Cutrone. The court looked to the assertions of NCM, the party who bore the burden of establishing the statutory basis for personal jurisdiction, which advanced Section 18-109 of the LLC Act, the conspiracy theory and Delaware’s long-arm statute in support of its argument that the court had personal jurisdiction over Cutrone.

NCM first argued that Section 18-109 of the LLC Act provided a basis for establishing jurisdiction because Cutrone allegedly was a manager of LVI and violated his fiduciary duties. However, in a previous decision, the court decided against NCM on the breach of fiduciary duty claim and, therefore, found that Section 18-109 did not establish personal jurisdiction over Cutrone.

NCM then argued that Cutrone conspired with members of LVI’s board and with LVI to commit fraud. Again, the court was unpersuaded. The court, relying on its prior decision in *Amaysing Techs. Corp. v. Cyberair Commc’ns, Inc.*, 2005 WL 578972, (Del. Ch. Mar. 3, 2005), held that NCM’s argument failed because a “corporation cannot conspire with itself.” The court quoted

Amaysing further, noting that “a corporation generally cannot be deemed to have conspired with its officers and agents for purposes of establishing jurisdiction under the conspiracy theory.” NCM then argued that the “personal reasons” exception to that rule espoused by the Third Circuit in *Johnston v. Baker*, 445 F.2d 424 (3d Cir. 1971), applied because Cutrone acted for his personal benefit—he was to become CFO of the new entity with substantial compensation. The court was not swayed, noting that courts generally apply that exception narrowly in instances where the individual is motivated by “personal animus and/or desire for financial benefit other than one’s corporate salary” (emphasis in original).

Finally, NCM argued that statutory jurisdiction was conferred on Cutrone by the Delaware long-arm statute, 10 *Del. C.* § 3104. In its counterclaim, NCM cited to subsection (c)(3) of the long-arm statute, alleging that Cutrone cause tortious injury in Delaware. The court noted that Cutrone committed no act or omission in Delaware and, therefore, subsection (c)(3) did not provide a basis for jurisdiction. In briefing, NCM changed its theory under the long-arm statute and relied on subsection (c)(1), which provides jurisdiction over a non-resident who “[t]ransacts any business or performs any character of work or service in the State.” Specifically, NCM pointed to Cutrone’s actions of executing and causing to be filed a certificate of merger with the Delaware Secretary of State for a merger that facilitated the subsequent merger between NCM and LVI and argued that the execution and filing of the certificate of merger constituted transacting business under subsection (c)(1). The court noted that the Delaware Supreme Court encourages broad construction of Section 3104(c) but that a plaintiff must still demonstrate that (1) the nonresident transacted some sort of business in the state and (2) the claim asserted arose out of that transaction. Based on its review of the record, the court began its analysis of subsection (c)(1)’s application by stating that Cutrone’s transaction of business relevant to the statute consisted of the execution and filing of a certificate of merger. However, that certificate did not cause the merger between LVI and NCM. Rather, that certificate related to a preceding merger to which NCM was not a party but that was an antecedent to the merger that was the subject of the litigation at hand. The court ultimately held that the execution of that

¹ C.A. No. 12067-VCG (Del. Ch. Sept. 7, 2017) (V.C. Glasscock).

certificate did not have a sufficiently tight nexus to the cause of action so as to form a source of the claim. Therefore, the court refused to assert personal jurisdiction over Cutrone under subsection (c)(1) of the long-arm statute.

*Eagle Force Holdings, LLC v. Campbell*²

After a protracted negotiation that spanned nearly a year, Stanley Campbell, who was the defendant in this action, and Richard Kay signed a contribution agreement and LLC agreement with respect to Eagle Force Holdings, LLC at the end of a long negotiation session. However, these documents contained several terms that had not yet been agreed upon by the parties, including terms relating to the consideration to be exchanged, and multiple schedules to the documents intended to set forth important information were still blank. Plaintiffs were relying on the forum selection clauses in these documents which provided for consent by the parties to the jurisdiction of the Court of Chancery. Campbell argued that the court cannot assert personal jurisdiction over him because these documents did not form binding contracts. The court agreed with Campbell that the parties did not form binding contracts because essential terms of the documents were missing and thus held that the forum selection clauses were not binding on Campbell. The court did not find another basis to assert personal jurisdiction over Campbell and consequently dismissed plaintiffs' complaint.

*Terramar Retail Centers, LLC v. Marion #2-Seaport Trust U/A/D June 21, 2002*³

This case addressed whether a Delaware court could exercise personal jurisdiction over a member of a Delaware limited liability company that played a meaningful role in the formation of the LLC and negotiation of the operating agreement, but had no management role in the LLC. Plaintiff Terramar Retail Centers, LLC ("Terramar") originally received a 50% membership interest in Seaport Village Operating Company, LLC, a Delaware limited liability company (the "Company"), and non-party Michael Cohen, through defendant Marion #2-Seaport Trust U/A/D June 21, 2002 (the

"Trust"), held a 25% membership interest in the Company. The operating agreement named Terramar as the sole manager of the Company and did not grant the Trust any power to act on behalf of the Company. Under the operating agreement, Terramar received a right to request that the other members buy out its member interest at fair market value any time after a certain date (the "Put Right"). In addition to the Put Right, Terramar had the right to dissolve the Company if the members did not purchase Terramar's interest within six months of the exercise of the Put Right at the contractually determined purchase price for Terramar's interest (the "Terramar Purchase Price").

After several disputes among the members of the Company, Terramar exercised the Put Right on December 18, 2015. Terramar did not receive the Terramar Purchase Price within the six-month period and subsequently brought suit against the Trust in the Court of Chancery seeking a declaration that it possessed the right to dissolve the Company and to sell its property and assets pursuant to the operating agreement. The Trust moved to dismiss the complaint for a lack of personal jurisdiction.

The court began its inquiry by setting forth the two-step analysis for determining whether a Delaware court has jurisdiction over a non-resident defendant: (i) the court must determine whether the plaintiff has identified a legally cognizable basis for asserting jurisdiction and (ii) the court must determine whether exercising personal jurisdiction over the defendant passes muster under the Due Process Clause of the United States Constitution. Terramar contended that the first step was met pursuant to Delaware's long-arm statute. The court initially noted that it has been consistently held that forming a Delaware entity constitutes the transaction of business within Delaware that is sufficient to establish specific personal jurisdiction under 10 *Del. C.* § 3104(c)(1). However, the court cautioned that there must be a nexus between the formation of the Delaware entity and the cause of action asserted in the lawsuit. The court stated that the principal factor in determining whether there is a sufficient nexus is the extent of the factual relationship between the formation of the Delaware entity and the cause of action, while the second factor is the degree of involvement that the defendant had in the formation of the entity.

The court initially noted that Delaware courts have traditionally interpreted the nexus factor

² No. CV 10803-VCMR (Del. Ch. Sept. 1, 2017) (V.C. Montgomery-Reeves).

³ 2017-12875-VCL (Del Ch. Aug. 18, 2017) (V.C. Laster).

broadly when the underlying claims involve the internal affairs of a Delaware entity. The court held that a sufficient nexus existed between the formation of the Company and Terramar's claims to enforce the operating agreement to permit the court to exercise specific personal jurisdiction over the Trust as Terramar's claims under the operating agreement implicated core issues discussed by the parties when negotiating the underlying transaction that gave rise to the Company's formation. The court reasoned that forming the Company was the act that resulted in the operating agreement being a legally viable contract and that the business deal Terramar sought to enforce was embodied in the operating agreement and implemented through the creation of the Company.

Turning to the second factor, the court held that the record supported a reasonable inference that the Trust played a meaningful role in forming the Company and negotiating the operating agreement. The court stated that "as a defendant's involvement in the underlying transaction and the formation of the Delaware entity becomes more attenuated, it becomes more difficult to hold that the defendant transacted business in the state." However, the court noted that Cohen had brokered the deal contained in the operating agreement, had an ongoing professional relationship with the other members of the Company and had bargained for a unique economic benefit in the form of an exclusive right to broker future financing for the related real estate property.

The court also held that exercising personal jurisdiction over the Trust comported with due process. The court looked to whether the Trust had engaged in sufficient minimum contacts with Delaware to require it to defend itself in Delaware courts consistent with the traditional notions of fair play and justice. Under this traditional due process analysis, the court held that because the Trust had participated in negotiating the deal that resulted in the formation of the Company and participated in negotiating the operating agreement itself, the Trust had purposefully availed itself to the benefits and protections of the laws of the State of Delaware and therefore exercising personal jurisdiction over the Trust comported with due process.

*In re Energy Transfer Equity L.P. Unitholder Litigation*⁴; *In re Energy Transfer Equity L.P. Unitholder Litigation*⁵

This case involved cross-motions for partial summary judgment in a dispute over the issuance of partnership units of defendant Energy Transfer Equity, L.P. ("ETE"). The litigation arose from the issuance of convertible units to some, but not all, unitholders in ETE, in return for which the unitholders gave up their common units (the "Issuance"). The Issuance was initially planned as a public offering to all unitholders to finance a proposed merger with The Williams Companies, Inc. ("Williams") and to strengthen ETE's credit profile; however, Williams refused to consent to the public offering. After Williams withheld consent of the proposed public offering, ETE sought to conduct a private placement of the convertible units by offering such units to certain accredited investors rather than all common unitholders, which would not require Williams' cooperation. The substantive terms of the private placement did not materially differ from the terms of the unsuccessful initial public plan.

The Issuance was subject to the approval of a Conflicts Committee (the "Conflicts Committee") of the board of LE GP, LLC, the general partner of ETE (the "General Partner"). The Conflicts Committee as initially established by the General Partner consisted of three members, but two of those members were on boards of the General Partner's affiliates and therefore unable to serve on the Conflicts Committee under the terms of the limited partnership agreement of ETE (the "LPA"). Two days after the original members of the Conflicts Committee had been designated, the board of the General Partner adopted a resolution indicating that the Conflicts Committee consisted of the only unaffiliated member. The Conflicts Committee engaged legal and financial advisors and after meeting multiple times and receiving presentations from the financial advisor, which indicated that the Issuance would lower ETE's leverage ratio closer to what rating agencies expect in order to provide a "neutral rating," the Conflicts Committee voted to grant special approval. Shortly thereafter the Issuance was

⁴ 2017-12197-VCG (Del. Ch. Feb. 28, 2017) (V.C. Glasscock).

⁵ 2017-12197-VCG (Del. Ch. July 31, 2017) (V.C. Glasscock).

consummated. Pursuant to the Issuance, the director defendants together with two other unitholders named as defendants in this action acquired the overwhelming majority of the convertible units.

Following the consummation of the Issuance, the plaintiffs commenced this action alleging among other things, (i) breach of the LPA related to a purportedly non-pro rata distribution, (ii) breach of the LPA related to entering into a conflicted transaction without complying with the relevant terms of the LPA, (iii) breach of the implied covenant in connection with approvals made under the LPA and (iv) breach of the LPA related to the adoption of an amendment to the LPA that was entered into to establish the convertible units. The plaintiffs moved for partial summary judgment that (A) the issuance of the convertible units was invalid because they were non-pro rata distributions of securities to some of the limited partners in their capacity as partners and (B) the defendants breached the LPA because the General Partner failed to properly constitute the Conflicts Committee, which resulted in the failure to establish “special approval” as defined in the LPA. The defendants moved for partial summary judgment for, among other things, a judgment that (i) as a matter of law the failure to obtain special approval cannot provide a claim for breach of the LPA and (ii) the plaintiffs’ breach of LPA claim regarding a non pro rata distribution fails as matter of law because the Issuance was an issuance of equity securities not a distribution. The court reasoned that the dispute primarily involved two issues: first, whether the Issuance (and the corresponding Conflicts Committee process) failed the contractual safe harbor provided by the LPA; and second, whether the Issuance (and the offering of such convertible units via receipt of the PPM) constituted a contractual “distribution.” The court denied the defendants’ motion for summary judgment on both issues, noting that both issues would benefit from further development of the factual record.

