April 2017
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FROM THE CHAIR

Garth Jacobson
CT Corporation
Seattle, Washington

Greetings from the Chair,

Why do we value the ABA, the Business Law Section (BLS) and the LLC, Partnership and Unincorporated Entities Committee? I pose this question because it always comes up when I pull out my credit card to pay for the annual dues or an upcoming meeting or the LLC Institute. Obviously, I continue to find the value because I continue to pay for the participation in the ABA and its events. But here are the reasons why. First and foremost I find the value in the people that are on the LLC committee. That also extends to the others in the BLS and beyond to the ABA. They provide a great wealth of wisdom, networks and connections that make attending the meetings more than worthwhile. Those contacts come through meeting people at the meetings or attending the social events. In addition to content, we as a committee we try to have great dinners at the least cost possible. The spring and annual meeting include great CLE programs with the top experts in their fields. Proudly our committee has or has connections to many
excellent presenters. We try to make the best event our LLC Institute. At the Institute we strive to keep the costs down while providing excellent content. But for those of you who can’t carve out the time to attend a meeting in person, then the work of Tom Rutledge, Beth Miller and others make the committee publication an extremely useful investment in you’re keeping up with the latest cases and trends that keep you on the leading edge or at the least help prevent malpractice. Additionally the books and webinars provide both an opportunity to participate or gain benefit from the activities. Finally if you have a hankering for doing sometime related to the committee we are willing to accommodate that desire. We believe you will find great value in all we do and encourage you to participate to the fullest.

In other news, ABA Business Law spring meeting is coming up April 6 – 8 in New Orleans. While it will be fun to go there and connect, the content of the programs drives attendance. The agenda related to our committee is as follows:

- Dissolution, Winding Up, and Termination of an Unincorporated Entity: When - If Ever - Does The Existence of an LLC or Partnership End? Thursday 4/6/2017 8:00AM - 10:00AM
- Structuring Oil and Gas Joint Exploration, Development and Production Operations: Contractual Joint Venture, LLC or LP Thursday 4/6/2017 10:30AM - 12:30PM
- LLCs, Partnerships and Unincorporated Entities Anti-Money Laundering Subcommittee Meeting Thursday 4/6/2017 1:30PM - 2:30PM
- International Use of U.S. Business Entities Subcommittee Meeting Thursday 4/6/2017 4:30PM - 5:30PM
- LLC Case Law Update Friday 4/7/2017 8:00AM - 10:00AM
- Partnerships and Unincorporated Entities Committee Meeting Friday 4/7/2017 10:00AM - 12:00PM
- Security Interests in LLC and Other Unincorporated Entity Interests Task Force Joint Meeting Friday 4/7/2017 11:30AM - 12:30PM

Additionally during the LPUE committee meeting I have invited expert speakers to discuss the new “Block Chain” technology and how it can be used for business organizations. The Delaware Secretary of State’s office is developing ways to use this technology for its business records. It is important to understand this new development and how it might impact you and your clients.

Lastly Johnny Lyle has set up our committee dinner for Thursday night and if you come in early and because New Orleans has such great place Johnny has arranged for a dinner on Wed night also for the usual suspects and anyone else who’s interested. The Thursday dinner is our traditional committee dinner and we will do our usual “partnership rules” method of payment. That is the cost is total is divided by the number of participants. We will try to keep it as reasonable as possible. Please let Johnny or myself know if you can attend so we can get a headcount and get further details. Johnny’s email address is: Johnny.Lyle@arlaw.com or mine is: garth.jacobson@wolterskluwer.com

I hope to see you in NOLA. Enjoy your spring.
Thursday, April 6, 2017

8:00 a.m. - 10:00 a.m.  Program (2 hrs.) Dissolution, Winding Up, and Termination of an Unincorporated Entity: When- If Ever – Does the Existence of an LLC or Partnership End? Strand 10A, Level Two

10:30 a.m. - 12:30 p.m.  Program (2 hrs.) Structuring Oil and Gas Joint Exploration, Development and Production Operations; Contractual joint Venture, LLC or LP Strand 13B, Level Two

1:30 p.m. – 2:30 p.m.  Program (1 hr.) Anti-Money Laundering Subcommittee Meeting
Celestin F, Level Three

