

TRANSACTIONAL REAL ESTATE

Recovery of Non-Permitted Distributions



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In 2005, the Merritt Square Mall in central Florida was sold pursuant to a purchase and sale agreement among Delaware limited liability companies. The sellers undertook in the purchase agreement to perform and pay for the work required to bring a JC Penney store in the mall into compliance with the fire code. At the closing, the sellers and the buyer entered into a separate escrow agreement pursuant to which the sellers deposited approximately \$250,000 into an escrow account to secure the work obligation, though the escrow agreement required the sellers to pay for the work whether or not the escrowed funds were sufficient.¹

Shortly after the closing of the sale, the sellers distributed substantially all of the sale proceeds and the sellers' other assets, other than the escrow account, to their respective members. The sellers subsequently filed certificates of cancellation, ending their legal existence effective Dec. 6, 2006. Although the sellers hired a contractor to perform the required work, it was never undertaken by the contractor. The buyer asserted, as noted by the court in the resulting litigation, that once it was determined after the closing that the presence of asbestos would substantially increase the cost of the work, the sellers abandoned their efforts. Eventually the buyer was forced to undertake the work at its expense with the same contractor, at an ultimate cost in excess of four times the escrow. Shortly after the dissolution of the sellers, the buyers sent a demand to the sellers for release of the escrowed funds and reimbursement of the excess costs, which demand went unsatis-

fied, and the buyer brought an action against the sellers.

The fact pattern in the Merritt Square is emblematic of an issue that is often confronted in commercial sale transactions. Buyers often attempt to negotiate escrows, holdbacks, guarantees, letters of credit and other forms of security for a seller's post-closing liabilities, including potential liabilities under contract representations and warranties. Sellers typically resist these arrangements, especially those that involve diversion of cash proceeds, because they diminish current distributions that could otherwise be made to the seller's equityholders and out of fear that the proceeds once escrowed or held back will be difficult to recover. In a robust sales market, buyers often have to live without such security. Fortunately for buyers in the position of the Merritt Square purchasers, statutory law may provide a remedy. This article explores the recourse that may be available to buyers under the Delaware Limited Liability Company Act and under corresponding statutory law in other jurisdictions.²

Statutory Language

At common law, no claims may be brought against a dissolved entity.³ However, each of the Delaware Limited Liability Company Act, the Delaware Revised Uniform Limited Partnership Act and the Delaware General Corporation Law (as well as the New York Limited Liability Company Law), contains a provision that provides a measure of protection for a buyer.⁴ Section 18-804(a) of the Delaware Limited Liability Company Act (the language is substantially similar for other statutes) provides that "upon the winding up of a limited liability company, the assets shall be distributed [first] to creditors,"⁵ and that a limited liability company (LLC) that

has dissolved "shall make such provision as will be reasonably likely to be sufficient to provide compensation for claims that have not been made known to the limited liability company or that have not arisen but that, based on facts known to the limited liability company, are likely to arise or to become known to the limited liability company within ten years after the date of dissolution."⁶ This includes contingent, conditional and unmatured claims and obligations known to the LLC, and obligations known to the LLC but for which the claimant's identity is unknown.⁷

Although the Delaware statute provides that claims may generally only be brought against an LLC until a certificate of cancellation is filed,⁸ a buyer can seek to have the cancellation nullified on the grounds that the LLC's affairs have not been wound up in compliance with the statute.⁹ Delaware courts have allowed the members of a dissolved LLC to nullify the certificate of cancellation and bring a breach of contract action against the LLC and the other members who participated in the dissolution when the LLC failed to make provisions for reasonably foreseeable compensation claims against the LLC.¹⁰

Although the statute requires provisions to be made for claims likely to arise within 10 years after dissolution, the statute of limitations for breach of contract claims in Delaware is three years,¹¹ and thus it is unclear whether claims could be made during the entirety of such 10-year period.¹² Courts have contrasted the 10-year period in the Delaware Limited Liability Company Act with the Delaware General Corporation Law, which requires corporations to continue their existence post-dissolution for three years for the purpose of defending against potential claims.¹³ In November 2013, the Delaware Supreme Court ruled that a receiver may