The court first considered the parties’ partial summary judgment requests related to Special Approval. The court noted that although the LPA provided the General Partner with broad authority to issue securities, the authority is not unlimited and was subject to the relevant appropriate contractual standard set forth in the LPA. The LPA provided that issuances that

arose out of interested situations were subject to a higher level of scrutiny. Section 7.9(a) provided a safe harbor for the General Partner or its affiliates to resolve a conflict, which included obtaining “Special Approval.” Special Approval was defined to include, among other things, approval by a majority of the members of the Conflicts Committee. The Conflicts Committee was initially comprised of three members, but two of those members were on boards of the General Partner’s affiliates and therefore unable to serve under the terms of Section 7.9(a). Two days after the original members of the Conflicts Committee had been designated, the board of the General Partner adopted a resolution indicating that the Conflicts Committee consisted only of the unaffiliated member. However, a resolution indicating the resignation of the two affiliated members was never adopted. Therefore, the plaintiffs argued that the approval by one member did not constitute a majority of the 3-member committee.

The court denied the motion for summary judgment because it was unclear based on the record before it whether the Conflicts Committee consisted of one member or three at the time of the Conflicts Committee’s finding. The court found that the Conflicts Committee’s approval would have met the Special Approval safe harbor of Section 7.9(a) if the committee had been comprised of the one unaffiliated director at the time of its finding, but a “gap in the record” warranted further development of this issue to determine if the Special Approval safe harbor had been met.

Plaintiffs also argued that even if defendant had complied with the Special Approval safe harbor, the Issuance constituted an impermissible distribution under the LPA. Under the terms of the LPA, all distributions were required to be pro-rata and the Issuance was only offered to some, but not all partners. Defendants also moved for summary judgment on this issue and argued that the Issuance was a permitted issuance of securities under Section 5.8 of the LPA, and not a distribution. The court first noted that the term “distribution” was not defined anywhere in the LPA or in the Delaware Revised Uniform Limited Partnership Act, 6 *Del. C.* §§ 17-101 *et seq.* (“DRULPA”) and that the default under DRULPA provides for pro rata distributions.

Defendants argued that a transaction could only be characterized as a distribution under the LPA where a transfer was made to a partner that lacked consideration and disbursed the wealth of the partnership to its partners. Defendants therefore characterized the transactions contemplated by the Issuance as an issuance of securities to certain partners in return for the surrender of other securities, which, according to defendants, would constitute a transfer of value and thus not a distribution. Plaintiffs defined a distribution as any transfer to partners in their capacity as partners, and disputed defendants' argument that there is a requirement that the transfer must be for no consideration. Plaintiffs also argued that, to the extent there was any ambiguity in the LPA it should be construed against defendants.

To interpret the term "distribution," the court looked to Black's Law Dictionary for the plain meaning of the term, which defined partnership distribution as "[a] partnership's payment of cash or property to a partner out of earnings or as an advance against future earnings, or a payment of the partners' capital in partial or complete liquidation of the partner's interest." The court found that the usage of the terms "issuance" and "distribution" in the LPA were consistent with the Black's Law Dictionary definition, but declined to find as a matter of law what the term "distribution" means in the context of the issuance of convertible units in return for common units because the record was incomplete or in dispute. In particular, the court noted that further factual development as to whether the Issuance was truly an exchange for value would be helpful to its analysis and therefore the court's analysis would benefit from further factual development. Thus, the cross-motions for summary judgment were denied.

In its July 2017 order, the court addressed two issues that the parties identified as outstanding following the court's February 28, 2017 opinion. First, Defendants sought summary judgment on the issue of whether failure to receive Special Approval would in and of itself constitute a breach of the LPA, noting that, generally, those types of safe harbor provisions are optional and not mandatory. Therefore, defendants argued that failing to pursue Special Approval would not be a breach of the LPA. The court denied defendants' motion on the basis that certain provisions of the LPA cross-referenced and potentially triggered an obligation to conform to the LPA's safe harbor provisions. Moreover,

defendants asserted that they complied with the safe harbor provisions of the LPA and, therefore, the declaration they sought from the court would be advisory in nature only. The court held that the effect of failure to receive Special Approval would be best decided on a full factual record that would be developed at trial, which was set to commence in the near future. Second, defendants requested that the unitholder defendants be dismissed from the case because they were not parties to the LPA. Defendants argued that the plaintiffs' case is based on claims of contractual breach and, because the unitholder defendants are not bound by the LPA, they should be dismissed from the case. The court noted that plaintiffs alleged that the unitholder defendants were not merely passive recipients but were active participants in the Issuance, and plaintiffs pointed to language in the LPA under which contractual liability would allegedly attach to such defendants and requested rescissory damages and other equitable relief. Because those defendants received the majority of the allegedly improper Issuance, the court denied defendants' request in order to develop a full record at trial and aid the court's ability to grant full relief.

*McKenna v. Singer*⁶

This case arose from the soured business relationship between Thomas and Garrett McKenna (the "McKennas") and David and Daniel Singer (the "Singers"). The Singers owned an energy distribution business that sold natural gas, heating oil and electricity to buildings in the New York City metropolitan area. Robison Energy, LLC ("Robison Energy"), a company owned by the Singers, was in the business of converting heating systems from oil to natural gas. The McKennas and the Singers began negotiations to develop a business that would provide customers with financing to pay for the heating system conversions performed by Robison Energy. In pitching the business to the Singers, the McKennas misrepresented their experience in loan financing and underwriting. The Singers did not have any experience with loan financing and therefore relied on the McKennas for their alleged expertise. The McKennas and the Singers formed a Delaware limited liability company named Robison Energy Fund LLC ("REF") to pursue this business and

⁶ C.A. No. 11371-VCMR (Del. Ch. July 21, 2017) (V.C. Montgomery-Reeves)

seek outside investment. An operating agreement was signed for REF which provided that REF was equally owned by the McKennas and the Singers. REF was able to secure a term sheet to finance the oil-to gas-conversion for fourteen properties owned by Mount Hope Housing Company, Inc. ("Mount Hope"), and the McKennas and Singers hoped to use this to test the viability of the conversion financing business.

The REF fundraising effort was unsuccessful, and the McKennas and Singers pursued a different fundraising model through a new entity, Green Energy Companies LLC ("GEC"). No operating agreement was executed for GEC, but the private placement memorandum relating to this new investment structure provided that 20% of GEC would be owned equally by the McKennas and the Singers and 80% would be owned by an investment fund that the McKennas and the Singers would indirectly control. The Singers and the McKennas were only able to garner investment interest from one investment fund, Westport Capital Partners, LLC ("Westport"), but only on terms dictated by Westport, which terms did not align with the investment structure anticipated by the McKennas and Singers.

Westport's interest in the business was contingent upon the Singers contributing Robison Energy to the new business and upon the contribution of the GEC name. The investment structure provided that members who made a capital contribution, i.e., Westport and the Singers, would receive a preferred return. The McKennas would only receive a carried interest because they would not be making a capital contribution and would therefore primarily be compensated as employees or consultants. After months of negotiations, it became apparent to the Singers and Westport that the McKennas did not have the loan financing and underwriting expertise required for the Mount Hope transaction. The relationship between the parties deteriorated to such a point that the Singers and Westport decided to form a new investment vehicle in which Westport and the Singers would contribute their respective capital and assets and pursue the conversion financing business without the McKennas.

The McKennas sued the Singers for allegedly breaching their fiduciary duties to the McKennas

by misappropriating the opportunity to receive an investment from Westport that belonged to REF or GEC. After trial, the court held that although the managers of REF and GEC owed fiduciary duties to the McKennas, the claim for breach of fiduciary duty failed for two reasons. First, the McKennas came to the court with unclean hands as a result of their misrepresentations to the Singers, which misrepresentations had an immediate and necessary relationship to the formation of REF and GEC. Accordingly, they were barred from bringing fiduciary duty claims that were related to those misrepresentations. Second, neither REF nor GEC had any interest or expectancy in the investment made by Westport. The court reasoned that (i) the fundraising for REF had never received investment interest from Westport and (ii) Westport was only interested in GEC for its name and for the contribution of Robison Energy to be made by the Singers. When the Singers and Westport ultimately decided to pursue the business without the contribution of the GEC name, the Singers did not take any asset or opportunity in which GEC or REF had an interest or expectancy, so there was no corporate opportunity to misappropriate.

*The Renco Group, Inc. v. MacAndrews AMG Holdings LLC*⁷

In another decision in a series of related cases, the court addressed the parties' cross-motions for partial summary judgment on The Renco Group, Inc.'s ("Renco") breach of contract and declaratory judgment claims. Renco's claims related to distributions made by MacAndrews AMG Holdings LLC ("AMG") to itself, by AM General Holdings LLC ("Holdco"). Renco and AMG were members of Holdco. AMG was the managing member of Holdco. The Holdco LLC Agreement (the "Holdco Agreement") sets forth a complex scheme by which the profits and losses of the Company should be allocated and distributions made to each Member. As the result of a recent valuation of Holdco, the parties' capital accounts became distorted, and Renco asserted that provisions in the Holdco Agreement entitled Renco to receive distributions to conform its capital account to the provisions in the Holdco Agreement.

⁷ C.A. No 7668-VCN (Del. Ch. May 17, 2017 and July 18, 2017) (V.C. Slights).

In beginning its analysis, the court stated that summary judgment would be granted if the relevant terms of the Holdco Agreement were clear and unambiguous. Additionally, the court noted that a contract is ambiguous if the language is “reasonably or fairly susceptible of different interpretations.”

Renco argued that, pursuant to Section 8.3 of the Holdco Agreement, it had the option to elect to reallocate profits and losses, or cause a distribution to be made to itself in order to keep its capital account balance below the contractually mandated cap. Further, Renco argued that AMG was prohibited from receiving distributions under Section 9.4(c) of the Holdco Agreement, if it would cause its capital account to be less than 20%. The court held that Renco’s reading was reasonable because Section 9.4(c) of the Holdco Agreement seemed to prevent AMG from receiving distributions when its capital account balance was below 20% if it violated the Renco 80% Capital Account Cap described in Section 8.3(b) of the Holdco Agreement, and Section 8.3 of the Holdco Agreement could reasonably be read to allow Renco to elect to receive distributions to bring the RCA balances to the contractually-mandated levels.

AMG argued that the allocations described in Section 8.3(a) of the Holdco Agreement were mandatory, and such allocations must be made prior to making any distributions to Renco to prevent any capital account balance issues. Additionally, AMG argued that Section 9.4(c) of the Holdco Agreement allowed AMG to prevent distributions that would cause its capital account from dropping below 20%. The court stated that AMG’s construction was reasonable because “even if Section 9.4(a) applies, it is not clear whether Renco has the immediate right to elect to receive a distribution under Section 8.3(b) prior to the managing member applying the allocation limitations in Section 8.3(a).”

The court held that both parties’ interpretations of the relevant provisions were reasonable and thus denied the cross motions for summary judgment, stating that the court’s construction of the Holdco Agreement would have to await the presentation of extrinsic evidence that hopefully will provide the court with insight regarding the parties’ intent.

In a subsequent opinion, the court denied Renco’s request to reargue its motion for partial summary judgement.

*Beach to Bay Real Estate Ctr. LLC v. Beach to Bay Realtors Inc.*⁸

Plaintiffs, Beach to Bay Real Estate Center, LLC, (“Center”), AJ Realty, LLC (“AJ”) and Anthony Kulp, filed this complaint after a dispute with defendants, Beach to Bay Realtors, Inc. (“Realtors”) and Andy Staton, arising from the winding down of Center. Plaintiffs alleged that Staton had wrongfully refused to pay amounts he had agreed to pay when Center dissolved, that Staton stole confidential client information from Center for his own benefit in breach of his fiduciary duties and that he had converted trade secrets and breached the implied contract. Plaintiffs also brought claims based on estoppel and constructive trust as well as piercing the corporate veil and conversion, misappropriation and restitution of Center’s funds. In response, defendants’ sought the dismissal of three of the counts in the complaint: the breach of fiduciary duties claim, breach of implied contract/estoppel claim and the constructive trust claim.

