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We Interrupt This Program...to Talk of Transfer Restrictions

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Abstract

A recent Iowa decision, REG Washington, LLC v. Iowa Renewable Energy LLC, is a useful first word on transfer restrictions applicable to ownership interests in a limited liability company, and more particularly transfer restrictions applicable to so-called transferable interests, i.e., economic rights. The decision's analysis centers around the "pick your partner" principle and expressly rejects any analogy to corporate law cases addressing stock transfer restrictions. The decision raises certain issues and is hardly the last word on this topic.

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In the time before the internet made breaking news available 24/7/365, the most important breaking news came via the three television networks. When important (usually bad) news broke, each of the networks would suspend regular broadcasts with a special "up to the minute" report, and would introduce the report with the phrase, "We interrupt this program to bring you…"

This column interrupts our coverage of LLC-related remedies to discuss an important and interesting decision of the Iowa business court. The case, which Professor Matt Dore of Drake Law School recently brought to my attention, is *REG Washington, LLC v. Iowa Renewable Energy LLC,* Equity No. EQCE128952 (Iowa District Court for Scott County, Sept. 27, 2017) (*REG v. IRE*). What makes the case noteworthy is its discussion of transfer restrictions applicable to ownership interests *in a limited liability company,* and more particularly transfer restrictions applicable to so-called transferable interests, i.e., economic rights. Relevant precedent in the LLC context is somewhere between scant and nonexistent, so the case provides a useful first word on the subject. (Most cases considering transfer restrictions in limited liability companies or partnerships do so in the context of a right of first refusal (ROFR). See, e.g., *Robertson v. Murphy,* 510 So. 2d 180, 182–83 (Ala. 1987) (upholding ROFR under partnership agreement); *RTS Landfill, Inc. v. Appalachian Waste Sys., LLC,* 598 S.E.2d 798 (Ga. Ct. App. 2004) (rejecting a ROFR pertaining to LLC interests because the right was permanent in duration and purported to permit the purchase at $500,000 less than any third-party offer)). Moreover, the decision's analysis centers around the "pick your partner" principle and expressly rejects any analogy to corporate law cases addressing stock transfer restrictions.

REG v. IRE involved an Iowa limited liability company, Iowa Renewable Energy, LLC (IRE), which "operates a bio-diesel production facility in Washington, Iowa," and REG Washington, LLC (REG), "a producer of bio-based fuel and renewable chemicals located in Ames, Iowa." The litigation arose out of two tender offers REG made for ownership interests in IRE.

Given that the IRE operating agreement has strict transfer restrictions, understanding the case begins with understanding the relevant provisions of the operating agreement. The IRE operating agreement refers to "Membership Interests" as comprising "two distinct interests in the company: 'Membership Economic Interest' and 'Membership Voting Interest,'" and provides that "[t]he Membership Economic Interest of a Member is quantified by the Unit of measurement referred to herein as 'Units.'" Through its tender offers, REG sought to purchase up to "49% of IRE's Class A units and 49% of IRE's Class B units."

Section 9.1 of the IRE operating agreement contained a strict limitation on transfers: "Except for Permitted Transfers [not relevant to the case], no Member shall transfer all or any part of its Units, voluntarily or involuntarily, or by operation or process of law or equity, unless and until

the Directors have approved the Transfer in writing, which approval may be withheld in the Directors' sole discretion." The operating agreement further provided that any purported transfer made without the directors' approval was void. Although the operating agreement did not appear to quantify member voting interest in terms of units, the court held Section 9.1 applicable to both of the "two distinct interests."

In any event, the focus of the case is on the operating agreement's control over the transfer of economic rights. Despite its knowledge of the operating agreement's transfer restriction, pursuant to its second offer, REG paid cash to 28 IRE members for, in the aggregate, 1,895 units, accompanied by signed proxies and powers of attorney. The IRE directors exercised their "sole discretion" and declined to give effect to the purported purchases. REG then brought suit "in equity seeking a writ of mandamus or, in the alternative, an injunction against Defendants Iowa Renewable Energy, LLC" and several individual defendants.

Like all LLC statutes, the Iowa act prohibits transfers of governance rights and complete membership interests unless authorized by the operating agreement or consented to by all the members. However, the "default setting" on economic rights is the opposite; unless the operating agreement provides otherwise, "a transfer, in whole or in part" of "a transferable interest . . . is permissible." Iowa Code Ann. § 489.502(1)(a).