4:30 p.m. - 5:30 p.m.  Program (1 hr.) International Use of US Business Entities Subcommittee Meeting
Imperial 2, Level Four

Friday, April 7, 2017

8:00 a.m. - 10:00 a.m.  Program (2 hrs.) Case Law Update (Non-Delaware) Strand 11B, Level Two

10:00 a.m. – 12:00 p.m.  LLCs, Partnerships and Unincorporated Entities Committee Meeting
Bolden 5, Level Two

11:30 a.m. – 12:30 p.m.  Security Interests in LLC and Other Unincorporated Entity Interests Task Force Joint Meeting Celestin E, Level Three
In El Paso Pipeline GP Company, L.L.C. v. Brinckerhoff, No. 103, 2016 (Del. Dec. 20, 2016), the Delaware Supreme Court reversed the Court of Chancery's holding that a limited partner maintained standing to pursue his claims challenging a dropdown transaction after the limited partnership was acquired by merger. The Supreme Court rejected the Chancery Court's holding that the plaintiff's claims arose out of a breach of the partnership agreement and, therefore, were direct in nature. As the claims were derivative, they passed to the buyer in the merger, thereby extinguishing the plaintiff's standing.

In the fall of 2010, El Paso Corporation ("El Paso Parent"), which owned El Paso Pipeline GP Company, L.L.C. (the "GP"), the sole general partner of El Paso Pipeline Partners, L.P. (the "MLP"), sold assets to the MLP in a "dropdown" transaction. The plaintiff filed suit derivatively on behalf of the MLP challenging the transaction. While the litigation was pending, Kinder Morgan, Inc. ("Kinder Morgan") acquired El Paso Parent. After this acquisition, Kinder Morgan acquired the MLP by merger. After the consummation of the MLP merger, the defendants moved to dismiss, arguing plaintiff's claims were exclusively derivative and that plaintiff lost standing as a result of the merger. The Chancery Court then issued an opinion holding the GP liable for breach of the MLP's partnership agreement, finding that the conflicts committee of the MLP "did not subjectively believe" that the approval of the dropdown transaction "was in the best interests of the partnership," and that the MLP suffered $171 million in damages. Subsequently, the Chancery Court denied the defendants' motion to dismiss. First, the Chancery Court distinguished the case at hand from the test articulated in Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031 (Del. 2004), for determining whether a claim is direct or derivative, stating that "Tooley does not apply to contract rights." Nevertheless, the Chancery Court analyzed the claim under the two-part test in Tooley—which involves an inquiry into (1) who suffered the alleged harm, and (2) who would receive the benefit of any recovery or other remedy—and concluded that plaintiff had asserted a "dual-natured" claim and thus could pursue the claim post-merger. As to the first prong, the Chancery Court found that the dropdown injured the limited partners by reallocating value from the unaffiliated limited partners to the GP and that, because the GP received benefits to the exclusion of the limited partners generally, the limited partners suffered a distinct injury. As to the second prong, the Chancery Court decided that, because both the MLP and the limited partners were harmed, either could recover for the alleged breach.

On appeal, the Supreme Court determined that plaintiff's claims were and remained derivative. The Supreme Court explained that, while claims for breach of a commercial contract are normally direct in nature, a partnership agreement is not merely a traditional commercial contract; rather, it is the constitutive contract of a partnership and sets forth the rights and duties of the partners. The Supreme Court found the plaintiff's claim sounded in breach of a contractual duty owed to the MLP and thus applied Tooley. As to the first prong, the Supreme Court concluded that the harm alleged in plaintiff's complaint solely affected the MLP, noting that plaintiff alleged the MLP overpaid for the assets in the dropdown and that overpayment claims are normally treated as harming the entity and are, therefore, regarded as derivative. The Supreme Court noted that, where an entity is alleged to have overpaid for an asset, the entity is harmed through the depletion of its assets, which harms its equity holders derivatively through the diminution of the value of their interests. The Court further noted that not every breach of a provision of the partnership agreement is "dual" by reason of rights and duties under the partnership agreement flowing to either the limited partners or the MLP. While recognizing that its opinion in Gentile v. Rossette, 906 A.2d 91 (Del. 2006), allowed for a dual-natured claim in circumstances where there is both an improper transfer of economic value and voting power from the minority stockholders to the controlling stockholder—so-called "equity dilution" claims—the Supreme Court found the plaintiff's claims failed to satisfy the unique circumstances presented by Gentile. The
Supreme Court declined to extend *Gentile* and dual-natured claims to circumstances where the “extraction of solely economic value from the minority by a controlling stockholder constitutes direct injury.”

