Professional Perspective

Legal Developments for Alternative Compensation Vehicles

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Legal Developments for Alternative Compensation Vehicles

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In the world of executive compensation, public companies often get more attention, given the size of compensation packages and the publicity that shareholder organizations such as ISS can generate to challenge compensation "say on pay" votes. But private entities deliver a broad range of significant compensation, whether it involves arrangements with partners, in the case of partnerships, or members, in the case of LLCs, in a wide variety of businesses—hedge funds, private equity firms, asset managers, law firms, and accounting firms. The compensation issues arising in this context are different, and some recent case developments in this area are worth noting.

When Can An LLC Member Be Expelled?

Continued compensation as a member of an LLC is not guaranteed. If a member is forced out or expelled from an LLC, they can be denied considerable future compensation opportunities. One threshold question is whether the LLC agreement has express provisions for a member to be expelled, or, as it is often referred to, "involuntarily withdrawn" or "disassociated." LLCs are governed by statute, and the statutes provide LLCs with the opportunity to contract on a variety of issues, including expulsion. The statues provide default rules in the absence of written operating agreements directly addressing the matter.

Two cases, one in New York and one in Delaware, provide an interesting view of how expulsion provisions work. In *Garcia v. Garcia*, 187 AD3d 859, 2020 NY Slip OP 05725, [2nd Dept 2020] the Appellate Division addressed a family dispute; the case involved two family-run LLCs that owned and operated residential real properties in Brooklyn, New York. Both LLCs had identical memberships (owned one third each by the three family members). Following the discovery that one of the members was diverting large sums of money to himself without consent, the other members voted to expel that member at a meeting attended by all three members.

The operating agreements of both LLCs stated that dissociation of a member would occur upon the expulsion of said member. The court found this language "clearly and unambiguously established the parties' intent to allow for the removal of a member." The fact that the operating agreements did not contain a mechanism for expulsion, and that the New York State LLC law does not have a default expulsion provision did not render the expulsion invalid. The operating agreements each provided that any action taken on behalf of the LLC was to be taken by a majority vote of the members. Since the two members of the LLC voted to expel the third member, at a meeting in which the third member attended, the action was a valid expulsion under the operating agreements.

The expelled member in *Garcia* could not rely on an earlier decision that held an attempted expulsion invalid, *Man Choi Chiu v. Chiu*, 71 AD3d 646, 2010 NY Slip Op 01768, [2nd Dept 2010]. In *Chiu* the Second Department affirmed the dismissal of a claim to expel a member, on the grounds that the LLC did not have an operating agreement setting forth a mechanism for the expulsion of members. The court further noted that although the New York limited liability law, Section 701 "mentions expulsion of members, there is not statutory provision authorizing the courts to impose such a remedy." *Garcia* is distinguishable from *Chiu* because the LLC agreements in *Garcia* did provide a passing reference to expulsion and also included general voting procedures whereby majority action by the members controlled.

An earlier decision under Delaware law, however, highlights the risk of straying too far afield from the expulsion provisions of the operating agreement. In *Walker v. Resource Dev. Co., L.L.C.*, 791 A.2d 799 (Del. Ch. 2000), the Delaware Chancery Court held that the expulsion of a member of an LLC was not permitted because the expulsion occurred for a reason not provided for in the LLC agreement. Plaintiff Walker, through his company, became a member of the Delaware LLC (REDECO) in April 1995. The LLC had four members, Walker and three other individuals with the first name of William, whom the court referred to as the "three Bills." Walker was brought on to identify and secure financing for projects.

During his tenure as a member, Walker acted erratically, and failed to ever secure a financing deal. As a result, the three Bills voted to remove Walker, citing poor performance and misconduct. The withdrawal of members provision under the relevant operating agreement provided for involuntary withdrawal under specific circumstances, which included:

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- The member filing a voluntary bankruptcy petition.
- The death of a member or a determination by a court of competent jurisdiction that the member was incompetent to manage their person or property.
- In the case where the member was a corporation, in the filing of a certificate of dissolution for the corporation or the revocation of the corporation's charter.
- In the case where a member was an estate, on the personal representative's distribution of the estate's entire interest in the company.

However, the court held that Walker was removed because he failed to secure financing. As such, the court held that the three Bills had no authority to remove Walker because neither the operating agreement, nor the Delaware LLC law allowed such removal. The Court noted that while the operating agreement "does address the voluntary and involuntary withdrawal from membership [it failed to identify any] instance even arguably applicable in this case."

