To the Drafting Committee from Reporter Dan Kleinberger

March 17, 2016 (103rd anniversary of the birth of Philip A. Kleinberger)

Steve and I have received written comments from several people, and this memo compiles those comments and provides the Reporter's thoughts on each. Most of these issues are listed in Steve's and my memo distributed from Chicago on March 15.

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1. Whether to define "associated" with regard to the possible relationship between a series limited liability company and a protected series. *See* Section 302, n. 37.
    a. Probably not, as explained below.
    b. The Committee's thinking on this point has evolved over the course of the project.
        i. Early-on decisions:
            - The company may not be an "associated member" of a protected series.
            - If a protected series has no associated members:
                - the economics go to the company; and
                - the company manages the protected series.
        ii. More recent decisions:
            - Bare naked series transferable interests may be created without any accompanying governance rights.
            - The company, as well as third parties, make take such interests.
        iii. Most recent decision:
            - To express the company's rights when a protected series has no associated members and no bare series transferable interests, the company is described as "associated", which in turn is described as "as if" an associated member, solely with regard to matters concerning the protected series. Section 302(e).
            - Under this construct, when a protected series has no associated members the he company:
                - has all the series transferable interests of the protected series; and
                - manages the protected series *in the capacity of the only member of the protected series* (because the default management rule is management by members).
        iv. Query – Unless there is a reason for wanting the company to be managing *as a sole member*, why not simplify matters by eliminating the construct of the company being associated with a protected series and provide that:
            - the company may own series transferable interests;

- as a default rule, whenever a protected series has no associated members, the company:
  - is the series manager of the protected series; and
  - owns the transferable interests of the protected series.

2. Definition of "asset", Section 102(a)(1)
   a. Several issues have been raised concerning this definition, including:
      i. Too complex.
      ii. Should simply refer to ownership.
      iii. Should not use "ownership" because the term is vague.
      iv. Should not refer to judgment enforceability but rather use the UCC § 9-203(b) language ("rights in the collateral or the power to transfer rights in the collateral to a secured party").
   b. The Committee has agreed that owning property is a precondition to associating the property. Put another way, a protected series may not associate with itself property that the protected series does not own.
   c. In 99% of situations, the concept of ownership is neither a difficult nor contested issue. The same is true under Article 9, where "ownership" of collateral is fundamentally important but rarely at issue. However, for the grey areas, Article 9 provides a definition. This act must do so as well.
   d. The chair has convened an informal working group to determine how to revise the definition.
3. Whether the act should use "non-associated property" as a defined term.
   a. Yes.
   b. To some, having a defined term is overkill; simply writing "not associated" suffices in the few places where the concept appears.
   c. On the other hand ("OTOH"):
      i. The act makes "associated or not" its fundamental dichotomy. The dichotomy is connected to the act's most novel provision – i.e. asset-by-asset exposure.
      ii. Having a defined term for each side of the dichotomy may help people, including judges, recognize the dichotomy and its function.
      iii. The suggestion for a defined term came from a creditors rights expert – thinking, I believe, that a label would help neophytes.
4. How to handle the definition of "person", Section 102(a)(7) – Should the act:
   - recommend that an enacting state's limited liability company statute be amended, if necessary, to specifically include protected series; or
   - provide its own definition

   a. This question is largely technical one, which will be resolved in consultation with the Committee on Style.
   b. Having a stand-alone definition is problematic, given the plug-in nature of the act.
5. Whether a series transferable interest in a protected series, received by a member already associated with the protected series, should be considered part of the member's ownership interest as an associated member or held as a mere series transferee. Section 102(a)(12) (defining series transferee).

a. The Reporter is at the moment agnostic on this point.
b. ULLCA (2013) happily ducked this issue.[1]
c. Assuming that the operating agreement does not address the analogous issue under this act, the situation should be the same as under ULLCA. Default management mode is management by associated members, and governance power is per capita.

