Selected Recent LLC and LLP Cases
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No Standing of Creditors to Sue Derivatively on Behalf of Insolvent LLC Under Delaware Law

CML V, LLC v. Bax, C.A. No. 5373-VCL, 2010 WL 4347927 (Del. Ch. Nov. 3, 2010).

In a lengthy analysis, the court concluded that, unlike creditors of an insolvent Delaware corporation, the creditors of an insolvent Delaware LLC do not have standing to sue derivatively for breach of fiduciary duty to the LLC. A creditor of an insolvent LLC asserted derivative claims on behalf of the LLC for breach of fiduciary duty by the managers in connection with certain acquisitions and sales by the LLC. The court dismissed the claims for lack of standing because the Delaware LLC statute states that the plaintiff in a derivative suit must be a member or assignee. The court acknowledged that this conclusion "might surprise wizened veterans of the debates over corporate creditor standing," but the court pointed out that the LLC was not a corporation, and the court concluded the plain language of the LLC statute dictated this result. The court contrasted the exclusive language of the LLC statute with the non-exclusive language in the Delaware General Corporation Law, and the court also traced the development of the derivative suit provisions in the Delaware limited partnership statutes since the LLC derivative suit provision was based on the provision in the Delaware Revised Uniform Limited Partnership Act. Although the court was not able to discern why NCCUSL drafted the derivative suit provisions of the 1976 Revised Uniform Limited Partnership Act in exclusive terms (and noted that the uniform language may simply have resulted from a desire to avoid use of the passive voice), the court found it significant that Delaware adopted such language faced with a clear choice between the non-exclusive provisions of Delaware's prior limited partnership statute and the exclusive language of RULPA. The court rejected the implicit assumption in dicta of two chancery court opinions that a creditor of an insolvent alternative entity can sue derivatively for breach of fiduciary duty, and the court found nothing absurd about the application of differing legal principles to corporations and LLCs. According to the court, barring creditor derivative standing does not conflict with the overarching purpose or structure of the LLC statute because of the contractarian emphasis of the statute. The court stated that creditors can protect themselves contractually and that limiting creditors to their negotiated rights and denying them the additional right to sue derivatively on behalf of an insolvent entity is consistent with the contractarian approach taken by the LLC statute. The court pointed out various provisions of the LLC statute that appear to have been drafted with creditors in mind and that allow creditors to avail themselves of additional rights and protections. The court characterized the provision of the LLC statute allowing creditors to enforce contribution obligations under certain circumstances as satisfying any equitable desire to enable LLC creditors to enforce subscription agreements and removing any impetus for an experiment with LLCs similar to the evolution of the corporate trust fund doctrine and eventual corporate creditor derivative action. In sum, according to the court, "In light of the expansive contractual and statutory remedies that creditors of an LLC possess, it does not create an absurd or unreasonable result to deny derivative standing to creditors of an insolvent LLC" and, rather than frustrating any legislative purpose of the LLC statute, such an outcome "fulfills the statute's contractarian spirit."

Unlawful Distributions: Creditor Standing to Enforce Return; Fiduciary Duty of Managers of Insolvent LLC to Creditors

Colborne Corporation v. Weinstein, __ P.3d __, 2010 WL 185416 (Colo. App. 2010, pet. granted).

The plaintiff, a creditor of a Colorado LLC, sought to hold the managers and members of an LLC liable for an unlawful distribution. The creditor argued that the managers were liable for breach of a common law fiduciary duty owed to the creditor and that members were liable under the Colorado LLC statute, which provides for liability of the members to the LLC in the event the members knowingly receive an impermissible distribution. The plaintiff argued that the court should follow Colorado case law in the corporate area by analogy, but the trial court dismissed the plaintiff's claims because there was no appellate decision extending either the statutory interpretation of the corporate statute or the common law limited fiduciary duty of directors to members or managers of an LLC. The court of appeals reversed the trial court on both issues.

With respect to the statutory liability of the members, the court held that case law in the corporate context allowing creditors of the corporation to enforce the liability of directors "to the corporation" for wrongful distributions should also apply to extend standing to creditors of an LLC who sue members under the LLC statutory provision providing for liability of the members "to the [LLC]." The court gave three reasons for relying on the corporate case law: (1) the corporation and LLC statutes are closely related statutory schemes that frequently, as in this case, employ identical language; (2) the legislature directed the courts to apply case law applicable to corporations in determining personal liability in the LLC context (i.e., the LLC statute provides that corporate veil piercing case law is applicable in determining liability of LLC members); and (3) the reasoning for extending standing to creditors is just as applicable to an LLC as it is to a corporation. The defendants argued that the plaintiff did not have standing to sue because the corporate cases extended standing to all creditors as a group, and the plaintiff did not file suit on behalf of all creditors. The court refused to dismiss the case merely because the plaintiff failed to expressly state that it was the only unpaid creditor. The court expressed no opinion as the standing of the plaintiff if the defendants on remand presented evidence that other unpaid creditors existed.

The court of appeals next addressed the plaintiff's claim against the managers for breach of fiduciary duty. After the trial court dismissed the case, a division of the Colorado Court of Appeals held that managers of an insolvent LLC owe to creditors the same fiduciary duty owed by directors and officers of an insolvent corporation, i.e., the limited duty to avoid favoring their own interests over creditors' claims. The defendants did not argue that *Sheffield v. Trowbridge* was wrongly decided but merely challenged the sufficiency of the pleadings with regard to whether the managers favored their own interests over the plaintiff's. The court concluded that the allegation that the managers authorized distributions to themselves as members when the distributions rendered the LLC unable to meet its financial obligations was sufficient to state a claim that the managers favored their own interests over the LLC's creditors.

