Uniform Protected Series Act

Briefing Memo and Draft of Section 601

for Internet Meeting – Wednesday, February 8, 2017; 2-3:30 PM CT

Section 601 – May a Protected Series be Party to an Entity Transaction?

Background

Entity Transactions with a Series Limited Liability Company as a Party

At its internet meeting on January 18, 2017, the Drafting Committee decided to allow a "narrow channel" through which one or more limited liability companies may be party to a merger involving a protected series indirectly – i.e., a merger in which at least one protected series is established, continued, or terminated. That decision is reflected in Section 602, which is part of the most recent draft of the act, distributed on January 31, 2017. Section 602 also reflects the Committee's decision to limit the channel to one type of entity (limited liability companies)[1] and one type of transaction (mergers), understanding that parties who wish to involve different entities or different entity transactions may do so through one or more subsequent transactions.

The Next Decision – Protected Series as Party?

May a protected series be a party to a merger?[2] Certainly, the practical advantages are substantial. Entirely aside from tax considerations, transfers "by operation of law" have come to comprise basic equipment for dealmakers and are essential to many deals. In addition, the capacity of a protected entity to be party to a merger underlines the separateness of the protected series and thereby supports the horizontal liability shields.

To date, the Reporter is aware of several contrary points: (i) excessive complexity; (ii) unwarranted risks to creditors; (iii) unintended consequences; and (iv) theoretical impropriety.

> Excessive complexity: Section 601 may well be less complex than Section 602. The mechanics of Section 601 rest on pre-existing merger mechanics (META) and this act's core mechanic of extrapolation.
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> Unwarranted risks to creditors: This concern pertains principally to a creditor's ability to pursue a Section 403 (formerly 402) claim and may in part rest on a misconception about

[1] The current draft limits participation to domestic limited liability companies, but the Committee has agreed to consider at some point Commissioner Jacob's proposal to include foreign limited liability companies whose statutes permit protected series.

[2] As discussed below, the Committee's decision to limit Section 602 to mergers should apply to Section 601 as well.

Section 403. A Section 403 claim does not hang "in the air,"[3] nor is it a brooding omnipresence.[4]

For a Section 403 claim to exist, it must have been formally asserted – i.e., the claimant must have sought "enforcement of a judgment against an [allegedly non-associated] asset of a series limited liability company or protected series of the company." Section 403(a). If through an enforcement proceeding, a claimant has marked the asset "by attachment, levy, lien, or the like," *id*, then the asset's status has changed.

Before that moment, however, the asset is "free and clear" of Section 403, and if the asset is transferred, *whether by contract, merger, gift or otherwise*, the transfer puts the asset beyond the reach of Section 403. This result comports with the rationale for Section 403 – i.e., not an extra remedy for creditors but rather a goad to good recordkeeping.

In one respect, a transfer by merger differs from the myriad other transfers recognized by ULLCA (2013)'s definition of "transfer".[5] A transfer by any of those means is subject to voidable transfer claims based on insolvency.[6] In the present context, a merger is not.

It might seem, therefore, that permitting a protected series to merge into another protected series or a limited liability company creates a method to "cleanse" an asset previously at risk under Section 403:

- By hypothesis, before the merger, the asset is exposed to a possible Section 403 claim because the asset was a non-associated assert when another protected series or the series limited liability company "incurred" a liability. See Section 403(b)(1)(B), (2)(B), 3(B).
- The merger eliminates the risk, because, due to the transfer, "when the liability giving rise to the claim was incurred, the asset was [not] a non-associated asset of the [surviving party to the merger]." *Id.*[7]

However, such a "cleansing" merger would be voidable under a non-insolvency provision of the Voidable Transfer Act:

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[3] Palsgraf v. Long Island R. Co., 248 N.Y. 339, 341, 162 N.E. 99, 99 (1928) ("Proof of negligence in the air, so to speak, will not do.") (quoting Pollock, Torts (11th Ed.) p. 455) (internal quotations omitted).
[4] S. Pac. Co. v. Jensen, 244 U.S. 205, 222, 37 S. Ct. 524, 531, 61 L. Ed. 1086 (1917) (Holmes, J. dissenting) (stating that "[t]he common law is not a brooding omnipresence in the sky").
[5] ULLCA (2013) § 102(23) ("'Transfer' includes: (A) an assignment; (B) a conveyance; (C) a sale; (D) a lease; (E) an encumbrance, including a mortgage or security interest; (F) a gift; and (G) a transfer by operation of law." The disappearance of the judgment debtor through a merger should have no effect on a Section 403 claim against a non-associated asset.
[6] *See* UVTA § 4(a)(2) and § 5.
[7] "[When the liability giving rise to the claim was incurred," the asset was not an asset of the future surviving party and *a fortiori* was not a non-associated asset of that party *Id.*

> A transfer made or obligation incurred by a debtor is voidable as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation … with actual intent to hinder, delay, or defraud any creditor of the debtor.[8]

In addition, an abusive, "cleansing" merger could give rise to affiliate liability – i.e., the surviving entity being held liable for all the debts of the judgment debtor.

