
The Plight of the Bare Naked Assignee

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I. INTRODUCTION AND IRONY²

In 1975, the Massachusetts Supreme Judicial Court decided what has since become an iconic case of the law of closely held corporations, *Donahue v. Rodd Electrotype Company of New England, Inc.*³ The company, Rodd Electrotype, had been founded by two men. One had died, leaving his stock essentially to his widow. The other founder, getting on in years, sought to have the company buy out his holding to the ultimate advantage of his adult children. Not surprisingly, the widow of the deceased founder saw no reason why

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2. The text of this article assumes a basic familiarity with partnership and LLC law. Footnotes provide background for readers lacking that familiarity. As a general matter, the reader may find helpful the following list of uniform acts pertaining to general and limited partnerships. “NCCUSL” refers to the National Conference of Commissioners on Uniform State Laws:

General Partnership Acts

- UPA: Uniform Partnership Act, the first uniform general partnership act, approved by NCCUSL in 1914
- RUPA: Revised Uniform Partnership Act, the revised general partnership act approved by NCCUSL in 1997 (following a series of earlier approved revisions that began in 1992)

Limited Partnership Acts

- ULPA (1916): the original Uniform Limited Partnership Act, approved by NCCUSL in 1916
- RULPA: the Revised Uniform Limited Partnership Act, first approved by NCCUSL in 1976 and substantially revised in 1985
- ULPA (2001): the newest Uniform Limited Partnership Act, approved by NCCUSL in 2001

Limited Liability Company Acts

- ULLCA: Uniform Limited Liability Company Act, the first uniform limited liability company act, approved by NCCUSL in 1996
- Re-ULLCA: the Revised Uniform Limited Liability Company Act, approved by NCCUSL in 2006

3. 328 N.E.2d 505 (Mass. 1975).

company money should redeem the stock of one founder while leaving her to take whatever fate (or that founder's children) might have in store for her.⁴

She sued, and the Supreme Judicial Court ruled in her favor. In doing so, the court made a historic characterization and announced a rule of law that have together remained at the core of the law of closely held corporations for more than thirty years:

Because of the fundamental resemblance of the close corporation to the partnership, the trust and confidence which are essential to this scale and manner of enterprise, and the inherent danger to minority interests in the close corporation, we hold that stockholders in the close corporation owe one another substantially the same fiduciary duty in the operation of the enterprise that partners owe to one another.⁵

For those who study the law of limited liability companies, this famous passage is full of irony, as is the *Donahue* case itself. If Rodd Electrotpe had been founded in the LLC era, then absent a contrary agreement among the founding "members," Mrs. Donahue's claim would have been DOA. Her husband's death would have effected his dissociation from the LLC, which would have stripped him and his estate of any governance rights. The estate and any heirs would have been confined to the role of "bare naked assignee"⁶—with neither management nor voting rights, no rights to information, and no rights even to complain.⁷

Thus, what the *Donahue* court wrote of minority shareholders in a closely held corporation would apply in spades to the assignee of an LLC member: "Although the [entity] form provides . . . advantages for the [owners] (limited liability, perpetuity, and so forth), it also supplies an opportunity for [those in control] to oppress or disadvantage"⁸ those without power. Certainly, member-

4. *Id.* at 511.

5. *Id.* at 515 (footnotes omitted).

6. The author advanced this descriptive phrase while serving as reporter for NCCUSL's project to produce a new uniform limited partnership act. The drafting committee preferred less colorful language, so the official comments refer to "mere transferees." See ULPA §§ 1102(b)(3) cmt., 1106(b)(3) cmt. (2001). Whether described prosaically or colorfully, however, the "mere bare naked transferee assignee" role is characteristic of the LLC structure; the resulting problems are essentially the same regardless of the statute under which an LLC is organized. See CAL. CORP. CODE § 17301(a)(2) (West 2008) (stating "assignee" has no right to participate in management of business and affairs of LLC, or to exercise any rights or powers of a member, unless otherwise provided for in operating agreement); DEL. CODE ANN. tit. 6, §§ 18-702(a), (b)(1) (2008) (noting same rule as California Corporate Code above); RE-ULLCA § 502(a)(3) (2006) (providing "transferee" of member's LLC interest not entitled to participate in management or conduct of company's activities, or to information concerning company's activities).

7. For a partnership case with just such a result, see *Dame v. Williams*, 727 N.Y.S.2d 816, 818 (N.Y. App. Div. 2001) ("[T]he various provisions of the Partnership Law . . . operate to deprive plaintiff of two of the three property rights of a partner [i.e., governance and information rights]. Further, the interest in the partnership that she did receive gives her no rights other than to receive the profits to which decedent would have been entitled had he lived.").

8. *Donahue v. Rodd Electrotpe Co.*, 328 N.E.2d 505, 513 (Mass. 1975).

upon-member oppression occurs within limited liability companies⁹ (like shareholder-upon-shareholder oppression within close corporations), but the LLC form gives rise to something more. A new and separate opportunity for oppression exists because LLC law purports to (1) recognize a species of persons holding legal rights vis-à-vis the LLC (assignees) while (2) denying those persons any remedies whatsoever in connection with those rights.

This article addresses the conceptual mechanics, history, and ultimate instability of that denial. The article also considers a note of irony—namely, that the plight of the “bare naked assignee” derives from a construct, the organization as “aggregate,” that LLC law has in all other respects emphatically transcended.

To understand the plight of the assignee of an LLC interest, one must first understand a bit of partnership law and history. Part II provides that necessary foundation, acknowledging that assignee vulnerability is a built-in aspect of partnership law. Part III examines how partnership law and even the original Uniform Limited Liability Company Act (ULLCA) limited that vulnerability, at least theoretically, and how the notion of a partnership with a perpetual term eliminated even that theoretical limit.

Part IV describes and characterizes the state of affairs for assignees under LLC law, explains the countervailing practical concerns (“freeze the deal” versus “oppression unlimited”), and shows how the drafters of the newest uniform LLC Act (Re-ULLCA) chose to “punt” to “other law.”¹⁰ Part V provides two different conceptual approaches for use by “other law.” One approach assumes that under LLC law a member’s assignment of rights constitutes an assignment of contractual rights under the operating agreement. The other approach assumes that the assignment is merely a transfer of property rights vis-à-vis the LLC. In its own way, each approach could equip courts with sufficient authority in “extreme and sufficiently harsh circumstances . . . to protect [assignees] against expropriation.”¹¹ Part VI provides an account of an unreported trial court decision, in which the judge fashioned a remedial approach worth considering and concludes with the author’s suggestion for further refining that approach.

II. THE “PICK YOUR PARTNER” PRINCIPLE AND ASSIGNEE VULNERABILITY

The “pick your partner” principle has always been at the core of U.S. partnership law. “Absent the consent of fellow partners, a partner simply lacks

9. See CARTER G. BISHOP & DANIEL S. KLEINBERGER, *LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW* ¶ 10.09 (RIA 2008); Sandra K. Miller, *The Role of the Court in Balancing Contractual Freedom with the Need for Mandatory Constraints on Opportunistic and Abusive Conduct in the LLC*, 152 U. PA. L. REV. 1609 (2004).

10. RE-ULLCA § 112(b) cmt.

11. *Id.*

the power to convey to any outsider any role in the partnership's management or governance"¹² Partnership is a voluntary association, resting on a contract (express or implied) to co-own a business. That contract co-exists with, and the business depends on, a relationship of trust and confidence among the co-owners who choose to co-associate.

As a matter of basic definition, "voluntary association" entails the power to pick one's associates, and partnership statutes have always protected that power. Absent a contrary agreement,¹³ partnership law requires unanimous consent to admit a new partner, and therefore a partner's right to alienate his, her, or its ownership interest is necessarily strictly limited. Economic rights are freely transferable. Governance rights are not.

In the original 1914 Uniform Partnership Act (UPA), the "admission" requirement is stated simply, but the transfer restrictions are not. UPA § 18(g) provides, "No person can become a member of a partnership without the consent of all the partners."¹⁴ In contrast, UPA §§ 26 and 27 must be read together to understand that the law bifurcates a partner's ownership interest into (1) economic rights and (2) rights to participate in, manage, and have information about the partnership.

Section 26 states, "A partner's interest in the partnership is his share of the profits and surplus, and the same is personal property."¹⁵ Section 27, captioned "Assignment of Partner's Interest" expresses no restriction on such a transfer, but does however strictly delimit a transfer's effect. Per subsection (1),

A conveyance by a partner of his interest in the partnership does not . . . as against the other partners in the absence of agreement, entitle the assignee, during the continuance of the partnership, to interfere in the management or administration of the partnership business or affairs, or to require any information or account of partnership transactions, or to inspect the partnership books; but it merely entitles the assignee to receive in accordance with his contract the profits to which the assigning partner would otherwise be entitled.¹⁶

The Revised Uniform Limited Partnership Act (RULPA) takes essentially the same approach, although moving the crucially limited definition of

12. Daniel S. Kleinberger, *The Closely Held Business Through the Entity-Aggregate Prism*, 40 WAKE FOREST L. REV. 827, 833 (2005).