Capital Call and Contribution Provisions

Racing Investment Fund 2000 v. Clay Ward Agency, Inc., 320 S.W.3d 654 (Ky. 2010).

The Kentucky Supreme Court held that a provision of an LLC operating agreement requiring the members to contribute to pay expenses of the LLC as determined by the manager did not alter the limited liability of the members and did not authorize the trial court to order a capital call to satisfy the unpaid portion of an agreed judgment against the LLC. The trial court and court of appeals had concluded that the capital call provision fell within the provision of the Kentucky LLC statute that allows members of an LLC to alter their limited liability in a written operating agreement, and the trial court ordered that a capital call be issued to each member for the member's pro rata balance owed on an agreed judgment against the LLC. The Kentucky Supreme Court disagreed. The court characterized the capital call provision as a "not-uncommon, on-going capital infusion provision" designed to assure members would contribute additional capital as deemed necessary by the manager. The court acknowledged that the manager could have made a capital call but stated that the provision was not a debt collection mechanism by which a court could order a capital call and effectively abrogate the liability shield. The court stated that assumption of personal liability by an LLC member is so antithetical to the purpose of an LLC that any such assumption must be stated in unequivocal terms leaving no doubt as to the member's intent to forego liability protection. The capital call provision here did not satisfy that standard.

Henry v. Masson, __ S.W.3d __, 2010 WL 5395640 (Tex. App. 2010).

Henry and Masson were partners in an orthopedic surgery practice. They formed their practice as an LLP in 2001, and personal disputes led to litigation in 2003. During a hearing in the case, they agreed in principle to wind up the LLP and sever all ties between them. Additional disputes and issues arose, and another suit was filed. In an attempt to resolve all their differences, they executed a settlement agreement. Litigation ensued over alleged breaches of the settlement agreement. Among the issues addressed in this appeal was a claim by Masson that the trial court erred in ordering Henry and Masson to make capital contributions to the partnership to allow the partnership to pay out funds it had taken in that actually belonged to two new entities formed by the parties. Masson based his argument on the fact that the partnership was an LLP and the provision of the Texas Revised Partnership Act providing that partners in an LLP are protected from individual liability for the debts and obligations of the partnership incurred while the partnership is an LLP. The court stated that neither the partnership agreement nor the statute prevented the trial court from ordering contributions to the partnership during winding up. According to the court, the payments the trial court ordered Henry and Masson to make were capital contributions to discharge debts of the partnership during winding up, not an adjudication of individual liability for the debts or obligations as contemplated by the statute. The court relied upon the partnership agreement, which provided that if no partner agreed to lend funds needed to discharge the partnership's debts, obligations, and liabilities as they came due, each partner was required to timely contribute the partner's proportionate share of funds needed. Masson argued that this provision was not intended to apply in the winding up process and that reference elsewhere in the partnership agreement to payment of the partnership's debts upon dissolution "to the extent funds are available" evidenced the partners' intent that they would not be required to make additional capital contributions during the winding up. The court stated that the phrase relied upon by Masson appeared in a section referring to steps to be taken after the sale of partnership property, and the funds mentioned are funds

received from the sale of partnership property. The court did not interpret the agreement to mean that sale of partnership property was the only source of funds to pay debts. The court also rejected Masson's argument that the reference in the capital contribution provision to payment of debts as they become "due and payable" was evidence that the parties did not intend to require capital contributions during winding up. The court stated that "due and payable" simply modified the type of debt to be paid and did not limit the provision to "operational" status of the partnership.

Default Fiduciary Duties in Delaware LLC; Discretionary Award of Attorney's Fees to Prevailing Plaintiffs Where Entire Fairness Standard Not Met but Damages Not Otherwise Available

William Penn Partnership v. Saliba, __ A.3d __, 2011 WL 440615 (Del. Feb. 9, 2011).

Two minority members of a Delaware LLC sued the Lingo brothers for breach of their fiduciary duties in orchestrating the sale of the LLC's sole asset, a motel, in a manipulative and deceptive sales process to a subchapter S corporation of which the Lingos were shareholders and directors. The Lingos were the managers of the LLC and owned 50% of the LLC through a partnership. The sale of the motel to the corporation for a purchase price of $6.6 million was advantageous to the Lingos because the corporation purchased the motel as an exchange property, and the corporation received a $1.6 million tax refund pursuant to Section 1031 (of which the Lingos' share was approximately $434,000). The Lingos orchestrated the two-thirds vote of the members required by the operating agreement to sell the LLC's motel by securing the approval of the remaining one-sixth member, who had some years earlier expressed interest in pursuing a sale of the LLC's motel or selling his interest in the LLC. The chancery court found that the Lingos breached their duty of loyalty to the plaintiffs, and the chancery court awarded the plaintiffs their attorney's fees because of the Lingos' faithless prelitigation conduct. The Delaware Supreme Court affirmed the chancery court's judgment. The supreme court noted that the parties agreed that managers of a Delaware LLC owe traditional fiduciary duties of loyalty and care to the members of an LLC absent provisions in the operating agreement expressly modifying or eliminating the duties. The Lingos were named as managers in the operating agreement of the LLC, and the agreement did not purport to modify or eliminate fiduciary duties; therefore, the parties agreed that the Lingos owed fiduciary duties of loyalty and care to the members of the LLC. As fiduciaries on both sides of a transaction, the Lingos bore the burden of establishing the entire fairness of the transaction. The court discussed and applied the two-prong test of entire fairness, i.e., fair dealing and fair price, and concluded that the chancery court did not err in finding that the transaction did not satisfy the standard. The court reviewed the conduct of the Lingos and identified multiple misrepresentations and material omissions that precluded the possibility that the property would be sold pursuant to an open and fair process. Several appraisals of the property, including the appraisal performed by the appraiser appointed by the chancery court, valued the property at under $6 million, but the court pointed out that the transaction must be evaluated as a whole. Merely showing that the sales price was in the range of fairness does not necessarily satisfy the entire fairness burden. The court concluded that the Lingos' self interest in the transaction and their domination of the sales process (by withholding full information, providing misleading information, and imposing an artificial deadline) tainted the entire transaction. Inasmuch as the plaintiffs were left without a typical damage award (because the chancery court's appraisal came in at a lower value than the sale price), the court found the chancery court's decision to award attorney's fees and costs to the plaintiffs to be well

