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The New Changes to UCC Article 9A

by Richard L. Goldfarb[1]

Effective July 1, 2013, important changes to Article 9A ("Article 9") of the Washington Uniform Commercial Code ("UCC") came into effect.

Before we begin, please pull out Volume 8 of the official RCW. Turn to Page 163. Take a red pen and cross out all of paragraph (4) on the top of the left-hand column. In the margin write, "SEE CHAPTER 118 OF THE 2013 SESSION LAWS, SECTION 34."

We now return to your regularly scheduled article.

Washington History of 2010 Amendments. In 2011, Washington became only the second state to adopt the 2010 Amendments to Article 9.[2] These amendments were the result of a Joint Review Committee formed by the American Law Institute and the Uniform Law Commission, joint sponsors of the UCC, to determine if the 1998 amendments to Article 9 that had been adopted in Washington in 2000, effective July 1, 2001 (which were so extensive the code reviser changed its name in Washington to Article 9A),[3] required updating. The committee had a very narrow charter that did not permit it to revisit any issues that had been resolved by the last set of amendments. Instead, it was looking for places where experience showed there were significant problems in practice, where case law or experience indicated there was ambiguity, or where a number of states had adopted non-uniform amendments.[4]

The biggest, and most controversial, change was in 9-503(a)(4), covering individual names on financing statements. Although the rule on how to name an individual debtor on a financing statement (simply to provide the "individual" name of the debtor) had not changed since the UCC was initially adopted, cases on individual names had vexed some lenders. At their behest, legislatures in Texas and some other states adopted non-uniform amendments to their UCCs. As a result, the joint review committee worked to find a solution, ultimately proposing two alternatives, known as Alternative A and Alternative B. Washington initially adopted Alternative B,[5] but last year's legislature changed it to Alternative A in a bill signed by Governor Inslee on May 3.[6] Since the law did not take effect until July 1, Alternative B never became the law in Washington. Since the law took effect less than two months after the bill was signed and is different from the law as contained in the printed RCW, it is important that practitioners be aware of the change. Thus the box on the left of the page.

Amendments That Do Not Concern Debtor Names

The 2010 Amendments cover a number of other topics.

In using secondary materials on the 2010 Amendments, it is important to distinguish between changes that were made to the statute, which are law in Washington, and changes that were made to the Official Comments, which are of mere persuasive value.

These were generally uncontroversial[7] and so are listed here as bullet points:

- The definition of "authenticate" in 9-102(a)(7) has been amended to conform to the definition used elsewhere in the UCC.
- The definition of "certificate of title" in 9-102(a)(10) has been amended to allow for notation in an electronic database without requiring a physical certificate if that is permitted by other law.

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- A similar change was made in 9-105 with respect to control of electronic chattel paper. This conforms it to the Uniform Electronic Transactions Act, although that law has not been enacted in Washington.
- A minor change was made to clarify in 9-307(f)(2) that a designation of a main office, home office or other comparable office of a registered organization organized under federal law, such as a national bank, will be its location for Article 9 purposes.
- A more significant change is in 9-316, which added new subsections (h) and (i). These deal with situations where a debtor changes its location for UCC purposes (e.g., incorporates in a different state) or where a new debtor is in a different jurisdiction from the original debtor (e.g., there is a merger where the surviving corporation is in a different state from the original debtor). In each case, you will have four months from the date the action occurs (whether a move to a different state or the addition of a new debtor) to file your new financing statement, but if you were perfected before the move, you remain perfected in collateral owned at the time of the move and acquired within the following four months if you make the subsequent filing. This clears up a gap in the old law.
- Minor changes to 9-317 are almost purely linguistic.
- Similarly, changes to 9-326 are mainly to clarify what the statute was intended to say in the first place.
- Changes to 9-406(e) and 9-408(b) correct an omission relating to certain kinds of dispositions of payment intangibles and promissory notes.
- Many practitioners will be happy to learn that 9-516 has been amended, as have the forms for filing financing statements, to omit the need to provide the jurisdiction of organization, type of organization and organizational number of the debtor. The benefit of these requirements was outweighed by the confusion they caused; they never had any effect on whether a security interest was in fact perfected.
- "Correction statements" under 9-518, which never had

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any legal effect anyway, are now referred to as "information statements" and can be filed by the secured party of record as well as the debtor. These may be useful to provide notice so a subsequent filer will make a phone call to determine the true state of affairs rather than relying on the filed records, which may be inaccurate because either a financing statement or an amendment, including a termination, was unauthorized.[8]

- 9-607 has been amended to clarify some of the language about default under mortgages.