As to the second prong of *Tooley*, the Supreme Court found that any recovery from the claim would benefit the MLP’s partners *pro rata* in proportion to their partnership interests. The Supreme Court rejected the Chancery Court’s reliance on cases where claims involving “insider transfers” or “stock dilution” were found to be dual-natured. The Supreme Court found that those cases were inapposite, as the plaintiff did not allege that the dropdown affected his voting rights or relative control of the MLP.

While the Supreme Court recognized the Chancery Court’s equitable concerns with a holding that would allow the claims to be extinguished, the Supreme Court declined to change settled law, noting the importance of certainty in the law for all parties. The Supreme Court stated that, in most circumstances, “permitting pending derivative claims to survive a merger would be inefficient and overly costly for public investors” and that “[u]seful transactions would be deterred or priced at a lower value because third-party acquirers would find themselves having bought into litigation morasses, the persistence of which they cannot control.”

In his concurrence, Chief Justice Strine wrote separately to state that the present case “highlights” that *Gentile* “muddies the clarity of [Delaware] law in an important context,” stating that “it ought to be overruled, to the extent it allows for a direct claim in the dilution context when the issuance of stock does not involve subjecting an entity whose voting power was held by a diversified group of public equity holders to the control of a particular interest.” Even in the case of a transaction that shifts control from a disaggregated investor base to a controller, the Chief Justice noted, stockholders would already have a direct claim under *Revlon*, leaving no “gap” for *Gentile* to fill.

This decision provides helpful guidance in finding that the contractual-based nature of Delaware limited partnerships are direct or derivative claims.
Delaware Chancery Court Enforces LLC Forum Selection Clause, Despite Carve-Out

By: Jonathan M. Stemerman
Elliott Greenleaf, P.C.
Wilmington, Delaware

In Merinoff v. Empire Merchants, LLC, C.A. No. 12920-VCS, 2017 Del. Ch. LEXIS 23 (Del. Ch. Feb. 2, 2017), the Delaware Chancery Court dismissed the plaintiffs’ advancement claims against an LLC for lack of jurisdiction due to the LLC agreement’s forum selection clause. Plaintiffs Charles Merinoff and Gregory L. Baird filed an action for advancement of legal fees in the Delaware Court of Chancery pursuant to defendant’s LLC agreement. The plaintiffs asserted that they were entitled to advancement of fees incurred in connection with a suit in which it is alleged that they, along with others, carried out a massive and long running bootlegging scheme to illegally divert wine and spirits from Maryland into New York.

Defendant Empire Merchants filed a motion to dismiss the Chancery Court action under Chancery Court Rule 12(b)(3) for improper venue. Defendant’s improper venue argument was based on Section 12.6 of the LLC agreement, which stated, in part, that the parties “agree that any suit, action or other legal proceeding arising out of this Agreement shall be brought in the United States District Court for the Southern District of New York or in any courts of the State of New York sitting in the Borough of Manhattan.” The forum selection clause was modified by a carve-out, which stated: “[notwithstanding the foregoing, any legal proceeding arising out of this Agreement which, under [Delaware’s Limited Liability] Act or, to the extent made applicable by the Company pursuant to this agreement, the DGCL, is required to be brought in the Delaware Court of Chancery and may only be brought in the Delaware Court of Chancery and the parties hereto consent to the jurisdiction of the Delaware Chancery Court under such circumstances.”

The Chancery Court began its analysis by noting that Delaware courts defer to forum selection clauses, routinely giving them effect, and that such clauses are interpreted according to the law chosen to govern the contract, which in this case was Delaware. The Court further noted that, under Delaware law, courts interpret contracts to effectuate the parties’ intent and give clear and unambiguous contractual language its plain and ordinary meaning.

The Court stated that the Delaware LLC Act does not specify where a claim for advancement must be filed. Thus, the Court explained, the plaintiffs were left to argue that, since the LLC agreement’s advancement provision mentions the DGCL three times, the parties must have intended that the DGCL should apply to their right to advancement. The plaintiffs further argued that, since 8 Del. C. § 145(k) vests the Chancery Court with exclusive jurisdiction over advancement claims brought under Section 145 of the DGCL, the carve-out applies to advancement actions.

