

The Transactional Lawyer

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Protecting the “Pick-Your-Partner” Principle

Stephen L. Sepinuck

In creating or restructuring a business as a closely held LLC, the members often wish to restrict themselves and each other from transferring a membership interest without the consent of the other owners. The Revised Uniform Limited Liability Company Act, and most state LLC statutes, protect the “pick-your-partner” principle in two ways. First, they generally allow the members to restrict the transfer of all or any portion of a membership interest. Second, most of them disassociate the economic rights of membership from governance rights, allowing the transfer of economic rights (e.g., the right to distributions) while not allowing the transferee to participate in governance. See, e.g., Rev. Uniform LLC Co. Act § 502(b), (g).

Of course, as with most things relating to an LLC, the operating agreement can alter these rules. See *id.* at §§ 110(a)(1), 407(d)(1). Thus, the operating agreement can permit members to transfer their entire membership interests, subject to whatever approval or conditions the members choose to impose. In drafting such an operating agreement, transactional lawyers need to be careful, as one recent case illustrates.

In *Sherwood Park Business Center, LLC v. Taggart*, [261 Or. App. 609](#) (Or. Ct. App. 2014), the operating agreement for an LLC contained three rules relating to transfers. First, it authorized members to transfer their distribution rights without the consent of other members. Second, it prohibited members from transferring their entire membership interest without

first offering to sell it to the other members. Third, it created an exception to the second rule for a transfer “to a trust or other entity controlled by the Member.”

The purpose of this exception is not clear. Perhaps the members wished to permit themselves to interpose an additional layer of insulation from liability for the obligations of the LLC. Perhaps there were tax reasons for such a transfer. Whatever the reason, the exception then threatened to devour the rule because one member, Taggart, created a new entity, attempted to transfer his membership interest to the new entity, and then transferred his ownership and control of the new entity to a third party. Through these steps, Taggart apparently sought to avoid the right of first refusal. Obviously, this was not consistent with the spirit of the operating agreement, but was arguably permitted under a strict reading of its text.

The trial court ruled against Taggart for two reasons. First, it concluded that Taggart had not properly transferred his membership interest to the new entity because, to do so under Oregon law, he had to provide notice and proof of the transfer to the LLC, which he did not do until after his membership interest was terminated pursuant to the operating agreement. Second, even if he had, his subsequent transfer of the new entity somehow constituted a second, not permitted, transfer of the membership interest.

The Oregon Court of Appeals affirmed on the first ground and declined to reach the second. Thus, if Taggart had provided the LLC with proper notice and proof of the assignment, he might have succeeded in bypassing the right of first refusal and the other restrictions on transfer.

For transactional lawyers, there are two lessons to draw from this case. First, think twice before drafting an operating agreement to permit the transfer of a membership interest to an entity controlled by the transferring member. Such a provision might not really be needed and, as the *Taggart* case illustrates, it creates problems. What the member controls at the time of transfer the member might not control the next day. Put more generally, contractual conditions are like valves in a pipe: once opened and liquid flows through, later closing the valve will not recapture that flow.

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Second, if a transfer of a membership interest to an entity owned and controlled by the transferor is to be permitted, then the agreement should also contain a clause on any subsequent change in the ownership or control of the transferee. But drafting such a clause requires great care and planning. It is doubtful that anything in the LLC operating agreement could actually prevent or restrict a change in the ownership or control of a completely different entity. At most, it could specify what happens to the transferred membership interest. For example, it could provide that any change in ownership or control of the transferee results in termination of the membership interest or of the governance rights associated with that membership interest. Whether this is a desirable result would depend on the nature of the LLC's business and the roles of the various members. If the transferor were the sole managing member and all the other members were passive investors who lacked the expertise and time to run the LLC's business, termination of that member's governance rights might create a vacuum of leadership. Given the complications involved, perhaps the first alternative is the wiser approach.

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Beware – Your Automatic Renewal Might Not Be Automatic

Allen Benson

Several states now have statutes or regulations requiring companies to notify a customer prior to the automatic renewal of a service contract. Many of these rules stipulate that failure to provide the required notification prevents the contract from renewing. One recent decision, *Healthcare I.Q., LLC v. Tsai Chung Chao*, [2014 WL 1775582](#) (N.Y. App. Div. 2014), illustrates this consequence well and provides a stark lesson for service providers and their counsel.

In that case, a physician contracted for coding, billing, and collection services with a health-care services company. The contract was for an initial term of 36 months and was to automatically renew for additional 18-month periods unless either party provided advance written notification of termination. The physician paid for the initial term and for one additional month before his payments ceased. The health-care services company then sued the physician for \$525,000 – the amount it claimed remained due for two renewal periods.