6. Whether a protected series should be prohibited from being a member of the company, Section 104(c)(2), or from having rights in another series. Section 104(c)(4).
    a. Yes.
    b. Although not strictly circular, allowing a protected series to be a member of the company would likely boggle the respective minds of the uninitiated.
    c. Allowing a protected series to have an interest in another protected series will feed the notion that the act facilitates shell games.
    d. The same results can be achieved in other ways.
7. Whether Section 105(1)'s reference to the "internal affairs" of a protected series will be correctly understood.
    a. The Reporter suggests reinserting language describing the key relationships within the internal affairs of a protected series.
    b. The Committee has gone back and forth on this question.
    c. "Internal affairs" was inserted at one point to save words and to connote the separateness of protected series from the company and each other.
8. Whether the current draft adequately extrapolates creditor protections (*e.g.*, distribution limitations).
    a. Yes, although reaching this conclusion requires several steps.
    b. Section 106(c) extrapolates provisions of the limited liability company statute to the extent that neither this act nor the operating agreement address a matter.

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[1] *See* ULLCA (2013) § 501, cmt.

> As to whether a member may transfer governance rights to a fellow member, the question is moot absent a provision in the operating agreement changing the default rule, see Section 407(b)(2) (allocating governance rights per capita). In the default mode, a member's transfer of governance rights to another member: (i) does not increase the transferee's governance rights; (ii) eliminates the transferor's governance rights; and (iii) thereby changes that denominator but not the numerator in calculating governance rights.
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> > EXAMPLE: LCN Company, LLC is a member-managed limited liability company with three members, Laura, Charles, and Nora. The operating agreement does not displace this act's default rule on the allocation of governance rights among members. Thus, each member has 1/3 of those rights. Laura transfers her entire ownership interest to Charles. The transfer does not increase Charles's governance rights but does eliminate Laura's. After the transfer, Laura has no governance rights (regardless of whether Charles and Nora agree to expel Laura under Section 602(5)(B)). As a result, Charles and Nora each have 1/2 of the governance rights.

c. Section 107(b) extrapolates any limitations in the limited liability company statute applicable to the power of the operating agreement.
d. For example:
    i. The operating agreement cannot vary the limited liability company statute's limitations on distributions from the limited liability company.
    ii. Section 106(a) extrapolates those limitations so that they pertain to distributions from a protected series.
        - This act does not address the issue.
        - Any attempt by the operating agreement to address the issue fails due to Section 107(b)
e. If this analysis is correct, Section 403 (charging order) may be unnecessary.

9. Whether the bracketed alternatives in Section 202(b) should be retained as such.
    a. Yes, in part, at least pending further consultation with IACA. Suggest deleting "begin with" and "end with" as too restrictive.
    b. The goal is to make protected series searchable in the public record by searching for the name of the limited liability company.
10. Whether to delete in Section 301(b)(1) the reference to "an ordinary business person".
    a. The phrase was initially inserted to respond to a commissioner's concern ("can't be that the standard is satisfied if it takes a forensic accountant to work through the records").
    b. OTOH, the phrase is asserted to be vague.
    c. The phrase does appear in the case law (albeit sometimes with reference to an ordinary business man).[2]

[2] *See, e.g.,* Adams v. Erickson, 394 F.2d 171, 173 (10th Cir. 1968) ("[T]he Wyoming court has said that it was committed to a liberal view in the matter of foundation for opinion evidence and 'that even a nonexpert may testify to the value of property if his knowledge has been derived through the general avenues of information to which the ordinary business man resorts to inform himself as to values for the conduct of his affairs.'") (quoting State Highway Comm'n v. Newton, Wyo., 395 P.2d 606, 609); Canright v. Gen. Fin. Corp., 35 F. Supp. 841, 844 (E.D. Ill. 1940) aff'd, 123 F.2d 98 (7th Cir. 1941) ("Failure to investigate will afford no excuse when the creditors' knowledge and information are sufficient to have put an ordinary business man on inquiry."); Myown Dev. Corp. v. Com., 159 Va. 1004, 1008, 167 S.E. 374, 375 (1933) ("It does not appear from the evidence that Bruce's reputation was such that knowledge of it can be imputed to an ordinary business man in Petersburg."); In re Gaylord, 225 F. 234, 242 (N.D.N.Y. 1915) ("Did the Sulzberger & Sons Company of America, acting by its agents in this matter, receive this mortgage under such circumstances and with such information and knowledge (actual or imputed) as naturally would have caused the ordinary business person of intelligence and reasonable prudence, had he been the creditor receiving it, to have believed that thereby a preference would be effected?"); Com. v. Dorman, 22 Pa. Super. 17, 18 (1903) (recounting part of the court's charge to the jury as "[n]wow, we say to you that if the jury believe from all the evidence in these cases that Henry W. Dorman, one of these defendants, knew that Charles N. Purvis was not a banker doing what an ordinary business man would understand to be a banking business, …."); Hearing No. 21,947, 1988 WL 153411 (Tex.Cptr.Pub.Acct. April 14, 1988) ("[T]he Comptroller's training program for auditors instructs them to provide written notice of the sampling procedures to be used, at the commencement of the audit. Verbal explanations of statistical sampling techniques are doubtless well understood by trained accountants, the persons often designated by taxpayers to work with the auditor. But, such sophisticated knowledge cannot