within its discretion and supported by Delaware law in order to discourage acts of disloyalty by fiduciaries. The court stated that, despite the general application of the American Rule that each party bears its own attorney's fees, potentially harsher rules come into play where there has been a breach of the duty of loyalty. Absent the award of attorney's fees in this case, the plaintiffs would have been penalized for bringing a successful claim against the Lingos for breach of their duty of loyalty, and the court of chancery court's decision was thus supported by the policy of Delaware law of discouraging disloyalty.

Application of Closely Held Corporation Case Law to LLC Context: Freeze-Out/Breach of Fiduciary Duty

Bluewater Logistics, LLC v. Williford, __ So. 3d __, 2011 WL 240731 (Miss. Jan. 27, 2011).

Four individuals formed two member-managed LLCs of which they were equal members. The LLC agreement contained a provision permitting the LLC to redeem any member's interest upon a vote of 75% of the members. Three of the members ousted the fourth member, Williford, locking him out and notifying him that his status as a "partner" was "terminated" and that he would be paid one-fourth of the fair market value of the LLCs. Williford filed a complaint against the other members and the LLCs in which he sought damages and injunctive relief preventing his ouster. Temporary injunctive relief was granted. Prior to trial, the LLC and the remaining members sought to dissolve the temporary injunction on the basis that the defendants had rescinded their offer to buy Williford's interest (although they reaffirmed his "firing") and that the relief sought by Williford was based on his desire to remain a member. The matter proceeded to trial, at which the defendants' attorney argued that the only relief Williford requested was to remain a member so that there was no issue ripe for trial. The defendants argued that they were authorized to change their minds and allow Williford to remain a member and at the same time "fire" him and exclude him from the business. The chancery court found that Williford's complaint was sufficient to put the defendants on notice that he was seeking damages, and the court awarded Williford the value of his interests in the LLCs. The defendants appealed, and the court of appeals concluded that the defendants' motion to dissolve the injunction had rescinded Williford's ouster and that the chancery court erred in awarding Williford damages. The Mississippi Supreme Court disagreed. As an initial matter, the supreme court found that the complaint sufficiently alleged a claim for breach of contract and compensatory damages. The court rejected the defendants' argument that the chancery court had no authority to award Williford the value of his interests in the LLCs, pointing out that the Mississippi Limited Liability Company Act specifically allows a chancery court to enforce an LLC agreement "by injunction or by such other relief that the court in its discretion determines to be fair and appropriate in the circumstances." This language provided the chancery court authority to award Williford the value of his interests in the LLCs. The defendant members argued that the chancery court had no authority to grant Williford judgments against them as individuals, but the court pointed out that the operating agreements included provisions that "[n]o member shall be liable, responsible or accountable in damages or otherwise to any other Member or to the Company for any act or omission performed or omitted by him except for acts of gross negligence or intentional wrongdoing." The court concluded that this provision established the chancery court's authority to hold the individual defendants liable for acts of gross negligence or intentional wrongdoing. The supreme court agreed with the chancery court's application of closely held corporation law that requires a controlling shareholder's action to be intrinsically fair to the minority, saying the rule

applies with equal force to LLCs. Accordingly, the LLC members in this case had a duty to one another and the LLCs, and the defendant members breached that duty by improperly squeezing out Williford. The supreme court concluded that the record supported the chancery court's findings that the defendants breached the LLC operating agreements in a willful, grossly negligent manner. The defendants ousted Williford without grounds required by the operating agreements and attempted to reverse their position only after Williford sued. The court rejected the defendants' argument that they could "fire" Williford and exclude him from the business while rescinding their offer to purchase and retaining him as a member. The court acknowledged that this argument might apply to other types of entities but stated it had no application to member-managed LLCs. The court pointed out that every member of a member-managed Mississippi LLC is an agent of the LLC and that the operating agreements vested management of the LLC in the members. Thus, under the statute, Williford could not be "fired," and the defendants could only remove him from management by amending the operating agreement, which required consent of all members. The court also rejected the defendants' argument that they had rescinded their "offer" to purchase. Relying on the terms of the redemption provisions of the operating agreements, the court stated that the LLCs were not merely making an offer, but invoking their right to purchase Williford's interests under the agreements. The operating agreements contained no provision for a unilateral rescission of the action. The defendants could have chosen under the agreements to make the exercise of their right to purchase effective immediately or at a future date, and the court said that, having chosen the former, the defendants had every right to exclude Williford but also had a companion duty to tender payment. Had the defendants chosen the latter, there would be no right to exclude Williford until they tendered payment. The court characterized the defendants' actions– locking Williford out and excluding him from the business and then later claiming they had not really decided for certain to purchase his interest– as the best of both options for the defendants and the worst for Williford. The court could not conclude that the chancery court was in error in finding this action to be a willful, grossly negligent breach of contract. The only error the supreme court found on the part of the chancery court was the chancery court's conclusion that it did not have authority to award Williford attorney's fees and its use of a "statutory rate" of post-judgment interest that is no longer specified in the statute. The supreme court acknowledged that attorney's fees generally are not available in breach of contract cases under Mississippi law, but the court stated that there are exceptions where the contract provides for attorney's fees or in the case of "outrageous" conduct that would support an award of punitive damages. The court thus remanded to the chancery court for consideration of whether an award of attorney's fees was factually warranted.