With respect to the breach of fiduciary duties claim, the court granted defendants’ motion because it held that minority members of an LLC do not owe fiduciary duties by default. The court noted that minority membership on its own is insufficient as a matter of law to create a fiduciary relationship. Plaintiffs argued that defendants owed a duty because defendants had access to confidential information and wrongfully stole that confidential information. In response, the court stated that stealing confidential information does not create a fiduciary relationship; plaintiffs must claim that there is an agreement supplying a duty or special relationship. The court noted the access to confidential information could in certain circumstances create a fiduciary relationship, but plaintiffs’ complaint did not support the creation of such a relationship. In regard to the breach of implied contract and estoppel claims, the court held that there was an absence of facts in the complaint to support a claim for the breach of an implied contract. However, the court denied defendants’ motion with respect to

⁸ No. CV 10007-VCG (Del. Ch. July 10, 2017), as revised (July 11, 2017) (V.C. Glasscock).

the promissory estoppel claim because the complaint alleged that Staton had promised to pay Kulp back for contributions and loans after Center dissolved, that the promise by Staton encouraged Kulp to procure loans and Kulp obtained additional loans after the alleged promise. Finally, the court granted defendants' motion to dismiss the constructive trust claim finding that plaintiffs had waived this claim.

*Morris v. Spectra Energy Partners (DE) GP, LP*⁹

In this case an investor in Spectra Energy Partners, LP (the "MLP"), a Delaware limited partnership, challenged a reverse dropdown transaction entered into by the MLP with Spectra Energy Corp. (the "Sponsor"), a Delaware corporation and the parent of the MLP's general partner. The Sponsor proposed a transaction whereby it would obtain a one-third interest in two pipeline companies from the MLP in exchange for a combination of a redemption of interests held by Sponsor and a waiver of its Incentive Distribution Rights. Prior to making the proposal to the MLP, Sponsor publicly promised to contribute the pipeline interests to a joint venture it owned with a third party at an implied value of approximately \$1.5 billion. The Sponsor proposed the transaction to Spectra Energy Partners (DE) GP, LP, a Delaware limited partnership and the general partner of the MLP (the "GP"). The GP established a conflicts committee to evaluate the Sponsor's proposed transaction. The conflicts committee's financial advisor initially prepared a financial presentation that indicated that the value of the total consideration proposed by Sponsor was \$1.46 billion, which was essentially on par with the implied value of \$1.5 billion. The financial advisor's initial presentation ascribed a value of \$575 million to the value of reduced distributions to be made to the GP as a result of the transfer of profitable assets to the Sponsor. The financial advisor's subsequent reports did not include the reduced GP distributions as part of the consideration to be received by limited partners and the final terms of the transaction allegedly provided the limited partners with consideration valued at approximately \$946 million. The GP's conflicts committee approved the transaction in reliance on a fairness opinion issued by its financial advisor.

⁹ C.A. No. 12110-VCG (Del. Ch. June 27, 2017) (V.C. Glasscock).

Plaintiff, an MLP unitholder, pled six counts challenging the transaction, two of which were relevant. The first relevant count asserted breach of the limited partnership agreement of the MLP (the "MLP Agreement") against the GP. Plaintiff alleged that the GP breached its contractual obligation to act in good faith by approving a "patently unfair and unreasonable" transaction. The Plaintiff argued further that the GP "improperly constrain[ed] the Conflicts Committee's authority" in the written consent establishing the conflicts committee. The written consent included a recital that stated that the aim of the reverse drop-down transaction would be to hold the MLP net-cash-neutral (the "Recital"). The second relevant count asserted a claim against the GP for breach of the implied covenant of good faith and fair dealing. Plaintiff alleged that this count would be relevant only if (i) the court found that the GP was not required to act in good faith or (ii) reliance on a fairness opinion altered the relevant standard of conduct for purposes of evaluating defendants' conduct in approving the transaction. Plaintiff alleged that the GP breached the implied covenant by (i) allowing the Sponsor to "engineer the Transaction on terms that are patently unfair and unreasonable to [the MLP]," (ii) constraining the conflicts committee's authority via the net-cash-neutral mandate in the Recital and (iii) relying on improper special approval and/or a flawed fairness opinion. Defendants moved to dismiss all counts for failure to state a claim. The Court of Chancery granted defendants' motion in part and denied it in part.

The Court of Chancery first analyzed whether the GP breached the MLP Agreement by violating its contractual obligation to act in good faith. The court noted that in interpreting the MLP Agreement, it would give effect to the parties' intent, interpret words according to their plain meaning (unless the parties intended a special meaning) and read the MLP Agreement as a whole in order to give effect to every provision if reasonably possible. The court also noted that to extent provisions of the MLP Agreement were ambiguous, the provisions would be interpreted against the GP and the court would give effect to the reasonable expectation of investors.

The court then considered plaintiff's argument that only the rebuttable presumption of good faith applied by operation of the special approval process or whether, as defendants argued, a

conclusive presumption attached given the conflicts committee's reliance on a fairness opinion. The court found that the rebuttable presumption applied because it would be "contrary to the plain terms of the contract and the reasonable expectations of the contacting parties" to find that the "more general" provision containing the conclusive presumption was applicable. The court then addressed defendants' argument that the conclusive presumption should attach and is intended to afford additional protection to the GP when it relied on a fairness opinion, thus heightening the burden in overcoming the good faith presumption arising from special approval. The court concluded that there was no binding authority that the MLP Agreement be interpreted to require that the conclusive presumption provision be read to alter the standard under the conflicts of interest provision. The court found helpful the case of *Employees Retirement System of City of St. Louis v. TC Pipelines*, which analyzed a partnership agreement that contained a conclusive presumption within the special approval provisions, rather than in a separate provision referring generally to "other matters." The court further observed that "when sophisticated entities intend to provide a conclusive presumption in a conflicts situation, they know how to draft such a provision." In the MLP Agreement, the conclusive presumption provision was absent from the conflicts of interest provision, and to the extent any ambiguity exists regarding its application, the court reasoned that such ambiguity should be resolved in the limited partners' favor. The court further found the reasonable expectation of an investor required the attachment of the rebuttable presumption because, if the conclusive presumption were applicable, a conflicted general partner would simply hire an investment banker to render a fairness opinion to acquire a conclusive presumption rather than establish an independent conflicts committee to obtain a rebuttable presumption. The court noted that the MLP Agreement could have been drafted to include a conclusive presumption in the conflicts of interest provision, but it was not. After finding that the rebuttable presumption attached, the court considered whether the complaint rebuts the presumption of good faith. The court noted that in order to successfully rebut the special approval presumption of good faith, plaintiff must plead facts to support an inference that the conflicts committee or the GP did not subjectively believe that the transaction

was in the best interests of the MLP. The court found that plaintiff sufficiently pled facts supporting an inference of subjective bad faith with respect to the alleged consideration gulf. The court found that plaintiff sufficiently alleged that the pipeline assets were worth approximately \$1.5 billion raising an inference of a gap in actual consideration of \$500 million. The court then held that in authorizing a "self-dealing transaction" in which the GP acquired assets from the MLP which it knew to be worth \$1.5 billion in exchange for consideration valued at less than \$1 billion, it was reasonably conceivable that the GP acted in subjective bad faith. Accordingly, the court denied defendants' motion with respect to this count.

With respect to the claim for breach of the implied covenant, the court noted that plaintiff conceded at oral argument that plaintiff's claims under the implied covenant would be mooted if the rebuttable presumption applied. Thus, because the court determined that the rebuttable presumption applied, the court noted that its construction of the MLP Agreement left no gap for the implied covenant to fill. Therefore, the court dismissed plaintiff's implied covenant claim.

*Meyers v. Quiz-DIA LLC*¹⁰

Plaintiffs Greg MacDonald and Dennis Smythe claimed entitlement to mandatory indemnification under the operating agreements of Quiz-DIA LLC ("Quiz-DIA"), Quizmark LLC ("Quizmark") and QCE Gift Card LLC ("QCE") (collectively, the "Subs")—all subsidiaries of the primary operating entity for Quiznos sandwich shops. Plaintiffs alleged that the indemnification obligations arose from their successful defense of a lawsuit brought in Colorado federal district court in which they had been accused of fraud and federal securities violations (the "Colorado Action") related to an out-of-court restructuring of Quiznos. The indemnification claims were initially dismissed by the Court of Chancery because the federal appeals court had not yet ruled on the Colorado Action, but the claims became ripe for review after the deadline to file a writ of certiorari had passed.

To determine whether plaintiffs were entitled to indemnification, the court analyzed the provisions of the Subs' respective operating

¹⁰ C.A. No. 9878-VCL (Del. Ch. June 6, 2017) (V.C. Laster).

agreements. Each operating agreement granted members and officers an identical right to indemnification and advancement under certain circumstances. Since plaintiffs were not members of the Subs, they necessarily had to be officers in order to qualify for indemnification. Although plaintiffs were appointed as officers of Quizmark and QCE pursuant to the relevant operating agreement, they were not appointed as officers of Quiz-DIA.

Plaintiffs argued that they served as de facto officers because they performed the same functions for Quiz-DIA as they did for other Quiznos entities. The court disagreed, stating that officers of Quiz-DIA were subject to additional requirements that neither plaintiff satisfied, including undergoing a mandatory background check, which was required of officers of Quiz-DIA in order to comply with its Colorado airport liquor license. Consequently, the Court concluded that the plaintiffs were not officers of Quiz-DIA and had no right to indemnification under Quiz-DIA's operating agreement. Therefore, summary judgment was entered in favor of Quiz-DIA on the plaintiffs' claim for indemnification. Having settled the indemnification claim with respect to Quiz-DIA, the court then turned to Quizmark and QCE.

Given that plaintiffs were in fact properly appointed officers of Quizmark and QCE, the court analyzed the Colorado Action to determine if the litigation defense entitled plaintiffs to indemnification under the Quizmark and QCE operating agreements. The operating agreements stated that officers were entitled to indemnification "to the fullest extent permitted by law" for "any loss, damage or claim incurred . . . by reason of any act or omission performed or omitted by such Officer in good faith on behalf of the Company." Here, the Court noted that in the corporate context, the "by reason of" standard is satisfied "if there is a nexus or causal connection between any of the underlying proceedings...and one's official corporate capacity." The court noted that the Colorado Action attacked plaintiffs' activities performed on behalf of Quizmark and QCE in negotiating the out-of-court restructuring, which the Court concluded were activities "by reason of" their status as CEO and CFO of the subsidiaries. Therefore, any losses suffered in the Colorado Action were by reason of acts performed on behalf of the subsidiaries.

Having settled the causal link, the court then turned to the issue of whether plaintiffs needed to prove that their actions were taken in good faith. The Court explained that as a matter of corporate law, indemnification "to the fullest extent permitted by law" has been interpreted to mean that good faith need not be proven if an officer successfully defends an action "on the merits." That phrase, in turn, had been interpreted in the corporate context to include dismissal of a federal action without prejudice—among certain other technical defenses like the statute of limitations. Since plaintiffs' defense of the Colorado Action was successful under this broad interpretation of "on the merits," the court held that plaintiffs were not required to prove that their actions were performed in good faith under Delaware law in connection with their indemnification claim. Furthermore, plaintiffs were also entitled to indemnification for their pre-litigation expenses incurred in addition to their actual litigation costs. The court noted that in the indemnification context, the concept of "losses" generally includes pre-litigation investigation expenses incurred when an officer suspects they will be sued. Thus, the plaintiffs were entitled to be indemnified for expenses they incurred investigating claims that the defendants might bring against them.

As a final note, the court acknowledged that QCE was an Arizona entity and that Arizona law would therefore govern whether an officer would be required to prove good faith in connection with an indemnification provision that applied "to the fullest extent permitted by law." However, since neither party argued for a different result under Arizona law, the court stated that it was entitled to apply Delaware law.