11. Whether the recordkeeping requirements of Section 301(b)(3) (recording from whom asset acquired if from the company or another protected series) should be extended to disposition of asserts within the "family".
    a. Maybe.
    b. Seems redundant, because the acquiring party is subject to Section 301(b)(3) as written.
    c. OTOH, belts and suspender convey a sense of anti-shell-ness.
12. Whether Section 301(c) should require that representative/nominee status be disclosed on the title.
    a. Yes.
    b. To the best of the Reporter's recollection, this requirement was omitted inadvertently.
13. Whether Section 301(d) should be deleted?
    a. Yes.
        i. The requirement is unnecessary – once a protected series no longer has any interest in the asset, the protected series cannot claim that the asset is associated property.
        ii. The act specifies no consequences for non-compliance.
14. Whether Section 302(d) should be modifiable, but only if the modification provides for a series manager or for dissolution of the protected series.
    a. Maybe.
    b. Unlike a limited liability company, a protected series can exist without an associated member. This subsection addresses the problem of management authority.
        i. If a protected series has no members *ab initio*, in the default mode:
            - the series limited liability company is associated as if an associated member; and
            - extrapolation makes the protected series member-managed.
        ii. In contrast, if a protected series has had an associated member, in the default mode that member (or members) comprise the series manager. There is no default fallback for management of the series when the last of these members is gone.
    c. The proposed revision solves this problem.
        i. If the operating agreement provides for a series manager when no associated member remains, the problem is solved directly.

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be imputed to ordinary business men or to relatively untrained bookkeepers."); In the Matter of Atd Catalogs, Inc., et al., 65 F.T.C. 71 (1964*), order set aside in part by* In the Matter of Atd Catalogs, Inc., et al. 71 F.T.C. 354 (1967) (referring to "such knowledge … [as would be had by] an ordinary business man knowing what advertising payments would be for in a program of this kind"). *Cf.* A&T Corporation, v. Paris Oxygen Company, First Amended Original Answer and Counterclaim,2004 WL 5781488 (E.D.Tex. May 18, 2004) ("Paris Oxygen did not know and had no means of knowing the real facts-that AT&T would thereafter attempt to impose on Defendant charges based on a series of complex calculations beyond the knowledge and understanding of any ordinary business person or consumer.")

ii. If the operating agreement provides for dissolution, in the absence of a series manager the default rule is winding up managed by the series limited liability company. Section 502(a).

d. OTOH, the act could provide as a default rule that, any time a protected series has no associated members, the series limited liability company manages the protected series. *See* #1.

15. Whether ULLCA's "formalities don't matter" provision should apply to the vertical and horizontal shields of a protected series.
    a. With regard to the vertical shields, there seems no reason to treat members associated with a protected series differently than members of a limited liability company.
    b. The horizontal shields pose a different issue.
        i. On one hand, so long as the association requirements are met, why bring formalities into the analysis?
        ii. OTOH:
            - The horizontal shield is a different type of shield. The analogy to *vertical* shields/formalities is not self-evident.
            - As a matter at least of optics, do we want to establish tight recordkeeping requirements and then say "notwithstanding the foregoing, you can otherwise be as sloppy as you want"?
16. Whether to provide the enacting state with discretion to apply its law of piercing to foreign protected series. *See* Section 601(b).
    a. Yes.
    b. Without this latitude, an enacting state is helpless in the face of very anti-creditor rules adopted in other jurisdictions.
    c. The ULC first codified the rule of deference to the state of formation in 1976, without any comment to explain why. Up to that time, deference was a matter of comity, within a court's discretion.