The Chancery Court rejected this argument, noting that the advancement provision of the LLC agreement did not incorporate the DGCL with respect to plaintiffs’ contractual advancement rights. Even if it did, however, the Court found that the carve-out would still not apply, because the references to the DGCL in the LLC’s advancement provision related to defining the fiduciary duties of the Managers of the LLC, clarifying that they would be interpreted consistently with the DGCL. Moreover, the Court determined that even if the references to the DGCL were interpreted as applying to a contractual right to advancement, the plaintiffs’ argument still failed. The Court reasoned that the unambiguous language of the forum selection carve-out states that it applies only if a legal proceeding is required to be brought in Delaware under the LLC Act or DGCL. The Court noted that, although the DGCL gives the Chancery Court “exclusive jurisdiction” to hear advancement claims, it does not require an advancement proceeding to be brought in Delaware Chancery Court to the exclusion of all other jurisdictions. Thus, because neither the DGCL nor the LLC Act require an advancement action to be brought in Delaware, the carve out did not apply and the defendant’s motion to dismiss was granted.
Founders’ Choice: Making The Case For Limited Liability Companies (“LLC”) For Venture-Backed Startup Companies

By: Raul Escatel
Escatel Tax Law
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INTRODUCTION

Working in the San Francisco Bay Area, I regularly advise entrepreneurs on choosing the most favorable legal entity for starting a new business. Founders typically establish their high-growth startups as C-corporations under the assumption this structure is required by venture capital funds for financing. But founders do not appreciate (1) the significant tax advantages available to them under the LLC structure in the several years they are growing their business, and (2) their startup can easily convert to a corporate structure if required by funders.

Why do startups use the corporate structure at all?

Venture capital funds have generally directed entrepreneurs to use a corporate structure for two reasons. First, only corporations can issue an Initial Public Offering (“IPO”). This might have been valid rationale for founders 20 years ago but no longer. Recent statistics reflect a slowdown in IPOs: 111 IPOs per year between 2001 and 2015 compared to 310 IPOs per year between 1980 and 2000. Given the reality that few startups will quickly go public, the prospect of a future IPO is not a sufficient reason to justify the corporate structure and attendant loss of tax advantages of the LLC.

Second, venture funds avoid investing in LLCs because the LLC generates income that passes-through to the fund’s investors, many of which are themselves tax-exempt and subject to the rules regarding Unrelated Business Taxable Income (“UBTI”)/Effectively Connected Income (“ECI”). But the flexibility of the LLC structure and a good advisor can allow use of an LLC while ensuring that venture funds need not worry about UBTI/ECI. For instance, a “blocker corporation” can be formed, allowing a venture capital fund to invest in this intermediate entity, which then invests in the LLC. The blocker will capture and pay corporate taxes on any operating business income from the LLC, ensuring that no UBTI/ECI reaches the venture fund’s investors. Moreover, in the event a startup is required to be structured as a corporation, the LLC can easily convert into a corporation, generally tax-free.

Although there are additional costs associated with using the LLC model for a startup, they are far outweighed by the benefits afforded to a startup’s growth.

Can an LLC model a corporation’s management and ownership?

How is the management and ownership structured in an LLC?

The LLC’s flexibility offers founders wide latitude in meeting their governance and ownership needs because the laws governing LLCs do not require the formalized governance and operating approach required for corporations. For founders who want a corporate-like governing structure, the LLC’s operating agreement essentially covers the same ground the charter, bylaws and stockholder agreements do for a corporation and can be structured to mimic the shareholder-