*Dietrichson v. Knott*¹¹

Plaintiff Aleksander Dietrichson ("Dietrichson"), who was one member of NxGenEd, LLC, a Delaware limited liability company (the "Company"), alleged that another member breached his fiduciary duties to the Company by improperly paying himself an unauthorized salary and misappropriating the proceeds of an asset sale. Plaintiff also alleged that these actions deprived him of contractually-mandated

¹¹ C.A. No. 11965-VCMR (Del. Ch. Apr. 19, 2017) (V.C. Montgomery-Reeves).

distributions and wasted corporate assets. Defendants Martin G. Knott (“Knott”) and the Company moved to dismiss the complaint on the basis that all of plaintiff’s claims were derivative and that plaintiff had failed to make demand or allege demand futility.

Plaintiff and defendant had formed the Company for the purpose of marketing intellectual property. Plaintiff and defendant were each a 50% member, director and officer of the Company. Plaintiff had contributed the intellectual property to the Company while defendant’s role was allegedly to gain investors and customers for the Company. Under the Company LLC Agreement (the “Operating Agreement”), Dietrichson and Knott were entitled to certain distributions as members, but no salary. The Company eventually faced a liquidity shortage and entered into an asset purchase agreement (the “Asset Purchase Agreement”) with Blackboard, Inc. (“Blackboard”). Shortly after the Company entered into the Asset Purchase Agreement, Dietrichson sent a letter requesting, among other things, confirmation that Knott had not paid Company funds to himself. Counsel for the Company replied stating that although Knott had not made any distributions to himself, he had paid himself a salary.

As an initial inquiry, the court applying the *Tooley* analysis found that plaintiff’s fiduciary duty and waste claims were derivative. Specifically, plaintiff had alleged that Knott breached his fiduciary duty by transferring sales proceeds from the Asset Purchase Agreement to himself as a salary without necessary approval under the Operating Agreement. Applying the two-part *Tooley* analysis, the court found that plaintiff’s claims were exclusively derivative as they pled harm to the Company and requested relief for the Company. The court noted that the complaint sought to challenge the improper transfer of the Company’s assets, alleged that Knott expended Company funds and that the waste claim alleged that Knott “caused the Company to waste valuable assets.” The court also found that under the second prong of *Tooley* the complaint clearly sought recovery for the Company, as the complaint sought restitution for the Company and a constructive trust in favor of the Company.

The court also rejected plaintiff’s claim that the fiduciary duty and waste claims were “dual

natured” under *El Paso Pipeline GP Co., L.L.C. v. Brinckerhoff*. The court acknowledged that the Supreme Court has recognized the existence of dual-natured claims in “unique circumstances” where certain claims have both direct and derivative aspects under *Brinckerhoff*. However, the court held that plaintiff’s claims were not dual natured since there was no allegation of dilution of voting power in this case. After finding that these claims were solely derivative, the court dismissed them because Dietrichson had not made demand on the board or made any attempt to establish demand futility. Dietrichson also argued that Knott had breached the Operating Agreement and the implied covenant of good faith and fair dealing by depriving him of certain guaranteed distributions. The court found that this claim was direct because the allegation was that Dietrichson had been deprived of distributions that were specifically guaranteed in the Operating Agreement, as opposed to an allegation challenging the discretion of Knott in making a distribution. The court then dismissed this contract claim as unripe. The provision of the Operating Agreement at issue provided for a “required distribution” to Dietrichson upon dissolution or liquidation of the Company. The court held that this claim was unripe because Dietrichson had made no allegation that Company was in dissolution or that a liquidation event had occurred.

*Sehay Energy LP v. Haven Real Estate Group, LLC*¹²

This suit was brought by certain investors in a Delaware limited partnership (the “Partnership”) alleging that they were falsely induced by the general partner (the “General Partner”) of the Partnership and the General Partner’s managing member, Albert Adriani (“Adriani”), to become investors in the Partnership and that the General Partner and its controller prevented the investors’ access to accurate partnership records and breached certain contractual and fiduciary duties. The Partnership filed for bankruptcy and plaintiffs filed a motion that, in effect, requested the court to rule that the bankruptcy stay did not apply to plaintiffs’ claims against the General Partner and Adriani. Defendants argued that all claims were or should be stayed. The court noted that, to the

¹² C.A. No. 12387-VCG (Del. Ch. Apr. 17, 2017) (V.C. Glasscock).

extent plaintiffs' claims were derivative in nature and, thus, belonged to the Partnership, the claims would be stayed. However, any direct claims against non-bankrupt defendants would not be stayed. Therefore, the court engaged in an analysis of the various claims at issue to determine whether such claims were derivative or direct.

The Partnership was formed to invest its partners' assets in publicly traded real estate securities. Investment authority was vested with the General Partner and the limited partners' interests were not freely transferable—thus, the only way for limited partners to redeem or liquidate their interests was to withdraw from the Partnership in accordance with the terms of its limited partnership agreement (the "Partnership Agreement"). The Partnership Agreement gave limited partners the right to inspect and copy books and records upon prior written notice and required the General Partner to distribute audited financials to each partner after the end of each fiscal year. Plaintiffs invested as limited partners in the Partnership after discussions with Adriani and review of a "pitch book" provided by Adriani. After their investment, Adriani provided periodic investment and performance updates to plaintiffs that made it seem that the Partnership's investments were performing quite well. However, upon plaintiffs' receipt of their K-1s in 2013, plaintiffs became suspicious that Adriani's disclosures to them were not entirely accurate. Plaintiffs continued to receive updated disclosures from Adriani that showed a steady net gain. Then, in 2015, Adriani sent plaintiffs a letter admitting that a significant asset of the Partnership had become substantially impaired due to the Partnership's loaning a certain person and his business entities (the "defaulting borrower") over \$4.4 million. Those loans were never repaid. Adriani promised plaintiffs that he would waive his management fees going forward and not receive any return on his investment until the limited partners were repaid their basis in full. Plaintiffs then demanded the investor list and other books and records of the Partnership, as well as audited financials from 2013 to 2015. Adriani never responded. Further, plaintiffs learned that the only major asset available to collect against the defaulting borrower was being sold in one month's time and that Adriani had a \$1 million security interest in that asset in favor of his personal investment vehicle. Plaintiffs then sued Adriani, the General Partner and the Partnership (which was only a

nominal defendant in this action), asserting breach of contract, breach of fiduciary duty, fraud and veil piercing claims. Subsequently, the Partnership and Adriani's personal investment vehicle filed for bankruptcy, requiring the court in this opinion to engage in an analysis of the claims to determine whether such claims were derivative (and thus, stayed by virtue of the bankruptcy) or direct.

Applying the Delaware Supreme Court's decision in *El Paso Pipeline GP Co. LLC v. Brinckerhoff* (stating that any contract claim does not necessarily have to be a direct claim), the court found the *Tooley* analysis applicable to the breach of contract claims. The court permitted certain of the breach of contract claims to go forward to develop the factual record regarding whether the court should apply the rationale set forth in *Anglo American Security Fund, L.P. v. S.R. Global International Fund, L.P.* (which stands for the proposition that direct claims exist when the entity at issue is a mere pass-through entity and the benefits flow directly back to the investors). The court also categorized certain other breach of contract claims -- specifically, those surrounding a failure to disclose required information -- as direct because plaintiffs alleged that the nondisclosure resulted in their failure to timely withdraw, which the court categorized as a claim running to the individual investors, not the entity.

The court also categorized the fiduciary duty claims, which alleged a breach of the duty of loyalty due to "dissemination of false and misleading disclosures" regarding the Partnership's performance, as direct because "such a disclosure violation involves injury to the limited partners individually and not to the Partnership, and is thus properly treated as a direct claim. The source of the duty, whether contractual . . . or equitable/statutory . . . is not material to the *Tooley* analysis."

Finally, the court categorized the fraud claims, which related to defendants' alleged misrepresentations, as direct as well, noting that plaintiffs, not the Partnership, relied on the misrepresentations, and plaintiffs alleged harm was the inability to exercise their right to withdraw from the Partnership which, as noted above, the court categorized as a claim running to the individual investors, not the entity.

The court found that plaintiffs could proceed with the claims that it categorized as direct and that the other claims were stayed by the bankruptcy.

*Trusa v. Nepo*¹³

Plaintiff was a creditor of XION Management LLC, a Delaware limited liability company (the “Company”), which was in the business of borrowing funding from investors and using the proceeds to provide debt financing to other companies. Plaintiff alleged that defendants, as managing members of the Company, made representations to plaintiff relating to the Company’s investment strategy in order to entice him into investing in the Company. Plaintiff then entered into a loan agreement with the Company (the “Loan Agreement”), which contained a power of attorney provision that granted plaintiff the right to “take any action and execute any instrument which [plaintiff] may deem reasonably necessary or advisable in pursuing [his] remedies set forth herein.” When plaintiff’s loan matured and the Company defaulted, plaintiff learned through various communications with defendants that the representations allegedly made by defendants prior to the execution of the Loan Agreement were false or misleading. Plaintiff then filed a complaint in the Court of Chancery and asserted derivative claims for breach of fiduciary duty against the defendants, as well as claims of fraud. Plaintiff also sought dissolution of the Company. Upon the filing of a motion to dismiss and oral argument on the motion, the court issued a memorandum opinion dismissing Plaintiff’s complaint in its entirety.

The court first addressed whether plaintiff, as a creditor, had standing to bring derivative claims for breach of fiduciary duty against defendants on behalf of the Company. Plaintiff argued that he could pursue such claims (i) as a creditor of the Company and (ii) through the power of attorney granted to him by the Loan Agreement. As to plaintiff’s first argument, the court cited its decision in *CML V, LLC v. Bax* and the Delaware Supreme Court’s affirmance thereof for the proposition that only members or assignees of a limited liability company, and not its creditors, have standing to bring derivative claims on behalf of the company. Thus, given that plaintiff was merely a creditor and not a

member or assignee of a limited liability company interest, the court found that plaintiff lacked standing to bring derivative claims on behalf of the Company despite being a creditor of the Company.

The court then addressed plaintiff’s argument that the Loan Agreement’s power of attorney provision contractually granted him the authority to assert such derivative claims. The court first found that the language of the power of attorney provision limited plaintiff’s authority to pursuing the remedies expressly provided in the Loan Agreement. The court then found that nothing in the Loan Agreement suggested that the parties intended to grant plaintiff the authority to bring derivative claims on behalf of the Company. Thus, the court held that plaintiff lacked standing to bring such claims. In a footnote, the court noted that because the language of the power of attorney provision did not give plaintiff the authority to bring derivative suits on behalf of the Company, it need not address the issue of whether the parties could contractually bestow derivative standing upon plaintiff in contravention of Section 18-1002 of the Delaware Limited Liability Company Act (the “Act”).

Next, the court analyzed whether plaintiff was entitled to dissolution of the Company. Plaintiff argued that he was entitled to dissolution either (i) under the provisions of the Act or (ii) through the court’s equitable powers. The court first held that plaintiff was not entitled to judicial dissolution under the plain language of Section 18-802 of the Act because he was not a member or manager of the Company. The court then examined whether plaintiff, as a creditor, could seek the appointment of a receiver under Section 18-805 of the Act. Plaintiff argued that his rights as a creditor to appoint a receiver under Section 18-805 were triggered upon any event of cancellation pursuant to Section 18-203(a) of the Act. However, the court reasoned that a creditor’s rights under Section 18-805 were triggered only upon the filing of a certificate of cancellation. The court also reasoned that under Section 18-203(a) of the Act, a certificate of cancellation may be filed only upon the dissolution and winding up of the company. Thus, because plaintiff failed to allege that the Company was dissolved, had begun winding up or had filed a certificate of cancellation, the court held that plaintiff could not seek the appointment of a receiver under Section 18-805 of the Act.

¹³ RESPONSE NO. 1:C.A. No. 12071-VCMR (Del. Ch. Apr. 13, 2017) (V.C. Montgomery-Reeves).