Pointer v. Castellani, 918 N.E.2d 805 (Mass. 2009).

Pointer, a minority member of a Massachusetts LLC who was terminated as its president, sued the other three members and the LLC alleging that the defendants engaged in a freeze-out, breached their fiduciary duty, breached Pointer's employment agreement and the covenant of good faith and fair dealing, and interfered with an advantageous relationship. The defendants counterclaimed, alleging that Pointer usurped a company opportunity, breached his fiduciary duty, breached his employment contract, and breached the implied covenant of good faith and fair dealing in relation to the operating agreement and employment contract. Pointer had been employed in the granite business operated by the LLC prior to its acquisition by the LLC. When the granite business was acquired by the LLC, Pointer joined with Castellani, Woodberry, and Herbert to form the LLC. Castellani and Woodberry owned 51% of the LLC, Pointer owned 43%, and Herbert owned 6%.

Pointer became president of the LLC, and Herbert acted as chief financial officer. Castellani, Pointer, and Herbert were the managers of the LLC. The operating agreement stated that the purpose of the LLC was to operate a quarry business and allowed members to conduct any other business or activity without being accountable. The operating agreement contemplated dealings with members and their affiliates and required that such dealings be at arm's length and on commercially reasonable terms. Pointer had an employment contract that generally required one year's notice of his removal, but such notice was not required for termination based on dishonest or disloyal behavior, material breach of the operating agreement, or substantial failure to perform his duty. The employment agreement required Pointer to work exclusively for the LLC, but the agreement also stated that Pointer could perform services for another company that he formed with another investor to purchase a residential subdivision that the owner of the granite business insisted on selling when the granite business was sold. Although Pointer did not disclose to the other members of the LLC the extent of his ownership in the company that owned the subdivision and another company that later acquired real estate from the LLC, the trial judge found that all the participants knew that Pointer was involved in other real estate activities that were relevant to the suit. The investor with whom Pointer formed the company to purchase the subdivision at the time the granite business was acquired by the LLC also had an interest in purchasing a piece of property acquired by the LLC in the acquisition of the granite business. Ultimately, Pointer joined with this other investor in acquiring the LLC's tract of land in order to pursue a real estate development opportunity. This transaction and certain other actions of Pointer were the basis of the defendants' defense as well as their counterclaims. Pointer's claims were based on the hiring of a new chief executive officer and the termination of Pointer's employment. The defendants argued that the termination of Pointer's employment was justified based on alleged improper business practices of Pointer that had come to light as well as his participation in the transaction involving the sale of the LLC's real estate, and the defendants further asserted that the real estate transaction constituted improper self-dealing and usurpation of a corporate opportunity by Pointer.

The Massachusetts Supreme Court applied Massachusetts case law on closely held corporations (i.e., *Donahue v. Rodd Electrotype Co. of New England, Inc*, and its progeny) in analyzing the claims and determined that the trial judge did not err in finding for Pointer on his freeze-out and wrongful termination claims. The court stated that a breach of fiduciary duty through a freeze-out occurs when the "reasonable expectations" of a shareholder are frustrated. The court acknowledged that the majority shareholders are permitted a measure of discretion in hiring and firing employees and that a court must allow the controlling group an opportunity to demonstrate a "legitimate business purpose" for its actions. The court reviewed the reasons offered by the defendants for Pointer's termination and concluded that the defendants did not establish a legitimate business purpose. According to the court, the trial court did not err in finding that only one of the allegations of improper business practices involved actual misconduct on Pointer's part and that termination was not necessary in that regard because all the owners had to do was talk to Pointer about the matter for it to be corrected.

With regard to the self-dealing and usurpation of corporate opportunity claims, the court upheld the trial court's decision in favor of Pointer. The court concluded that provisions of the operating agreement defining a limited purpose of the LLC and permitting members to conduct other businesses and activities supported the trial court's conclusion that the real estate development activity in which Pointer was involved was not a corporate opportunity of the LLC. The court characterized the defendants' reliance on a provision of the operating agreement imposing on

managers the fiduciary duty of a director of a corporation as misplaced because there would first have to be a corporate opportunity for Pointer to breach a duty. The court pointed out that the record supported the trial judge's conclusion that the remaining members had no interest in the real estate and that there was sufficient information available to the members regarding the relationship of the LLC's piece of property to the development opportunity to allow them to take action if they had been interested in doing so. The court acknowledged that the sale of the LLC's property was unquestionably a corporate opportunity once the LLC decided to sell, but the court rejected the defendants' challenge to the trial court's finding that Pointer engaged in unfair self dealing in the transaction. Although Pointer did not reveal that he owned 50% of the entity purchasing the property from the LLC, he did not participate in the vote on the sale and the transaction was negotiated between Castellani and Pointer's fellow investor. The record showed that the other members knew that Pointer owned part of the entity acquiring the property and that Pointer and his fellow investor were assembling parcels of land for development. Although Pointer did not disclose that his fellow investor was pursuing the parcel at a discounted price as compared to the price specified in an option held by the investor, the record showed that the members were aware they could hold out for a higher price in the future but preferred to sell rather than risk the deal falling apart. There was also expert testimony that the price was a commercially reasonable price. The court thus held that the trial judge did not err in concluding that the transaction was fundamentally fair.

The court upheld the trial court's finding that Castellani, Woodberry, Herbert, and the new CEO were liable for interference with Pointer's employment contract with the LLC because they terminated Pointer for cause that was contrived.