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1 For purposes of this article, all references to “corporation” refer exclusively to a c corporation.
3 Many of the typical investors in venture funds are tax-exempt investors such as pension funds and foreign persons. The investment gains are generally not subject to U.S. taxation. However, one major exception is UBTI, which is generally income from a trade or business. See I.R.C. §§511, 512 and 513. Therefore, income from a trade or business conducted by an LLC, would be taxable in the hands of the tax-exempt investors in the venture fund. Similarly, foreign investors are subject to tax on such trade or business income, known as ECI, i.e., income effectively connected with a U.S. trade or business. See I.R.C. §§ 864, 871, 881 and 882. As a result, many venture capital funds place limits or outright prohibitions upon investments by the fund that will generate UBTI or ECI.
4 A “blocker” is a special purpose corporation formed in order for a venture capital or private equity fund to invest in a company classified as a pass-through entity for tax purposes. The fund puts money into the blocker corporation, which in turn invests in the company.
director structure of a corporation. An operating agreement will confirm material matters, such as the management structure and responsibilities (for instance, including officers for day to day management), voting rights, financial allocations, issuing and/or transferring ownership interests, tax matters, fiduciary relationships, indemnity, dissolution and liquidation of the LLC.

Can an LLC issue equity incentive compensation to key employees similar to that found in a corporation?

Founders in startups often want to reward their employees by using stock as equity compensation. Most young entrepreneurs understand the concept of stock options as a form of compensation but may not be aware that an LLC can also issue equity based compensation to reward its employees (also referred to as service providers). The LLC issues equity compensation in the form of a “profits interest” which provides a flexible form of equity compensation that can be designed to support a wide range of business objectives in an LLC. There are two basic types of membership units: capital interests and profits interest. A capital interest is similar to a common share in a corporation. It normally results from a capital investment and provides participation in current and future equity value, a share of income, and distributions. Capital interests can also include features such as a required return or liquidation preferences.

Profits interests are distinct from capital interests. They represent a restricted economic interest and generally provide only a share of a specific future income, which can be ideal for an employee providing his/her services in exchange for growth in the startup. Profits interests issued as equity compensation are usually a junior class of equity and do not have all the rights of capital interests. There is no standard definition for the terms of a profits interest. Quite simply, it’s whatever the parties agree to, or just identified as any equity unit that is not a capital interest. This flexibility in the design of profits interest is an attractive component in the use of LLCs in equity compensation.

A particular advantage of profits interests (as compared to restricted stock in a corporation) is the ability to issue such interests at any time in the life cycle of a company without tax to the recipient. In the case of restricted stock, the value of the shares will increase as the company matures and that means the price to be paid for the shares by the service provider must increase or the service provider incurs a substantial tax on the compensation income once the restriction lapses, or is treated as lapsed pursuant to a special election (“83(b) election”). In the case of profits interests, the Internal Revenue Service has issued special safe harbor valuation rules permitting the recipient to treat the value of the interest as zero so long as the interest is subordinate to the market value of all other equity outstanding on the day of grant. The value of the outstanding equity is determined by assuming that the business is sold and then liquidated in accordance with the provisions of the governing documents. Simply put, the receipt of a profits interest is not a taxable event to the service provider, no matter when in the life cycle of the business it is granted, and distributions of sales proceeds can qualify for capital gains treatment. In addition, the interests can be granted with customary performance and time vesting provisions.

CONCLUSION

It is time to disrupt tradition and rethink how venture deals are structured and documented. The flexibility of the LLC should make it the entity of choice (or go to) for entrepreneurs developing new technologies, with the potential for high-growth. Since the pressure for entrepreneurs to incorporate or convert into a corporation is considerable, it is important for startups and their founders to be fully aware of the implications of adopting one structure vs. another.

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5 For instance, and LLC can structure their LLC to be a manager-managed LLC with a board of directors and other corporate-like features. However, note that if you opt into a corporate-like LLC governance structure and you don’t want corporate law rules to apply by analogy presumably you will have to say so very explicitly in your governing documents. See Obeid v. Hogan, C.A. No. 11900-VCL (Del. Ch. June 10, 2016).

6 I.R.C. section 83(b).

No Implied “Disinterested” Requirement as to Approving Transfers of LLC Interests or Freeze-Out Merger

By: Peter A. Mahler
Farrell Fritz, P.C.
New York, New York

Thomas E. Rutledge
Stoll Keenon Ogden PLLC
Louisville, Kentucky

A recent decision from the New York Supreme Court (i.e., the trial court), Huang v. Northern Star Mgmt. LLC,1 provides interesting guidance with respect to both squeeze out mergers and transfers of LLC interests. In effect, this decision held that neither transaction is subject, absent private ordering to the contrary, to a disinterested requirement. This decision follows on a number of other New York decisions wherein the courts have rejected procedural barriers to squeeze out mergers. See Stulman,2 Alf Naman,3 Slayton4 and SBE Wall.5

Tai Huang was a member in Northern Star Management LLC, a New York LLC, holding a 13.5% interest therein. Ling Lian Huang held another 13.5% interest, while Jian Chai Qu held a 6% interest; those three comprised the “Minority Members.” The balance of the 67% interest in Northern Star (“NSM”) was held by four unnamed and otherwise undifferentiated members (the “Majority Members”). NSM was a single-asset realty holding company that owned a mixed use property in Flushing, New York.