Both the Official Comments and the Washington Comments to the revisions that became effective in 2001 became part of the legislative record of that statute.[9] This is not true of the 2010 revisions. Including these Official Comments as legislative history faced an insuperable obstacle: many of the new Official Comments relate to sections of Article 9 that were not being amended by the 2010 Amendments. It is hard to distinguish among the comments, and of course it is impossible for a subsequent legislature to say what was in the mind of the legislature in 2000. When the subcommittee of the UCC Committee of the Business Law Section of the WSBA, which I chaired, considered this issue, Professor Stephen Sepinuck of Gonzaga Law School, who served as the ABA advisor to the study committee that had promulgated the amendments, had a very simple take on the issue. We should, he suggested, simply consider that the Official Comments were the equivalent of a particularly knowledgeable law review article. This was persuasive to the subcommittee and no attempt was made to include the comments in the legislative history in Washington.

Organizational Debtor Names

The amendments clarify something that many felt was evident beforehand: the name that is required for an organizational name is the name on the document that created it, which is now defined as the "public organic record," a new definition in 9-102(a)(68). This means that if there is any difference between the name you would find on the Secretary of State's website, or the name on a Certificate of Status from the Secretary of State, and the name on the articles of incorporation or similar document, as amended, only the latter will prevail. This has been good practice from July 1, 2001, but after July 1, 2013, it is written in stone in the law.

An additional change has made the rules on organizational names expressly applicable to debtors that hold their assets in a trust that is itself a registered organization, such as a Massachusetts trust. Thus, the rule that you must get the name exactly right or be at serious risk of non-perfection applies to such trusts as well.

Common Law Trusts as Debtors

That is a good segue into the next change, which covers the way in which filings against common law trusts are accomplished. Under trust law, the trustee is usually the technical owner of the assets. However, the UCC recognized that filing against the name of a trustee could be both useless to searchers and entirely misleading to creditors of the trustee in its non-trustee capacity. Where a single organization, such as a bank or trust company, is trustee for thousands of trusts, a search under the name of the trustee would be of no value to determine priority. Where the trustee, in its individual capacity, is also a debtor, filings against it as a trustee can be misleading to the trustee's own creditors. So another rule needed to be devised.

The rule essentially says that if property is held in trust, you put the name of the trust on the financing statement if the document creating the trust gives it a name, and if it doesn't you put the name of the settlor or testator who created the trust.

The 2010 Amendments clarify some ambiguities without changing this rule. There are many potential variants on this, and we are fortunate that my friend Norman M. Powell, who chairs the UCC Committee of the Business Law Section of the ABA, has written a highly readable and authoritative article on this very topic, complete with a handy chart that will answer nearly any question you might have about how to file a financing statement where the debtor is a trustee or trust.[10] I commend it highly.

Individual Names: How Big of a Deal Is This?

A lot of ink has been spilled about the changes to 9-503(a)(4), the requirements for individual names.[11] One question is, why? Most loans that are made to individuals fit into a few categories, none of which require a financing statement under Article 9:

- real estate loans,[12]
- loans secured by purchase money security interests on consumer goods,[13]
- unsecured credit card loans and
- secured credit card loans where the issuer retains the collateral in the form of a cash deposit.

Many fairly active UCC practitioners have never filed a financing statement against an individual.

When do financing statements need to be filed against individuals? In the course of work on these amendments, five major classes of transactions have been identified:

- Agricultural loans, since many farms are held in individual ownership for water rights and similar reasons.
- Loans to high net worth individuals.
- Equipment and similar business loans to individuals who do business as sole practitioners.
- Loans involving the purchase of a closely held business.
- Loans to family members.

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As we analyze the issues that are raised under the 2010 Amendments to 9-503(a)(4), we will keep these categories of loans in mind, as they will help to explain how best to deal with the 2010 Amendments.

Alternatives A and B: Does It Really Matter?

Washington is unique in having adopted Alternative B and then switched to Alternative A. Our neighbors are split: Idaho has adopted Alternative A; Oregon and Alaska have adopted Alternative B. California has rejected both approaches and adopted a non-uniform amendment that keeps the pre-amendment rules in place except for adding a safe harbor for the first given name and surname; its amendments do not go into effect until July 1, 2014. Nationwide, the vast majority of states have adopted Alternative A. From a lawyer's perspective, what are the differences?

