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Law Alert

To: Firm Clients and Contacts

From: Niesar & Vestal LLP

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Re: **Warning Regarding Using Redemption Notes for a Limited Liability Company Founder Buyout**

When a founder of a business desires to sell the business to a new owner, use of a redemption promissory note is a very common practice where the buyer needs to stretch out payments over a number of years. Following a recent bankruptcy case, *In re Tristar Esperanza Properties, LLC,* 488 B.R. 394 (9th Circuit Bankruptcy Appellate Panel 2013), such a promissory note may be subject to subordination to all creditors in the event of a bankruptcy, even if the promissory note is secured with a UCC-1 on all the assets of the entity. The seller's likelihood of being paid, therefore, may rest entirely on the new buyer's ability to continue the successful operation of the business being sold.

In re Tristar Esperanza Properties, LLC

In *In re Tristar Esperanza Properties, LLC,* a member of a real estate LLC ("Tristar") gave a notice of withdrawal as permitted under the Operating Agreement. After a lengthy dispute over valuation, the withdrawing member received an arbitration award, subsequently reduced to a judgment, and then sought to enforce the judgment. Tristar defaulted and subsequently initiated a Chapter 11 reorganization proceeding. In the Chapter 11 proceeding, Tristar initiated an adversary proceeding seeking a determination that the withdrawn member's judgment claim must be subordinated to all

creditors, invoking Section 510(b) of the Bankruptcy Code. That section says that a claim arising from rescission of the purchase and sale of a security, or for damages arising from such a transaction (e.g., a judgment arising out of a securities fraud claim), shall be subordinated to all claims that are senior to or equal to that security. However, if the claim is based upon common stock ownership, it remains with the ranking of common stock. Hence: once equity, always equity, if the original interest purchased was a security.

The result of *Tristar* is similar to the recent amendment to Section 500 of the California Corporations Code dealing with redemptions of corporate stock effected with a corporate promissory note. See our Law Alert, "Succession Planners Beware! Section 500 Amendments Impact Use of Promissory Note in Stock Buyback", dated March 20, 2012. The *Tristar* case extends our discussion in the prior Law Alert to limited liability companies and partnerships.

Is *Tristar* good law?

To our knowledge, *Tristar* is the first case to apply Bankruptcy Code Section 510(b) to a transaction involving a repurchase of an LLC interest pursuant to a withdrawal right in the Operating Agreement. The Court emphasizes that it disagrees with *Tristar's* argument that Section 510(b) was inapplicable because there was no showing of "fraud or wrongdoing relating to the purchase or sale of a security". Thus, we must assume that in the 9th Circuit, at least, the reasoning in *Tristar* will apply to any situation where an equity interest is redeemed by a corporation, limited partnership or LLC. The reasoning is that people who acquire an equity interest are taking on a greater risk than creditors, in exchange for which the equity holders get to share in profits, which creditors do not. Therefore, it is argued that Congress intended that any conversion of equity to creditor status be subordinated to other creditors in bankruptcy.

Note that Section 510(b) relates to a claim arising out of the purchase and sale of a "security". Under California's definition of "security" as applied to LLC interests, the interest in *Tristar* clearly would have been a security. But what would be the case if the claim were advanced by one who joined in a member managed LLC where all members participated essentially as if they were general partners of a partnership, albeit with limited liability (i.e., like a limited liability partnership)? In that case, one may argue that Section 510(b) should not apply because the original investment was not a security under California and under most states' laws. Likewise, the federal law treatment of LLC interests for securities law purposes generally appears to be that an LLC interest purchased by an active participant in the business is not a "security". See *Robinson v. Glynn* (2003) 349 F.3d 166.

However, the *Tristar* Court did not look to California law when it examined the issue of whether the specific LLC interest involved was a "security". The Court looked only at the definition of security in the confines of the Bankruptcy Code and concluded that "if the interest of a limited partner in a limited partnership is a 'security' under the Bankruptcy code, then the interest of a member in an LLC is also a 'security' for purposes of the Bankruptcy Code. Accordingly, an interest of a member in an LLC is a 'security', the purchase or sale of which is vulnerable to Section 510(b) mandatory subordination." This suggests that in most, and possibly all, bankruptcy cases, an LLC interest will fit the *Tristar* reasoning and be found to be a "security".

One can speculate that a very long-term redemption note may not be eternally subordinated to creditors, even in a bankruptcy proceeding. The *Tristar* opinion contains the following at page 404: "The dispute over the buy-back amount and the chapter 11 filing were sufficiently proximate in time to warrant the conclusion that this is an effort by equity to capture paper (and arguably mythical) profits via a judgment for money damages." This opens the door at least a crack for an argument that once sufficient time (to be later defined) has passed, that conclusion is unwarranted. Moreover, after a considerable time has passed and most or all creditors have extended credit knowing of the existence of the redemption note, the argument that they were looking to an equity cushion that included the former equity investment is untenable.

Conclusion

Unless and until *Tristar* is overruled by a Supreme Court decision or by legislation, one will have to assume that in any case where a redemption note is given in connection with the buyback of equity securities, in a bankruptcy proceeding that note will be permanently subordinated to all creditor claims.

If you would like to speak with a Niesar & Vestal attorney about any matter discussed in this law alert, please contact Gerald Niesar (gniesar@nvlawllp.com), Oscar Escobar (oescobar@nvlawllp.com) or June Lin (jlin@nvlawllp.com).