13. Given the heavy contractual aspects of both partnerships and LLCs, the owners can of course increase their power of assignment and increase the rights of assignees. See DANIEL S. KLEINBERGER, AGENCY, PARTNERSHIP, AND LLCs: EXAMPLES & EXPLANATIONS (3d ed. Aspen 2008) [hereinafter APLLC]; BISHOP & KLEINBERGER, *supra* note 9, ¶ 8.06[2][c]. Such arrangements are unusual, and this article deals with the more typical circumstance in which the contract among the owners either leaves in place or re-affirms the built-in statutory restrictions on transfer.

14. UPA § 18(g) (1914).

15. *Id.* § 26.

16. *Id.* § 7(1).

“partnership interest” to the statute’s definition section¹⁷ and expressly providing for that interest’s assignability.¹⁸ The result is the same: “An assignment of a partnership interest does not . . . entitle the assignee to become or to exercise any rights of a partner. An assignment entitles the assignee to receive, to the extent assigned, only the distribution to which the assignor would be entitled.”¹⁹

Beginning with the Revised Uniform Partnership Act (RUPA), the Uniform Law Commissioners have sought to state the matter more directly and to use the more inclusive term “transfer” rather than “assign.” The construct, however, has remained essentially the same. The “pick your partner” principle controls a partner’s power to transfer rights relative to the partnership.

In fact, the RUPA formulation emphasizes that point even further by stating, “The *only* transferable interest of a partner in the partnership is the partner’s share of the profits and losses of the partnership and the partner’s right to receive distributions.”²⁰ Moreover, while transfer of these economic rights “is permissible,”²¹ the transfer of economic rights occurs naked of any governance role.²²

In theory, at least, if a transferee obtains rights from a person who remains a partner, the transferee may shelter under the rights of the transferor. If, for example, the transferee suspects that a new contract between the partnership and an affiliate of one of the other partners is bleeding profits out of the company (and thereby away from the transferee), the transferee can push the transferor partner to demand information and, as appropriate, take further action.²³ When, however, the transferor ceases to be a partner, the assignee is left naked—owning potentially valuable economic interests but by statute stripped bare of any means to protect those interests.

*Dame v. Williams*²⁴ illustrates the point succinctly. The case concerned a general partnership whose “stated purpose was the acquisition, development and management of real property investment opportunities.”²⁵ The original

17. RULPA § 101(10) (1976) (“‘Partnership interest’ means a partner’s share of the profits and losses of a limited partnership and the right to receive distributions of partnership assets.”).

18. *Id.* § 702 (“Except as provided in the partnership agreement, a partnership interest is assignable in whole or in part.”).

19. *Id.*

20. RUPA § 502 (1997) (emphasis added).

21. *Id.* § 503(a)(1).

22. *Id.* § 503(a)(3) (stating transfer “does not, as against the other partners or the partnership, entitle the transferee, during the continuance of the partnership, to participate in the management or conduct of the partnership business, to require access to information concerning partnership transactions, or to inspect or copy the partnership books or records”).

23. A person obtaining a transfer in return for value would be prudent to insist upon such rights. If the transfer occurred pursuant to a contract, it might also be possible to find an implied term obliging the transferor to act to avoid the transferee being denied the fruits of the bargain.

24. 727 N.Y.S.2d 816, 818 (N.Y. App. Div. 2001).

25. *Id.* at 817.

managing partner had that role for fifteen years, until health problems caused him to resign that position while remaining a partner. He died two years later, and in due course his widow, acting as his executor, brought suit against the successor managing partner. The court rejected her claims essentially out of hand (i.e., for failing to state a claim) because the estate was nothing but a bare naked assignee. The court quoted New York Partnership Law § 51 (equivalent to UPA § 26), which expressly precludes an assignee from asserting management or informational rights, and then stated,

As can be seen, the various provisions of the Partnership Law hereinbefore set forth operate to deprive plaintiff of two of the three property rights of a partner [i.e. to participate in management and to have information]. Further, the interest in the partnership that she did receive gives her no rights other than to receive the profits to which decedent would have been entitled had he lived (see, Partnership Law § 53[1]).²⁶

*Bauer v. Blomfield Co./Holden Joint Venture*²⁷ further illustrates the assignee's plight. In that case, an assignee of a partnership interest sought to object to a commission arrangement between the partnership and a third party because the arrangement had the effect of drying up all profits and thereby depriving the assignee of any value from the assigned interest. All the partners had approved the commission arrangement, and the court majority flatly rejected the assignee's right to object. A mere assignee "was not entitled to complain about a decision made with the consent of all the partners."²⁸

The results in *Dame* and *Bauer* may seem harsh, but they are the inevitable consequence of the "pick your partner" principle and representative of the law on this issue in the partnership realm.²⁹ Although the case law is scant, it all points in the same direction.³⁰ Those who own the business owe neither a duty

26. *Id.* at 818. The court could have rested its decision on an amendment to the partnership agreement, but preferred instead to see that amendment as reflecting the rules of the statute:

Nor are we persuaded that the 1982 amendment to the partnership agreement provided plaintiff with any greater rights. When read in conjunction with the language "said executor shall take no active part in the conduct of the partnership affairs nor shall said executor be required to devote any of his or her time to the partnership affairs," the language "the partnership shall continue with the executor of the deceased partner substituted in the place and stead of the deceased partner" strikes us as entirely consistent with the provisions of Partnership Law § 53(1).

Id.

27. 849 P.2d 1365 (Alaska 1993).

28. *Id.* at 1367.

29. See RE-ULLCA § 112(b) cmt. (2006) (discussing *Bauer*).

30. Of course, the partners may agree to different arrangements. See, e.g., *Jacoby v. Feldman*, 146 Cal. Rptr. 334, 339-40 (Cal. App. 1978) (construing partnership agreement to accord non-voting partner status to estate of deceased partner and holding "it would be unreasonable to construe the amended partnership agreement as totally precluding a nonvoting member of the . . . partnership from ever being able to resort to a

of good faith nor a fiduciary duty to mere assignees.³¹ In practical terms, the “pick your partner” principle means, “Our business is our business, and we collectively decide who’s got a right to stick a nose into our business.”

III. DURATION BECOMES PERPETUAL AND SO TOO DOES ASSIGNEE VULNERABILITY

The “pick your partner” principle first developed when most partnerships were either juridically fragile, short term, or both. Under the UPA, a general partnership was either at will or limited to a particular term or undertaking.³² Moreover, the dissociation of any partner caused the partnership to dissolve regardless of term or undertaking.³³ Before ULPA (2001), limited partnership law required each partnership to have a limited term of existence³⁴ and the dissociation of any general partner could put a limited partnership’s existence in doubt.³⁵

These limits were linked to some protection of assignee rights. The UPA, RULPA, and RUPA each seem to reflect a notion that an assignee’s vulnerability ought not extend beyond the partnership term in effect when the assignment took place:

- UPA § 32(2) permits an assignee to seek judicial dissolution of an at-will general partnership at any time and of a partnership for a term or undertaking if the partnership continues in existence after the completion of the term or undertaking.
- RULPA § 201(a)(1)(4) requires the certificate of limited partnership to state “the latest date upon which the limited partnership is to dissolve” Linkage [to the underlying general partnership act] arguably makes UPA § 32 applicable and permits an assignee to bring suit if a limited partnership continues past the term stated in its certificate.³⁶

court of equity to seek redress from improper partnership management.”).

31. See BISHOP & KLEINBERGER, *supra* note 9, ¶ 8.06[2][e] (“Non-Statutory Protections for Mere Transferees”).

32. UPA § 31(1)(a)-(b) (1914) (stating dissolution of UPA partnership caused “[b]y the termination of a definite term or particular undertaking, [or] by the express will of any partner when no definite term or particular undertaking is specified” in partnership agreement).

33. *Id.* § 31(1)(b). Therefore, had the *Donahue* situation occurred within a UPA partnership, the widow would have had significant rights. See *Id.* § 42 (Rights of Retiring or Estate of Deceased Partner When the Business is Continued).

34. See RULPA § 201(a)(1)(4) (1976) (requiring certificate of limited partnership to set forth “the latest date upon which the limited partnership is to dissolve”).

35. See *Id.* § 801(4) (providing dissociation of general partner causes dissolution automatically unless, within 90 days of dissociation, all partners agree to continue business; and if there is no remaining general partner, all partners must agree to appoint a replacement general partner).

36. See *Id.* § 1105 (providing for linkage to general partnership statute). Because RULPA § 802 addresses judicial dissolution, it is arguable that linkage does not apply. However, because the RULPA provision does not address the situation covered by UPA § 32, it is also arguable that linkage does apply. For an explanation of linkage, see APLLC, *supra* note 13, at 427-28 (explaining RULPA not “stand alone” statute)

- RUPA § 801(6) is the same as UPA § 32, except the RUPA provision requires the court to determine whether dissolution is equitable.³⁷

Of course the “LLC at 20” has a perpetual term,³⁸ and ULPA (2001) presaged the consequences for assignee rights of perpetual duration. Early versions of what became ULPA (2001) carried forth both the related notions that (1) a limited partnership should have a limited term of duration and (2) assignees might have some right to judicial intervention if the partners somehow played “fast and loose” with that end date.