After the settlement of litigation between the Minority Members and the Majority Members regarding the financing of NSM property, the Majority Members effected a cash-out merger of the Minority Members. This was accomplished by: (i) the Majority Members causing to be created NewCo; (ii) the Majority Members transferring to NewCo their respective interests in NSM, receiving in return interests in NewCo; (iii) NewCo approving, as the Majority Member of NSM, a merger of NewCo with and into NSM pursuant to which all other members of NSM (i.e., the Minority Members) were cashed-out. Under the merger agreement, Newco’s membership interest in Oldco was cancelled for no consideration and the Oldco membership interests held by the three minority members were converted into the right to receive approximately $2.9 million cash.

Two of the three Minority Members sought to set aside the merger on the basis that NewCo was not a member of NSM because the Majority Members’ transfers of LLC interests to it violated § 9.3 of the NSM operating agreement. Section 9.3 of the NSM Operating Agreement provided that:

[a] Member may freely transfer his interest in [NSM] to another person or entity…, only with the prior majority consent of other Members either in writing or at a meeting called for such purpose. If majority Members do not approve of the transfer, the transferee shall have no right to participate in the management of the business and affairs of [NSM] or become a Operating Member.

The Minority Members asserted that § 9.3 required the approval of a disinterested majority of the members in order to effect a transfer of interests in NSM to NewCo. The court refused to read into the operating agreement a limitation to the “disinterested” membership. Rather:

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Despite the Huangs's contentions, Section 9.3 of the NSM Operating is completely devoid of the term “disinterested,” which is the crux of the Huangs’s application. The plain language of the provision the Huangs cite to clearly permits a member to transfer their membership interest upon approval by a simple majority of members. It does not state that a majority of the disinterested members is required, as the Huangs assert. (emphasis added by court)

From there the court concluded:

NSM and [NewCo] clearly established that for each of the four Majority Members each obtained majority consent from the other three Majority Members for their respective transfers. In each instance, the three non-transferring Majority Members held over 33% of the NSM membership interests, which was the collective NSM membership interest of the Minority Members. Consequently, the Minority Members never held enough membership interest in NSM to prevent or challenge the transfers.

The first takeaway is that absent the operating agreement requiring a disinterested vote, one will not be implied. Nothing too surprising there, although it should be recognized that where “unanimous” consent is required, courts have inserted a disinterested requirement to avoid absurd results.6

Perhaps of greater import, the court did not aggregate the Majority Members in assessing the transfer of the LLC interests in NSM to NewCo. Rather, each member’s assignment was approved, inter alia, by the other members within the Majority Members; it was as if there were four distinct transfers, each approved by the other of the Majority Members. Had there been aggregation, none of the Majority Members could have voted to admit NewCo as a substitute member, and only the Minority Members, they not participating in the capitalization of NewCo, could have done so. Assuming disaggregation of members who are acting in concert is the correct rule, it presents questions as to how an operating agreement should provide for disinterested votes. Consideration needs to be given to whether and when aggregate treatment will be provided for, being aware that on certain facts aggregation may have the effect of vesting control in a minority.

For example, the default rule under the Kentucky LLC Act is that the admission of an assignee as a member requires the approval of a “majority-in-interest” of the members.7 The Act is express that the member seeking to assign a limited liability company interest may not (unless there is a contrary provision in the operating agreement) vote with respect to the admission of the assignee as a member.8 It is, however, silent as to collective action by several members, and is likewise silent as to an assignee’s ability to vote with respect to admission as a member vis-à-vis an additional tranch of interests.