With regard to plaintiff's request that the court exercise its equitable jurisdiction to dissolve the Company, the court noted that equitable dissolution is extreme in nature and is sparingly granted. Plaintiff argued that defendants had abandoned the Company and had led the Company into insolvency. However, the court found that plaintiff's allegations were conclusory and contrary to allegations contained in his complaint. Specifically, the court noted that according to plaintiff's complaint, several defendants were actively trying to resolve creditor claims and had communicated with plaintiff about the same. The court found that plaintiff's complaint showed "active engagement" by defendants and that plaintiff merely disagreed with their actions. The court held those facts alone were not grounds for equitable dissolution. The court also found that plaintiff's assertion that the Company was insolvent was not supported by non-conclusory allegations. The court held that bare assertions were insufficient to allege insolvency, abandonment or managerial dysfunction. Accordingly, the court held that no basis for equitable dissolution existed. After addressing plaintiff's remaining claims of fraud, material omission, fraudulent transfer, conspiracy to commit fraud and aiding and abetting fraud and holding such claims must be dismissed for failure to state a claim, the court dismissed plaintiff's complaint in its entirety.

*Brinckerhoff v. Enbridge Energy Company, Inc.*¹⁴

On appeal to the Supreme Court, plaintiff, a unitholder of Enbridge Energy Partners L.P., a master limited partnership (the "MLP"), challenged the reasonableness of the Court of Chancery's interpretation of the MLP's limited partnership agreement (the "Partnership Agreement"). Plaintiff also argued that the Supreme Court's prior decision in *Brinckerhoff v. Enbridge Energy Co., Inc.* ("*Brinckerhoff III*"), 67 A.3d 369 (Del. 2013) improperly defined what was needed to plead bad faith.

The plaintiff's action challenged a conflicted dropdown transaction in which the parent ("Enbridge") of the MLP's general partner (the "GP") sold to the MLP Enbridge's interest in a pipeline joint venture, which Enbridge had acquired six years earlier from the MLP at a lower price, on the grounds that the transaction

was not "fair and reasonable" to the MLP, which was the standard articulated in the MLP's limited partnership agreement (the "Partnership Agreement"). The Court of Chancery granted defendants' motion to dismiss based on precedent that set aside a governing document's specific requirements and focused instead on its good faith standards. Further, because the plaintiff failed to satisfy the rigorous pleading standard for bad faith, the Court of Chancery determined that the defendants were exculpated from any liability and dismissed the complaint. On appeal, the Supreme Court reasoned that a gating issue was whether the Court of Chancery reasonably interpreted the Partnership Agreement to permit the GP to breach any of the Partnership's specific requirements if the GP acts in good faith.

As it relates to this gating issue, the Supreme Court noted that the Partnership Agreement provided that the GP was authorized to approve a conflicted transaction if it determined that the transaction was fair and reasonable to the MLP. Other provisions of the Partnership Agreement replaced traditional default fiduciary duties with a general "good faith" contractual standard of care that the GP "reasonably believe that its action is in the best interest of, or not inconsistent with, the best interests of the MLP." The Supreme Court held that the Court of Chancery erred when it held that the "good faith" provisions of the Partnership Agreement modified the specific requirement that conflicted transactions be fair and reasonable to the MLP. The Supreme Court reasoned that the contractual standards of good faith provided in the Partnership Agreement provided a standard of care that operated in spaces of the Partnership Agreement without express standards, but it did not displace specific requirements. The Supreme Court stated that the Court of Chancery's interpretation of the Partnership Agreement "leads to an unreasonable result no public investor would have considered possible when reviewing the LPA-that [the GP] is free to violate any specific LPA requirement so long as the breach is in good faith." Consequently, the Supreme Court found that the Court of Chancery erred when it determined that the general standards of care modified the obligation applicable to interested transactions, and therefore the "fair and reasonable" requirement would govern the disputed transaction.

¹⁴ No. 273, 2016 (Del. Mar. 20, 2017, rev'd Mar. 28, 2017) (en banc).

The Supreme Court then considered the viability of plaintiff's breach of Partnership Agreement claims. With respect to plaintiff's claim that the transaction breached the fair and reasonable provision, the Supreme Court held that plaintiff had pled sufficient facts leading to an inference that the challenged transaction was not fair and reasonable to the MLP because the transaction was less favorable to the MLP than those available from unrelated third parties.

The Supreme Court upheld the Court of Chancery's decision that the special tax allocation and the corresponding amendment did not breach the provisions of the Partnership Agreement governing new unit issuance and tax allocations. The Partnership Agreement provided that the GP could not adopt amendments which would "enlarge the obligations" of any limited partner without such limited partner's consent. Plaintiff argued that the special tax obligation "enlarges the obligations" of the unitholders because of its potential to generate significant taxable income to the unitholders. The Supreme Court noted that the term "obligations" did not have a specific definition in the Partnership Agreement, but its usage in other provisions of the Partnership Agreement indicated that it was intended to refer to the responsibilities or lack of responsibilities to the MLP not obligations to third parties or the government. Consequently, the Supreme Court held that the GP did not breach the Partnership Agreement by adopting the amendment related to the special tax allocation because the special tax allocation did not enlarge the limited partners' obligations to the MLP.

Having determined that the plaintiff pled a viable claim for breach of the "fair and reasonable" provision, the court considered potential remedies in light of the exculpation provisions. Under the terms of the Partnership Agreement the GP would be exculpated from monetary damages if it acted in good faith. Although recognizing that its prior decision, *Brinckerhoff III*, indicated that to plead bad faith, the plaintiff had to show that the challenged transaction essentially amounted to "waste" or was "so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith," the Supreme Court changed course. The Supreme Court instead held that to plead a claim that the GP did not act in good faith, plaintiff must plead facts supporting an inference that the GP did not

reasonably believe that the challenged transaction was in the best interests of the MLP. The court also noted that prior cases had established that the use of the qualifier "reasonably" imposes an objective standard of good faith. Applying the newly articulated pleading standard, the Supreme Court found the following sufficient to support an inference that the GP did not reasonably believe the transaction was fair and reasonable to the MLP: (a) the GP did not consider the prior transaction, despite express direction in the Partnership Agreement to do so, (b) Enbridge changed its valuation methodology from that used in the prior transaction, (c) failed to consider that the EBITDA for the following year was 20% lower than it was in 2009 although valued 25% higher in 2009; (d) failed to negotiate the purchase price despite the negative oil pricing environment; (e) failed to value the special tax allocation benefits to Enbridge, and the financial detriment to the unaffiliated unitholders, (f) failed to consider the lack of expansion rights sold in 2009 and (g) relied upon a purportedly flawed financial opinion. Consequently, the Supreme Court concluded that the GP could not rely upon Section 6.8(a) of the Partnership Agreement to exculpate it from damages.

Finally, the Supreme Court held that the GP was not entitled to the Partnership Agreement's conclusive presumption of good faith that applies to decisions made in reliance on an advisor. This provision of the Partnership Agreement required that the GP reasonably believe that an advisor was professionally equipped to opine on the fairness and reasonableness of a transaction. The Supreme Court found that in this case, whether the GP could have reasonably believed that an investment banker was an appropriate advisor would depend on the factual record developed through discovery. Provided, further, the Supreme Court found that the conclusive presumption provision was a more comfortable fit when the advisor assists with setting the sale price as opposed to coming in when the financial terms are financially baked by the time the financial advisor appears on the scene to render a fairness opinion.

*Ensing v. Ensing*¹⁵

¹⁵ C.A. No. 12591-VCS (Del. Ch. Mar. 6, 2017) (V.C. Slights).

The suit was brought by Sara Ensing, a member and the sole manager of two Delaware limited liability companies, International Wine Capital Partners, LLC (“IWCP”) and Loggio Finance LLC (“Loggio” and together with IWCP, the “Companies”), against her ex-husband, Hans Ensing (“Hans”), and the Companies. When married, plaintiff and Hans formed the Companies to act as holding companies of an Italian company (“S.A. Villa Loggio”), which owned and operated a vineyard, winery and hotel in Italy. The members of IWCP were plaintiff and her two minor children. IWCP was the sole member of Loggio. Hans was neither a member nor manager of the Companies.

After his separation from plaintiff, Hans began to interfere with the day-to-day operations of S.A. Villa Loggio. Plaintiff sought to convene a special meeting of S.A. Villa Loggio’s shareholders (the Companies) in order to change the composition of S.A. Villa Loggio’s board of directors to prevent further interference by Hans. In response, Hans advised plaintiff that he was activating a pledge agreement between Loggio and an entity he controlled that purported to permit Hans to appoint Loggio’s manager. Hans also executed, on behalf of himself and as guardian of the couple’s minor children, a written consent of the members of IWCP that purported to appoint him as manager of IWCP pursuant to a trust agreement produced by Hans that was allegedly executed by Hans and plaintiff and granted Hans the power to appoint the manager of IWCP. At the special meeting of shareholders of S.A. Villa Loggio, plaintiff appointed herself as the sole director of the S.A. Villa Loggio.

Acting as the purported manager of the Companies, Hans engaged in a series of transactions intended to remove plaintiff from the Companies as manager, and vested control of the Companies in himself and another entity he controlled. At this point plaintiff filed suit in the Court of Chancery seeking a declaration under Section 18-110 of the Delaware Limited Liability Company Act that she was rightful manager of the Companies.

After trial, the court concluded that Hans had engaged in deceitful, bad faith and possibly fraudulent conduct by presenting falsified documents and unreliable testimony. The court found that the documents initially relied upon by Hans to support his allegation of control over the

Companies were of dubious credibility and that ultimately the plain, unambiguous terms of the limited liability company agreement of IWCP (the “IWCP Agreement”) contradicted Hans’ position. First, the IWCP Agreement indicated that plaintiff alone was authorized to act on behalf of her minor children and therefore Hans was not authorized to execute on their behalf the written consent of members of IWCP that appointed him as manager of IWCP. That action was voided by the court as a matter of law. Second, Hans failed to give plaintiff proper notice of her purported removal from IWCP, as was required by the IWCP Agreement. Thus, even if Hans was authorized to execute the consent, it was nonetheless void as a matter of law for failure to give proper notice. Finally, Hans’ attempt to issue to himself, and then transfer, membership interests in IWCP was deemed by the court to be void because the IWCP Agreement required transferees to enter into a joinder agreement to the IWCP Agreement to become a member and provided that the failure to do so would cause the transfer to be null and void. No such joinder agreement was ever executed. The court also found that the IWCP Agreement did not authorize the manager of IWCP, which Hans claimed he was, to issue membership interest in the first place; therefore, such issuance was void as a matter of law.

The court concluded that Hans’ actions to remove and replace plaintiff as a member and manager of the Companies were void as a matter of law based on the plain terms of the IWCP Agreement.

*Glazer v. Alliance Beverage Distributing Co., LLC*¹⁶

Plaintiffs requested advancement of legal fees and expenses from defendant, Alliance Beverage Distributing Co., LLC, a Delaware limited liability company (“Alliance”), pursuant to Section 5.5 of the limited liability company agreement of Alliance (the “Company Agreement”) and Section 18-101 of the Delaware Limited Liability Company Act. The two members of Alliance, Arizona Beverage Distributing Co., LLC, a subsidiary of Breakthru Beverage Group (“Breakthru”), and Cactus Beverage Distributing Company, a subsidiary of Glazer’s, Inc. (“Glazer’s”), were in a dispute over

¹⁶ No. CV 12647-VCMR (Del. Ch. Mar. 2, 2017) (V.C. Montgomery-Reeves).

Glazer allegedly depriving Alliance of the opportunity to distribute Bacardi, Inc. brands. In response to plaintiffs' request for advancement in connection with that dispute, defendant moved to dismiss the case for lack of subject matter jurisdiction because the Company Agreement contained an agreement to submit disputes to arbitration. In the alternative, defendant moved to stay the case pending the resolution of the matter through arbitration.

The court first noted that the threshold issue was whether it had jurisdiction to determine whether the dispute was subject to arbitration (i.e., substantive arbitrability). The court applied the standard established in *James & Jackson, LLC v. Willie Gary*, 906 A.2d 76 (Del. 2006), which presumes that the question of arbitrability is one for the court to decide, not arbitrators, unless there is "clear and unmistakable" evidence that the parties agreed to arbitrate. Clear and unmistakable evidence that the parties intended to arbitrate arbitrability exists if the arbitration clause: (1) generally refers all disputes to arbitration and (2) references a set of arbitration rules that empowers arbitrators to decide arbitrability. Additionally, in *McLaughlin v. McCann*, 942 A.2d 616, 627 (Del. Ch. 2008), the court further held that to realize the efficiency goals of the *Willie Gary* rules "absent a clear showing that the party desiring arbitration has essentially no nonfrivolous argument about substantive arbitrability to make before the arbitrator, the court should require the signatory to address its arguments against arbitrability to the arbitrator."

