A Tale of Two
LLPS Sets a New
Precedent

Corporation or
Partnership?

By Anthony Michael Sabino
and Michael A. Sabino

Dewey & LeBoeuf. Words that continue to send tremors throughout the legal profession. This readership knows all too well about the epic collapse of this once venerable firm (in reality, the collapse of two legendary firms that merged less than a decade ago). The papers are full of stories about certain of the defunct law firm’s leadership being indicted for various alleged frauds and felonies, as those individuals and the prosecutor now jostle for position at the upcoming trial. Since that ground has been well covered, it serves no purpose to regurgitate it here.

But there is value to be had in telling the story of the bankruptcy court’s most recent ruling in this sad tale, captioned Jacobs v. Alitorelli (In re Dewey & LeBoeuf LLP), 518 B.R. 766 (Bankr. S.D.N.Y. 2014). The paramount issue therein was the impact of Dewey’s status as a limited liability partnership upon the obligations of its partners. Certainly, that is where the more enduring story resides, because it establishes a bold, new, and much-needed precedent as to the interaction between state laws of business organization, and important provisions of the Bankruptcy Code.

continued on page 6
Two LLPs
continued from page 1

It would be understatement to call this ruling significant. The LLP has become the structure of choice for any law or professional firm of more than a de minimis size. Therefore, when such an entity falls upon hard times, and seeks refuge under the bankruptcy laws, its organizational status takes on great import as to how its liabilities shall be assessed. Thus, and to be clear to the reader, the dramatic fall of Dewey & LeBoeuf is not the tale we seek to tell here. Rather, there is far more long lasting utility to be had from a straightforward analysis of the state LLP provisos and Bankruptcy Code statutes that collided in the instant case.

The essence of the litigation is simply this. Alan Jacobs, the court-appointed trustee for Dewey, had entered into an agreement with a significant number of the law firm’s former partners, calling for them to return funds previously received. This was part of the trustee’s overall efforts to increase the size of the debtor’s estate available to repay creditors. However, some former partners of the defunct firm refused to sign on to the repayment plan. Thus, the trustee was compelled to commence adversary proceedings against them, in order to secure by trial what they would not repay voluntarily.

Phase One of the trustee’s assault was to invoke Bankruptcy Code Section 548, and seek the return of monies received pre-bankruptcy by the Dewey partners, on the grounds that such transfers were fraudulent conveyances. Most of our readers are well aware that Section 548 is a mainstay of bankruptcy proceedings, utilized to recover property of the debtor that was conveyed away for the purpose of defrauding creditors, whether that fraud is actual or constructive. See generally 11 U.S.C. § 548. Consistent with the overarching goals of the Bankruptcy Code to maximize creditor recovery and prevent injustice, the fraudulent conveyance proviso forestalls debtors’ attempts to spirit away property, by restoring such money or things to the estate, and make them available to increase the payout to creditors.

The trustee’s precision strike called upon subsection (b) of Section 548, which provides that any conveyance to a general partner of a partnership debtor within two years prior to the bankruptcy filing, and made while the partnership is insolvent, is a fraudulent conveyance, and thus can be undone. It was here that the Dewey court made its first ruling, the holding that, to date, has garner ed so much attention, and will likely lead to this case becoming an enduring precedent.

"The threshold issue," declared Bankruptcy Judge Martin Glenn, "is whether Dewey, a registered LLP under New York law, should be considered a ‘partnership’ or a ‘corporation’ for purposes of Section

continued on page 7
Two LLPs
continued from page 6

548." This is not mere semantics. As should be self-evident, a ruling that Dewey was a corporation for purposes of this statute would deprive the trustee of the ability to invoke Section 548(b).