The court found no error in the trial court's conclusion that Pointer was entitled to indemnification under the indemnification provisions of the operating agreement, which required indemnification of managers and members unless their action or inaction was the result of active and deliberate dishonesty. The defendants argued that the trial judge's findings indicated that Pointer was, at the very least, dishonest, but the court cited statements by the trial court that its decision did not include any findings that Pointer committed actions in bad faith or with deliberate dishonesty.

Finally, the court discussed the remedy for a freeze-out and remanded for further proceedings because the court concluded that the trial judge's order for a forced sale of the LLC violated the court's holding in *Brodie v. Jordan*, in which the court held that a forced buy-out of a shareholder was improper without some authorization from the shareholders. The court stated that Pointer was entitled to damages or other equitable relief that would put Pointer in the position he would have been in had the freeze-out not occurred and compensate him for the denial of his reasonable expectations.

Arbitration Clause in Operating Agreement Not Binding on LLC

Trover v. 419 OCR, Inc., 921 N.E.2d 1249 (Ill. App. 2010).

The plaintiff, a member of two LLCs, filed a derivative suit alleging various claims on behalf of the LLCs against fellow members of the LLCs and two non-member entities affiliated with the member defendants. The defendants sought to compel arbitration based on broadly worded arbitration clauses in the LLC operating agreements. The court found that the dispute in question, which involved a land transaction, fell within the scope of the arbitration clauses, but the court concluded that the non-member defendants were not bound by the arbitration clauses and thus could not enforce the arbitration clauses as to the counts against them. Further, the court held that the

LLCs were not bound by the arbitration clauses because they were not parties to the operating agreements. The court characterized this issue as one of first impression in Illinois and stated that Illinois law and the facts of the case required a different result from *Elf Atochem North America, Inc. v. Jaffari*, in which the Delaware Supreme Court concluded that an LLC was bound to arbitrate by an arbitration clause in the operating agreement even though the LLC was not a signatory to the agreement. In *Jaffari*, the arbitration clause covered all disputes, and the court specified that the members of the LLC were the real parties and that the LLC was simply a joint business vehicle for the members. In distinguishing the law and facts of this case from that involved in *Jaffari*, the court emphasized that the arbitration clauses here specified that the controversy must be "between the parties," and the court relied upon the separate legal existence of an LLC under the Illinois LLC statute, the LLC's power to sue and be sued, the recitation in the operating agreements that the agreements were by and among specified parties that did not include the LLC, and the signatures (which did not refer to or purport to bind the LLCs) at the end of the agreements. The court also pointed to a provision of the operating agreements that gave the managing member authority to sign contracts on behalf of the LLCs when authorized by the members, thus indicating that the drafters understood what was necessary to contractually bind the LLCs. The court also relied on the statutory authorization for a derivative suit and the unlikelihood that the defendant members would have brought the derivative actions naming themselves as defendants. The court concluded that a fraud claim brought by the plaintiff individually against the other members was subject to the arbitration clause, and a defendant member who was not an original signatory of the operating agreements but was subsequently admitted as a member was entitled to enforce the arbitration clause under the terms of the agreements.

Constraints on Amendment of Operating Agreement By Non-unanimous Vote

Abbey v. Fortune Drive Associates, LLC, No. A124684, 2010 WL 1553616 (Cal. App. 1 Dist. April 20, 2010).

The sole manager and owner of a majority interest in a Delaware LLC concluded that it would be in the best interest of the LLC to remove a minority member, Abbey, who owned a 2.98% interest and had expressed disagreement with a restructuring of the LLC approved by the other members. The sole manager/majority member initiated an amendment of the operating agreement to provide for the termination of a member upon the vote of other members and to set the financial terms under which the termination would occur. The amendment also contained a provision requiring any dispute over a termination to be arbitrated and requiring the arbitrator in such a dispute to value the ownership interest of the terminated member. The operating agreement provided that it could generally be amended by a majority vote of the LLC's membership interests, but certain enumerated "major decisions" required a two-thirds vote of the membership interests. The provision authorizing amendment of the agreement placed no substantive limits on amendment of the agreement. All members other than Abbey consented to the amendment and to Abbey's termination pursuant to it. The LLC commenced arbitration, and Abbey sought to stay the arbitration on the basis that he was not bound by the arbitration provision of the amendment. The court recognized that Delaware law governed the internal affairs of the LLC but determined that California law on contract interpretation applied under both the Federal Arbitration Act and state arbitration law. The court noted that the LLC did not appear to argue for application of Delaware law to the issue of contract interpretation and had not demonstrated the result would be different under Delaware law.

The court recognized the emphasis on freedom of contract under Delaware LLC law, referring to the operating agreement as the "heart and soul of an LLC," but relied upon California case law dealing with amendment of a contract to conclude that the arbitration provision was beyond the intent of the parties in permitting majority amendment of the operating agreement. The court stated that Delaware's grant of freedom to the members to structure their operating agreement at the outset of the LLC does not necessarily mean that the members have the same broad authority to amend the agreement after formation if the amendment is less than unanimous. The court stated that general principles of contract law include certain common law constraints on amendment of a contract by less than all parties. The court stated that the members' expectations constrain the changes that can be made without consent of all members, and that the requirement of definiteness and the obligation of the parties to act in good faith and deal fairly limit the scope of amendments. As a matter of traditional contract interpretation, based on the intent of the parties, the court concluded that the arbitration clause, adopted in the circumstances presented, went beyond the scope of amendments anticipated by the members. The court noted that the operating agreement contained no restriction on fiduciary duties and that the members thus owed the traditional fiduciary duties owed by directors of a corporation, but the court stated that whether the arbitration provision violated the members' fiduciary duties and the implied covenant of good faith and fair dealing was a substantial question not raised by the parties and not addressed by the court.