Alternative A is the so-called "only if" rule. It provides that if the debtor is a resident of "this State" and "this State" has issued the debtor a driver's license or alternative ID card, then the only name that is sufficient on the financing statement is the name on the debtor's unexpired driver's license or alternative ID card. If "this State" has not issued such a card, then the only name that is sufficient is the debtor's first given name and surname. If "this State" has issued more than one such card, then only the most recently issued counts.

Alternative B is the so-called "safe harbor" rule. It provides that any of three names are sufficient on a financing statement: either of the two alternatives under Alternative A or "the debtor's individual name," exactly as it is under current law.

For the vast majority of individuals, this should not matter at all. For nearly all males and most females in the United States, there will be no difference amongst the names that would be placed on a financing statement under either rule. My driver's license has exactly the name that a prudent secured party would put on a financing statement under the law as in effect before the 2010 Amendments become effective.

Given the narrow scope of who is likely to qualify for the kind of secured financing that requires the filing of a financing statement, this is likely to be true of nearly everyone. But there are obviously exceptions:

- People who change their surnames upon a change in marital status. Based on societal norms, this will have an impact on more women than men, although the degree to which this is true has changed over our lifetimes.
- People whose individual names include characters that may be placed on a financing statement but are not available on a driver's license. In many states, the only characters permitted on a driver's license are the standard 26 letters and ten numerals. Thus, Eduardo Nuñez will most likely have a driver's license with "Eduardo Nunez" on it.
- People with really long names. Different states have different rules on how they truncate the name on the driver's license, but nearly all of them will delete certain characters so that the license will have readable type.[14]
- People who were born in countries that do not use the Latin alphabet, and whose names, in official and other documents, may vary in spelling when transliterated into the Latin alphabet.
- People who, for various reasons, have typographical errors on their driver's licenses. This can happen due to a number of factors, from simple negligence to a computer glitch. I once had the ZIP Code on my driver's license transposed (the Department of Licensing uses the ZIP Code to fill in the city), and my license was sent initially to Burton, Washington (98013) instead of to Seattle (98103). People may not even notice a mistake in the name field because they do not often need to refer to how their name is spelled on their license.

How to Cope with the Amendment: Location, Location, Location

The first thing that must be determined when filing a financing statement against an individual is the location of the individual for Article 9 purposes. This has not changed under the 2010 Amendments and it is critical. The rule is deceptively simple: "A debtor who is an individual is located at the individual's principal residence."[15] There is no definition of "principal residence," and there is no coordination between this rule and the rules for issuing a driver's license. In Washington, an individual must obtain a Washington driver's license within 30 days of the day the individual becomes a "resident."[16] A "resident" is defined as "a person who manifests an intent to live or be located in this state on more than a temporary or transient basis."[17] Such a move expressly requires the surrender of any prior state's driver's license.[18]

It can readily be seen these are somewhat different standards. Assuming that the rules are similar in other states for when an individual must obtain a driver's license, an individual could easily have his or her "principal residence" in one state while not being required to surrender the prior home state's driver's license. Take the not unusual example of a Washington resident who is slowly retiring to Arizona. Initially, he or she spends just two months of the year in Arizona. Gradually, however, two months turns into four months turns into ten months. When present in Arizona ten months of the year, it is not unlikely that the individual will be deemed to have his or her "principal residence" in Arizona. Arizona, however, requires that one obtain a license if one "[r]emain[s] in Arizona for a total of 7 months or more during any calendar year, regardless of your permanent residence."[19] This "principal residence" rule is of course the same under the law as in effect before the 2010 Amendments, and the issues that it presents with respect to the proper

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place to file are not new. What is different, however, is that it now matters under Article 9. Because the name on the license is only relevant if "this State" (i.e., the state in which the debtor is located for Article 9 purposes) has issued the license, there may be situations where you not only need to file in two different states, but you need to file under two, or more, different names.

Learn to Read a Driver's License

You can, if you have a driver's license number in Washington, check the status of the driver's license online, for free. Just go to this link: https://fortress.wa.gov/dol/dolprod/dsdDriverStatusDisplay/?checkstatus.