The Iowa LLC statute is based on ULLCA (2006). Like all other LLC statutes (including ULLCA (1996) and ULLCA (2013)), ULLCA (2006) gives no direct, express guidance on the extent to which an operating agreement may restrict the transferability of economic rights. However, all uniform LLC acts (including Iowa's) provide a centralized list of "thou shall nots" that limit the power of an operating agreement. Restricting the transfer of transferable interests is not on the "thou shalt not" list. Moreover, Iowa Code Ann. § 489.502(6) provides categorically and without exception that "[a] transfer of a transferable interest in violation of a restriction on transfer contained in the operating agreement or another agreement to which the transferor is a party is ineffective as to a person having notice of the restriction at the time of transfer."

In the corporate realm, where shares are freely transferable absent a contrary agreement, both case and statutory law impose some sort of reasonableness requirement on stock transfer restrictions. See, e.g., Iowa Code Ann. § 490.627(3) (stating that "[a] restriction on the transfer or registration of transfer of shares is authorized . . . [t]o maintain the corporation's status when it is dependent on the number or identity of its shareholders[,] [t]o preserve exemptions under federal or state securities law[, and] [f]or any other reasonable purpose") (derived from Mod. Bus. Corp. Act § 6.27; *Elson v. Schmidt*, 140 Neb. 646, 650–51, 1 N.W.2d 314, 316 (1941) (upholding a stock transfer limitation "[a]fter a careful reading of the authorities" because the limitation "is a reasonable restriction").

In assessing the reasonableness of stock transfer restrictions (and thereby departing from a laissez faire or "freedom of contract" approach), courts have often written of the law's hostility toward "restraints on alienation." In REG v. IRE, REG invited the court to embrace that hostility,

"argu[ing] that a transfer restriction is subject to a 'reasonableness' standard that some courts apply to transfers of corporate stock."

The court rejected the invitation. Noting that "REG routinely cites corporate law cases to support its allegations that the Operating Agreement's restrictions on transfers of Membership Interest are improper," the court held that, "[w]hile analogies to corporate law may be appropriate in certain situations, the transferability of membership interest in an LLC entity is not one of them." Quoting the official comments to ULLCA (2006) at section 502, the court emphasized the contractual nature of an LLC and explained:

> Re-ULLCA counsels that the intention of the contracting parties must be controlling: "Unless the operating agreement otherwise provides, a member acting without the consent of all other members lacks both the power and the right to: (i) bestow membership on a non-member; or (ii) transfer to a non-member anything other than some or all of the member's transferable interest." Rev. Unif. Ltd. Liability Co. Act § 502 introductory cmt. (2006) (internal citations omitted). Here, IRE has provided otherwise. The Member parties contracting to form IRE specifically limited their ability to transfer any aspect of Membership Interest under the Operating Agreement by requiring approval by the Board of Directors.

Having rejected any reasonableness standard, the court had neither need nor occasion to consider the reasonableness of section 9.1 of the IRE operating agreement.

There is much to be said for the court's holding. After all, in sharp contrast to the corporate construct, the LLC construct hardwires restraints on alienation into the entity-creating statute; all LLC statutes restrict the transfer of governance rights. See, e.g., ULLCA (2013) § 501, cmt. ("Absent a contrary provision in the operating agreement or the consent of the members, a "transferable [i.e., economic] interest" is the only interest in an LLC which can be transferred to a person who is not already a member.") Moreover, many (perhaps most) LLC statutes also provide that as a default rule, a member's dissociation strips away the dissociating person's governance rights and locks the person in as a mere transferee of its own economic rights. See, e.g., ULLCA (2013) § 603(3) (providing that, upon a person's dissociation, "any transferable interest owned by the person in the person's capacity as a member immediately before dissociation is owned by the person solely as a transferee."). Certainly, the typical limited liability company is the wrong place to be if one seeks free transferability of any aspect of one's ownership interest.

On the other hand, however, how threatening is the transfer of economic rights to the pick-your-partner principle? LLC statutes provide transferees no entrée to (much less influence over) a limited liability company's activities and affairs, see, e.g., ULLCA (2013) § 502(a)(3)(A), no right to participate in management, no general right to access to company financial information, and precious little access even to information directly relevant to the transferee's interest, see, e.g., ULCCA (2013) §§ 502(a)(3)(B), 502(c) (providing that a transferee has no "access to records or

other information concerning the company's activities and affairs," except that "[i]n a dissolution and winding up of a limited liability company, a transferee is entitled to an account of the company's transactions only from the date of dissolution").

However, in contrast to this general proposition, *REG v. IRE* involved at least two sets of circumstances that would have justified the application of a "sole discretion" standard. First, it is by no means certain that REG was seeking to obtain only economic rights. By acquiring proxies and powers of attorneys from its transferors as well as economic rights, in effect REG sought the transfer of governance rights. If so, the pick-your-partner principle was centrally at issue, and enforcing the restriction was indubitably necessary. Before the check-the-box regulations, practitioners and some academics worried that giving proxy rights to persons that were neither fellow members nor managers of the company created the corporate characteristic of free transferability of interests. At least one LLC statute addressed the concern directly. See Minn. Stat. § 322B.363(8) ("A member may not grant any proxy to any person who is an assignee of any member's financial rights and who is not also a member.").