Consider, for example, section 802(b) of the February 1998 discussion draft of what was then colloquially labeled “Re-RULPA”:

(b) On application by or for a transferee the [designate the appropriate court] court may decree dissolution of a limited partnership if:

- (1) the limited partnership amended its certificate of limited partnership to extend the limited partnership’s term after having notice of the transfer or entry of the charging order that gave rise to the transferee’s interest;
- (2) the limited partnership’s term would have expired but for that amendment; and
- (3) it is equitable to dissolve the limited partnership and wind up its business.³⁹

The provision persisted through the October 1998 draft⁴⁰ and the March 1999 draft, although a comment to the latter stated, “Query whether this provision should remain, given that the default term is [now] perpetual duration.”⁴¹ The query was answered, in the negative, at the March 1999 drafting session, and this remnant of assignee protections disappeared.⁴² The disappearance was conceptually inevitable because the protection was premised on a partnership that had a limited term.

and *Prefatory Note* to ULPA (2001).

37. APLLC, *supra* note 13, at 567 (footnotes omitted). Also, RUPA § 701 provides for the buyout of a dissociated partner’s economic interest if the dissociation does not lead to dissolution.

38. CAL. CORP. CODE § 17051(c)(3) (West 2006) (providing articles of organization may, but need not, include the time at which the LLC is to dissolve); DEL. CODE ANN. tit. 6, § 18-801(a)(1)(2008) (providing LLC has perpetual duration unless operating agreement provides otherwise); MASS. GEN. LAWS ANN. ch. 156C, § 12(b) (West 2008) (providing LLC’s existence shall continue until cancellation of company’s certificate of organization); RE-ULLCA § 104(c) (2006) (providing LLC has perpetual duration).

39. RE-RULPA § 802(b) (Discussion Draft Feb. 1998), *available at* http://www.law.upenn.edu/bll/archives/ulc/lp/lp298.htm#N_114_ (endnotes omitted). Endnote 391 stated that “this provision is derived from RUPA § 801(6)(i), which was also the source for ULLCA § 801(5)(i).” *Id.*

40. RE-RULPA (Discussion Draft Oct. 1998), *available at* http://www.law.upenn.edu/bll/archives/ulc/ulpa/rulp1098.htm#N_415_.

41. RE-RULPA § 802(b), draft cmt (Discussion Draft March 1999), *available at* <http://www.law.upenn.edu/bll/archives/ulc/ulpa/rulpa399.htm>; *see also id.* § 201(a)(4), draft cmt (“The reference to the limited partnership’s term is deleted, following the Drafting Committee’s decision at the October, 1998 meeting.”).

42. RE-RULPA § 802, Reporter’s Notes to former subsection (b) (Discussion Draft July 1999), *available at* <http://www.law.upenn.edu/bll/archives/ulc/ulpa/lp712.htm>.

IV. THE LLC AND ASSIGNEE RIGHTS

The limited liability company began as an attempt to create an entity taxed as a partnership but with a corporate-like liability shield. Thirty years ago, the applicable tax classification regulations—the so-called “Kintner Regulations”—identified four key attributes that separated the paradigmatic corporation from the paradigmatic partnership. Phrased in terms of the corporate paradigm, these attributes were limited liability, continuity of life, centralized management, and free transferability of interests.⁴³

Consistent with the way partnership tax is applied, these regulations approached the partnership *vel non* question by viewing a partnership primarily as an aggregate of owners.⁴⁴ Two of the four attributes connected directly to that construct—continuity of life and free transferability of (full) ownership rights. Conceptually and as a matter of statute, the corporation had no “stake” in the identity of its owners. In a partnership, in contrast, the organization was its owners. Thus,

IN THE PARADIGMATIC CORPORATE FORM	IN THE PARADIGMATIC PARTNERSHIP FORM	(CHARACTERISTIC UNDER THE THEN APPLICABLE TAX CLASSIFICATION REGULATIONS—EXPRESSED IN TERMS OF CORPORATE CHARACTERISTICS)
The dissociation of an owner had no effect on the organization’s continued legal existence.	The departure of a general partner either dissolved or threatened the dissolution of the partnership itself.	(Continuity of life)
The corporate statute contains no restrictions on the rights of any owner to transfer full ownership rights to a “stranger.”	Transfer restrictions are a core part of every partnership statute.	(Free transferability of interests)

43. See BISHOP & KLEINBERGER, *supra* note 9, ¶ 2.01; APLLC, *supra* note 13, at 461-62; see also ALAN R. PALMITER, CORPORATIONS: EXAMPLES & EXPLANATIONS 4-5 (5th ed. Aspen 2006).

44. In general, a partnership is not taxed. Instead, profits, losses, etc. are “passed through” to the partners. APLLC, *supra* note 13, at 458 (discussing partnership tax classification).

Under the “Kintner Regulations,” a business organization was classified as a partnership unless it possessed a majority of corporate characteristics. Limited liability was obviously a corporate characteristic, so in the early days of LLCs the planning goal was to structure enterprises to avoid at least two other of the corporate characteristics.

As transactional and tax lawyers “pushed the envelope” on the Kintner Regulations, these practitioners often sought IRS approval for (1) LLCs with centralized management and (2) LLCs that attenuated the connection between owner dissociation and entity dissolution. It was virtually unheard of, however, to “push the envelope” on the free transferability characteristic.⁴⁵ (Most LLCs are closely held, and built-in statutory transfer restrictions are typically seen as quite helpful.)

In 1997, the IRS junked the Kintner Regulations and replaced them with the wide open tax classification regime known colloquially as “check the box.”⁴⁶ Under “check the box,” in general,

- a business organization organized under a corporate or joint stock statute is taxed as a corporation;
- any other business organization:
 - with two or more owners is taxed as a partnership,
 - with one owner is disregarded for income tax purposes, unless the organization elects to be taxed as a corporation (by “checking the box”).⁴⁷

The “check the box” regulations produced almost an avalanche of changes to LLC statutes across the country, as legislatures sought to maximize flexibility.⁴⁸ Without much thought, these changes wrested the LLC away from most of its partnership roots and especially from many aggregate-like characteristics that previously accompanied the “pick your partner” principle.

These changes included:

- eliminating the requirement that an LLC have at least two members (like a general or limited partnership) and authorizing one-member LLCs;
- authorizing operating agreements in one-member LLCs;
- allowing LLCs to have perpetual existence;
- changing the default rule on member dissociation to make dissociation more difficult, either by:
 - depriving members of the power to dissociate, or

45. *See id.* at 462-63.

46. *See* 26 C.F.R. § 301.7701-3(a) (2006).

47. APLLC, *supra* note 13, at 464.

48. BISHOP & KLEINBERGER, *supra* note 9, ¶ 7.

- freezing in the economic interest of dissociated members;
- changing the default rule on the relationship between member dissociation and entity dissolution, either by:
 - providing that member dissociation does not even threaten dissolution, or
 - changing the quantum of consent necessary to avoid dissolution following a member's dissociation⁴⁹

Most LLC statutes retained a governance template that offered a choice between member management and manager management, which somewhat resembled the choice between a general and limited partnership. But, for the most part, “check the box” invited the LLC out of the shadow of venerable partnership constructs. Notably, however, “[s]tates did not . . . change the default rules on transferability of ownership interests.”⁵⁰

The impact on assignee rights has been substantial, for both conceptual and practical reasons. Conceptually, “Even under the most modern LLC statute, the entity remains fundamentally engaged in the identity of its owners through built-in, statutory restrictions on the transfer of governance rights.”⁵¹ Maintaining the “pick your partner” principle within an organization that has jettisoned almost every other aspect of partnership structure inevitably “stacks the deck” against assignees. In fact, the deck is stacked in a manner impossible under the law of corporations:

If the owners [of a corporation] wish to restrict transferability, they may do so by contract. However, their contract-based restrictions will have to be carefully drafted and will be narrowly interpreted by courts if challenged. Moreover, because stock inextricably connects financial rights to at least some governance rights, either:

- the transferee of a shareholder's financial rights will directly have some governance rights (and therefore standing as a shareholder to bring suit if the financial rights are unjustly affected by those in control of the corporation); or
- the original transferor will still be a shareholder and available (and perhaps contractually obligated) to protect the transferee's rights.⁵²

49. APLLC, *supra* note 13, at 464-65.

50. *Id.* at 465.

51. Daniel S. Kleinberger, *The LLC as Recombinant Entity: Revisiting Fundamental Questions Through the LLC Lens*, 14 FORDHAM J. CORP. & FIN. L. (forthcoming 2009).

52. APLLC, *supra* note 13, at 563-64; *see also* Kleinberger, *supra* note 51 (“Severing the nexus between dissociation and entity termination, retaining the entity's engagement in owner transfer (the “pick your partner” principle), and providing for perpetual duration have created a “lock in”/oppression danger inconceivable in the law of close corporations.”).

The naked LLC assignee has no such protections; the practical consequence is a significant increase in the opportunities for oppression in closely held businesses.⁵³

Theoretically, perhaps the easiest solution would be to force LLCs to full entity status—i.e., to eliminate the statutory protection for the “pick your partner” principle and cause LLC members to rely on the contractual protections that have been developed and tested over more than 100 years of close corporation law. Although the rules on such contractual arrangements can be complex, at their essence they allow any reasonable pre-agreed accommodation between the interests of those continuing a business and the interests of those who acquire ownership interests as transferees. The LLC would thus complete its conversion from partnership-like aggregate to corporate-like entity, adopting the corporate approach to free transferability and relying on “private ordering” to limit transferability as appropriate.