What do you get? You get to learn what the class of license is, what its expiration date is and whether it has been suspended, canceled, expired or revoked.

What don't you get? The name of the licensee.

Want to check a driving record? You can, if you are the driver. According to the state website, you can request the record if you are the driver, the driver's attorney, certain agencies, insurance companies and prospective employers. This information is considered confidential and can't be shared.[20] The federal Drivers Privacy Protection Act[21] provides a floor, but not a ceiling, to what information states can share about driving records. While it permits a state to allow a financial institution to see a driver's record, Washington apparently does not.

There are a number of different forms of driver's license and ID card issued in Washington, including the standard license, enhanced licenses (which can work like passports at North American land border crossings), commercial licenses and ID cards, each of which can include different formats depending on the date on which the license was issued.[22] In particular, the name field on the standard license has changed. Licenses issued before July 2010 have a single line on the name field, so that John George Doe will come out as "Doe, John George." Licenses issued since July 2010 have two name fields, one for the surname and one for all given names:

Doe
John George

What the license itself won't tell you is what the fields actually mean, so that someone with a surname that sounds like a given name and a given name that sounds like a surname may confuse you. It also won't tell you if a person whose name is "Mary Ann Doe" has the first name "Mary Ann" or the first name "Mary" and the middle name "Ann." Other states, of course, have differing formats, and they change all the time.

How Does This All Affect How You File a Financing Statement and How You Search?

This is, of course, the real question. If you had a name like "Mary Ann Doe," you should probably both search and file under both "Mary" and "Mary Ann." But that is the easier case.

To understand how some other cases should be handled, a careful practitioner and a client should consider both what they know about the debtor and what they know about the nature of their collateral.

Let's consider the three examples of likely debtors from above.

Our first example is a dairy farmer. The reason I pick a dairy farmer is that dairy farmers ordinarily have only one day's supply of farm products, their milk, on hand at any time. For most dairy farmers, a truck comes every day to pick up the milk for processing at a nearby plant, turning the farm products into proceeds, i.e., an account. Those accounts are also paid off fairly frequently, no more than monthly, thus turning first into instruments (checks) and then into funds in a deposit account.

Under 9-507(c), a security interest is valid against a debtor who changes his or her name for collateral acquired by the debtor before the name change or four months after the change, but not afterward. So if you were lending to a dairy farmer against farm products and accounts, five months after a name change you would be entirely unperfected in both categories of collateral. For such a debtor, you would want to have in place covenants that allowed you to see the debtor's driver's license three times a year at least.

Other farmers, with different cycles for their harvests and payment for their crops, might lead to a different rule, such as requiring the driver's license to be shown at the time the annual crop loan was made and around harvest time.

Now consider a purchase money equipment loan to an individual. In this case, because the debtor will obtain rights in the collateral at around the time of filing, you may not care if the debtor's name subsequently changes. So you may not require the driver's license again.

Now consider the wealthy individual debtor borrowing against valuable jewelry or paintings. I like to resurrect Elizabeth Taylor for this example, because most people know she both owned an incredibly valuable ring and married and divorced numerous times. A lender's concern with a latter-day Elizabeth Taylor is not so much filing, but searching. If the debtor borrowed against valuable property under a prior name and has not changed jurisdictions, that filing against her will still be good[23] and can even be continued under the old name, and a subsequent lender will lose to the old secured party who filed under the old name.

What Should I Do Now?

First, if you have a database that lists all the UCCs you have filed in the past and as to which you still have some

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responsibility to your clients, you should look through it to determine how many filings have been made against individual debtors and when the continuation statements for them are due. Assuming they are liable to be continued (i.e., they won't have been paid off or have gone into default), you should then look at your loan documents to see if you can reasonably argue that you have the right to demand that the debtor send you the debtor's driver's license. Even if you don't necessarily have the legal right, you or your client can certainly ask.

Second, you should amend your form documents to include provisions to require that debtors, if they are individuals, provide a driver's license and give notice upon any change in the name on the driver's license as soon as possible and no later than 30 days after the change occurs. But more importantly, you should make sure your clients who deal directly with their borrowers are trained to get the message across that there's this new law and you need to look at their driver's licenses periodically.

Third, you will need to get yourself familiar with the peculiarities of driver's license technology in Washington and in other states where you may be documenting secured lending against individuals. There is no standardization of how the names appear on licenses and there are different forms in all states. Some have the first name first and some have the surname first. Some, as in Washington, have different forms extant at the same time.