The possibility that the judgment debtor might not survive a merger has raised another question. Is a judgment creditor's ability to bring or maintain a Section 403 action prejudiced? Since the merger will not extinguish the judgment, the answer to the question is "no." In any event, the same situation exists when a protected series that is the judgment debtor in question winds up and terminates.[9]

Unintended consequences: This concern rests on two premises: that the issue is exceedingly complex and the Committee comes to the issue very late in the drafting process. In the Reporter's opinion, the danger of unintended consequences is omnipresent in legislative drafting, but for the following reasons Section 601 is not specially vulnerable:

i. The Committee has now been addressing the issue of entity transactions for almost ten weeks.[10]
ii. At various points during that time some very sharp and learned individuals have focused their very considerable respective intellects on both the issues and the mechanics.
iii. The work on Section 602 has substantially raised the Committee's level of understanding of matters pertaining to protected series and entity transactions.
iv. As noted above, the mechanics of Section 601 rest on pre-existing merger mechanics (META) and this act's core mechanic of extrapolation.
v. In the ULC's ordinary, two-year drafting process, substantial questions often persist into the months before the annual meeting.
vi. The vetting of Section 601 (and Section 602) will continue throughout the Fine Tooth Comb process.

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[8] UVTA § 4(a).

[9] For the avoidance of doubt, the Committee could add a sentence to Section 403(d), as follows:

> (d) In a proceeding under this section, the party asserting that an asset is or was an associated asset of a series limited liability company or a protected series of the company has the burden of proof on the issue. A claimant may seek and be granted enforcement under this section regardless of whether the judgment debtor still exists.

A comment will note that any Section 403 claims abate if the judgment debtor is discharged in bankruptcy.

[10] The Reporter's earliest memo on the issue is dated 10-4-16.

Theoretical impropriety: This concern pertains to the entity *vel non* issue[11] and rests on the premise that only an entity may participate in a merger.[12] The Committee decided years ago that a protected series is a legal person but will not be labeled an entity. But this mere "person" has a legal existence separate from those owning an interest in it and can hold title to real property in its own name. How is participation in a merger any more "entity-like" than having these two attributes?

Moreover, as much as the Committee has treated "entity" to mean "legal person plus,"[13] many statutes treat "entity" as a subset of "person." Most notably:

- "Person" means an individual, business corporation, nonprofit corporation, partnership, limited partnership, limited liability company, … or any other *legal or commercial entity*. ULLCA (2013) § 102(15) (emphasis added).
- "Person" means an individual, corporation, business trust, estate, trust, partnership, limited liability company, …, or any *other legal or commercial entity*. UCC § 102(b)(27) (emphasis added).

The Narrow Channel and Section 601

The "narrow channel" approach adopted for Section 602 should apply equally to Section 601. That is, if the act permits a protected series to be party to an entity transaction, both transaction and entity types should be limited. As drafted, Section 601 permits only mergers. Permissible parties are: one or more protected series established by one domestic series limited liability company, domestic limited liability companies, including the series limited liability company that established the protected series (provided that a series limited liability company must survive a merger.)

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[11] That is: "To be [an entity] or not to be. That is the question."
[12] Presumably this same point applies to conversions, domestications, and interest exchanges.
[13] What is the plus factor? The answer is unclear.

SECTION 601. MERGER AUTHORIZED BUT LIMITED; OTHER ENTITY TRANSACTIONS PROHIBITED.

(a) Except as otherwise provided in subsection (b), a protected series may not be party to or established by a merger, interest exchange, conversion, domestication, or a transaction similar to a merger, interest exchange, conversion or domestication.

(b) One or more protected series of the same series limited liability company may be a party to a merger with each other, the company, another limited liability company that is not a series limited liability company, or any combination thereof, under [cite the provisions of this state's limited liability company statute pertaining to mergers], in accord with Section 108, and according to the following rules:

(1) If a series limited liability company is a party to the merger, the company must be the surviving entity.

(2) The surviving entity may not be formed by the merger.

(3) In connection with a merger under this subsection:

(A) For a protected series that will be the surviving entity, the series limited liability company that established the protected series[14] must deliver to the [Secretary of State] for filing the statement of merger, captioned "statement of designation change – merger".

(B) For a protected series that will be not be the surviving entity, the series limited liability company that established the protected series[15] must deliver to the [Secretary of

[14] Requirement applies even if the series limited liability company is not a party to the merger. The act does not authorize a protected series to deliver records for filing.
[15] See note 14.

State] for filing the statement of merger, captioned "statement of designation cancellation – merger".

(4) A series limited liability company's compliance with paragraph (3) is merely ministerial, does not make the company a party to the merger, or create for the company any rights or obligations pertaining to the merger.