Effect of Conversion

Grohman v. Kahlig, 318 S.W.3d 882 (Tex. 2010).

The Texas Supreme Court disagreed with the conclusion of the court of appeals in this case and held that the conversion of two corporations into limited partnerships did not violate the terms of a security agreement covering shares of stock in the corporations. As part of a divorce settlement in 2001, Kahlig executed a promissory note payable to Grohman secured by 70% of Kahlig's stock in two corporations. In 2003, the corporations were converted to limited partnerships to save franchise taxes. Pursuant to the plan of reorganization, as described by the court, Kahlig formed a holding company for each of the two corporations and contributed his stock in each corporation to the corresponding holding company. Kahlig then converted the corporations to limited partnerships, and each holding company received limited partnership units in exchange for the stock in the converted corporations, which was canceled once it was replaced with the limited partnership units. In 2007, when the limited partnership form no longer provided a franchise tax advantage, the entities were converted back to corporations. Grohman sued Kahlig in 2005 and asserted that the conversions resulted in a breach of the terms of the security agreement under which Kahlig agreed not to "sell, transfer, lease or otherwise dispose of the Collateral or any interest therein" without Grohman's consent and further agreed not to "allow the Collateral to become wasted or destroyed." The court of appeals agreed with Grohman and held that Kahlig breached the security agreement because he "disposed of" the Collateral in violation of the security agreement. According to the court of appeals, Kahlig destroyed the shares of stock when the shares were converted to limited partnership units because the shares were canceled and ceased to exist. The supreme court, however, focused on the definition of "Collateral" in the security agreement, which encompassed "all replacements, additions, and substitutions," and concluded that the conversion did not destroy the Collateral. The court pointed out that the shares of stock that were canceled in the conversion were first replaced with limited partnership units that represented the same interest in the businesses.

Kahlig remained the owner of his interest in the businesses, and the change in form of the Collateral did not destroy it according to the supreme court. Grohman did not dispute that the value of the Collateral actually increased (due to the more beneficial franchise tax treatment). Grohman also argued that Kahlig "transferred" the Collateral in the conversion because the plan of reorganization involved movement of interest in the companies between Kahlig and the holding companies. The court stated that Kahlig retained ownership of his entire interest in the companies throughout the conversion despite the technical movement of business interests between him and his holding companies. Thus, the Collateral was not transferred, and Grohman's security interest was not impaired. The court noted that the security agreement lacked any specific mention of the consequences of a business entity conversion, and the court stated that the most reasonable interpretation of the agreement, read as a whole, was that it did not prohibit Kahlig from converting the business entities and that Kahlig did not breach the agreement at any point in the conversion.

Contract Under Seal

Whittington v. Dragon Group, L.L.C., 991 A.2d 1 (Del. 2009).

The Delaware Supreme Court decided, as a matter of first impression, that the typed word "seal" next to an individual signatory's name was sufficient to create a "specialty contract," i.e., a contract under seal, which is subject to a twenty-year statute of limitations under Delaware law rather than the three-year statute of limitations applicable to regular contracts.

The dispute in this case involved the rights of family members with respect to a Delaware LLC. The plaintiff brought this action against the LLC, the plaintiff's siblings, and other family members to enforce his rights as an alleged member of the LLC, and the chancery court concluded that the plaintiff's rights were ultimately predicated on a global settlement agreement entitled "Agreement in Principle" ("AIP") entered into by the plaintiff and his siblings in 2001 during prior litigation between the parties. The terms of the AIP were never carried out because of ongoing disputes between the parties. The court held that the plaintiff's equitable action to enforce his rights under the AIP was barred by laches by analogy to the statute of limitations applicable in an action at law on the contract. In the chancery court, the plaintiff argued that the AIP was a contract under seal to which the common law twenty-year statute of limitations would apply. The typed word "seal" appeared next to each party's signature, but the chancery court determined that more than a minimal reference to a seal was required for contracts other than documents of debt, such as mortgages or promissory notes, to escape the three-year statute of limitations. The Delaware Supreme Court reviewed conflicting trial court decisions in Delaware and case law in other states and noted that many states have enacted statutes that address the issue of what constitutes a contract under seal. In the absence of legislative guidance in Delaware, the Delaware Supreme Court was persuaded by a decision of the Delaware Orphan's Court in a 1940 case. Under this rule, the presence of the word "seal" next to an individual's name (in contrast to a corporation) is all that is required to create a sealed instrument regardless of whether there is any indication in the rest of the contract that it was intended to be a sealed instrument. Thus, the court remanded to the chancery court for reconsideration of its holding by applying the twenty-year statute of limitations for purposes of analogy in determining the laches issue. Justice Jacobs dissented, arguing that it is unreasonable and unadvisable in today's commercial environment to subject parties to commercial contracts to the risk of litigation for twenty years without requiring at least minimally persuasive evidence (i.e., more than use of the boilerplate term "seal") that the parties intended that result.

<u>Remedies of Judgment Creditor of Limited Partner or LLC Member: Charging Order, etc.</u>

Stanley v. Reef Securities, Inc., 314 S.W.3d 659 (Tex. App. 2010).

A judgment creditor obtained a turnover order requiring Stanley, the judgment debtor, to turn over monthly payments received from a limited partnership. The general partner of the limited partnership was an LLC of which Stanley was 90% owner, president, secretary, and sole employee. Stanley was the sole limited partner of the limited partnership. Stanley testified that the monthly payments from the limited partnership were his salary as an employee of the LLC, the amount of which he determined in his capacity as president of the LLC and communicated to himself as president of the limited partnership to be paid by the limited partnership. On appeal, Stanley challenged the turnover order on a number of grounds, including that the charging order was the judgment creditor's exclusive remedy and that the payments to Stanley were exempt wages. The judgment creditor cross-appealed the trial court's refusal to appoint a receiver.