Assume there is an LLC with 8 equal (12.5%) members. Five of those members want to transfer their interests to Laura (not already a member). In series, each of the five could transfer their interests to Laura as follows:

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6 See, e.g., Young v. Ellis, 172 Wash. App. 1014 (Wash. Ct. App. Div. 2, Dec. 4, 2012) (where managing member of LLC was named in the operating agreement, and amendment of operating agreement required unanimous consent of the members, court rejected as “absurd” suggestion that managing member could be removed only with his consent. Rather, the operating agreement’s general rule of majority consent of the members would apply to removal of managing member.).

7 See, e.g., KRS § 275.265(1). See generally 1 LARRY E. RIBSTEIN AND ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES, Appendix 7-8 (cataloging thresholds for admission of an assignee as a member).

8 Id.
<table>
<thead>
<tr>
<th>Assignor</th>
<th>Laura’s Cumulative Interest Pre-Assignment</th>
<th>Assignment &amp; Admission of Laura as a Member Approved By</th>
<th>Laura’s Cumulative Interest Post-Assignment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Member 1</td>
<td>0%</td>
<td>Members 2, 3, 4 &amp; 5 (57.14% of all interests other than those held by Member 1)</td>
<td>12.5%</td>
</tr>
<tr>
<td>Member 2</td>
<td>12.5%</td>
<td>Laura and Members 3, 4 &amp; 5</td>
<td>25%</td>
</tr>
<tr>
<td>Member 3</td>
<td>25%</td>
<td>Laura and Members 4 and 5</td>
<td>37.5%</td>
</tr>
<tr>
<td>Member 4</td>
<td>37.5%</td>
<td>Laura and Member 5</td>
<td>50%</td>
</tr>
<tr>
<td>Member 5</td>
<td>50%</td>
<td>Laura</td>
<td>62.5%</td>
</tr>
</tbody>
</table>

Applying the rule of independent legal significance, Members 6, 7 and 8 have had no voice with respect to Laura’s admission as a member. If, however, that result is not desired, then the operating agreement will need to: (i) waive the application of the rule of independent legal significance; (ii) adopt a test for aggregation; and (iii) provide that no participants in an aggregated transaction may vote with respect to the admission of the assignee as a member.

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9 See, e.g., KRS § 275.003(5) (“Action validly taken pursuant to one (1) provision of this chapter shall not be deemed invalid solely because it is identical or similar in substance to an action that could have been taken pursuant to some other provision of this chapter but fails to satisfy one (1) or more requirements prescribed by such other provision.”).
Every LLC Act, as a default rule, requires some threshold of the members to approve the admission of an assignee as a member in the company. Often left unaddressed is whether an assignment among the members results in (a) the assignee being, with respect to the assigned interest, treated as a member or (b) treats the assignee, with respect to the assigned interest, as an assignee. In an article recently published in the Journal of Passsthrough Entities, I reviewed two decisions, one from Delaware and one from North Carolina. The Delaware decision, *Achaian, Inc. v. Leemon Family LLC*, is of little assistance in that it is the interpretation of what can be fairly characterized as curious language in the subject limited liability company agreement.

The second decision reviewed in that article is *Blythe v. Bell*. The one advantage of the *Blythe* decision is that it interpreted essentially the default rules of the statute. In this decision, the North Carolina Business Court determined that upon an assignment of all of the interest from one incumbent member to another: (i) the management rights are fully conveyed to the assignee; (ii) the assignee may exercise the management rights related to the assigned interest.

The recent decision from Louisiana, *Bourbon Investments, LLC v. New Orleans Equity LLC*, came to the opposite conclusion as did the *Blythe* court. Curiously, the *Blythe* decision was not referenced by the Louisiana court.

This dispute arose out of a failed effort to acquire the famous Galatoire’s Restaurant (as well as a related restaurant in Baton Rouge). One of the issues in contention was whether the suit filed against the prior owners was legitimate turned on the question whether it had been validly approved. In support of the notion that there had not been valid approval of the lawsuit, the defendants pointed to certain interest transfers amongst the members of the plaintiff, claiming that required majority approval had not been received. In opposition, the plaintiffs “maintained that the general rule that requires unanimous consent for the transfer of full membership interest in an LLC does not apply where such transfer takes place between current member.” The LLC at issue not having a written operating agreement, the question turned on state law, the court observing that:

La. R.S. 12:1330 provides that a membership interest in a limited liability company is assignable, but such assignment entitles the assignee to only “receive such distribution or distributions, to share in such profits and losses, and to receive such allocation of income, gain, loss, deduction, credit, or similar item to which the assignor was entitled to the extent assigned.” La. R.S. 12:1332 provides that, except as otherwise provided in the articles of organization or in an operating agreement, “[a]n assignee of an interest in a limited liability company shall not become a member or participate in the management of the limited liability company unless the other members unanimously consent in writing.” The statute further states that an assignor continues to be a member unless and until the assignee becomes a member.