The court ruled that the services contracted for were related to personal property – the physician's patient records – and thus the agreement fit within the scope of [N.Y. Gen. Oblig. Law § 5-903](#), which requires notification in advance of an automatic renewal of a contract for services relating to personal property. Because the health-care services company had not provided that notification, the contract had not renewed and the physician, who had not utilized the services after the initial term, was not liable for any further payment. Thus, by failing to provide the statutorily required notification prior to the automatic renewal, the health care services provider lost more than a half-million dollars in anticipated revenue.

As the two charts on the next page illustrate, customer notification requirements are becoming increasingly common across the country. Many of these statutes and regulations, those identified in the first chart, have a fairly broad scope, covering contracts for a wide variety of services, though most of them apply only to contracts with consumers.

Many other states have more narrow rules that apply only to a single type of services. The second chart identifies a small sample of these more specific statutes.

Transactional attorneys need to be aware of these statutes and regulations, remain vigilant for similar legislation being proposed in additional states, and advise their clients accordingly. Knowledge of these requirements is particularly important if clients conduct business across state lines where different rules may apply because, as *Healthcare I.Q.* illustrates, failure to follow these rules can have severe consequences.

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| Broad Automatic Renewal Notification Requirements | | | | | |
|---|--|--------------|---|--|---|
| State | Citation | Year Enacted | Scope | Brief Explanation | Consequence of Violation |
| Florida | Fla. Stat. § 501.165 | 2010 | Contracts for the provision of services to a consumer with initial term of 12 months or longer. | Written or electronic notification to the consumer 30-60 days before the consumer's renewal cancellation is due. | Automatic renewal is ineffective. |
| Georgia | Ga. Code § 13-12-3 | 2013 | Contracts for the sale or lease of services to a consumer with initial term of 12 months or longer. | Written or electronic notification to the consumer 30-60 days before the consumer's renewal cancellation is due. | Automatic renewal is ineffective. |
| Illinois | 815 ILCS 601/10 | 2010 | Contracts for the sale of products or services to a consumer with initial term of 12 months or longer. | Written or electronic notification to the consumer 30-60 days before the consumer's renewal cancellation is due. | Violation of Consumer Fraud and Deceptive Business Practices Act. |
| New Mexico | N.M. Admin. Code 12.2.11.8 | 2009 | Contracts with a consumer for service, maintenance, or repair. | Written notification to the consumer 30-60 days before the consumer's renewal cancellation is due. | Violation of Unfair Practices Act. |
| New York | N.Y. Gen. Oblig. Law § 5-903 | 1963 | Contracts for service, maintenance, or repair to or for any real or personal property. | Written notification to the customer 15-30 days before automatic renewal. | Automatic renewal is ineffective. |
| Utah | Utah Code § 15-10-201 | 2003 | Contracts with a consumer for service, maintenance, or repair relating to real property with an initial term of 6 months or longer. | Written or electronic notification to the consumer 30-90 days before the consumer's renewal cancellation is due. | Automatic renewal is ineffective. |

| Industry-Specific Automatic Renewal Notification Requirements | | | | | |
|---|--|--------------|---|--|--|
| State | Citation | Year Enacted | Scope | Brief Explanation | Consequence of Violation |
| Arkansas | Ark. Code § 4-86-109 | 2013 | Personal property leases with an initial term longer than 1 year. | Written notification to the lessee 30 days before the lessee's renewal cancellation is due. | Automatic renewal is ineffective. |
| Maine | Me. Rev. Stat. tit. 38, § 2112 | 2003 | Solid Waste Disposal | Written notification to the customer 60-90 days before the customer's renewal cancellation is due. | Automatic renewal is ineffective. |
| South Carolina | S.C. Code Regs. 28-100 | 1990 | Health Club | Written notification to the customer "near expiration" of initial contract. | Violation of Unfair Trade Practices Act. |
| South Dakota | S.D. Codified Laws § 49-31-116 | 2004 | Telecommunications | Written or electronic notification to the subscriber 30-60 days before the subscriber's renewal cancellation is due. | Automatic renewal is ineffective. |

Recent Cases

SECURED TRANSACTIONS

Scope Issues

Jackson Walker LLP v. FDIC,
[2014 WL 1509285](#) (D. Minn. 2014)

Law firm had no security interest in retainer paid to it because the retainer agreement, although it stated that the law firm could apply the retainer to the payment of fees and expenses from time to time, did not commit the retainer as a means to ensure payment and in fact contemplated that the client would timely pay for services through direct billing. Further, the retainer served as advanced payment because the agreement provided that it would be applied toward the final statement. Even if the retainer agreement were a security agreement, the additional \$100,000 retainer provided later was not collateral because the agreement provided that it could only be modified by a signed writing.