The Code is not entirely helpful in this area, noted the court. While the insolvency law's prevailing definition of a corporation includes partnerships organized under such state law that limits the personal liability of its "partners," i.e., a limited liability partnership such as the one at the heart of the matter here, Congress, in its wisdom, did not embellish upon the prosaic terms of "partnership" nor "partnership debtor" in the Code's definitional provisions. See 11 U.S.C. § 101, et seq. Briefly, Judge Glenn noted that one of Congress' difficulties was, when drafting the original Code in 1978, how best to define "partnership" for purposes of federal bankruptcy law, given the divergence in state codifications of those same common terms in various jurisdictions' individual business organization laws.

Nonetheless, the court found its answer in that self-same state law. First, the Dewey court was careful to point out that federal bankruptcy judges are to be guided by relevant state enactments when determining whether or not a debtor/LLP falls on either the "partnership" or "corporation" side of Section 548, among others. Citing the known authorities, the court noted that said determination hinges upon the degree to which state law insulates such partners (or shareholders) from personal liability. In a word, the more insulation, the more the person is like a shareholder, and thus immunized from 548(b).

This rightly compelled Judge Glenn to analyze New York's LLP act. Quoting it at length, the court determined this body of law provides partners of an LLP a significant degree of relief from personal liability. Further, the court noted the now familiar credo of LLP statutes, in that partners in an LLP face the greatest risk from their individual negligence or misconduct, as distinct from the general financial liabilities of the firm. And that distinction proved to be significant, in the court's eyes.

Indeed, the bankruptcy court specifically cited landmarks from New York State's highest court for the proposition that New York's LLP law nearly eliminates personal liability for LLP partners entirely, and thereby renders them largely equivalent to corporate shareholders. To be sure, Judge Glenn further refuted the trustee's claim that the residual liability of LLP partners, that being their inability to avoid consequences for their own personal misconduct, did not detract from their overall kinship with shareholders in a corporation.

The Dewey court's conclusion, in sum, was that state LLP law accorded Dewey's partners protection from personal liability fairly equivalent to corporate shareholders. Thus, they did not fit the definition of partners subject to a Section 548(b) fraudulent conveyance action. Since the trustee could not surmount the threshold question, 548(b) had no application here, and so the trustee's claims on that account were dismissed.

But did the case end there? Certainly not. Because then, the trustee moved to his alternative argument. To do so, the trustee once more took due regard of applicable state law.

To be sure, our readers are generally familiar with the concept that each and every one of the states has its own promulgation of a fraudulent conveyance law, in modern times more often entitled a fraudulent transfer law. The latter moniker is derived from the updated Uniform Fraudulent Transfer Act, a more contemporary revision of the historical law of fraudulent conveyances, which itself has been in existence at least since the seminal Statute of Elizabeth was enacted in England over 600 years ago. Common to both is that each mimics, in relevant part, Section 548 of the Code. In other words, each is but a branch of the same tree of Anglo-American jurisprudence, again consistently aimed over the intervening centuries to maximize creditor recovery of assets, and reverse fraudulent maneuvering by miscreant debtors.

Finally, notwithstanding its status as purely state law, and thereby intended for non-bankruptcy situations, state fraudulent conveyance law almost always proceeds in company with Section 548 in these litigations. Trustees and creditors leave little to chance; when alleging a fraudulent conveyance, they assert both Section 548 and applicable state law causes of action.

The Dewey trustee was no different. He, too, had invoked state fraudulent conveyance law in this action, as found in New York under that jurisdiction's Debtor and Creditor Law, commonly referred to as the "DCL." Like its Bankruptcy Code brethren, the New York DCL is most accommodating to creditors of insolvent entities, providing them with significant remedies to avert debtor shenanigans and recover property rightfully belonging to the creditor body. See generally N.Y. D.C.L. § 270, et seq.

It was there the trustee found D.C.L. Section 277, which bears a striking resemblance to Bankruptcy Code 548(b) in its applicability to insolvent partnerships. As point in fact, Judge Glenn was constrained to point out that this state proviso imposes a "stricter standard of liability" for conveyances made by an insolvent partnership to its constituent partners. Indeed, the law outright declares as fraudulent any transfers made by the entity to the partners, and further sweeps up non-partners if they too received value from the partnership when the entity was insolvent. N.Y. D.C.L. § 277.