Fourth, you and your clients need to sit down and figure out what is a cost-effective way of doing this work, so that you are not spending inordinate amounts of time for little benefit, but also so you are not on the hook for malpractice if there is a problem down the road. Getting an individual's name right on a financing statement, and filing that financing statement in the right jurisdiction, is art, not science. The 2010 Amendments to Article 9 have not changed that. You need to make sure that your clients are aware of that fact and that the allocation of risk does not fall squarely on you.[24]

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2 *See* Laws of 2011, ch. 74.

3 Laws of 2000, ch. 250.

4 Edwin E. Smith, *A Summary of the 2010 Amendments to Article 9 of the Uniform Commercial Code*, 42 UCC L.J. 345 (2010).

5 Laws of 2011, ch. 74, § 401(d).

6 Laws of 2013, ch. 118, § 34.

7 When I testified on behalf of WSBA to the Senate Judiciary Committee in 2011, I asked if there were any questions on any part of the statute other than the choice of Alternative A versus B and was met with silence.

8 The most significant such case, both in terms of time and the depth of analysis, is *In re Motors Liquidation Co.*, 486 B.R. 596 (Bankr. S.D.N.Y. 2013), *available at http://www.nysb.uscourts.gov/opinions/reg/233503_71_opinion.pdf*. In that case, a termination statement was wrongly filed ostensibly releasing collateral on a $1.5 billion term loan. General Motors filed for bankruptcy before anyone found that the termination statement had been filed in error. The case is currently on direct appeal to the Second Circuit.

9 Gordon W. Tanner, *Introduction to New Article 9: Basic Resources for Lawyers*, UCC Revised Article 9 Deskbook, at 1-16 (WSBA 2002).

10 Norman M. Powell, *Filings Against Trusts and Trustees Under the Proposed 2010 Revisions to Current Article 9—Thirteen Variations*, 42 UCC L.J. 375 (2011).

11 *See*, e.g., Richard H. Nowka, *Twenty Questions About an Individual Debtor's Name Under Amended Article 9 Section 9-503(a)(4) Alternative A*, 3 Wm. & Mary Bus. L. Rev. 139 (2012); Austin Morris, *The 2010 Amendments to U.C.C. §9-503: Sufficiency of An Individual Debtor's Name*, 4 Elon L.Rev. 115 (2012); Harry C. Sigman, *Improvements (?) to the UCC Article 9 Filing System*, 46 Gonz. L.Rev. 457 (2011).

12 Excluded from Article 9 by 9-109(d)(11).

13 For which a financing statement is not required under 9-309(1).

14 See "This Hawaiian Woman's Name Is Too Long For A Driver's License." *http://jalopnik.com/this-hawaiian-womans-name-is-too-long-for-a-drivers-l-1313683178* (retrieved October 29, 2013).

15 9-307(b)(1).

16 RCW 46.20.021(1).

17 RCW 46.20.021(3).

18 RCW 46.20.021(2).

19 *See* Arizona Department of Transportation, New to Arizona?: Resident Definition, *http://www.azdot.gov/mvd/azwelcome.asp* (retrieved May 20, 2013).

20 *See* Washington State Department of Licensing, Frequently asked questions: Driving records, *http://www.dol.wa.gov/driverslicense/drivingrecfaq.html* retrieved May 11, 2013).

21 18 U.S.C. § 2721, *et seq*.

22 Washington State Department of Licensing, Driver license samples, *http://www.dol.wa.gov/driverslicense/licensesamples.html* (retrieved May 11, 2013).

23 9-507(c).

24 For further information, I highly recommend Paul Hodnefield's article, Individual Debtor Names Under the 2010 Amendments to UCC Article 9, *http://www.cscflash.com/archives/2011_05/article1.html* (retrieved May 20, 2013).

Washington LLC Member Files Bankruptcy – Court Reinstates His Membership Rights

by Doug Batey[†]

Charles McSwain, a 53 percent member of Hawks Prairie Casino, LLC, a Washington LLC, filed a voluntary Chapter 11 bankruptcy petition in 2007. Hawks Prairie operates a gambling casino in Thurston County, Washington.