Priority Issues

Co-Alliance, LLP v. Monticello Farm Service, Inc.,
[7 N.E.3d 355](#) (Ind. Ct. App. 2014)

Agreement by which secured party in first priority position agreed to subordinate its interest to secured party in third priority position did not result in “complete subordination” to the benefit of the intermediate secured party, and instead resulted in “partial subordination,” which effectively left the intermediate secured party unaffected. The junior secured party steps into the shoes of the senior secured party only to the extent of the lesser of: (i) the amount owed to the senior secured party; or (ii) the amount owed to the junior secured party.

Sturtz Machinery, Inc. v. Dove’s Industries, Inc.,
[2014 WL 1383403](#) (N.D. Ohio 2014)

Lender perfected its security interest in the debtor’s fixtures by filing a financing statement in Pennsylvania, where the debtor was located, even though the fixtures were located in Virginia. The lender’s security interest had priority over the seller’s security interest that was later perfected by a fixture filing in Virginia almost a year after delivery of the goods to the debtor.

Enforcement & Liability Issues

Ross v. Rothstein,
[2014 WL 1385128](#) (D. Kan. 2014)

Summary judgment denied on the commercial reasonableness of the secured party’s sale of stock on the OTCQB market because factual disputes about how that exchange operates left unresolved whether it qualifies as a “recognized market” under § 9-627.

Born v. Born,
[320 P.3d 449](#) (Kan. Ct. App. 2014)

Creditor with a security interest in stock adequately proposed to accept the stock in satisfaction of the secured obligation even though the creditor’s post-default letters to the debtor did not state that the debtor had the right to object or indicate either the amount due or a means of calculating that amount. Although the debtor timely objected to the proposal, because the security agreement limited the secured party’s rights after default to acceptance of the collateral, and thus the secured party could not conduct a disposition, the debtor had to redeem the collateral within a timely manner. Because the debtor did not do so, the secured party became the owner of the stock.

Merit Homes, LLC v. Joseph Carl Homes, LLC,
[2014 WL 1568846](#) (9th Cir. 2014)

Because the bank that made a construction loan received from the borrower a collateral assignment of the construction plans for the benefit of itself, as well as for its successors and assigns, and the borrower warranted that it had received from its predecessors an assignment of all rights to the plans, the bank and its assignee had at least an implied license from the apparent copyright owner – a guarantor and partial owner of the debtor – to use the plans to complete construction.

BANKRUPTCY

Claims & Expenses

In re Khalil,
[2014 WL 1725811](#) (Bankr. C.D. Cal. 2014)

Individual who provided 80% of the funds to acquire property with the debtor as tenants in common was not entitled to 80% of the proceeds of the sale of the property by the bankruptcy trustee or to reimbursement for his larger contribution because the deed did not indicate that the individual and the debtor owned different percentages of the property.

In re C & K Market, Inc.,

[2014 WL 1377573](#) (Bankr. D. Or. 2014)

Although term sheet for DIP loan created an enforceable contract subject to the condition subsequent of court approval, and thus the lender had a claim for the \$250,000 breakup fee when the debtor chose to use another lender for DIP financing, the claim was not entitled to administrative expense priority under § 503(b)(1)(A) because the contract was with the prepetition debtor, not the debtor in possession, and there was insufficient evidence that the contract benefitted the estate (by leading to better financing terms). The creditor was also not entitled to administrative expense priority under § 503(b)(3)(D) because the fee was not an expense or expenditure at all.

Fraudulent Transfers

In re The Brown Publishing Co.,

[2014 WL 1338102](#) (Bankr. E.D.N.Y. 2014)

Prepetition payments that debtor made to a critical service supplier in satisfaction of an obligation of a subsidiary was not an avoidable fraudulent transfer for less than reasonably equivalent value even though the subsidiary was insolvent – and thus the debtor did not receive an indirect benefit of increased equity – because the debtor and its subsidiaries operated as a single entity, commingling all cash, the payment increased the debtor’s borrowing base, and when the debtor later sold the subsidiary, the price paid was based on the subsidiary’s receivables and goodwill, which would have been much less if it had ceased operations.

Ritchie Capital Management, L.L.C. v. Stoebner,

[2014 WL 1386724](#) (D. Minn. 2014)

Security interest granted by a legitimate business to secure a debt owed by the owners and incurred to pay off other investors in a Ponzi scheme was an avoidable fraudulent transfer because, even though the business was not involved in the scheme, the transfer was in furtherance of it.