Unfortunately, that theoretical dog won’t hunt. If anything the trend may be in the other direction.⁵⁴ To even moot the notion that “pick your partner” ought to be contractual rather than statutory is to risk condemnation for the heresy of “corpufuscation.”⁵⁵

Yet some solution will have to emerge, because the tension between members and assignees is real, substantial, and inevitable. As explained by a comment to Re-ULLCA,

The law of unincorporated business organizations is only beginning to grapple in a modern way with the tension between the rights of an organization’s owners to carry on their activities as they see fit (or have agreed) and the rights of transferees of the organization’s economic interests. (Such transferees can include the heirs of business founders as well as former owners who are “locked in” as transferees of their own interests . . .).

If the law categorically favors the owners, there is a serious risk of expropriation and other abuse. On the other hand, if the law grants former owners and other transferees the right to seek judicial protection, that specter can “freeze the deal” as of the moment an owner leaves the enterprise or a third party obtains an economic interest.⁵⁶

53. These opportunities for oppression are increasing, as the limited liability company replaces the close corporation as the “organization of choice” for most new closely held businesses. Larry E. Ribstein & Bruce H. Kobayashi, *Choice of Form and Network Externalities*, 43 WM. & MARY L. REV. 79, 135 (2001).

54. See, e.g., NEV. REV. STAT. § 86.401 (2007).

55. Kleinberger, *supra* note 12, at 872.

56. RE-ULLCA § 112(b) cmt. (2006); see, e.g., *U-H Acquisition Co. v. Barbo*, Civ. A. No. 13,279, 1994 WL 34688, at *5 (Del. Ch. Jan. 31, 1994) (holding assignee of limited partner had no standing to object to allegedly prejudicial amendment to partnership agreement, obtained in derogation of rights to vote in writing, because at relevant time assignee had not become substituted limited partner).

From the inception of LLCs, all LLC statutes have resolved this conundrum sharply in favor of the owners. Through statutory provisions derived from partnership law, LLC law: (1) expressly limits assignees/transferees to economic rights; and (2) provides that an LLC is governed by its operating agreement, which is defined as an agreement among members. Under LLC statutes, the operating agreement comprises “the rules of the game,” subject to change by agreement of the “players,” and “players” does not include mere assignees.

Re-ULLCA makes starkly clear the consequences for assignees:

The obligations of a limited liability company and its members to a person in the person’s capacity as a transferee or dissociated member are governed by the operating agreement [A]n amendment to the operating agreement made after a person becomes a transferee or dissociated member is effective with regard to any debt, obligation, or other liability of the limited liability company or its members to the person in the person’s capacity as a transferee or dissociated member.⁵⁷

This approach has the virtue of clarity, and according to the official comment, the rule follows the law of partnership as stated in *Bauer*. But *Bauer* had a dissent, which is worth considering carefully:

It is a well-settled principle of contract law that an assignee steps into the shoes of an assignor as to the rights assigned. Today, the court summarily dismisses this principle in a footnote and leaves the assignee barefoot As interpreted by the court, the [partnership] statute now allows partners to deprive an assignee of profits to which he is entitled by law for whatever outrageous motive or reason. The court’s opinion essentially leaves the assignee of a partnership interest without remedy to enforce his right.⁵⁸

V. SURCEASE FOR THE ASSIGNEE: CONTRACT LAW AND PROPERTY LAW

A. *Interest Assignee as Assignee of Contract Rights*

The *Bauer* dissent points to one source of protection for naked assignees. Both partnership law and LLC law view the agreement among the owners as stating the fundamental rules of the owners’ relationships.⁵⁹ Indeed, recently

57. RE-ULLCA § 112(b).

58. *Bauer v. Bromfield Co./Holdon Joint Venture*, 849 P.2d 1395, 1367-68 (Alaska 1993) (Matthews, J., dissenting).

59. See BISHOP & KLEINBERGER, *supra* note 9, § 1.04[3][a] (explaining how partners and LLC members,

the Delaware Court of Chancery went so far as to proclaim that “[i]n the context of limited liability companies, which are creatures not of the state but of contract . . . duties or obligations must be found in the LLC Agreement or some other contract.”⁶⁰

If so, then:

- any assignment of economic rights from an LLC member to an outsider must necessarily involve an assignment of rights under the operating agreement; and
- absent some direction in the relevant LLC statute, ordinary principles of contract law should apply to assignment of those rights.

Contract law does have something to say about the rights of contracting parties to modify their agreement after an assignment has taken effect. The Restatement (Second) of Contracts states that “any modification of or substitution for the contract made by the assignor and obligor in good faith and in accordance with reasonable commercial standards is effective against the assignee. The assignee acquires corresponding rights under the modified or substituted contract.”⁶¹ The Uniform Commercial Code (UCC) provides similarly, in a subsection captioned “Effect of Modification on Assignee”: “A modification of or substitution for an assigned contract is effective against an assignee if made in good faith. The assignee acquires corresponding rights under the modified or substituted contract.”⁶²

Under UCC § 1-201(20), “good faith” is defined as “honesty in fact and the observance of reasonable commercial standards of fair dealing.”⁶³ Therefore, both the Restatement (Second) and the UCC would seem to provide the bare naked assignee recourse against expropriating behavior, assuming that expropriation is outside “commercially reasonable standards.”

There are, however, difficulties with this avenue of analysis. Several concern “fit” —i.e., whether these essentially commercial-law propositions are apposite to contracts that structure the governance of entities. Another difficulty is even more fundamental. This avenue of analysis may rest on a flawed premise: it is questionable whether contract law is the proper doctrine with which to view the assignments of LLC membership interests.

when faced with bankruptcy of co-owner, argue property interest of co-owner should be interpreted as an executory contract involving personal services and therefore exempt from bankruptcy law provisions that override contractual and statutory provisions that apply *ipso facto* upon bankruptcy). For an example of this argument, see *In re DeLuca v. DeLuca*, 194 B.R. 65 (Bankr. E.D. Va. 1996).

60. *Fisk Ventures, L.L.C. v. Segal, C.A.*, No. 3017-CC, 2008 WL 1961156, at *8 (Del. Ch. May 7, 2008) (footnote omitted).

61. RESTATEMENT (SECOND) OF CONTRACTS § 338(2) (1981).

62. U.C.C. § 9-405(a) (2000).

63. *Id.* § 1-201(20).

Understanding the “fit” issue requires understanding some legal history. The UCC and Restatement propositions were developed to overcome a supposed rule of common law that strictly prohibited modifications and novations once the obligor received notice of assignment.⁶⁴ That is, they were intended as a compromise “fix” on a common-law regime that, in light of modern commercial practices, unduly “locked in” and overprotected the rights of assignees.⁶⁵ Therefore, these propositions seem inapposite to contracts adopted within a statutory regime that expressly and repeatedly limits assignee rights.

Likewise, although by their terms the UCC and Restatement propositions encompass any contract and any assignment, they fit at best uneasily with agreements among multiple parties. For example, how would either authority apply when the modification occurs without the consent of the assignor because the assignor has ceased to be a party to the contract? (This situation will always be the case with a bare naked assignee, because by hypothesis the assigning member or partner will have dissociated from the limited liability company or partnership and will therefore no longer be party to the operating or partnership agreement.)

Further, the UCC and Restatement propositions rest on a very thin foundation. In a 1964 article, Grant Gilmore considered “Freedom of the Contracting Parties to Modify or Rescind without the Assignee’s Consent” and remarked that, as to the common law, “The novelty of our subject matter is best illustrated by the fact that the extraordinarily rich literature of the law of contracts contains almost no reference to the problem stated in this subtitle.”⁶⁶ Indeed, a comment to § 9-318 acknowledges that “[t]his rule may do some violence to accepted doctrines of contract law,”⁶⁷ which the comment implies (but does not state) was hostile to any modifications made after the obligor received notice of assignment.

Finally as to “fit,” the Restatement/UCC approach seems to have developed in response to a narrow range of situations—i.e., long-term commercial contracts, in which an assignor’s performance had become difficult or impracticable and the modification or novation was necessary to save the situation. A comment to § 9-318 characterizes the rule as “a sound and indeed a necessary rule in view of the realities of large scale procurement” and further explains,

64. Grant Gilmore, *The Assignee of Contract Rights and His Precarious Security*, 74 YALE L.J. 217, 243 (1964).

65. It is questionable whether the common law actually contained the supposed rule. *See id.* at 249 (“[T]he contract law assumption rests on a flimsy foundation.”).

66. *Id.* at 243. As for the Restatement (Second), it acknowledges frankly that its formulation “follows Uniform Commercial Code § 9-318”—the predecessor to § 9-405(a)—rather than case law.

67. U.C.C. § 9-318 cmt. 2 (1972) (amended 2000). The implication from the comment as a whole is that pre-Code law may have prohibited absolutely any change in a contract once the obligor received notice of the assignment. However, there is little authority for that proposition. *See Gilmore, supra* note 64.