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be appointed for a dissolved corporation more than 10 years after dissolution, holding that the “dissolution statutes impose no generally applicable statute of limitations that would time-bar claims against a dissolved corporation by third parties.”¹⁴

Recouping Distributed Funds

In addition to directing the entity how to appropriately wind up, the statute also places liability on distributees. “A member who receives a distribution in violation of [§18-804(a)] and who knew at the time of the distribution that the distribution violated [§18-804(a)] shall be liable to the limited liability company for the amount of the distribution.”¹⁵ While the statute requires a seller to make provisions for claims that “have not been made known to it,” in order for a buyer to recoup the distributions made to the seller’s members, it must be shown that the members themselves had knowledge of the entity’s failure to make adequate provisions at the time of the distribution (but not necessarily knowledge of a specific claim). Absent such knowledge, the LLC cannot reclaim the funds that have been distributed to the members. The existence of such knowledge is a factual matter that may be disputed between the parties. However, because it is likely that the managing member (or other managing equityholder) has knowledge of the potential claims against the entity at the time of the distribution, at a minimum the proceeds distributed to that managing member will be within the LLC’s reach. To prevent itself from becoming solely liable, the managing member is incentivized to properly retain funds, as necessary, for all reasonably likely claims with a cushion beyond that. Although the distribution statute requires provision for claims that are likely to arise or to become known to the LLC within 10 years after the date of dissolution, the statute provides that a member who receives a distribution is only liable for the amount of the distribution for three years from the date of the distribution.¹⁶

The LLC Act does not explicitly give a creditor the right to enforce this provision, which is vested in the LLC itself. However, creditors can bring a fraudulent transfer claim or claim a right of receivership per the LLC Act, which provides for the Delaware Court of Chancery to appoint receivers who are empowered

to take charge of the limited liability company’s property, and to collect the debts and property due and belonging to the limited liability company, with the power to prosecute and defend, in the name of the limited liability company, or otherwise, all such suits as may be necessary

or proper for the purposes aforesaid[...] and to do all other acts which might be done by the limited liability company, if in being, that may be necessary for the final settlement of the unfinished business of the liability company.¹⁷

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The sellers of the Merritt Square Mall never performed the work required under the purchase agreement. They failed to pay for the work when it was eventually performed by the buyer, and they terminated their existence without making a reasonable provision for its payment. The buyer alleged that the sellers knew shortly after the closing of the purchase agreement that bringing the JC Penney to code would cost far more than anticipated under the escrow agreement because of the presence of asbestos.¹⁸

The buyer and sellers of the Merritt Square Mall continually communicated with one another regarding the required work, but the sellers did not inform the buyer of its 2005 distribution or 2006 dissolution until 2009, at which point the buyer brought suit against the sellers in the Delaware Court of Chancery, attempting to nullify the sellers’ certificates of cancellation.¹⁹ In the complaint, the plaintiffs cited the Delaware LLC Act, claiming that because the defendants refused to pay for the work and then terminated their existence without making a reasonable provision for its payment, they failed to properly wind up and distribute the assets of the dissolved entities.

The court denied the defendants’ motion to dismiss the claim. The defendants contended that they had met requirements of the LLC Act, because the escrow agreement constituted a reasonable provision to account for the plaintiffs’ claims. But the court cited the plaintiffs’ complaint, that the defendants were “responsible for all costs incurred in connection with the work required to bring the JC Penney store in the shopping center in compliance with the fire

code” (emphasis added), and that the defendants knew before their dissolution that “the cost of the work ‘would far exceed initial estimates and the amount in escrow.’”²⁰ Unable to obtain a dismissal of the claim, the defendants were ultimately forced to settle. Although the terms of the settlement were not disclosed, the dissolved entities had no assets, so any financial compensation received by the plaintiffs in excess of escrow would likely have to have come from one or more of the distributees.

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1. *Thor Merritt Square v. Bayview Malls*, No. 4480-VCP, ___A3d___, 2010 Del. Ch. LEXIS 52, at *1 (Del. Ch. 2010).