Background. The President of Hawks Prairie, Tryna Norberg, knew of McSwain's bankruptcy filing and continued to treat him as a voting member of the LLC until early 2009, when McSwain called on her to resign and threatened to call a meeting to appoint a new President. Shortly thereafter Hawks Prairie informed McSwain that he was dissociated from the LLC, and after that he received no further member communications from the LLC.

Several months later McSwain filed his plan of reorganization. The plan provided that upon its confirmation by the court, all of McSwain's rights and interests in the LLC, as they existed immediately prior to the bankruptcy filing, would be automatically reinstated. That would restore his member voting rights and give him majority control of the LLC.

Norberg objected to confirmation on the grounds that full reinstatement of McSwain's member interest was inconsistent with the LLC's Operating Agreement and Washington law, and that under Bankruptcy Code Section 365(c)(1) McSwain was precluded from assuming the voting and other management rights of a member. Norberg sought a declaration that McSwain no longer possessed any management rights in the LLC, and that his interests in the LLC were solely those of an assignee, i.e., he had only the right to share in profits, losses, and distributions. *Norberg v. Hawks Prairie Casino, LLC (In re McSwain)*, No. 07-43338, 2011 Bankr. LEXIS 3921, at *2 (Bankr. W.D. Wash. Oct. 6, 2011).

Washington's LLC Act provides that an LLC member is dissociated, ceases to be a member, and takes on the status of an assignee upon the member's insolvency or bankruptcy, unless the LLC agreement provides otherwise or the members all consent in writing. RCW 25.15.130(1)(d). (Many other states have similar provisions. *E*.g., Del. Code Ann. tit. 6, § 18-304.)

The Hawks Prairie Operating Agreement was clear: A member that files a voluntary bankruptcy is dissociated and treated as an assignee rather than as a member, unless all other members consent or 70 percent of the initial members consent. *McSwain*, 2011 Bankr. LEXIS 3921, at *7-8. Washington's LLC Act therefore barred McSwain from being readmitted as a member without the requisite member vote, which was not forthcoming.

Bankruptcy Code. The Bankruptcy Code gives a bankruptcy trustee, or the debtor in possession in a Chapter 11 case (as in *McSwain*),the authority to assume, assign, or reject the executory contracts of the debtor, subject to several limitations. 11 U.S.C. § 365. The issue before the court was whether Bankruptcy Code Section 365(c)(1) prevented McSwain from assuming all his rights as a member. That section is concise:

> (c) The trustee may not assume or assign any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if–
>
> (1)(A) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and
>
> (B) such party does not consent to such assumption or assignment[.]

11 U.S.C. § 365(c)(1).

The Ninth Circuit has ruled that this section "by its terms bars a debtor in possession from *assuming* an executory contract without the nondebtor's consent where applicable law precludes *assignment* of the contract to a third party." *Perlman v. Catapult Entm't, Inc. (In re Catapult Entm't, Inc.)*, 165 F.3d 747, 750 (9th Cir. 1999). (In *Catapult*, the Ninth Circuit joined the Third and Eleventh Circuits in a circuit split on whether Section 365(c)(1) applies to an assumption by the debtor even if a third-party assignment is not contemplated, with the *Catapult* court concluding that it does.)

Court's Analysis. The *McSwain* court concluded that the LLC's Operating Agreement was an executory contract, and that applicable nonbankruptcy law, i.e., Washington's LLC Act, forbids its assignment. The court interpreted *Catapult* as imposing a third requirement: "assignment must be forbidden [by applicable nonbankruptcy law] because the identity of the nondebtor party is material." *McSwain*, 2011 Bankr. LEXIS 3921, at *21. The court went on to say: "It is certainly possible that the identity of Hawks Prairie's other members is material, such that McSwain could not assume the contract." *Id*. at *22.

In the event, though, the court concluded it need not determine whether the identity of the members other than McSwain was material. Instead it decided the case on the grounds of an implied waiver by Norberg. From the beginning Norberg was fully aware of McSwain's bankruptcy and knew that McSwain could be treated as an assignee under the Operating Agreement. She nonetheless permitted McSwain to exercise all the rights of a full member, including attending management meetings and voting on major transactions. Norberg had sent the members multiple emails, letters, and minutes of meetings that referred to McSwain as a member. The court concluded that by her actions Norberg impliedly

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continued

waived her right to enforce the Operating Agreement's dissociation provisions against McSwain. *Id*. at *24. Under the confirmed plan of reorganization, McSwain was therefore entitled to exercise his full membership rights in the LLC, including voting and management rights. *Id*. at *30.