Here, the Company Agreement provided generally for arbitration of any controversy or claim, satisfying the first prong of *Willie Gary*. The second prong of *Willie Gary* was also satisfied because the Company Agreement required that arbitration proceedings be "administered by the American Arbitration Association under its Commercial Arbitration Rules and Supplemental Procedures for Large, Complex Disputes." The American Arbitration Association rules provide that the arbitrator has the power to rule on her or his own jurisdiction. Finally, the court held that defendant had more than a non-frivolous argument that the arbitrator should decide substantive arbitrability because the broad arbitration clause in the Company Agreement included no exceptions and plaintiffs did not argue that their claim did not fall within the broad arbitration clause or was not related to

the Company Agreement. Therefore, the court held that it lacked subject matter jurisdiction to decide substantive arbitrability and stayed the case pending the arbitrator's decision on arbitrability.

*Merinoff v. Empire Merchants, LLC*¹⁷

Plaintiffs Charles Merinoff and Gregory Baird brought an action for advancement of legal fees they claimed were owed to them by defendant, Empire Merchants, LLC, a Delaware limited liability company (the "Company"), in connection with their defense of a lawsuit brought against them by defendant in New York federal court for running a cross-border alcohol bootlegging scheme. Defendant moved for dismissal under Court of Chancery Rule 12(b)(3) for improper venue, arguing that the forum selection clause in Section 12.6 of the Company's Amended and Restated Limited Liability Company Agreement (the "LLC Agreement") designated New York as the proper venue for the action. Section 12.6 stated, in relevant part, that any "suit, action or other legal proceeding arising out of [the LLC Agreement would] be brought" in New York. Arguing against dismissal, plaintiffs relied on a carve-out in the same provision specifying that "notwithstanding the foregoing, any legal proceeding arising out of the LLC Agreement which, under [the Delaware LLC] Act or, to the extent made applicable to the Company pursuant to the [LLC] Agreement, the DGCL, is required to be brought in the Delaware Court of Chancery may only be brought in the Delaware Court of Chancery and the parties hereto hereby consent to the jurisdiction of the Delaware Court of Chancery under such circumstances."

Although plaintiffs acknowledged that the Delaware LLC Act does not mandate the venue in which an advancement action must be brought, plaintiffs argued that the carve-out nonetheless applied. Plaintiffs contended that because the advancement section of the LLC Agreement referenced the DGCL three times, the parties must have intended to make the DGCL apply to contractual advancement rights. Consequently, plaintiffs argued that because the DGCL expressly designates the Court of Chancery as the exclusive Delaware venue for advancement actions, venue was not only proper in the Court of Chancery but was also

¹⁷ C.A. No. 12920-VCS (Del. Ch. Feb. 2, 2017) (V.C. Slights).

required pursuant to the carve-out, thereby overriding the New York forum selection clause. The court began its analysis with a general overview of Delaware judicial deference to forum selection clauses that are mutually contracted for by parties to an agreement. The court stated that the rule of interpretation of such clauses gives language its plain and ordinary meaning in an attempt to effectuate the parties' intent. Applying that interpretive method to the LLC Agreement, the court noted that in order for the carve-out to override the forum selection clause, the DGCL must (i) have been made applicable to the advancement provision and (ii) require that advancement actions be brought in the Court of Chancery. The court determined that the LLC Agreement had not made the DGCL applicable to the advancement provision, noting that the references to the DGCL were meant to define the fiduciary duties of managers and officers of the Company and to clarify the type of conduct that could give rise to indemnification rights. The court stated that "[n]o reasonable interpretation of [the advancement provision] would suggest that the parties intended to incorporate the DGCL to define or address in any manner the contractual right to advancement." Therefore, the court concluded that the DGCL was inapplicable by the LLC Agreement's own terms and that the carve-out did not override the New York forum selection clause. The court went on to note that even if the DGCL had been made applicable by the LLC Agreement, the DGCL does not require that advancement actions be brought in the Court of Chancery; rather, the DGCL simply states that the Court of Chancery has exclusive jurisdiction among the Delaware courts over such actions. Indeed, the court recognized that advancement actions involving Delaware entities are "regularly brought and adjudicated" outside Delaware. In the court's view, plaintiffs' reading of the carve-out was an attempt to twist its unambiguous language into an overbroad provision that would nullify the forum selection clause any time a DGCL section (made applicable by the LLC Agreement) conferred exclusive jurisdiction on the Court of Chancery. The court therefore upheld the forum selection clause and granted defendant's motion to dismiss for improper venue.

*CelestialRX Investments, LLC v. Krivulka*¹⁸

Plaintiff, CelestialRX, LLC ("CelestialRX"), which is wholly owned by non-party Steve Laumas ("Laumas"), is a member of Akrimax Pharmaceuticals, LLC (the "Company"). CelestialRX and Krittika Life Sciences, LLC brought this claim against, among others, the two other members of the Company, Joseph J. Krivulka ("Krivulka") and Leonard Mazur ("Mazur" and together with CelestialRX and Krivulka, the "Members") for improper self-dealing transactions. Plaintiffs alleged that Krivulka improperly inserted entities that he controlled or had an investment in as middlemen (the "Middlemen Entities") between the Company and other companies with whom the Company did business. By acting as middlemen, the Middlemen Entities received a percentage of the sales and marketing revenue of the Company. In 2013, certain of the Middlemen Entities informed the Company that the Company's rights to sell and distribute certain drugs were being terminated under various agreements between the Middlemen Entities and the Company, which caused a dispute to arise among the Members. After CelestialRX and Mazur threatened to bring suit against Krivulka and the Middlemen Entities, the parties entered into a settlement agreement (the "Settlement Agreement") in which the Middlemen Entities agreed not to terminate the Company's rights to sell and distribute certain drugs in exchange for additional royalty fees. Additionally, a release agreement (the "Release Agreement") was signed in connection with the Settlement Agreement that included a general release in which Laumas released all of his claims against Krivulka and Mazur. In addition to the Settlement Agreement, the Members entered into an amendment (the "Amendment") to the LLC Agreement of the Company (the "Company Agreement") that amended the applicable fiduciary duty standard and also named Krivulka the manager of the Company. Subsequently, the Company defaulted on its payment obligations under the Settlement Agreement and, as a result, the Company's rights to sell and distribute drugs reverted back to the Middlemen Entities.

In this opinion, the court addressed defendants' motion for partial summary judgement. First,

¹⁸ C.A. No. 11733-VCG (Del. Ch. Jan. 31, 2017) (V.C. Glasscock).

defendants asserted that the Release Agreement, which was signed by Laumas in his individual capacity, released the claims that CelestialRX brought in this action because Laumas was the sole member of CelestialRX. The “Parties” in the Release Agreement were defined as Krivulka, Laumas and Mazur. The Release Agreement defined the “Releasing Parties” as Krivulka, Laumas and Mazur “and their past, present and future agents, employees, representatives, attorneys, estates, and assigns” The court held that CelestialRX was not a Releasing Party under the terms of the Release Agreement and thus denied defendants’ request for summary judgment that CelestialRX’s claims were released in the Release Agreement.

The court then examined the fiduciary duty standard applicable to conflicted transactions under the Company Agreement, as modified by the Amendment. Defendants argued that the Amendment eliminated all fiduciary duties. Alternatively, defendants argued that Sections 8.01 and 8.02 of the Company Agreement expressly provided for contractual standards that supplanted any fiduciary duties that might apply with respect to conflicted transactions and corporate opportunities. The court began its review of the applicable fiduciary duty standard by examining the effect of the Amendment. The court noted that under the Delaware LLC Act, a manager has implied fiduciary duties unless otherwise provided in the limited liability company agreement. The court continued by stating that to waive fiduciary duties in a limited liability company agreement, the waiver must be clear and unambiguous. The Amendment amended Section 4.01(h) of the Company Agreement to provide that the Manager and the members of the Board of the Directors of the Company did not have any fiduciary duties to the Company or the Members and would not be personally liable for any breach “that [did] not involve (i) an act or omission not in good faith or which involve[d] intentional misconduct or a knowing violation of law; or (ii) a transaction from which such Manager, a member of the Board of Directors, or Member derived an improper personal benefit.” The court held that the plain language of Section 4.01(h) eliminated fiduciary duties except for “intentional or illegal misconduct and other bad faith actions, as well as for improper self-dealing.” The court noted that the alleged conflicted transactions must be examined in light of Sections 8.01 and 8.02 of

the Company Agreement because those provisions provided contractual standards specifically governing conflicted transactions and corporate opportunities.

Section 8.02 of the Company Agreement eliminated the corporate opportunity doctrine and allowed conflicted interests to be held by directors and the Members. Section 8.01(a) of the Company Agreement provided that unless entered into in bad faith, a conflicted party was not liable to the Company or any other person as a result of a conflicted transaction involving the Company and its Members or any “Indemnified Party” if the transaction was entered into in absence of bad faith and the Manager, in good faith, determined that the transaction was fair and reasonable to the Company. “Indemnified Party” was defined to include officers and affiliates. Section 8.01(b) set forth an alternative safe harbor for the same types of transactions described in Section 8.01(a) if the terms of the transaction were fair and reasonable to the Company or any Member and the conflicted party did not enter into the transaction in bad faith. In seeking a safe harbor under Section 8.01(b), the conflicted party must “resolve such conflict of interest, taking such action or providing such terms, considering in each case the relative interest of each party (including its own interest) to such conflict, agreement, transaction or situation and the benefits and burdens relating to such interests, any customary or acceptable industry practices, and any applicable generally acceptable accounting practices or principles.” The court, after construing Section 4.01(h) and Sections 8.01 and 8.02 together, held that parties that entered into conflicted transactions that did not comply with the safe harbor requirements under Sections 8.01 and 8.02 may be shown to have derived an improper personal benefit under Section 4.01(h)(ii). Because the parties did not argue that the Section 8.01(a) safe harbor applied, the court concluded that the challenged transactions entered into after the date of the Amendment should be evaluated under the following standard: “Defendants will be found not to have breached a duty under Section 4.01(h)(ii), and are insulated from liability under Section 8.01(b), where the conflicted transaction was (1) entered in good faith and (2) where the particular Defendant subjectively determined that the transaction was fair and reasonable to the Company and Members after the required good-faith balancing

of interests.”

*Dieckman v. Regency GP LP*¹⁹

Appeal was taken by plaintiffs below to the Court of Chancery’s dismissal of plaintiff’s complaint challenging a unit-for-unit merger between Regency Energy Partners LP (“Regency”), a Delaware MLP, and an affiliated MLP. Plaintiff, a Regency unitholder, argued below that Regency’s general partner breached the good faith requirement of the Regency limited partnership agreement (the “Regency LPA”) by favoring the interests of the general partner’s affiliates to the detriment of Regency’s unaffiliated unitholders by approving the merger while the trading price of Regency’s common units was artificially depressed. Defendants below moved to dismiss plaintiff’s complaint and argued that the affiliate merger was safeguarded from judicial review by operation of two safe harbor provisions set forth in the Regency LPA. The first safe harbor would be satisfied if a potentially conflicted transaction was approved by a majority of unaffiliated common units (the “Unaffiliated Unitholder Vote” safe harbor). The second safe harbor would be satisfied if a potentially conflicted transaction was approved by a conflicts committee (the “Special Approval” safe harbor). Plaintiff alleged that the Special Approval safe harbor was not satisfied because one member of the conflicts committee served on the board of an affiliate entity while serving on the conflicts committee. Plaintiff further alleged that the Unaffiliated Unitholder Vote safe harbor was not satisfied because a proxy statement issued by the general partner to the unitholders contained false and misleading statements relating to the independence of the conflicts committee. The Court of Chancery ruled in favor of defendants and reasoned that the affiliate merger was shielded from judicial review by operation of the Unaffiliated Unitholder Vote safe harbor because the Regency LPA waived all fiduciary duties and that the general partner of Regency complied with the express disclosure requirements of the Regency LPA (which merely required the disclosure of the merger agreement). The Court of Chancery did not address whether the affiliate merger was shielded by the Special Approval safe harbor because it found that the affiliate merger was protected by the Unaffiliated Unitholder Vote safe harbor.