The distinguishing factor between the two cases appears to be the level of specificity in the provisions. In *Walker*, the LLC agreement contained a provision that listed specific circumstances when a member could be expelled. Contrast this with *Garcia*, which referenced expulsion generally, and which the court viewed as the type of action subject to majority action.

Repurchasing Interests of Former Members and Partners

When an LLC or partnership allows for expulsion or resignation of a member or partner, it is often the case that the parties agree that the interest will be repurchased. This is done through a buyout or call process that allows the LLC or other members to notice their intent to repurchase. The call mechanism also sets the price for the repurchase and may often include an outside appraisal mechanism if there is a dispute of the value of the interest.

An issue that arose in a 2020 case is whether exercise of this call is under the sole control of the LLC or its members, and whether an initial decision to call the interest of an existing member can be rescinded and "turned off."

Walsh v. White House Post Productions, LLC, No. 2019-0419 (Del. Ch. 2020) involved a dispute over a call provision in the LLC agreement of Carbon Visual Effects, LLC. The company determined not to renew the plaintiffs' service agreements, which ended their employment, and in anticipation of the plaintiffs' departure exercised its right to acquire the plaintiffs' units, but then changed its mind. The plaintiffs sued the company and its managing member for breach of contract and specific performance. In denying the company's motion to dismiss, the court rejected the company's argument that it could withdraw from the buyout process once it had noticed an intent to purchase the units.

The applicable buyout or call provisions in the LLC agreement allowed the company to purchase a former employee's LLC units at a price determined by a contractual appraisal process once the employee's employment with the company ended. As part of the price-fixing process, as many as three independent appraisals could occur. The first step in the appraisal process required the company to provide notice of intent to buy the shares and obtain an independent appraisal. Nothing in the provision expressly prohibited the company from withdrawing from the process and rescinding its notice of intent to acquire the shares.

When the plaintiffs' service agreement was not renewed by the company and their employment terminated, the company noticed its intent to purchase plaintiffs' units and obtained an initial appraisal, which was provided to the plaintiffs. The plaintiffs responded by stating they would obtain a second appraisal (as allowed under the provision) and requested information from the company to provide to the second appraiser.

However, the company informed the plaintiffs that it had "reevaluated [its] needs" and had decided not to exercise its right to purchase their units. The plaintiffs viewed this as a breach of the provision and brought suit. The company argued that it had the right to withdraw from the price-fixing process and therefore was not required to follow through with the purchase. The plaintiffs argued that the buyout provision was a form of option contract such that, under common law, once the company delivered notice and exercised its call it could not withdraw from the price-fixing process.

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The court held that the buyout provision was a call option and that upon exercising the option by delivering notice, the company could not withdraw from the price-fixing process. The court held that the provision contained both elements of an option contract, an offer to enter into an underlying agreement for the sale of property and a promise to keep that offer open. In this case, the promise to keep the offer open was made by the plaintiffs in the agreement because they were obligated to sell their shares in the event they ceased to be employed by the company.

Interestingly, as the court noted, the LLC buyout provision did not specify the "method by which the company is required to exercise its power of acceptance." Thus, the court was required to determine if acceptance by the company could be implied by the company's conduct. It held that, for purposes of denying the company's motion to dismiss, the only reasonable interpretation of the buyout provision was that the delivery by the company of notice constituted acceptance and exercise of the call option, which the company could not rescind. The court further held that the plaintiffs had stated a claim for specific performance of the appraisal process.

Another variation of this issue arises in *Flink v Smith*, 2020 NY Slip Op 50305[U] [Sup Ct, Albany County, 2020], a New York case where former members of a law firm were forced to buy-out their former co-member despite their withdrawal. In *Flink*, a law firm established an operating agreement that established a process by which a retiring partner would be bought out of his shares by his retirement date. The court held that the parties to the operating agreement were still bound by the buyout despite withdrawing from the firm before the buyout date.

The operating agreement provided that the retiring member (Flink) would gradually sell his shares to the remaining partners up until his retirement date. Upon his retirement date, the remaining members would have the first opportunity to purchase his remaining shares. If the remaining members did not exercise this right, the LLC was obligated to purchase the shares. In the event that that the LLC was no longer an operating entity and the other members of the LLC did not elect to purchase the shares, two members (Smith and Dominelli) agreed to purchase the shares.