Comments. The court's waiver analysis is unexceptional and clearly seems to be the right result. The court's discussion in dicta of the applicability of the *Catapult* rule, however, focuses on the identity of the other members in the LLC, and conjectures that if the LLC had a large number of passive members, their identity would not be material and McSwain would then be able to assume his rights as a member. *Id*. at *22-23.

Catapult, on the other hand, relied on the policy of the nonbankruptcy law that restricts assignment, not on the degree to which the policy applied to the facts of the specific case. *Catapult* involved the assumption of nonexclusive patent licenses, and noted that "the federal law principle against the assignability of nonexclusive patent licenses is rooted in the personal nature of a nonexclusive license – the identity of a licensee may matter a great deal to a licensor." *Catapult*, 165 F.3d at 752, n.4.

The dissociation provisions of the LLC Act fit that description well. They preserve the economic rights of the dissociated member, but prevent the dissociated member from interfering in the management of the LLC. This is consistent with the "know your partner" principle, which is reflected in multiple provisions of most state LLC Acts, such as limitations on assignment and the rules on charging orders.

The *McSwain* court reached the right result because of Norberg's implied waiver. But the focus in McSwain on the specific facts of the LLC and its members, rather than the rationale of the nonbankruptcy law that prohibits assignment, is inconsistent with *Catapult* and should not be relied on.

Given the increasing use of LLCs in business organizations, it seems likely that disputes over the interaction between Bankruptcy Code Section 365(c)(1) and the dissociation provisions of state LLC Acts will continue to arise as LLC members have occasion to file Chapter 11 bankruptcies. There will be further developments.

Originally published on the Stoel Rives ***LLC Law Monitor*** *blog, available at* http://www.llclawmonitor.com.

An LLC's Single Member Cannot Represent It in a Washington Court – An Attorney Is Required

by Doug Batey†

The common-law rule is that a corporation appearing in court must be represented by an attorney. That's the rule in Washington and all federal courts. Not surprisingly, in 2011 Washington applied that rule to limited liability companies. *Marina Condo. Homeowner's Ass'n v. Stratford at the Marina*, LLC, 161 Wn. App. 249, 263, 254 P.3d 827 (2011).

One might have thought that the *Marina* decision foreclosed the issue, but the plaintiff in *Dutch Village Mall, LLC v. Pelletti*, 162 Wn. App. 531, 256 P.3d 1251 (2011), an LLC with a single member, contended that its sole member should be able to represent it in court.

The *Dutch Village* LLC owned a shopping mall and sued a tenant. The LLC's complaint was signed by its sole member, Jay Lei. The defendant moved to strike the complaint on the grounds that it had to be signed by an attorney. The trial court granted the motion and the Court of Appeals accepted review. Lei argued for an exception:

> Lei contends the right to appear pro se belongs to a single-person LLC as much as a person because the single owner is likewise acting solely on his own behalf, making all the decisions and taking all the risks, much like a sole proprietor. Lei contends the separate legal entity status of a single member LLC is a technicality that the court should disregard.

Id. at 536.

The court rejected Lei's argument. First, said the court, allowing nonlawyers to conduct litigation creates burdens for the other party and for the court, resulting in poorly drafted pleadings, inadequate presentations of motions, and proceedings that are unduly prolonged and numerous. *Id*. at 538. (This does seem to reflect a hostility to pro se litigants, even when the litigant is an individual and therefore fully entitled to represent him- or herself.) Additionally, said the court, a lay litigant lacks many of an attorney's ethical responsibilities. The court referred to the "elaborate and inappropriate claims pleaded by Lei in this case and his refusal to withdraw a moot and pointless motion for default." *Id*.

Second, the court was troubled by the inconsistency between disregarding the entity for the member's convenience (thereby obviating the need for a lawyer in court), and respecting it for other issues (the LLC's liability shield). For example, if the defendant successfully counterclaimed against

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An LLC's Single Member Cannot Represent It in a Washington Court – An Attorney Is Required
continued

the LLC, Lei presumably would be unwilling to disregard the LLC and accept personal liability.

The court also pointed out that a rule allowing single-member LLCs to appear in court without an attorney would likely result in disputes over the LLC's claim to have only one owner. What if the LLC's ownership changed in the middle of a lawsuit? Could a plaintiff assign its claim to a single-member LLC, thereby eliminating the need to hire a lawyer to represent it in court?