Reorganization Plans

In re Meridian Sunrise Village, LLC,

[2014 WL 909219](#) (W.D. Wash. 2014)

Because loan agreement prohibited the creditor from assigning the right to payment to anyone other than an “eligible assignee,” the non-eligible assignees to whom the creditor assigned the loan postpetition were not entitled to vote on the debtor’s plan. Even if the assignees could vote, they would be collectively entitled to only one vote.

GUARANTIES & RELATED MATTERS

Peyton Building, LLC v. Niko's Gourmet, Inc.,

[323 P.3d 629](#) (Wash. Ct. App. 2014)

Buyer of leased real estate that did not receive an assignment of the lease or the supporting guaranty could enforce the lease against the tenant because a lease runs with the land, but could not enforce the guaranty because a guaranty does not run with the land.

CP III Rincon Towers, Inc. v. Cohen,

[2014 WL 1357323](#) (S.D.N.Y. 2014)

The creation of a mechanic’s lien on the borrowers’ property did not trigger liability under a clause of the nonrecourse note and guaranty that provided for liability if the borrower failed to obtain the lender’s consent to any “voluntary lien” because mechanic’s liens are involuntary, even if the owner had the funds to pay the lien claimants. The creation of the liens also did not trigger liability pursuant to a clause that provided for liability if the borrower failed to obtain the lender’s consent to any transfer of the collateral because a contrary ruling would render the limitation of the lien clause to voluntary liens meaningless.

RBS Citizens Bank v. Purther,

[2014 WL 2116988](#) (E.D. Mich. 2014)

Guaranty of debt that was limited to 50% of the outstanding balance was ambiguous as to whether the proceeds of the collateral should be deducted before or after calculating the guarantor’s liability.

Wells Fargo Bank v. Osprey Commerce Center, LLC,

[2014 WL 1271460](#) (M.D. Fla. 2014)

Term in guaranty agreements providing that the guarantors “expressly waive[] to the extent permitted by law any and all rights and defenses” was unambiguous and sufficient to waive their suretyship defenses.

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JPMorgan Chase Bank v. East-West Logistics, LLC,
[2014 WL 1292905](#) (Ill. Ct. App. 2014)

Because the guaranty agreement provided that the guarantor waived “all rights and benefits under any laws or statutes regarding sureties,” the guarantor had waived the affirmative defense that the warranty was extinguished when the lender continued to loan funds despite the borrower’s default. A waiver that is clear and unambiguous must be given effect according to its language, even when that language consists of broad statements.

Legendary Investors Group No. 1, LLC v. Niemann,
[224 Cal. App. 4th 1407](#) (Cal. Ct. App. 2014)

Lender whose right to payment was supported by both a letter of credit and a guaranty did not extinguish the debt and thereby release the guarantors by certifying, as required to draw on the letter of credit, that the amount of the draw “represents and covers the unpaid indebtedness” because the amount of the draw was for substantially less than the outstanding debt and because the letter of credit permitted multiple draws, making it clear that the required statement could not mean that every draw was for the entire indebtedness. Moreover, the guarantors waived defenses based on acts by the lender that released either the debt or the borrower.

LENDING & CONTRACTING

Biotronik A.G. v. Conor Medsystems Ireland, Ltd.,
[2014 WL 1237514](#) (N.Y. 2014)

Distribution agreement that limited liability to “general damages” and disclaimed liability for “indirect, special, consequential, incidental, or punitive damage” did not exclude damages for lost profits because, in the context of this type of agreement in which the price paid by the distributor was tied to the price at which it later resold the goods, lost profits were the direct and probable result of the breach of the parties’ agreement.

Nissan World, LLC v. Market Scan Info. Sys., Inc.,
[2014 WL 1716451](#) (D.N.J. 2014)

Despite (i) a hell-or-high-water clause in finance leases, (ii) a clause indicating that the supplier was not the lessor’s agent, and (iii) a merger clause, the lessor was not entitled to summary judgment against the lessee for breach for failing to make a required balloon payment because material facts remained in dispute about whether the supplier was the agent of the lessor and breached an option agreement with the lessees which somehow modified the leases.

Healthcare I.Q., LLC v. Chao,
[2014 WL 1775582](#) (N.Y. App. Div. 2014)

Agreement by which health care services company provided coding, billing, and collection services to physician by collecting, scanning, and uploading patient records and then making those records available to the physician through propriety software was subject to N.Y. Gen. Oblig. Law § 5-903, covering automatic renewal of contracts for service, maintenance or repair to or for personal property, regardless of who owned the patient records. Thus, the automatic renewal clause in the agreement was unenforceable because the health care services company did not timely notify the physician of the renewal.



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