The partner/defendants here were nothing if not consistent. Once again they argued that they could not be legally defined as "partners" subject to the working of DCL Section 277, for much the same reason that they were not "partners" for Code Section 548 purposes. Legal history played an important role here, as the former Dewey partners pointed out the fact that New York's fraudulent conveyance law predated by a wide margin the jurisdiction's more continued on page 8
Two LLPs
continued from page 7

contemporary enactments parsing limited partnerships and LLPs as modern business organizations. The trustee's notable rejoinder to that claim: Partners are partners, so, in his view, the Dewey members were subject to Section 277's proscriptions all the same.

And what did the court think? Judge Glenn found fault with the partners' denial of liability pursuant to the state statute. It does not follow, held the bench, that the legal characteristics of current-day LLP partners somehow immunized them from the working of pre-existing fraudulent conveyance law.

Significant to the court's calculus was that limitations upon liability, as bestowed by the present-day LLP act, did not necessarily impact the type of direct transfer by an insolvent partnership to a partner long prohibited by the DCL. Part of the proof of that, found Judge Glenn, was that in 1991 New York did amend the relevant laws, ever so slightly, to afford a modicum of protection to limited partners in a straight-up limited partnership business organization. Yet New York did not extend that revision to LLPs organized pursuant to its laws.

Continuing in a similar vein, Dewey reviewed, at length, other statutory amendments, made both to New York's DCL and LLP laws over the years, and found these revisions did little or nothing to alter the personal liability of partners in an allegedly fraudulent conveyance scenario. The court acknowledged the recent trend of the state's modern business organization laws toward diminishing, if not outright eliminating, the personal liability of participants in professional LLPs and similar organizations. Nevertheless, Judge Glenn just as surely ruled that New York still retained a great deal of the generalities of partnership law, most especially with regard to the liability of partners for property transferred directly to them while the entity labored under the specter of insolvency.

Not surprisingly, this led the court to announce the following conclusion; in New York, "partners of LLPs should not be treated any differently than partners in general partnerships for purposes of N.Y.D.C.L. [Section 277]." Thus, in that regard, the trustee prevailed on his claim of liability against the Dewey partners, this time pursuant to state fraudulent conveyance law.

CONCLUDING THOUGHTS

We would like to tell you that the case ends there, but it does not. The Dewey court went on at length to address numerous other legal issues of significance, the locus of them being what other defenses were available to the defendants to refute the claims against them alleging fraudulent conveyances. To be sure, we commend for further reading the worthwhile discussion had by Judge Glenn of the defenses of reasonably equivalent value, fair consideration, and good faith, as they all play significant roles in adjudicating fraudulent conveyances actions. But we leave all that for another day.

For our ending, we return to our beginning. Notwithstanding that LLPs (and their cousins in the business organization family, LLCs) have now been around for decades, precious little is still known about their reaction when tested by the rigors of the Bankruptcy Code, and, as was significant here, state fraudulent conveyance laws. We attribute this to the truism, and a beneficent truth, to be certain, that while business evolves at a rapid pace, the evolution of law is far slower. Indeed, when it comes to the nation's bankruptcy law, the pace could be called glacial. And we respectfully contend that is for the better, since it allows for far greater deliberation in drafting legal precedents that will survive for generations.

Thus, when we have modern iterations such as LLPs succumbing to bankruptcy proceedings, we are compelled to take their measure against far older laws, even the comparatively modern Bankruptcy Code. Sometimes the results are unanticipated. But what matters is that we have thoughtful and prudent results.

Prior to the instant decision, it was largely unknown to what extent partners in an LLP could be subjected to the vagaries of the Bankruptcy Code and state fraudulent conveyance law. Dewey marks a significant milestone in filling that gap in our experience and jurisprudence. Will it be the last word? Doubtful. But Dewey is, inarguably, a strong, well-reasoned decision. And for the future of LLP law and its interaction with the Bankruptcy Code, it represents a solid foundation upon which to build.