Again, the plaintiff would argue “that the transfer restrictions set forth in La. R.S. 12:1332 apply only when the assignment is made to a third party who wishes to become a member of
the LLC.” Rejecting this assertion, the court would find that:

The literal language of the statute does not support Plaintiffs’ interpretation of La. R.S. 12:1332. The plain language of the statute requires unanimous written consent of all members for an assignee to become a member of or participate in the management of the LLC. The statute does not differentiate between a third party assignee and a current LLC member assignee. The fact that the legislature did not draft a separate set of rules for membership transfers between current LLC members further supports the conclusion that the default transfer restrictions apply regardless of whether the assignee is a third party or a current member.

So there you have it. At least under the North Carolina LLC Act, an interest assignment among the members is not subject to the requirement of member approval to constitute the assignee as a member with respect to the assigned interest. In contrast, in Louisiana, the opposite is true, and the consent of the incumbent members is required to constitute a member with respect to an additional assigned interest.

Several state statutes, with greater or lesser precision, address this point. Tennessee exempts the transfer of management rights among members from any requirement of consent from another member. Utilizing a different statutory formula, the same result is dictated by the North Carolina LLC Act. Operating agreements should address the question and provide a clear answer.

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6 See TENN. CODE ANN. § 48-249-508(b)(1) (“A member may, without the consent of any other member, transfer governance rights to another member.”) Thanks to Joan Hemingway for the lead.

7 See NC LLC ACT § 57D-5-04(b) (“[A] transferee of an ownership interest [a term of art defined to mean all of the rights and obligations (economic, management, and others) of an interest owner in a LLC] or portion thereof who is or becomes a member has to the extent transferred to the transferee (i) the rights and powers and is subject to the restrictions and liabilities of a member under the operating agreement and this Chapter with respect to the transferred ownership interest.” (emphasis added). Thanks to Warren Kean for the lead.

8 See 15 Pa. C.S. § 8851(b) (“Only right that may be transferred. — A person may not transfer to a person not a member any rights in a limited liability company other than a transferee’s ownership interest.”) See also Pa. Drafting Committee Comment:

This section is patterned after UNIFORM LIMITED LIABILITY COMPANY ACT (2006) (Last Amended 2013) § 501. Absent a contrary provision in the operating agreement or the consent of the members, a “transferable interest” is the only interest in a limited liability company that can be transferred to a non-member. See 15 Pa.C.S. § 8852. As to whether a member may transfer governance rights to a fellow member, the question is moot absent a provision in the operating agreement changing the default rule, see 5 Pa.S. § 8847(b)(2), allocating governance rights per capita. In the default mode, a member’s transfer of governance rights to another member: (i) does not increase the transferee’s governance rights; (ii) eliminates the transferor’s governance rights; and (iii) thereby changes the denominator but not the numerator in calculating governance rights.

Thanks to Lisa Jacobs for the lead.
WORTH READING

Mohsen Manesh, The Case Against Fiduciary Entity Veil Piercing, 72 BUSINESS LAWYER 61 (Winter 2016-17).


PLANNING AHEAD

The Committee on LLCs, Partnerships and Unincorporated Entities will meet three times in 2017: at the Spring Meeting of the Section on Business Law, at the Annual Meeting of the Section of Business Law, and at the 2017 LLC Institute. Looking forward:

<table>
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<th>Event</th>
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<tr>
<td>2017 ABA BLS Annual Meeting Chicago, Illinois</td>
<td>September 14-16, 2017</td>
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<tr>
<td>2017 LLC Institute Arlington, Virginia</td>
<td>November 3-4, 2017</td>
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<tr>
<td>2018 ABA BLS Spring Meeting Orlando, Florida</td>
<td>April 12-14, 2018</td>
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<td>2018 ABA BLS Annual Meeting TBD</td>
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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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