With regard to Stanley's argument that a charging order was the exclusive remedy available to the judgment creditor, the court examined the charging order provision in the Texas limited partnership statute and agreed with the judgment creditor that the statute only limits the ability of a judgment creditor to proceed against a partner's partnership interest and does not limit the ability to apply for turnover relief against the judgment debtor's non-exempt property. The court discussed the charging order remedy and acknowledged that a charging order is the exclusive remedy by which a judgment creditor may satisfy a judgment out of a judgment debtor's partnership interest. The court explained that a "partnership interest" is not an interest in specific partnership property; it is the partner's right to receive his distributive share of the profits and surplus of the partnership. The court further explained that a creditor who obtains a charging order may not compel a distribution of profits by the partnership and does not obtain a right to participate in the partnership. The charging order creates a lien on the partner's distributive share, but the judgment creditor is prohibited from foreclosing the lien, and the debtor partner has the ability to control the timing and amount, if any, of distributions by the partnership. Once a partnership distribution has been made, however, it ceases to be the partner's "partnership interest" (i.e., the right to receive his share of the profits) and becomes the partner's own property. The court concluded that nothing in the language of the statute precludes a judgment creditor from seeking the turnover of proceeds of a partnership distribution once it has been made and is in the debtor partner's possession. (The Business Organizations Code contains identical charging order provisions in the LLC context.)

Another issue addressed by the court was whether the payments by the partnership were exempt from turnover as current wages. Stanley argued that the payments were salary paid to him as an employee of the LLC general partner of the limited partnership. The court pointed out, however, that the payments were not made by the limited partnership to the LLC to be paid in turn to Stanley. Instead, the payments were made directly by the limited partnership to its limited partner, Stanley. The court pointed out that the general rule is that a partner is not entitled to compensation for services, and the court found no circumstances showing an agreement, express or implied, to pay compensation. The partnership agreement contained no such provision, previous tax returns did not treat Stanley as an employee or indicate he was paid compensation, and there was no evidence Stanley devoted any more time or attention to the business than was anticipated at formation. Thus, the court held that the trial court did not abuse its discretion in determining that the payments were distributions from the partnership and not exempt wages.

The judgment debtor cross-appealed the trial court's refusal to appoint a receiver over Stanley's interests in the LLC and partnership, and the court of appeals concluded that the trial court did not abuse its discretion in refusing to do so. The Texas Civil Practice and Remedies Code gives a trial court discretion to appoint a receiver over a judgment debtor's non-exempt property with the authority to take possession of the property, sell it, and pay the proceeds to the judgment creditor. Based on Stanley's testimony, the trial court could have reasonably concluded that a receiver was not necessary to enforce the judgment because Stanley had the means to pay the judgment but had not paid because of the dispute over whether the monthly payments from the partnership were exempt wages or non-exempt distributions. Thus, it was not an abuse of discretion to decline to appoint a receiver. [Note: The court referred to the issue as involving appointment of a receiver over Stanley's "interests" in the LLC and partnership, but did not discuss or reconcile the exclusivity of the charging order with the possibility of a receivership over the "interests." Perhaps the court was referring to the payments/distributions rather than the actual partnership and membership interests, since the court had earlier acknowledged that the charging order provision in the limited partnership statute provides the exclusive remedy of a judgment creditor to satisfy a judgment out of a partnership interest.]

In re LaHood (LaHood v. Covey), 437 B.R. 330 (C.D. Ill. 2010).

The judgment creditor of an LLC member claimed that it obtained a lien on the member's membership interest by serving a citation to discover assets pursuant to the general judgment collection procedures in the Illinois statutes. The bankruptcy court concluded that the general provision for perfecting a judgment lien by service of a citation to discover assets is trumped by the charging order provision and that the charging order is the exclusive mechanism for impressing a judgment lien upon a judgment debtor's interest under Illinois law. The judgment creditor appealed, and the district court reversed the bankruptcy court on this issue. The district court reviewed the general statutory provision for perfection of a judgment lien by citation and the charging order provision in the Illinois LLC statute and noted that the issue was one of first impression on which "there is very little authority that is even marginally relevant." The court considered *Dowling v. Chicago Options Associates, Inc.*, an Illinois appellate court decision in which the only issue was whether a public sale by the sheriff was required and the validity of a lien on a membership interest by service of a citation to discover assets was not challenged, and *Bobak Sausage Co. v. Bobak Orland Park, Inc.*, an unpublished federal district court opinion in which the court acknowledged the charging order provision in the course of determining that a public sale by the sheriff should not be the only method of disposal of an LLC interest that has been subjected to a judgment lien under the general citation provision. The court stated that these cases arguably stand for the proposition that liens against a member's LLC interest may be created through the service of a citation or by obtaining a charging order, and the court thus disagreed with the bankruptcy court's conclusion that the judgment creditor could not have created a lien via service of citation. The court remanded for the bankruptcy court to determine whether the citation complied with the statutory requirements to create a valid lien. The court stated that the next logical issue, assuming the judgment creditor complied with the citation statute, would be how the lien would be treated in terms of satisfaction or remedy. The court noted a Virginia bankruptcy decision, *In re Pischke*, that addressed the priority of a charging order lien versus a lien created under the general procedure for execution on intangibles and suggested that the failure to obtain a charging order may prevent a judgment creditor from obtaining priority status in terms of execution or satisfaction of the judgment. Under this rationale,

said the court, the judgment lien would not be entitled to priority absent a charging order because the provision of the charging order statute stating that the statute provides the exclusive remedy by which a judgment creditor of a member may satisfy a judgment out of the judgment debtor's LLC interest would be rendered meaningless if a judgment creditor who obtained a lien by citation could satisfy the lien or obtain a remedy. The court commented that *Pischke* indicated that it may be possible for a judgment creditor to obtain relief from the automatic stay to seek a charging order, but the court stated that whether such an opportunity was appropriate in this case was not before the court. In light of its conclusion that the judgment creditor could have created a valid lien by serving its citation and the theoretical possibility that a charging order might still be obtained to allow satisfaction of such a lien, the court remanded the matter to the bankruptcy court for further proceedings consistent with the court's opinion.