Second, leaving the proxy argument entirely aside, the IRE operating agreement contains an unusual definition of economic rights. The agreement defines a "Membership Economic Interest" to include not only "the right to receive distributions of the Company's assets," but also (for some undiscussed reason) "the right to information concerning the business and affairs of the Company," thereby providing unusual and potentially disruptive access rights to those who own merely member economic interests.

The court made neither of these points. Instead, it hitched its wagon to the pure, unvarnished pick-your-partner principle:

> While analogies to corporate law may be appropriate in certain situations, the transferability of membership interest in an LLC entity is not one of them. Contrasted with other principles of incorporated business organizations, "[o]ne of the most fundamental characteristics of LLC law is its fidelity to the 'pick your partner' principle."

It is not clear that the court chose the correct wagon, given the paradigmatic circumstances that gave rise to the principle. Under the first uniform partnership act promulgated in 1914 almost a century before the advent of the limited liability company:

1. general partnerships were closely held, i.e., only a few partners;
2. each partner had the inescapable power to bind the partnership ("statutory apparent authority");
3. a partner's power to bind the partnership was also the power to encumber the personal assets of the partners because each partner was personally liable for the partnership's debts; and
4. the departure of even one partner from the enterprise dissolved the legal relationship of partnership.

Almost all limited liability companies are closely held, but statutory apparent authority for members is not ubiquitous, i.e., not in any manager-managed company and not at all under some LLC statutes. See ULLCA (2006 & 2013) § 301(a) ("A member is not an agent of a limited liability company solely by reason of being a member."). As for member liability for the entity's debts, limited liability is of course a hallmark of the limited liability company, and the dissociation-dissolution link is a thing of the past for virtually all (if not all) LLC statutes. Carter G. Bishop & Daniel S. Kleinberger, Limited Liability Companies: Tax & Business Law ¶ 1.01[3][e] (Warren Gorham & Lamont, 1994; Supp. 2018-1) (LLC characteristics after "check-the-box").

An almost 25-year-old Louisiana appeals shows the above-described paradigm in action. The case, *LeBreton v. Allain-LeBreton Co.*, 631 So. 2d 662, 664 (La. Ct. App.), *writ denied,* 637 So. 2d 159 (La. 1994), involved restrictions on the transfer of partner interests in a non-LLP general partnership. The party challenging the transfers argued for the corporate jurisprudence. The court rejected the argument, explaining as follows.

> Every partner in a partnership is liable for the debts of the partnership, absent contrary agreement. Attempts to limit the ability of a partner to bind the partnership are invalid against a good faith party. Thus, because any partner may obligate the partnership and therefore, his partners, it would seem appropriate that there would be a presumption against transferability of interests in a partnership.

Unlike the circumstances in *LeBreton*, in the context of limited liability companies, only the closely held characteristic remains to justify applying the pick-your-partner principle to restrictions on the transfer of economic rights. In addition, as *REG v. IRE* itself exemplifies, even that characteristic has exceptions. According to the court, "IRE has issued over 26,000 units, which are held by approximately 600 unitholders." Doubtlessly, the persons managing the limited liability company owed fiduciary duties to the company and in some circumstances to the unit holders, but a "community" of 600 is far from the paradigmatic closely held business in which personal, mutual relations of trust and confidence are expected and salutary. Note also that, at least for as long as uniform partnership acts have existed (since 1914), partnership law has protected the pick-your-partner principle *while accepting economic interests as freely transferable.*

Why then should LLC law invoke the mantra of pick your partner to make transfer restrictions on LLC transferable interests immune from judicial scrutiny? Yet, on information and belief, transfer restrictions like those in the IRE operating agreement are far from rare. Given the scarcity of precedent, *REG v. IRE* provides useful first words on the subject, but given the issues raised in this column, hardly the last.

Article 9 of the Uniform Commercial Code also bears on this issue. UCC sections 9-406 and 9-408 have overridden some transfer restrictions often included in partnership and operating

agreements. In May and July 2018, the ALI and the ULC adopted amendments to sections 9-406 and 9-408, placing transfer restrictions on ownership interests in limited liability companies and partnerships outside the sections' reach. For a discussion of the override issue and the new exception, see LLC and Partnership Transfer Restrictions Excluded from Article 9 Overrides, *soon to be published* in Business Law Today.