When for example it becomes necessary for a government agency to cut back or modify existing contracts, comparable arrangements must be made promptly in hundreds and even thousands of subcontracts lying in many tiers below the prime contract. Typically the right to payments under these subcontracts will have been assigned. The government, as sovereign, might have the right to amend or terminate existing contracts apart from statute. This subsection gives the prime contractor (the account debtor) the right to make the required arrangements directly with his subcontractors without undertaking the task of procuring assents from the many banks to whom rights under the contracts may have been assigned. Assignees are protected by the provision which gives them automatically corresponding rights under the modified or substituted contract.⁶⁸

Professor Gilmore's article suggests that a major theme of the scant pre-Code case law was comparably narrow: "an assignee of the proceeds of an executory contract takes subject to the right of the obligor to make further advances to the assignor [and thereby decrease the amount eventually due to the assignee], provided that such advances are necessary to enable the assignor to complete the performance of the contract and are so used."⁶⁹

Professor Gilmore also cites a series of "mortgage-milking" cases in which mortgages were secured with an assignment of rents, the mortgagor agreed with lessees to discount the rent in return for prepayment, leaving the mortgagee with significantly reduced security in the event of default.⁷⁰ The courts addressed these cases more from the perspective of property law than contract law, with a very different view on the subject of modification:

The basic assumption of all the case law on "milking" seems to have been that the right of the mortgagor and tenant to deal with each other, without consulting the mortgagee or getting his consent, was so obvious that, in the absence of fraudulent intent, it could not even be questioned On the assumption that good faith adjustments between mortgagor and tenant could not be questioned, the "milking" cases elaborately considered what circumstances might amount to fraud. One proposition that emerged from the discussion was that there was no fraud when the money which the tenant paid the mortgagor was used in the maintenance or operation of the property.⁷¹

That proposition might provide some basis for extrapolating what constitutes commercial reasonableness, but the line of cases bears little resemblance to a context where an agreement is essentially the constitution (or "cornerstone") of

68. U.C.C. § 9-318 cmt. 2 (1972) (amended 2000).

69. Gilmore, *supra* note 64, at 245.

70. *See id.* at 247-49. In Professor Gilmore's words, "[W]hen the mortgagee or his receiver moved in to collect the rents, they would find that the cow had already been milked—assuming, that is, that the tenants' arrangements with the mortgagor were binding on the mortgagee." *Id.* at 248.

71. *Id.*

an entity.⁷² In short, on the issue of “fit,” it is far from clear that essentially commercial law principles should be extrapolated to govern the internal affairs of unincorporated entities.⁷³

To address the question of doctrine—i.e., to decide whether contract law itself is the proper perspective—one must cut through plenteous judicial verbiage about the nature of LLCs and consider precisely what is being assigned. Despite the near adulation of LLCs “as creatures of contract,”⁷⁴ LLC statutes (following partnership statutes) do not deal with assignments of membership interests as assignments of contractual rights. The doctrinal frame of reference is property law.

Thus, for example, Re-ULLCA states, “A transferable interest is personal property,”⁷⁵ and nowhere refers to the transfer or assignment of a member’s rights under the operating agreement. Instead, the Act provides a set of rules governing “[a] transfer, in whole or in part, of a transferable interest”—i.e., of a property interest.⁷⁶

Delaware’s LLC Act uses slightly different language but to the same effect. A “limited liability company interest” is characterized not as a contract right but rather as “personal property,”⁷⁷ and the LLC statute addresses “[a]ssignment of limited liability company interests” rather than assignment of rights under the limited liability company agreement.⁷⁸

This distinction may seem a mere matter of semantics,⁷⁹ and certainly LLC operating agreements often, perhaps typically, address the issue of assignment.⁸⁰ Many agreements merely restate more or less verbatim the rules from the governing LLC statute. Others take those rules as a starting point and then fine tune or revise.⁸¹ For example, the following provisions appeared in

72. *Elf Atochem N. Am., Inc. v. Jaffari*, 727 A.2d 286, 291 (Del. 1999).

73. *But see, e.g.*, DEL. CODE ANN. tit. 6, § 18-1101(g) (2008) (purporting to override UCC §§ 9-406 and 9-408 but not mentioning § 9-405).

74. *See* R&R Capital, L.L.C. v. Buck & Doe Run Valley Farms, L.L.C., No. Civ. A. 3803-CC, 2008 WL 3846318, at *1 n.1 (Del. Ch. Aug. 19, 2008); *Fisk Ventures, L.L.C. v. Segal*, No. Civ. A. 3017-CC, 2008 WL 1961156, at *8 (Del. Ch. May 7, 2008); *TravelCenters of Am., L.L.C. v. Brog*, No. Civ. A. 3516-CC, 2008 WL 1746987, at *1 (Del. Ch. Apr. 3, 2008).

75. RE-ULLCA § 501 (2006).

76. *Id.* § 502.

77. DEL. CODE ANN. tit. 6, § 18-701 (2008).

78. *Id.* § 18, subchap. VII.

79. *But see In re Allentown Ambassadors, Inc.*, 361 B.R. 422, 456 (Bankr. E.D. Pa. 2007) (acknowledging court’s decision rests in part on semantics but nonetheless using semantic analysis to reach major decision on the constraints bankruptcy law places on an LLC and its members when one member becomes bankrupt).

80. The Delaware LLC Act essentially presupposes such involvement. Section 18-702(a) provides, “A limited liability company interest is assignable in whole or in part except as provided in a limited liability company agreement.” § 18-702(a). Subsection (b) then states the typical delineation of an assignee’s rights, which applies “[u]nless otherwise provided in a limited liability company agreement.” § 18-702(b).

81. *E.g.*, *Lake v. Sealy*, 165 So. 399, 400 (Ala. 1936) (“[Y]et McCaskill had the right, reserved by the partnership agreement, Exhibit B, to transfer his interest to the Sealys”).

the operating agreement interpreted recently in a Mississippi case, *Andrews v. Ford*⁸²:

Section 9.1. Restriction on Assignment. No Member shall have the right to sell, assign, pledge, hypothecate, transfer, exchange, gift, bequeath or otherwise transfer (by voluntary or involuntary means) all or any part of his Limited Liability Company interests, except in accordance with that certain BUY-SELL AGREEMENT, executed by the Members and attached hereto as Exhibit "A."

Section 9.2. Death of Member. Upon the death of a Member, purchase of the deceased Members' ownership interest shall be in accordance with that certain BUY-SELL AGREEMENT, executed by the Members and attached hereto as Exhibit "A."

....

Section 9.6. Assignee not Member in Absence of Consent. Notwithstanding any provision contained in this Operating Agreement to the contrary unless the Members owning 51% of the Limited Liability Company interests then owned by the non-assigning Members grant their written consent to any assignment of a Limited Liability Company interest to an assignee who is not a Member immediately before the assignment, the proposed assignee shall have no right to participate in the management of the business and affairs of the Company or to become or exercise any rights of a Member. An assignee shall merely be entitled, to the extent assigned, to share in the net profits and net losses and to receive such distribution[s] to which the assignor would have been entitled.⁸³

Certainly, this operating agreement encompasses assignment, and presumably the operating agreement also delineates each member's rights to profits, losses, and distributions. It is therefore plausible to argue that an assignment of "net profits and net losses and to receive such distribution[s]" would be an assignment of rights granted by the operating agreement—i.e., an assignment of contract rights.

The opposite interpretation, however, is at least equally plausible. The *Andrews* operating agreement refers not to rights under the operating agreement but rather to the "assignment of a Limited Liability Company interest." This formulation parallels the typical statutory formulation, which

- first defines a property right and then
- delineates
 - the circumstances under which a person owning that right might assign or otherwise transfer it and
 - the consequences of such a transfer or assignment.

82. 990 So.2d 820 (Miss. App. 2008).

83. *Id.* at 822-23.

If this latter, property-based view is the proper one, then the issue of “fit” is moot. No contract is being assigned, and the commercial law propositions do not apply.

B. Property Law and Equity

From the perspective of property law, the circumstances of a bare naked assignee are, to say the least, unusual. The assignee owns a property right, but is seemingly without any remedy to protect that right from abuse or even outright expropriation.

If the abuse effectively destroys the property right, the assignee might try to assert a claim of conversion. A federal bankruptcy court has been willing to contemplate a claim for conversion arising where one member of an LLC purports to read just ownership interests to the prejudice of another member.⁸⁴ From a property law perspective, the distinction between a member’s rights and an assignee’s rights might not matter.

But the tort of conversion was initially aimed at protecting chattels,⁸⁵ and extension to intangible property has generally been limited to intangible interests “of the kind customarily merged in a document.”⁸⁶ A Texas case has applied the tort of conversion to stock, which reflects intangible rights and is in some ways analogous to the economic rights of an assignee. That case, however, involved stock certificates (i.e., rights merged into a document) and a companion theory of fraud.⁸⁷

A Colorado court has held that because a member’s interest is personal property, abuse of that interest may be grounds to appoint a receiver.⁸⁸ The decision, however, rested on a specific statute providing for the appointment of receivers and has not been followed elsewhere. It is a frail hope for a claim by a non-member assignee.