¹⁹ No. 208, 2016 (Del. Jan. 20, 2017) (J. Seitz).

The Delaware Supreme Court began its analysis by noting that when fiduciary duties are waived in a partnership agreement, investors must rely on the express language of a partnership agreement in order to determine the parties’ rights and obligations. However, the court further noted that despite such a waiver of fiduciary duties, investors nevertheless have some protections. Among these protections, the court explained, included the doctrine of *contra proferentem* and the implied contractual covenant of good faith and fair dealing. The court further explained that the express terms of an MLP’s partnership agreement may, in some circumstances, “be reasonably read to imply certain other conditions, or leave a gap, that would prescribe certain conduct” in order to uphold the apparent intentions and reasonable expectations of the parties at the time of contracting.

Turning to the affiliate merger, the court held that the Court of Chancery should have focused on the reasonable meaning of the safe harbor provisions, rather than narrowly focusing on whether the disclosure provisions of the Regency LPA displaced the implied covenant. The court found that both safe harbor provisions contained an implicit requirement that the general partner of Regency not undermine the protections afforded unitholders in the safe harbor process. The court reasoned that drafters of a partnership agreement would not include “obvious and provocative” conditions in such an agreement (like “the General Partner will not mislead unitholders when seeking Unaffiliated Unitholder Approval” and “the General Partner will not subvert the Special Approval process by appointing conflicted members to the Conflicts Committee”). The court explained that such terms are implied because the parties must have intended them and excluded them only because they were too obvious to expressly include in the partnership agreement.

The court further noted that its use of the implied covenant was based on the language of the Regency LPA and not the waived fiduciary duties. The court held that once the general partner went beyond the express requirements of the Regency LPA by issuing a proxy statement, along with the merger agreement, in order to induce the unitholder approval, there was an implied obligation in the Unaffiliated Unitholder Vote safe harbor not to mislead the

unitholders with false or misleading statements. Likewise, the court held that the Special Approval safe harbor contained an implicit condition that (i) the members of the conflicts committee must be genuinely unaffiliated and independent and (ii) the general partner must not use deceptive conduct to create the false appearance of an unaffiliated and independent conflicts committee. Accordingly, the court found that plaintiff pled facts raising sufficient doubt about the general partner's ability to use the safe harbor provisions and reversed the judgment of the Court of Chancery that dismissed Counts I and II of plaintiff's complaint.

*El Paso Pipeline GP Company, L.L.C. v. Brinckerhoff*²⁰

The Court of Chancery below found that the sole general partner (the "General Partner") of El Paso Pipeline Partners, L.P. (the "MLP") was liable for over \$171 million for a dropdown transaction referred to by the court as the "Fall Dropdown". After plaintiff won at trial, the MLP was acquired in a merger. The Court of Chancery held that the plaintiff did not lose his standing to pursue his claim after the consummation of the merger, characterizing his claims either as derivative for purposes of claim initiation and as direct for purposes of claim termination or (if forced to choose a single characterization) as direct because the plaintiff proved that the General Partner breached a contract--the limited partnership agreement--to which the plaintiff was a party and the plaintiff was entitled to enforce the terms of that contract. The plaintiff appealed to the Supreme Court and the Supreme Court reversed, finding that the plaintiff's claims were not dual-natured or direct but rather that his claims "were and remain derivative in nature" and thus his standing to pursue those claims was extinguished by the consummation of the merger.

In its opinion, the Supreme Court analyzed the two principal conclusions that the Court of Chancery formed (noted above) in the context of the ultimate question—whether plaintiff had standing to pursue his claims after the consummation of the merger.

In supporting its decision below, the Chancery Court distinguished this case from *Tooley v.*

Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031 (Del. 2004), noting by reference to *NAF Holdings LLC v. Li & Fung (Trading) Ltd.*, 118 A.3d 175 (Del. 2015), that *Tooley* does not apply to contract rights and that limited partners can sue directly to enforce contractual provisions of limited partnership agreements. The Supreme Court stated that the Chancery Court interpreted the *NAF Holdings* case too broadly. The Supreme Court noted that "*NAF Holdings* does not support the proposition that any claim sounding in contract is direct by default, irrespective of *Tooley*" because such a reading would essentially abrogate *Tooley* for cases involving alternative entities, which are "creatures of contract."

Because plaintiff's claims sounded in breach of a contractual duty owed to the MLP, the Supreme Court proceeded to apply the two prongs of *Tooley* – specifically, (1) who suffered the alleged harm and (2) who would receive the benefit of the recovery or other remedy? With respect to the first prong, the Supreme Court noted that plaintiff's complaint alleged that the MLP was injured because the MLP paid too much in the Fall Dropdown and that such a claim is typically viewed as causing harm to the entity itself and therefore is regarded as derivative in nature. The Supreme Court also noted that plaintiff presented evidence of harm only to the MLP, not to the individual unitholders. The Supreme Court found the analysis in *Gerber v. EPE Holdings, LLC*, 2013 WL 209568 (Del. Ch. Jan. 18, 2013), persuasive, stating that the plaintiff in this case, like in *Gerber*, asserted an overpayment claim that resulted in harm to the partnership in the form of loss in the entity's overall value. The *Gerber* court declined to distinguish *Tooley* even though the plaintiff in *Gerber* had contractual claims, noting that such claims would be considered direct if the limited partners' contractual rights were "independent" of the partnership's rights. The Supreme Court found that the contract right that plaintiff asserted in this case "was not separate and distinct from the rights of the entity. The 'best interests of the Partnership' standard provided 'no separation' between the Partnership's contractual rights and any rights of the limited partners." The Supreme Court refused to expand the "universe of claims" that a plaintiff may assert dually and found that, under the first prong of *Tooley*, plaintiff's claim was derivative. In applying the second prong of *Tooley*, the Supreme Court found that the benefit of

²⁰ No. 103, 2016 (Del. Dec. 20, 2016) (en banc).

recovery flowed to the MLP, which the Chancery Court recognized in its opinions below and which was evidenced by the necessity of the *pro rata* recovery that the Chancery Court awarded to unitholders of the MLP. The Supreme Court was unpersuaded by the Chancery Court's reliance on cases involving insider stock transfers and stock dilution because plaintiff did not claim that the Fall Dropdown either affected his voting rights or the parent's control of the MLP. Thus, under the second prong of *Tooley*, plaintiff's claim was derivative.

The Supreme Court applied the continuous ownership requirement set forth in *Lewis v. Anderson*, 477 A.2d 1040 (Del. 1984), and found that plaintiff's claims were an asset of the MLP that passed by operation of law to the surviving entity in the merger, thus extinguishing plaintiff's standing to assert his claims. The Supreme Court also dismissed plaintiff's cross-appeal challenging the so-called "Spring Dropdown", noting that the same reasoning outlined in this opinion applied.

Chief Justice Strine authored a concurring opinion to express his view that *Gentile v. Rossette*, 906 A.2d 91 (Del. 2006), a "dual-natured claims" case, should be overruled.

*Employees Retirement System of the City of St. Louis v. TC Pipelines GP, Inc.*²¹

The appellants challenged the Chancery Court's May 11, 2016 decision, wherein the Chancery Court found that the existence of special approval precluded judicial scrutiny of the substance of the challenged drop-down transaction. The Supreme Court agreed that the appellant "could not escape the conclusive effect given to Conflicts Committee approval solely by attacking the fairness of the underlying transaction" and in this order affirmed the judgment of the Chancery Court.

*In re Arctic Ease, LLC*²²

In a dissolution action, certain limited liability company members filed third-party complaints against another limited liability company member and some of its owners and affiliates

which alleged breach of fiduciary duty, misrepresentation, fraud, and related claims. The allegations contained in the third-party complaint focused on the conduct of William Cohen. Cohen was a member of the Board of Directors of Summetria, LLC, a Delaware limited liability company ("Summetria"), and a member of Costar Partners, LLC, a New Jersey limited liability company ("Costar"), which owned 20 percent of Summetria's equity. For den Holdings, Inc., WCFOTM, Inc., BC Parent, LLC, and Arctic Advisors, LLC (collectively, the "For den Entities") owned 60 percent of the equity of Summetria and Bruce Heck, Eileen Nigro, Eileen Slawek, and Joseph Slawek (collectively, the "Heck Parties") together owned the remaining 20 percent of Summetria's equity. Summetria owned 100 percent of Arctic Ease, LLC, a Delaware limited liability company ("Arctic Ease").

In 2012, Cohen provided a \$1 million loan to Summetria (the "Cohen Note"), and shortly thereafter agreed to provide an additional \$250,000 of principal to Summetria. In early 2013, Arctic Ease remained in need of capital and Cohen allegedly negotiated bridge financing for Arctic Ease through CSG Re Partners, LLC ("CSG"). However, Cohen ultimately would not agree to the bridge financing through CSG after they insisted that Cohen guarantee any bridge financing that they would arrange. Later in 2013, Cohen resigned from the Summetria board of directors and notified Summetria of its default on the Cohen Note. Summetria and Arctic Ease then defaulted on other secured loans and their assets were purchased at a foreclosure sale by Gawi, LLC, a New Jersey limited liability company controlled by Cohen ("Gawi"). In relation to these transactions, the For den Entities and the Heck Parties asserted claims against Cohen for breach of fiduciary duty, fraud, misrepresentation and other related claims. Cohen moved to dismiss the complaint for lack of personal jurisdiction. The Heck Parties and For den Entities opposed the motion and alleged that the court had personal jurisdiction over Cohen under the Delaware Limited Liability Company Act (the "LLC Act"). The court looked to the LLC Act's implied consent provision in 6 *Del. C.* § 18-109 to determine whether the court could exercise personal jurisdiction over Cohen. Section 18-109 allows a Delaware court to exercise personal jurisdiction over parties who manage Delaware limited liability companies in actions

²¹ C.A. No. 291, 2016 (Del. Dec. 19, 2016) (ORDER).

²² C.A. No. 8932-VCMR (Del. Ch. Dec. 9, 2016) (V.C. Montgomery-Reeves).

“involving or relating to the business” of the company. The court noted that Section 18-109(a) describes two different types of “managers” for personal jurisdiction purposes under the statute: (i) managers as defined in the operative limited liability company agreement and (ii) parties who “participate materially in the management” of a Delaware limited liability company. The court held that a Delaware court could not exercise personal jurisdiction over Cohen under Section 18-109(a) because he was not a manager of Summetria under either definition provided in the statute.

The Forden Entities and the Heck Parties argued that Cohen was a manager of Summetria under Section 18-109(a)(i) because, as a member of the Summetria board of directors, he possessed voting power. The court rejected this argument based on the specific terms of the Summetria LLC Agreement, which made clear that Forden was the sole manager of Summetria and did not grant any management authority to the board of directors, other than the authority to set board members’ compensation. The court held that under the terms of the Summetria LLC Agreement, Cohen could not be considered a manager under Section 18-109(a)(i) because Forden exclusively, and not the Summetria board of directors as a whole, had the authority to manage the business and affairs of Summetria.

The Forden Entities and Heck Parties also argued that a Delaware court could exercise personal jurisdiction over Cohen under Section 18-109(a)(ii) because Cohen materially participated in the management of Summetria. In support, the third-party plaintiffs provided evidence that Cohen negotiated a distribution agreement for Arctic Ease, conveyed information to Summetria members about Summetria’s finances, attempted to arrange bridge financing for Arctic Ease and discussed Arctic Ease products with potential medical distributors in Indonesia, Japan, and Korea. The court held that these activities did not show a “control or decision-making role” which the court in *Wakely Ltd. v. Ensotran, LLC*, 2014 WL 1116968, at *5 (D. Del. Mar. 18, 2014) held was required for material participation under Section 18-109(a)(ii). The court found Cohen’s conduct to be similar to that alleged in *Wakely*, and because Cohen’s power was subject to Forden’s authority under the Summetria LLC Agreement, he lacked the requisite control or decision-

making role required to show material participation in the management of Summetria under Section 18-109(a)(ii).