Olmstead v. Federal Trade Commission, 44 So.3d 76 (Fla. 2010).

The Florida Supreme Court answered a certified question from the Eleventh Circuit Court of Appeals regarding the rights of a judgment creditor of a single member LLC and concluded that the Florida LLC charging order statute does not preclude a judgment creditor from using the remedy of execution on the interest of a single member of an LLC to reach all of the member's right, title, and interest in the LLC. The court reviewed the concepts of membership, a membership interest, assignment, and the charging order under the Florida LLC statute and concluded that the assignee of a single member of an LLC becomes a member without the consent of anyone other than the transferor member because the set of "all members other than the member assigning the interest" (whose consent is required under the statute to admit an assignee of a member) is empty. The court then concluded that the charging order remedy is not the exclusive remedy of a judgment creditor of an LLC member because the charging order provision does not state that the charging order is the exclusive remedy, in contrast to the Florida general and limited partnership statutes, which explicitly provide that the charging order is the exclusive remedy by which a judgment debtor of a partner may satisfy a judgment out of the judgment debtor's interest. The court noted that there is a general execution provision in Florida that applies to various forms of real and personal property, including "stock in corporations," and the court stated that an LLC is a type of corporate entity the ownership interests of which can reasonably be understood to fall within the scope of "corporate stock." The appellant judgment debtors did not contend that the execution statute did not by its terms extend to an ownership interest in an LLC or that the challenged order did not comport with the requirements of the execution statute. They relied only upon the exclusivity of the charging order provision. Because the court concluded that there was no basis to infer that the charging order statute provides the sole remedy for a judgment creditor against a judgment debtor's interest in a single member LLC, it does not displace the general execution remedy with respect to such an interest. Thus, the court held that a court may order a judgment debtor to surrender all right, title, and interest in the debtor's single member LLC to satisfy a judgment. A strenuous and lengthy dissenting opinion argued that the majority rewrote the LLC statute and rendered the assets of all LLCs in Florida vulnerable because the majority's reasoning applied with equal force to multi-member LLCs.

Charging Order: Conflict of Laws, Proper Forum

New Times Media, LLC v. Bay Guardian Co., Inc., C.A. No. 10-72-GMS-LPS, 2010 WL 2573957 (D. Del. June 28, 2010).

A judgment creditor obtained a multi-million dollar judgment in California against New Times Media, LLC ("New Times"), a Delaware LLC. New Times did not pay the judgment, and the judgment creditor was granted a charging order by the California court against the interests of New Times in sixteen wholly-owned non-debtor entities, fourteen of which were Delaware entities. The charging order gave the judgment creditor the option to foreclose on the entities. New Times sought a permanent injunction prohibiting the judgment creditor from foreclosing on the sixteen wholly-owned entities of New Times. New Times argued that the Federal Anti-Injunction Act did not apply to the case but sought remand of the case to the Delaware Chancery Court in the event the court determined that the Act applied. New Times argued that its claim was valid in Delaware state court and that there was no other available forum offering a sufficient remedy. The judgment creditor asserted a counterclaim for enforcement of the California judgment against New Times. The court determined that the magistrate had properly concluded that the judgment creditor's request for a permanent injunction should be denied because the Anti-Injunction Act required the court to refrain from granting an injunction staying the California state proceedings. The court also determined that the magistrate correctly concluded that remand should be denied. The court stated that California state court offered a sufficient remedy, noting that the California proceedings remained ongoing and that the California court had not ruled on the choice of law issue so that New Times was free to advocate that Delaware law should govern. Furthermore, the court stated that the request for remand incorrectly assumed the Anti-Injunction Act is jurisdictional, and the Act is not strictly jurisdictional. Finally, the court concluded that the magistrate correctly determined that the judgment creditor's counterclaim, which effectively demanded that the court register the California judgment, should be dismissed. The court stated that the magistrate correctly distinguished between giving a state court judgment full faith and credit, which means giving it preclusive effect, from registration of the judgment, which requires the court to adopt the judgment as its own. Because only a judgment rendered by a federal court may be registered in a federal court, the judgment creditor failed to state a claim.

Effect of Death of Trustee Partner or Member

Compare ***Presta v. Trepper***, 102 Cal. Rptr. 3d 12 (Cal. Ct. App. 2009) (holding that the death of a trustee partner triggered buy-out provisions of the partnership agreement applicable on the death of a partner, relying heavily on the principle that an ordinary express trust is not an entity separate from its trustee) with ***Dunbar v. Willis***, No. D054146, 2010 WL 336406 (Cal. Ct. App. Jan. 28, 2010) (interpreting provisions of an LLC operating agreement and holding that the death of the trustee of a revocable living trust to which the trustee had previously transferred his entire membership interest (as permitted by the operating agreement) did not trigger the provision of the operating agreement permitting the remaining members to purchase the interest of a member on the member's death).