Ironically, the absence of *legal* remedies may point to the solution for the problem of the bare naked assignee. Where members use their power to expropriate value from a defenseless assignee, the answer may lie in *equity*. “[E]quity abhors a penalty and a forfeiture, even as nature abhors a vacuum.”⁸⁹ Even short of forfeiture, “equitable relief is generally available where there is no adequate remedy at law.”⁹⁰

84. *In re McCabe*, 345 B.R. 1, 8–9 (D. Mass. 2006).

85. RESTATEMENT (SECOND) OF TORTS § 222A(1) (1965) (“Conversion is an intentional exercise of dominion or control over a chattel which so seriously interferes with the right of another to control it that the actor may justly be required to pay the other the full value of the chattel.”).

86. *Id.* § 242(2); *see also* Phansalkar v. Andersen Weinroth & Co., L.P., 175 F. Supp. 2d 635, 639-40 (S.D.N.Y. 2001).

87. *Hoad v. Winchester*, 279 S.W. 875 (Tex. Civ. App. 1926).

88. *Diaz v. Fernandez*, 910 P.2d 96, 97 (Colo. Ct. App. 1995).

89. *Merrill v. Trimmer*, 2 Pa. C.C. 49, 1886 WL 8255, at *2 (Pa. Com. Pl. May 3, 1886).

90. *Key Corporate Capital, Inc. v. County of Beaufort*, 644 S.E.2d 675, 678 (S.C. 2007) (internal quotations omitted).

Equity has both the power and flexibility to address the freeze-the-deal/oppress-the-assignee conundrum:

The essence of equity jurisdiction has been the power of the Chancellor to do equity and to mould each decree to the necessities of the particular case. Flexibility rather than rigidity has distinguished it. The qualities of mercy and practicality have made equity the instrument for nice adjustment and reconciliation between the public interest and private needs as well as between competing private claims.⁹¹

Of course, “an adequate legal remedy may be provided by statute,” and “a court’s equitable powers must yield in the face of an unambiguously worded statute.”⁹² But LLC statutes provide no adequate legal remedy for the bare naked assignee, and the statutory provisions pertaining to assignee interests are either ambiguous or absurd. LLC statutes clearly recognize an assignee’s interest as a property right and just as clearly provide no protection for those rights.

LLC statutes do not purport to deny courts their inherent power to do equity,⁹³ and thus the plight of the bare naked assignee is appropriate for equitable relief. Faced with a claim of inequitable conduct by members against assignees, a court may be reminded that “[i]t is axiomatic, that where there is no remedy, there is no right”⁹⁴ and may therefore fashion a remedy to preserve the right.

This approach would be entirely consistent with the historic role of equity, which “functions as a supplement to the rest of the law where its remedies are inadequate to do complete justice.”⁹⁵ Even when a statute purports to cover a subject matter exhaustively, “A statute is not to be construed in derogation of well-established principles of . . . equity, unless so required by express words

91. *Hecht Co. v. Bowles*, 321 U.S. 321, 329-30 (1944).

92. *Key Corporate Capital*, 644 S.E.2d at 678 (internal quotations omitted).

93. RE-ULLCA § 112(b) does provide that “an amendment to the operating agreement made after a person becomes a transferee or dissociated member is effective with regard to any debt, obligation, or other liability of the limited liability company or its members to the person in the person’s capacity as a transferee or dissociated member.” However, a comment to that section virtually invites a claim in equity for oppressive conduct.

94. *K.M. v. G.H.*, 678 So.2d 1084, 1087 (Ala. Civ. App. 1995) (internal quotations omitted), *rev’d* on other grounds, *ex parte Jenkins*, 723 So.2d 649 (Ala. 1998). For a more sophisticated elaboration, see OLIVER WENDELL HOLMES, *THE COMMON LAW* 169 (Mark DeWolfe Howe ed., 1963) (1881) (“A legal right is nothing but a permission to exercise certain natural powers, and upon certain conditions to obtain protection, restitution, or compensation by the aid of the public force. Just so far as the aid of the public force is given a man, he has a legal right, and this right is the same whether his claim is founded in righteousness or iniquity.”).

95. *Swogger v. Taylor*, 68 N.W.2d 376, 382 (Minn. 1955) (discussing, with regard to a statute providing for partition, “whether equitable principles have now been restricted to a statutory strait jacket or whether such principles remain as an interstitial supplement to the partition statutes” and taking the later position).

or by necessary implication and then only to the extent clearly indicated.”⁹⁶ Therefore, principles of equity “remain as an interstitial supplement” to LLC statutes, and in particular to the rights of assignees facing obvious mistreatment.⁹⁷

The suggestion is not that equity will accord an assignee all the rights of members or even any specific rights applicable in all circumstances. Equity has no power to reshape legal rights. As the New York Appellate Division explained in *Levine v. Murray Hill Manor Co.*,⁹⁸ to ask for (or grant) that type of relief is to overreach.

Levine involved an arrangement under which the promoters obtained investments from persons who had the status merely of assignees of an original limited partner.⁹⁹ The lower court had been offended by the promoters’ ingenious strategy of self-protection. Noting “the cleverness with which [the promoters] drew up the partnership and limited partnership agreements in order to insulate the general partners from a potential lawsuit such as this,” the lower court determined “as a matter of equity plaintiff should be accorded the rights of a limited partner.”¹⁰⁰ The quasi-limited partners were therefore entitled to make claims for breach of fiduciary duty.

The appellate division reversed, stating flatly, “We find no authority to support the [lower court’s] extraordinary construction of plaintiff’s rights under the agreements.”¹⁰¹

Thus, when acting “interstitially”—i.e., within a statute—equity’s perspective must take into account both the express language and the broad intent of the statute. In the context of a claim by a bare naked assignee, equity

96. *Id.*

97. *Id.* There is, of course, contrary authority, some of it grouped around the maxim “*equitas sequitur legem*” (equity follows the law). However, cases citing that maxim typically involve distinguishable situations. For example, in *Hedges v. Dixon County*, 150 U.S. 182, 192, (1893), the Supreme Court stated, “The established rule, although not of universal application, is that equity follows the law, or as stated in *Magniac v. Thomson*, 15 How. 299, ‘that, wherever the rights or the situation of parties are clearly defined and established by law, equity has no power to change or unsettle those rights or that situation, but in all such instances the maxim ‘*equitas sequitur legem*’ is strictly applicable.” The Court also held, “Courts of equity can no more disregard statutory and constitutional requirements and provisions than can courts of law.” *Id.* But *Hedges* involved a bill seeking equitable relief for plaintiffs who, as a matter of law, had purchased invalid bonds. The claim in equity was thus an attempt to create rights rather than to protect them. As the Court properly held, “Where a contract is void at law for want of power to make it, a court of equity has no jurisdiction to enforce such contract, or in the absence of fraud, accident, or mistake to so modify it as to make it legal, and then enforce it.” *Id.* Other “equity follows the law” cases involve situations in which the statute itself provides a remedy to the party seeking to invoke equity. *E.g.*, *Reno v. Bossier Parish Sch. Bd.*, 520 U.S. 471, 485 (1997) (invoking maxim when relevant statute, the Voting Rights Act, contained sufficient remedial option); *Thompson v. Greenwood*, 507 F.3d 416, 424 (6th Cir. 2007) (holding equity could not overcome plain statutory language of venue provisions that rather than leaving property interests without a remedy, merely channeled litigants into statutorily specified court).

98. 532 N.Y.S.2d 130 (N.Y. App. Div. 1988).

99. *Id.* at 131.

100. *Id.* at 132.

101. *Id.*

must begin with the understanding that—absent egregious circumstance—the property rights of assignees are dependent according to statute on the business decisions of the owners of the enterprise—i.e., the members.

The challenge, then, is to define “egregious,” which is an attractive sounding word but of indefinite meaning. Moreover, equity functions flexibly rather than categorically.¹⁰² Nonetheless, the following three examples may provide some guidance:¹⁰³

EXAMPLE A. One of the founding partners of a three-person limited liability company dies, and as provided in the operating agreement and LLC statute, the limited liability company does not dissolve. Under the decedent’s will, her interest “passes in its entirety with all rights and privileges thereunto pertaining” to the widower. Assuming the operating agreement is silent on the widower’s rights in the LLC, is the widower’s consent required in order to amend the operating agreement? Should equity intervene?

Comment: The widower’s consent is not required, unless the operating agreement overrides the typical statutory transfer restrictions. There is no basis for equity to intervene, because the widower’s rights are not in danger. Those rights are economic rights and do not include a right to participate in management in any way.

EXAMPLE B. After a limited liability company has been in existence for ten years, its members note that 35 percent of the interests in its profits are owned by mere transferees. Due to personal guaranties, however, each of the members is personally liable for the limited liability company’s line of credit and other loans while the transferees are not. The members therefore agree unanimously to buy a very large liability policy for the limited liability company. The stated purpose is to prevent tort and similar claims from undercutting the company’s ability to stay current on the guaranteed loans. If a transferee believes that the coverage is unreasonably large and that the premium is therefore wasted, should equity intervene?

Comment: Equity should not intervene. Even assuming that the coverage might be excessive, there is no evidence of (1) bad faith or (2) unjust enrichment. The premiums decrease the amount available for distributions to members as well as to transferees.