However, Smith and Dominelli left the LLC and formed a new firm, without dissolving the LLC. When Flink retired, Smith and Dominelli refused to buy Flink's shares, and Flink sued.

The court held that the LLC was no longer an operating entity and therefore Smith and Dominelli were obligated to purchase Flink's shares under the operating agreement. Smith and Dominelli's withdrawal from the LLC did not relieve them of their individual obligation to buy-out Flink under the operating agreement. As noted by the Court, "[d]efendants' withdrawal from [the LLC] deprived them of the status as members, but they did not lack power to perform under the operating agreement. Defendants provided no authority to support the contention that they must be members of [the LLC] for them to be obligated to buy-out Flink." One factor influencing the court's holding is that the LLC agreement failed to limit the repurchase obligation solely to Smith and Dominelli in their status as members of the LLC. In the absence of such language the repurchase obligation was treated as an individual obligation of the defendants, separate and apart from their status as members of the LLC.

Setting Off Amounts Due Partners or Members

Partnership agreements and LLC agreements often have set-off provisions, which permit the sponsor or employer to reduce amounts due to a partner or member by an amount owed by the partner or member to the sponsor, employer, or often their affiliates. The scope of these provisions can be quite broad, because there can be multiple payment sources to a partner or member. These sources may include payment of carry from GP carry vehicles or distributions from co-investment vehicles that can be shut down under these provisions if the partner or member is determined to owe amounts to the sponsor, employer, or affiliates.

Similarly, the partner or member may have multiple payment obligations to the sponsor, employer or affiliates, such as capital commitments, loan obligations or claw-back obligations. The failure to comply with these obligations could trigger the set-off of amounts due the partner or member from these other payment sources.

When all is going according to plan, this web of relationships is manageable, and cash flows and related payment obligations are handled as the parties may expect. However, in situations where a partner or member defaults on a payment obligation, resigns or is involuntarily terminated, then interests may diverge and the risk of a failure to comply with payment obligations could give rise to set-off.

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A 2020 case, *Wagner v. Pegasus Capital Advisors, L.P.*, 2020 NY Slip Op. 33407 (Sup Ct, New York County, 2020) involved an investment firm that successfully applied a set-off provision in a note executed by an investor to reduce profits payable to the investor, because the note was in default. The investor in the case had in February 2011 invested $1 million in a deal that turned successful and in February 2019 resulted in a $2.6 million distribution payable to the investor.

The problem was that the investor had borrowed $2 million in May 2012 to invest in another deal, with the loan on that investment due in December 2012. The investor subsequently defaulted on the loan. When the profits on the first deal arose in 2019 the investment firm set-off the full amount of the profits from the first deal against the then outstanding balance of the loan on the second deal. As a result, the investor got nothing.

The investor sued and challenged the set-off as effectively barred by the six-year statute of limitations applicable to the defaulted note, on the grounds that the set-off occurred more than six years after the note became due. The court rejected that argument, holding that even if an affirmative lawsuit to enforce the note was time-barred, set-off was a permissible alternative. The court further rejected the investor's argument that the note involved a separate financial investment that could not affect his right to profits from the first deal.

The holding in the *Wagner* case shows the power of a broad set-off provision, which can apply across investments. At the same time, practitioners should exercise care when applying set-offs. Certain types of payments cannot be subject to set-off. First and foremost, earned wages may not be subject to reduction or set-off under various state laws. The same generally holds true for formulaic bonus amounts tied to the personal productivity of an employee. Set-offs affecting deferred compensation arrangements also may trigger issues under Section 409A of the Internal Revenue Code, but only to the extent that funds of the employee being accessed are deferred compensation. This in turn requires a careful review of the underlying arrangement and consultation with counsel experienced in Section 409A matters.

Conclusion

As practitioners consider partnerships and LLCs as compensation vehicles, it is important to understand all the factors that affect these arrangements. First and foremost, these vehicles operate within a framework of state partnership and LLC statutes. In many cases, these statutes allow the parties freedom of contract to structure their arrangements, but also provide default rules if matters are not addressed in operating documents.

Careful attention should be given to the long-term nature of these arrangements, and whether members or partners are exposed to expulsion or, conversely, to commitments that may extend beyond their withdrawal. The web of payments in these arrangements are often interconnected. As a result, payment defaults or other breaches could jeopardize economics and future payouts across the full investment platform.

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