*Gomes v. Karnell*²³

Plaintiff and defendants were members of two Delaware limited liability companies, PTT Capital, LLC (“PTT”) and Montext, LLC (“Montext”). Plaintiff sued defendants for breach of fiduciary duty, breach of the PTT LLC Agreement, waste and aiding and abetting a breach of fiduciary duty. Plaintiff also sought judicial dissolution of PTT and the appointment of a liquidating trustee of PTT for purpose of selling PTT’s assets. Defendants moved to dismiss plaintiff’s claims for lack of subject matter jurisdiction, contending that the parties had agreed to arbitrate the matters at issue.

The court held that the agreement among the parties to arbitrate their disputes was enforceable and granted defendants’ motion to dismiss the fiduciary duty, breach of PTT LLC Agreement, waste and aiding and abetting claims. With respect to the claims for judicial dissolution and appointment of a liquidating trustee, defendants agreed with plaintiff that the court should make the ultimate determination on those claims and therefore the court stayed those claims pending the results of the arbitration.

In the course of its analysis, the court rejected plaintiff’s claim that the arbitration agreement must be incorporated by reference into the PTT LLC Agreement, or the PTT LLC Agreement must be incorporated by reference into the arbitration agreement, in order for the arbitration agreement to be binding with respect to disputes under the PTT LLC Agreement. The court noted that the PTT LLC Agreement did not mention arbitration and the PTT LLC Agreement was in existence long before the arbitration agreement was allegedly executed and thus held that the PTT LLC Agreement did not prohibit the parties from entering into the arbitration agreement to govern their disputes.

²³ C.A. No. 11814–VCMR (Del. Ch. Nov. 30, 2016) (V.C. Montgomery-Reeves).

*Trascent Mgmt. Consulting, LLC v. Bouri*²⁴

The defendant in a Court of Chancery summary proceeding, Trascent Management Consulting, LLC (“Trascent”), appealed to the Delaware Supreme Court following the Court of Chancery’s ruling granting a request by the plaintiff, George Bouri (“Bouri”), for indemnification advancement. Bouri, who was a former executive officer and manager of Trascent, sought advancement in accordance with the plain terms of both his employment agreement and Trascent’s LLC agreement. Trascent argued that the Court of Chancery erred in enforcing the plain language of the agreements without first adjudicating Trascent’s claim that the agreements were induced by fraud and, therefore, unenforceable.

Relying on authority that included *Homestore v. Tafeen* and *De Lucca v. KKAT Mgmt.*, the Court of Chancery based its decision on the plain language of the agreements and refused to examine Trascent’s fraud claim on the basis that it was “identical to what is properly a plenary claim and beyond the narrow scope of a summary advancement proceeding.” The Court of Chancery reasoned that sanctioning a defense of this nature would undermine the purpose for providing a summary proceeding for advancement cases by allowing entities to employ key officers and directors under a promise of advancement, and then seek to escape or delay that obligation by injecting into the summary proceeding a plenary claim that the underlying contract was induced by fraud. The court also noted its concern that permitting this defense would subsequently “encourage any employer offering advancement at the outset of the employment relationship to turn around and add a fraud in the inducement claim to a dispute” to avoid its obligation and deny a party’s right to advancement at the very time it is needed most. Accordingly, the Court of Chancery held that Trascent’s allegations regarding Bouri’s conduct were not properly raised in the summary proceeding and, although they could be raised in a separate plenary action, they would not be considered in the summary proceeding. On appeal, the Supreme Court upheld the Court of Chancery’s decision, asserting that the determination not to delay enforcing the plain language of the agreements was well reasoned and wholly consistent with

²⁴ C.A. No. 10915-VCM (Del. Nov. 28, 2016) (en banc).

Delaware’s public policy in favor of indemnification and advancement.

*Abelmann v. Granum*²⁵

Plaintiffs, who were members and managers of NAP Partners, LLC (the “Company”), filed a petition for judicial dissolution under LLC Act Section 18-802 on the grounds that the Company was deadlocked and unable to fulfill its defined purpose. Defendants agreed that the Company should be judicially dissolved but requested that the court use its equitable powers to delay dissolution to avoid a potentially prejudicial effect on pending California civil litigation involving the Company. Defendants’ primary concern was that dissolution of the Company could give rise to issues of standing and mootness in the California action. In an attempt to alleviate defendants’ fear of such prejudice, plaintiffs submitted that they would agree to a dissolution order that prohibited plaintiffs from using the dissolution of the Company as a defense or as a means of challenging defendants’ standing in the California litigation. Defendants agreed they would not use the dissolution as a sword in the California action. The court granted the petition for judicial dissolution, subject to the limitations agreed to by the parties.

*Finger Lakes Capital Partners, LLC v. Honeoye Lake Acquisition, LLC*²⁶ This case involved whether a special purpose entity’s operating agreement superseded prior agreements between the parties. Zubin Mehta (“Mehta”) and Gregory Shalov (“Shalov”) created an asset management firm in 2003 called Finger Lakes Capital Partners, LLC (“Finger Lakes”). Finger Lakes’ main capital provider was Lyrical Partners, L.P. (“Lyrical”) through defendant Lyrical Opportunity Partners, L.P. After Finger Lakes’ portfolio companies performed poorly, Lyrical exercised its contractual rights to take control of the portfolio companies. Subsequently, one of the portfolio companies, Revolabs, Inc. (“Revolabs”), was successfully sold. Finger Lakes and Lyrical bickered over how to distribute the proceeds. As a result of this dispute, Finger Lakes filed this action to compel Lyrical to distribute the Revolabs sale

²⁵ C.A. No. 12041–VCMR (Del. Ch. Nov. 15, 2016) (V.C. Montgomery-Reeves).

²⁶ C.A. No. 9742-VCL (Del. Ch. Oct. 26, 2015), *aff’d in part, rev’d in part* No. 42, 2016 (Del. Nov. 14, 2016) (en banc).

proceeds in accordance with Revolabs' Operating Agreement (the "Operating Agreement").

In addition to the Operating Agreement, Finger Lakes' and Lyrical's relationship was also governed by a term sheet between the principal of Lyrical, Jeffrey Keswin, Mehta and Shalov (the "Term Sheet") and a clawback agreement between Lyrical and Finger Lakes (the "Clawback Agreement"). The Term Sheet provided that Lyrical had a 25% interest in Finger Lakes and a right to a portion of the management fees earned by Finger Lakes. The Clawback Agreement provided that Lyrical would recoup any losses from its investments in Finger Lakes' portfolio companies before Mehta and Shalov received their appropriate distribution. The main issue in this case was whether the Operating Agreement superseded the Term Sheet and the Clawback Agreement. Finger Lakes argued that as a result of the Operating Agreement's integration clause, the Operating Agreement superseded the Term Sheet and the Clawback Agreement—thus Finger Lakes was not bound by the Term Sheet and the Clawback Agreement. The integration clause stated that the agreement superseded all prior agreements "with respect to the subject matter hereof." The court held that the "subject matter hereof" was the investment in Revolabs and that "[a]s with all of the special purpose vehicles, the scope of the governing agreement did not extend to the ongoing business relationship between Finger Lakes and Lyrical." With respect to the Term Sheet, the court noted that Mehta and Shalov abided by the Term Sheet in their interactions with Lyrical. In addition, the court stated that it was never the intent of Mehta and Shalov to supersede the Term Sheet because Finger Lakes obtained its capital from Lyrical through the Term Sheet and superseding the Term Sheet would have gone against their own interest. In regard to the Clawback Agreement, the court noted that the Operating Agreement only discussed how to distribute proceeds to the members of Revolabs. Therefore, the court held that the Operating Agreement did not supersede the Term Sheet and the Clawback Agreement.

As a secondary issue, Finger Lakes attempted to recover all fees and expenses incurred in litigating this matter before the proceeds of the sale were distributed. Pursuant to the Operating Agreement, Revolabs would indemnify Finger

Lakes for all fees and expenses incurred in matters it became involved in because it was a member of Revolabs. The court noted that Finger Lakes was entitled to indemnification even though it is a plaintiff because there was no restriction in the Operating Agreement limiting indemnification to defendants. However, the court restricted the amount that Finger Lakes received to the legal fees and expenses incurred for the "portion of the action [that] involved Finger Lakes' status as a member and its efforts to compel a distribution in that capacity." For the part of the case that pertained to the "implications of the Term Sheet and the Clawback Agreement," the court denied Finger Lakes request for indemnification because "[t]hose agreements did not govern Finger Lakes' rights as a member of Revolabs."

Finger Lakes appealed the Court of Chancery's post-trial decision to the Delaware Supreme Court, arguing that the Operating Agreement superseded the Term Sheet and the Clawback Agreement and that even if the Clawback Agreement was not superseded, the Court of Chancery applied it incorrectly. In addition, Finger Lakes argued that Lyrical could not recover its unpaid management fees through setoff or recoupment and that the Court of Chancery improperly limited Finger Lakes' indemnification to expenses incurred until Finger Lakes was awarded a partial judgment on the pleadings rather than awarding indemnification for all expenses related to those proceedings. The Supreme Court affirmed the Court of Chancery's holding that the Operating Agreement did not supersede the Term Sheet or the Clawback Agreement and affirmed the Court of Chancery's holding denying Finger Lakes indemnification for the part of the case that pertained to the implications of the Term Sheet and the Clawback Agreement.

The Supreme Court, however, reversed the Court of Chancery's holding that Lyrical could use the doctrine of setoff or recoupment to recover time-barred management fees from amounts otherwise payable to Finger Lakes. In the Chancery Court action, Lyrical had filed a counterclaim seeking its share of management fees, including those that were due more than three years before the filing of the claim and therefore barred by the statute of limitations. The Court of Chancery rejected Finger Lakes' argument that laches barred recovery of these earlier amounts, holding that the statute of

limitations did not apply to the affirmative defenses of recoupment and setoff. The Supreme Court held that 10 *Del. C.* § 8120 precluded setoff for amounts owed outside the statute of limitations and that Lyrical could not assert its time-barred claims by way of recoupment because the defensive claims did not arise from the same transaction as Finger Lakes' claims. The Supreme Court stated that while setoff is clearly subject to a three year statute of limitations, time-barred claims can be considered for recoupment when they arise out of the same factually-related transaction as plaintiff's claim. The court found that Lyrical's claims to use the earlier amounts owed to it arising from the management of multiple portfolio companies as a defense to Finger Lakes' claim for a distribution of the proceeds from the sale of Revolabs were not factually related and therefore could not be considered for recoupment.

WORTH READING

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Daniel B. Kelly, *Remedies for Breach of Trust* (April 14, 2017). Available at SSRN: <https://ssrn.com/abstract=2952755>

Thomas E. Rutledge and Katharine M. Sagan, *An Amendment Too Far?: Limits on the Ability of Less Than All Members to Amend the Operating Agreement*, 16 FLORIDA STATE UNIVERSITY BUSINESS REVIEW 1 (Spring 2017)

Thomas E. Rutledge, *Rock Paper Scissors Lizard Spock and Other Innovative Dispute Resolution Mechanisms*, 20 J. PASSTHROUGH ENTITIES 41 (July/August 2017)

PLANNING AHEAD

The Committee on LLCs, Partnerships and Unincorporated Entities will meet three times in 2018: at the Spring Meeting of the Section on Business Law, at the Annual Meeting of the Section of Business Law, and at the 2018 LLC Institute. Looking forward:

2018 ABA BLS Spring Meeting Orlando, Florida	April 12-14, 2018
2018 ABA BLS Annual Meeting Austin, Texas	August 2-7, 2018
2018 LLC Institute	TBD
2019 ABA BLS Spring Meeting Vancouver, BC	March 28-30, 2019
2019 ABA BLS Annual Meeting Washington, DC	September 12-14, 2019

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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