EXAMPLE C. After a limited liability company has been in existence for ten years, its members note that 35 percent of the interests in its profits are owned by mere transferees. The members arrange to merge the limited liability company into another shell limited liability company, and the plan of merger

102. See *Bata v. Hill*, 112 A.2d 519, 522 (Del. Ch. 1955) (finding “the flexible remedies of a Court of Equity” were most appropriate).

103. These examples are derived from “Transferee Exercises” used in the author’s class on Agency, Partnerships, and LLCs. The comments to the examples, in italics, were prepared for this article.

converts the interests in profits held by transferees into highly subordinated and arguably worthless debt of the surviving limited liability company. The merger has no independent, legitimate business purpose. Its sole function is to “shuffle the equity” to the grave prejudice of the transferees. Should the transferees have a claim in equity?

*Comment: Here equity should doubtlessly intervene to preserve the property rights of the transferees. The merger is tantamount to a forfeiture of the transferees' property.*¹⁰⁴

VI. CONCLUSION: *LOTTON V. SAVICH HEREFORDS, L.L.C.* (A LESSON LEARNED FROM THOSE “ON THE GROUND”)

Approximately two years ago, the author served as an expert witness in a “bare naked assignee” case venued in the County of Itasca, Ninth Judicial District of Minnesota.¹⁰⁵ The case, *Lotton v. Savich Herefords, L.L.C.*,¹⁰⁶ pitted the children of one member of a Minnesota LLC against the remaining active member.

Savich Herefords, LLC (“the LLC”) originated as an estate-planning device and has had a tangled and disputatious history. At the time relevant to this litigation, the LLC had only two active members, Gary Lotton and Buddy John Savich. The suit arose after Gary Lotton died in a car accident and Buddy John Savich was named the personal representative of Mr. Lotton’s estate. Pursuant to the LLC Member Control Agreement (roughly equivalent to an operating agreement)¹⁰⁷ and the Minnesota LLC Act, Mr. Savich assigned all of Gary Lotton’s economic rights in the LLC to Gary’s two children, Tony Lotton and Laura Lotton, in equal shares. Tony Lotton was a minor at the time of assignment and his mother, Denise Lotton, therefore held his interest as guardian and trustee.¹⁰⁸

The assignees had no rights to participate in the management of the LLC. The Minnesota LLC Act so provided,¹⁰⁹ and, moreover, the member control

104. See ULPA § 1106(b)(3) (2001) (“If a constituent organization is a limited partnership, the plan of merger will determine the fate of any interests held by mere transferees. This Act does not state any duty or obligation owed by a constituent limited partnership or its partners to mere transferees. That issue is a matter for other law.”).

105. Chambers for the Ninth Judicial District are located in Bemidji, in northwestern Minnesota, 104 miles from the Canadian border.

106. *Lotton v. Savich Herefords, L.L.C.*, No. 31-CV-06-177 (D. Minn. July 24, 2007).

107. MINN. STAT. § 322B.37 (2004).

108. Defendants’ Memorandum of Law in Support of Motion for Summary Judgment at 3, *Lotton v. Savich Herefords, L.L.C.*, No. 31-CV-06-177 (D. Minn. 2007) [hereinafter Defendants’ Memorandum].

109. MINN. STAT. § 322B.323, subd. 2(1) (providing when death “causes the termination of a member’s membership interest and the termination does not result in dissolution . . . the terminated member’s interest will be considered to be merely that of an assignee of the financial rights owned before the termination of membership”).

agreement expressly assigned Mr. Lotton's governance rights to Mr. Savich.¹¹⁰

In November 2005, Denise¹¹¹ and Laura Lotton filed suit against Buddy John Savich and the LLC.¹¹² The complaint included the following allegations:

1. LLC assets were misapplied or wasted.
2. The defendant Buddy John Savich acted prejudicially when he entered into a residential lease agreement with a private party concerning a home owned by the LLC.
3. LLC assets, particularly certain cattle, were sold without the plaintiffs' knowledge or consent, and without knowledge of how the proceeds were used.
4. The plaintiffs were not informed of, nor given any notice of, any LLC meetings or decisions made by LLC members.
5. Members breached their fiduciary duty to act in an honest, fair, and reasonable manner when they eliminated the plaintiffs' participation and control, took out loans in the name of the LLC (without plaintiffs' consent or knowledge), and disposed of company assets.
6. The plaintiffs' attempts to obtain information relating to company affairs were unlawfully rejected.

The Complaint sought the following relief:

1. An order directing the appointment of a receiver to handle the affairs of Savich Herefords, LLC and manage the company's property
2. An order appointing an accountant to conduct a full audit of the company
3. A preliminary injunction prohibiting further member control over the company's business affairs and assets until further order of the court
4. A civil money judgment of at least \$50,000
5. An order enjoining the defendants from dissipation of any company assets

The defendants denied the allegations but, more fundamentally, vigorously contested the plaintiffs' rights even to bring the claims. The defendants relied heavily on the "pick your partner" attributes of the Minnesota LLC Act, which "stringently limit the power of assignees of financial rights to interfere with or

110. Defendants' Responsive Memorandum of Law in Support of Motion for Summary Judgment at 3-4, *Lotton v. Savich Herefords, L.L.C.*, No. 31-CV-06-177 (D. Minn. 2007) [hereinafter Defendants' Responsive Memorandum].

111. Because Tony Lotton was a minor at the time of the lawsuit, Denise brought the suit as parent and guardian of Tony.

112. The suit also named as defendant another, inactive member of the LLC.

pry into the business and activities of a limited liability company.”¹¹³ In the defendants’ view:

- “Assignees of financial rights have no right to interfere in or even inquire into the conduct of the entity because allowing any such power would undercut the fundamental associated principle that characterizes the partnership or LLC organization.”¹¹⁴
- “Plaintiffs do not understand, do not like, or misrepresent the LLC statute.”¹¹⁵

As a matter of statute, the defendants’ position should have prevailed. Although the Minnesota LLC Act is unusual in its use of corporate style governance rules,¹¹⁶ the Act clearly follows the partnership-style bifurcation of membership rights into economic rights and other rights. Indeed, the Act is unusually careful and elaborate in conceptualizing a membership interest and separating the interest into its assignable and non-assignable parts.

The Act:

- Directly defines “membership interest” as reflecting a bifurcation into “financial rights” and “governance rights.”¹¹⁷
 - Defines “financial rights” exhaustively to entail a share of losses and profits, distributions, interim distributions, and termination distributions.¹¹⁸
 - Defines “governance rights” expansively to mean “all a member’s rights as a member in the limited liability company other than financial rights and the right to assign financial rights.”¹¹⁹
- Stringently restricts the transfer of governance rights:

[A] member may, without the consent of any other member, assign governance rights, in whole or in part, to another person already a member at the time of the assignment [A]ny other assignment of any governance rights is effective only if all the members, other than the member seeking to make the assignment, approve the assignment by unanimous written consent.¹²⁰

113. Defendants’ Responsive Memorandum, *supra* note 110, at 3.

114. *Id.*

115. *Id.* at 2.

116. MINN. STAT. § 322B.01, Reporter’s Notes, Overview Comments (2004) (explaining that “[m]ost of the governance and management provisions of chapter 322B [the LLC Act] are drawn from chapter 302A [the corporate statute], even though chapter 322B provisions differ from chapter 302A”).

117. § 322B.03, subdiv. 31.

118. § 322B.03, subdiv. 19.

119. § 322B.03, subdiv. 22.

120. § 322B.313, subdiv. 2.

- Expressly provides for the consequences when an attempted assignment of governance rights fails (voiding any assignment of financial rights that accompanied the failed transfer of governance rights).¹²¹
- Specifically limits the effect of a transfer of financial rights:

“An assignment of a member’s financial rights . . . does not entitle or empower the assignee to become a member, to exercise any governance rights, to receive any notices from the limited liability company, or to cause dissolution.”¹²²

- Defines “member” with particularity as “the owner of some governance rights.”¹²³
- Limits participation, information rights, and the right to judicial intervention to “members.”¹²⁴

The Reporter’s Notes to the Act further bespeak the strict limitations on mere assignees:

[A] nonmember who takes assignment merely of financial rights does not become a member and has no governance rights. As a result, an assignee of mere financial rights cannot use the governance machinery of chapter 322B, even to protect the value of the assigned financial rights. For example, an assignee of mere financial rights has no power to assert dissenters rights (section 322B.383) or to invoke section 322B.833 (Judicial Intervention and Equitable Remedies, Dissolution and Termination).¹²⁵

Unfortunately, for the defendants—at least as an initial matter—the judge would not accept the anomalous notion that a person might have rights but “no means of protecting their interest.”¹²⁶ In the situation of a bare naked assignee, some recourse must exist:

In cases where the member who transferred the financial rights remains alive and retains governance rights, that member can act to protect the rights of his assignees. Where, as here, the rights were transferred upon the death of a member, there is no one left with governance rights to protect the interest of the assignees and there must be some mechanism for the assignees to protect their financial interest.¹²⁷

121. § 322B.313, subdiv. 5.

122. MINN. STAT. § 322B.31, subdiv. 2 (2004).

123. § 322B.03, subdiv. 30.

124. § 322B.356, subdiv. 2 (participation); § 322B.373, subdiv. 2 (information); § 322B.833 (judicial intervention).