The court's refusal to allow the LLC to be represented in court by its single member is unexceptional and consistent with the rules on corporations. It is also consistent with the lawyer licensing system and the body of rules that regulate legal services. The system is usually justified by the need to protect the public from incompetent or unethical legal representation, but the *Dutch Village* case shows that the convenience of the courts is also a factor in supporting the rule.

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Washington Law Firms Organize as LLCs, Sometimes Unlawfully

by Doug Batey†

Law firms traditionally have organized as partnerships, but in recent years many states have authorized law firms to organize as professional corporations or professional LLCs, subject to special requirements. You might expect lawyers to comply with the law when they form an entity for their law firm. If so, you could be disappointed. In Washington state, at least, many law firms are unlawfully organized.

I began to look into this in 2011, when I noticed a press release from a law firm in South Carolina that trumpeted the firm's change from a partnership to a limited liability company. The press release indicated that the firm was "positioning ourselves to maximize our efficiencies so we can continue to achieve the most successful outcomes for our clients." That sounded good. I started wondering about Washington state.

Washington's LLC Act authorizes professional limited liability companies (PLLCs) for licensed professionals such as attorneys. RCW 25.15.045. The LLC Act subjects PLLCs to the provisions of Washington's Professional Service Corporation Act (PSCA), RCW chapter 18.100. The PSCA prohibits licensed professionals, such as attorneys and health care providers, among others, from operating as a corporation unless they use a "professional service corporation." This form preserves the professional relationships between service providers and their clients or patients, and prohibits ownership of shares or member interests in the entity by persons not licensed to render the professional services for which the entity was formed. RCW 18.100.090.

A review of the Washington Secretary of State's online business entity *search page* showed that there are hundreds of Washington law firms organized as limited liability companies. Roughly 15 percent of the law firms organized as LLCs are not PLLCs, but instead are standard LLCs. This is determinable from the names, because a PLLC must have the word "professional" or "PLLC" in its name. RCW 25.15.045(4). The Secretary of State's records also show for each entity a category that distinguishes PLLCs from standard LLCs. The Secretary of State's categorization is apparently determined from each LLC's certificate of formation, which is filed with the Secretary of State. The certificate of formation for a PLLC is required to state that it is a professional LLC. RCW 25.15.005(10).

A large majority of those law firms that are nonprofessional LLCs appear to be solo practitioners. That is not a defense to the professional LLC requirement, because the PLLC statute applies even to single-member LLCs. RCW 25.15.045(1). There are also a number of Washington multilawyer firms organized as standard LLCs.

Why are there so many violations? I assume the lawyers that formed these entities did not intend to violate the law. That leaves two possible explanations: either inadvertence, or perhaps a difference of opinion as to whether the PLLC structure is optional or mandatory for law firm LLCs.

It is not obvious on the face of the LLC Act that the PLLC structure is mandatory: "A person or group of persons licensed or otherwise legally authorized to render professional services within this or any other state *may* organize and become a member or members of a professional limited liability company under the provisions of this chapter for the purposes of rendering professional service." *Id*. (emphasis added). The word "may" suggests an alternative rather than a requirement.

In 2010, however, the Washington Supreme Court removed any doubt on this issue. *Columbia Physical Therapy, Inc., PS v. Benton Franklin Orthopedic Assocs., PLLC*, 168 Wn.2d 421, 228 P.3d 1260 (2010). The court treated an LLC like a corporation, and held that licensed medical professionals practicing in an LLC would violate the rules against the corporate practice of medicine if the LLC were not organized as a PLLC. 168 Wn.2d at 438. The court's analysis makes clear that the same result would hold for the other licensed professional services

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Washington Law Firms Organize as LLCs, Sometimes Unlawfully *continued*

listed in the PSCA, including the practice of law. Washington law has long prohibited lawyers from practicing law as a corporation. *State ex rel. Lundin v. Merchs.' Protective Corp.*, 105 Wash. 12, 177 P. 694 (1919).

Law firms improperly organized as standard LLCs rather than PLLCs have apparently not drawn much attention from the Washington State Bar Association. That may change if law firms formed as nonprofessional LLCs begin conducting other businesses in addition to the practice of law, which RCW 18.100.080 prohibits for professional service corporations and PLLCs. RCW 18.100.080.

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