2. Buyers may also have alternative arguments, such as setting aside the distributions as a fraudulent conveyance or piercing the corporate veil to pursue the equityholders. The New York Debtor and Creditor Law has been construed by the Southern District of New York Bankruptcy Court to provide that a distribution can be considered a fraudulent conveyance if it will make a limited liability company insolvent or if it is made as an attempt to move the company’s assets out of the reach of potential creditors. NY Debt. & Cred. §273-a; see *In re Die Fliedermaus*, 323 B.R. 101, 105 (Bankr. S.D. N.Y. 2005). See also *Pepsi-Cola Bottling of Salisbury Md. v. Handy*, No. 1973-S, ___A2d___, 2000 Del. Ch. LEXIS 52 at *16 (De. Ch. 2000). The Bankruptcy Code allows a creditor to reach not only the immediate transferee of a fraudulent conveyance but also transferees for whose benefit such a transfer has been made. 11 U.S.C.A. §550 (2013); see *In re Die Fliedermaus*, at 107.

3. Carter G. Bishop & Daniel S. Kleinberger. Limited Liab. Co. ¶14.07[3], citing *Metro Commun. BVI v. Advanced Mobilecomm Techs.*, 854 A.2d 121 (Del. Ch. 2004).

4. See Del. Code Ann. 6 §18-804, Del. Code Ann. 6 §17-804, Del. Code Ann. 8 §281, NY Ltd. Liab. Co. §508.

5 Del. Code Ann. 6 §18-804(a).

6 Del. Code Ann. 6 §18-804(b)(3).

7. Id., Del. Code Ann. 6 §18-804(b)(1).

8. Del. Code Ann. 6 §18-803(b).

9. See, e.g., *Metro Commun. BVI v. Advanced Mobilecomm Techs.* (an example citing the LLC Act); *In re CC&F Fox Hill Assocs.*, No. 15430, ___A2d___, 1997 Del. Ch. LEXIS 89 (Del. Ch. 1997) (an example citing the Limited Partnership Act); *Lyman Commerce Solutions v. Lung*, No. 12-cv-4398, 2013 WL 4734898 (S.D. N.Y. 2013) (an example which cites both the LLC Act and the Limited Partnership Act).

10. See, e.g., *Metro Commun. BVI v. Advanced Mobilecomm Techs.* In this case the breach of contract claim alleged that the LLC violated its operating agreement.

11. Del. Code Ann. 10 §8106.

12. Bishop & Kleinberger. ¶14.07[3].

13. Del. Code Ann. 8 §278; see *Roz Trading v. Zeromax Group*, 517 F.Supp.2d 377, 384 (D. D.C. 2007).

14. *In re Krafft-Murphy*, No. 85,2013, ___A2d___, 2013 WL 6174485, at *1 (Del. 2013). The court cited the legislative history of the dissolution statutes, noting that “the General Assembly clearly contemplated that a dissolved Delaware corporation could continue to be liable to third parties long after its forma dissolution. ... Had the General Assembly intended the ten year period to operate as a limitations time bar, that body would have clearly expressed that intent in either the synopsis or in the statutory language.” Id., at *8. Note that the statutory language in the Delaware Limited Liability Company Act and the language in the Delaware General Corporation Law are substantially similar. Compare Del. Code Ann. 6 §18-804 to Del. Code Ann. 8 §281.

15. Del. Code Ann. 6 §18-804(c).

16. This serves as a limitation even when a longer statute of limitations (i.e. the statute of limitations applicable to the underlying claim) would otherwise apply. For example, the statute of limitations for fraudulent conveyance claims in New York is six years. N.Y. C.P.L.R. §213(1) (2013), but a member’s distributions are not recoverable beyond three years. See *In re Die Fliedermaus*, at 107-109.

17. Del. Code Ann. 6 §18-805. A creditor can petition for the court to appoint such a receiver as a way of pursuing the members. Note, however, that a creditor cannot bring a derivative action for the benefit of the LLC. See, e.g., *Otto v. Otto*, 110 A.D.3d 620 (N.Y. Sup. Ct., 2013), *CML V v. Bax*, 28 A.3d 1037 (Del. 2011).

18. *Thor Merritt Square v. Bayview Malls*, at *5.

19. Id.

20. Id., at *14.