125. § 322B.31, subdiv. 2, Reporter’s Notes.

126. District Court’s Order at 4, *Lotton v. Savich Herefords, L.L.C.*, No. 31-CV-06-177 (D. Minn. Feb. 8, 2007) [hereinafter District Court’s Order].

127. *Id.*

As to the statement in the Reporter's Notes, cited by defendants, to the effect that no such mechanism exists under the Act, the court was not persuaded: "the comment cited by defendants appears to strip assignees of a financial interest from any means of protecting their interest."¹²⁸

The court would not accept that result. There was a right; there must be a duty whose breach would give rise to a remedy.

The court's answer was to find a part of the statute not completely "battered down" against assignee rights—namely, section 322B.69 of the Minnesota Statutes. That section merely states a general standard of conduct for anyone acting as a manager of an LLC (under the Minnesota Act, a position equivalent to a corporate officer) and nowhere indicates that the duties extend beyond the LLC and its members to mere assignees.

The plight of the bare naked assignee, however, pushed the court to read the statute expansively:

[T]he duty imposed by the statute is meaningless if those owed the duty have no means of protecting their interest [I]n the absence of any language in § 322B.69 stating that the duty is only owed to "members," this Court reads the statute as imposing upon the manager a fiduciary duty to anyone with a membership and/or financial interest in the company.¹²⁹

The court then had to cabin in its holding, because "the question is how to protect that interest consistent with the other provisions of Chapter 322B, particularly the comment cited by defendants [explaining how mere assignees have no recourse under the Act]."¹³⁰ The court therefore imposed both procedural and substantive limitation on the assignees.

The substantive limitations are not especially protective. They read like a statement of the business-judgment rule, which would apply even to a claim brought by a member:

[B]reach of fiduciary duty in the context of Chapter 322B would require a showing of something more than a claim that the defendant(s) may have made a poor business decision. The type of breach contemplated could include illegal acts, fraudulent acts, misallocation of LLC assets or profits or other ultra vires acts.¹³¹

128. *Id.* at 7

129. *Id.* at 4.

130. District Court's Order, *supra* note 126, at 4.

131. See RE-ULLCA § 409 cmt. (2006) (discussing business-judgment rule as applied to limited liability companies). Compare District Court's Order, *supra* note 126, at 7, with *In re UnitedHealth Group Inc. S'holder*, 754 N.W.2d 544, 551 (Minn. 2008) (stating, "Under the business judgment rule, so long as a disinterested director makes 'an informed business decision, in good faith, without an abuse of discretion, he or

The procedural limitations are, in contrast, significant.

[I]t would be contrary to the overriding intent of Chapter 322B to permit financial interest assignees to bring baseless claims in an effort to compel the company to provide them with company records, financial statements, or any notices from the company. Therefore, before an assignee may compel a company to disclose any such documents as part of the discovery process on a breach of fiduciary duty claim, the complainant must make some showing of a valid basis for the claim.¹³²

This requirement is reminiscent of Delaware's famous rule for establishing demand futility in a derivative case—i.e., pleading facts with particularity without the benefit of any discovery.¹³³ The court's standard, however, is more demanding than mere pleading; the order refers to a *prima facie* showing that defendants have breached a fiduciary duty.¹³⁴

The court acknowledged the difficulty a plaintiff would have under this standard, but noted that allowing a “non-member of an LLC who had a financial interest to make such a request on little more than a hunch or a whim [would] allow [an] intrusion into the affairs of the LLC contrary to the purpose and philosophy of Chapter 322B.”¹³⁵ Further to protect against that intrusion, the court noted that even if the plaintiffs made a *prima facie* showing, the court might refer the matter to a third party for a confidential investigation into the LLC's records.

The court allowed the plaintiffs forty-five days to make a showing, and the plaintiffs utterly failed at that task. The court held that “not one of the plaintiffs' claims is sufficient to establish reason to believe that the defendants may have acted improperly.”¹³⁶ Having dismissed some of the plaintiffs' claims earlier on a motion for summary judgment, the court now dismissed the remainder of the claims.¹³⁷ The defendants' claim for sanctions and for an order buying out the plaintiffs' interests were eventually dropped in a settlement in which the plaintiffs relinquished all rights in the LLC.

she will not be liable for corporate losses resulting from his or her decision.”).

132. District Court's Order, *supra* note 126, at 7.

133. See *Aronson v. Lewis*, 473 A.2d 805, 808 (Del. 1984) (stating “demand can only be excused where facts are alleged with particularity.”). Indeed, the barrier set by the Minnesota court is even more difficult, because the Delaware rule presupposes a claim by an owner (i.e., a shareholder) and shareholders have certain statutory information rights that can be exercised before filing a derivative claim. See *Wood v. Baum*, 953 A.2d 136, 144 (Del. 2008) (dismissing derivative plaintiff's claim because “plaintiff could have, but chose not to, make a books and records request.”).

134. District Court's Order, *supra* note 126, at 8.

135. *Id.* at 7.

136. District Court's Order, at 4, *Lotton v. Savich Herefords, L.L.C.*, No. 31-CV-06-177 (D. Minn. July 23, 2007).

137. *Id.* at 3.

The moral of this story is that judges, unlike the Red Queen in *Alice in Wonderland*, are unlikely to believe “six impossible things before breakfast.”¹³⁸ A property interest established and recognized by statute, but with its owners bereft of “any means of protecting their interest,”¹³⁹ is an impossible thing.

As for the solution fashioned in *Lotton v. Savich Herefords, L.L.C.*, in this author’s respectful opinion the court did effective “rough justice” in a difficult matter of first impression.¹⁴⁰ Upon reflection, a more refined formulation might look to equity rather than statutory duty provisions. Equitable intervention is a narrower avenue than expanding standing.

As to particulars:

1. Statutory limitations on assignee access to information should remain effective, except by court order (as provided below). Any other approach would categorically override statutory language and fundamentally undermine the “pick your partner” principle.
 - a. A court should not grant an assignee additional information rights before the filing of a complaint.
 - b. Upon filing of a complaint, discovery should be stayed pending an initial determination on the sufficiency of the complaint.¹⁴¹

2. To avoid prompt dismissal on the pleadings, a complaint should have to
 - a. plead with particularity facts, which,
 - b. if true,
 - c. would establish a prima facie case that¹⁴²
 - d. those in control of the limited liability company have
 - i. intentionally,
 - ii. without plausible business justification, and
 - iii. not as the result of mere errors in judgment,¹⁴³

138. LEWIS CARROLL, *ALICE’S ADVENTURES IN WONDERLAND* (Macmillan and Co. of London 1865).

139. District Court’s Order, *supra* note 126, at 6.

140. See *SST, Inc. v. City of Minneapolis*, 288 N.W.2d 225, 231 (Minn. 1979) (complimenting trial court for its evaluation of proposed settlement and noting, “[t]he evaluation of a proposed settlement requires an amalgam of delicate balancing, gross approximations and rough justice.” (quoting *City of Detroit v. Grinnell Corp.*, 495 F.2d 448, 468 (2d Cir. 1974) (internal quotations omitted))).

141. This point reflects the law governing derivative litigation. *E.g.*, RE-ULLCA § 905(a) (2006) (“If the company appoints a special litigation committee, on motion by the committee made in the name of the company, except for good cause shown, the court shall stay discovery for the time reasonably necessary to permit the committee to make its investigation.”).

142. This proposal for “how to plead” is derived from *Aronson v. Lewis*, 473 A.2d 805, 808 (Del. 1984), although the proposal for “what must be pleaded” is different.

143. These three points reflect the business judgment rule, applicable to claims by members. BISHOP & KLEINBERGER, *supra* note 9, ¶ 10.05[2] (stating that “the question is not whether the business judgment rule should apply to limited liability companies but rather which [form of the] business judgment rule should apply”). Moreover, these points are *a fortiori* appropriate when an assignee is claiming egregious conduct and

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- e. done or threaten to do one or both of the following:
 - i. destroy or substantially diminish the value of the claimant assignee's financial interest in a manner that benefits one or more members of the LLC
 - ii. target the claimant assignee's interests for substantially and invidiously inferior treatment when compared to the treatment of comparable financial interests owned by members.
 3. If a complaint survives a motion to dismiss, the court should determine whether to allow regular discovery or, instead
 - a. itself or by special master
 - b. make an *in camera* inquiry into the books and records of the limited liability company
 - c. in order to determine whether substantial evidence exists to support the allegations and permit full discovery to proceed.¹⁴⁴

Whatever the precise standards and procedures, three fundamental points must remain in view:

- A characteristic of every LLC (and partnership) statute in the country is a sharp dividing line between full owners and mere assignees of financial rights.
- Courts should overlook that dividing line only when faced with well-pleaded, detailed claims of abuse that has been targeted at the assignees.
- At each stage of any proceeding, "the question is how to protect [the assignee] interest consistent with" the overwhelming statutory intent to protect the "pick your partner" principle.

seeking extraordinary intervention under a court's equitable powers.

144. It may be possible to extrapolate from the law concerning *in camera* review in other contexts, such as disputes over whether to apply the fraud-crime exception to the attorney-client privilege. *E.g.*, *United States v. Zolin*, 491 U.S. 554, 564 (1989).