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The Connecticut Limited Liability Company Act: A Lasting Legacy for Connecticut LLCs

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By: Marc J. Herman

The State Legislature first recognized the limited liability company structure in 1993 when it enacted the Connecticut Limited Liability Company Act (“Old Act”).¹ Two-and-one-half decades later, though, it repealed the Old Act and passed the Connecticut Uniform Limited Liability Company Act, which came into effect on July 1, 2017 (“New Act”).² Even so, because the New Act only applies prospectively, its predecessor, the Old Act, still governs disputes about Connecticut limited liability companies if:

1. The dispute concerned alleged liability that arose before July 1, 2017; or
2. The dispute led to litigation before July 1, 2017.³

With litigation under the New Act still in its infancy, the Old Act plays its part in shaping commercial disputes. In particular, its restrictions on derivative lawsuits—that is, lawsuits to enforce rights belonging to a limited liability company—continue to hamper would-be plaintiffs. The New Act, in contrast, exhibits greater comfort with the derivative lawsuit concept, ushering in a similar framework as used for corporations under the Connecticut Business Corporation Act.

Current members and managers of Connecticut limited liability companies should heed this dichotomy and understand how it might impact them. A recent case from the Connecticut Supreme Court provides a good example:

SAUNDERS v. BRINER, ET AL., 332 CONN. 135 (2019)

A. Facts

In 2009, Clark Briner and Sloan Saunders created Revere Investments, LLC (“Revere”)—a loan provider and servicer for commercial real estate loans. Clark (through another LLC) and Sloan each owned 50% of Revere. To help kick-start their venture, Clark and Sloan approached Sloan’s father—Saunders—for assistance. Saunders, who was already well established in the lending business, agreed to provide Revere with bridge loans—i.e., temporary funds to close a loan before Revere could secure investors to fund the loan. After Revere raised the necessary capital from investors, it repaid Saunders’s bridge loans.

Revere profited from its venture in two ways: (i) the interest-rate spread between the rate offered to investors and the rate charged to borrowers; and (ii) loan-origination fees. Because Revere required its borrowers to finance these fees, Revere would need to advance less than the principal borrowed. In other words, Revere would receive principal and interest payments on an amount larger than that advanced (net funding).

Revere’s outside investors did not receive this benefit. So these investors would only receive principal and interest payments on the amount they invested (no net funding). Inside investors, however—like Saunders and other family members—enjoyed net funding. This benefit comprised their receiving principal and interest payments on an amount more than they had invested (grossing up). On top of this arrangement, Saunders had agreed with Clark and Sloan that he would also keep the interest-spread profit for any outside investors that he had originated.

In mid-2011, Clark, Sloan, and Saunders created a new entity—Revere High Yield Debt Fund, L.P. (“Fund”), which pooled outside investor capital. Clark began to get agitated at Saunders’s profit-sharing scheme. So he created another entity—Revere Capital CT—in which he stored funds from outside investors. By doing this, Clark could invest in Revere Capital as an inside investor by using outside investors’ money; and as an inside investor, Clark could gross-up. After Saunders—who had inherited Sloan’s interest in Revere—caught wind of this and other misgivings, he sued Clark and two of his entities, asserting both direct and derivative counts.

B. The Trial Court’s Decision

The trial court awarded judgment to Saunders on some of his direct and derivative claims. On appeal, Clark argued: (1) Saunders lacked standing to assert derivative claims on behalf of Revere; (2) Saunders lacked standing to assert direct claims because any alleged injury belonged to Saunders’s LLC, which had infused the capital into Revere.

C. The Connecticut Supreme Court's Decision⁴

1. Saunders lacked standing to assert derivative claims on behalf of Revere

The Connecticut Supreme Court reversed the trial court's decision that Saunders had standing to assert a derivative claim on behalf of Revere. Because Saunders had started this lawsuit in 2012—i.e., before the New Act—the Old Act governed this dispute.

The Supreme Court clarified that—unless authorized in an LLC's operating agreement—the Old Act does not authorize derivative lawsuits. Rather, it offers a different mechanism for members or managers to launch an action in the name of the limited liability company: a member-directed lawsuit. While theoretically similar to derivative actions, member-directed lawsuits under the Old Act require litigants to satisfy more arduous conditions, such as obtaining the requisite consent from a majority of disinterested members or managers; and likely litigating which members or managers are in fact disinterested.

Against this backdrop, Saunders lacked standing to bring either a derivative action or a member-initiated action: First, he had not complied with the hefty procedural hurdles under the Old Act to bring a member-initiated action. Second, neither Revere's nor the Fund's operating agreements authorized members or managers to bring derivative actions.

2. Saunders had standing to assert direct claims

The Connecticut Supreme Court, though, affirmed the trial court's decision that Saunders had standing to assert direct claims against Clark for his failing to repay one of the bridge loans.

Clark had argued that because Saunders Capital—rather than Saunders—had advanced the bridge loan to Revere, any claim against him belongs to Saunders Capital. That is, Saunders lacked standing to sue because he lacked a separate and distinct injury from Saunders Capital.

The Supreme Court recounted its settled view that members of a limited liability company—like shareholders in a corporation—cannot bring direct actions to recover for injuries suffered by the company. It explained that this rule serves multiple purposes, such as to prevent duplicative litigation and the unequal distribution of any recovery. But the Supreme Court rejected a one-size-fits-all approach and explained the need for a more flexible mechanism.

In this regard, the Supreme Court cautioned that sometimes the concept of a separate and distinct injury approaches fiction when a limited liability company has a single member. So it carved out a narrow exception to permit a member of a single-member limited liability company to bring otherwise

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derivative claims as a direct action, unless doing so would dis-advantage the company, its owners, or its creditors. Because Saunders was Saunders Capital's sole member, and the bridge loan to Revere comprised Saunders's personal funds, the Supreme Court agreed with the trial court that Saunders had standing to assert direct claims.

D. Concluding Thoughts

Saunders v. Briner imparts two main lessons:

First, the Old Act bears relevance, at least for the time being. Again, despite the passage of the New Act, the Old Act continues to govern disputes concerning Connecticut limited liability companies if:

1. The dispute concerned alleged liability that arose before July 1, 2017; or
2. The dispute led to litigation before July 1, 2017.

With this in mind, it is prudent to ensure that an operating agreement remains updated to account for the Old Act's lasting legacy for derivative actions.

Second, as the traditional demarcation between a single-member limited liability company and its member has blurred, the single-member structure may provide an advantage over its multi-member counterpart.

¹ *Connecticut General Statutes § 34-100, et seq.*

² *Connecticut General Statutes § 34-243, et seq.*

³ See *Connecticut General Statutes § 34-283b* (*The Connecticut Uniform Limited Liability Act does "not affect an action commenced, proceeding brought or right accrued before July 1, 2017."*).

⁴ *The Defendants had originally appealed the trial court's decision to the Connecticut Appellate Court, but the Connecticut Supreme Court transferred the matter to itself under Connecticut General Statutes § 51-199 (c).*

ATTORNEYS

Marc J. Herman

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