

MARYLAND STATE BAR ASSOCIATION

BUSINESS LAW SECTION

ESTATES AND TRUSTS SECTION (REGARDING 1-401 OF ESTATES AND TRUSTS ARTICLE)

SENATE BILL 261: BILL EXPLANATION

1. AMENDMENTS TO SECTIONS 4A-101(q), 4A-203(15), 4A-402(a)(9), AND 4A-603(d) OF THE MARYLAND LIMITED LIABILITY COMPANY ACT (the “LLC ACT”)

The purpose of these amendments is to reverse the decision of the Maryland Court of Special Appeals in Potter v. Potter, 250 Md. App. 569 (2021).

In Potter, the Court of Special Appeals held that the provisions in an operating agreement of a Maryland limited liability company (an “LLC”) governing the transfer of a Maryland resident member’s economic interest in the LLC to a person named in the operating agreement upon the member’s death were void because the operating agreement was not executed in accordance with Maryland’s requirements for execution of a will.¹ While Potter concerned the transfer of a member’s economic interest to a non-member, the holding in Potter arguably may also apply to transfers of non-economic interests and transfers between members of an LLC.²

As a result of Potter, operating agreements of Maryland and non-Maryland LLCs that provide for a transfer of a member’s membership interest upon the member’s death may not be enforceable even though the transfer provision was agreed upon by all of the LLC’s members. For example, Potter suggests that the following is not enforceable unless the operating agreement is executed by the member who dies in accordance with requirements for execution of a will: Mary, Sue and Tom form an LLC to provide public relations services (or any type of service). The LLC’s operating agreement, signed by Mary, Sue and Tom provides that each member will own 1/3 of the LLC, each will work full time for the LLC, and that, upon the death of any member, 50% of the deceased member’s membership interest will be transferred to the surviving two members. Similarly, Potter holds that an operating agreement (which is not executed in accordance with the execution requirements for execution of a will) that provides that, upon the death of Mary, Sue or Tom, the deceased member’s membership interests are transferred to the employees of the LLC, would not be enforceable. Instead, the deceased member’s rights in the LLC would transfer to the deceased member’s heirs (whether by a will or the laws of intestacy (dying without a will)).

Using the examples above, assuming Mary dies and Sue and Tom continue to work for the LLC, instead of Sue and Tom splitting the LLC’s profits between them or with the LLC’s employees (as Mary, Sue and Tom had agreed), Sue and Tom would have to give 1/3 of the profits to Mary’s heirs,

¹ More specifically, the Maryland Court of Special Appeals held that that the provisions in the operating agreement of the LLC at issue, which provided that a deceased member’s economic interest in the LLC be transferred to a person named in the operating agreement who was not a member of the LLC, were testamentary in nature. Therefore, the operating agreement had to be executed in accordance with Maryland’s requirements for wills. Since, among other things, the operating agreement did not have two witnesses (required for a will in Maryland), the operating agreement’s provisions regarding the disposition of the deceased member’s economic interest were deemed to be void, and the economic interest passed to the deceased’s next of kin (his spouse) in accordance with Maryland’s laws of intestacy (dying without a will).

² Potter was appealed to the Maryland Court of Appeals, and the Maryland Court of Appeals granted certiorari to consider the case, but the parties to the litigation settled the case prior to the case being heard by the Court of Appeals.

even though Sue and Tom may not know any of the heirs and even though the heirs are not doing any work for the LLC.

Alternatively, if the LLC in the above example was created in New Jersey (where the provision leaving the LLC interest to the surviving members would be enforceable) but Mary moved to Maryland where she died, the valid New Jersey provision of the New Jersey LLC may fail to control Mary's LLC interest which would, instead, pass to her estate under Maryland law. This raises concerns for LLC members who would like to move to Maryland.

Almost no operating agreements currently in place have been executed with the formalities of a will. It is likely that, even after the Court of Special Appeals decision in Potter, few will be executed with these formalities, because many operating agreements are drafted by general practitioners who would typically be unaware of the unique holding in Potter.³ Perhaps even more operating agreements are drafted by the LLC's members themselves without a lawyer through online resources such as LegalZoom. In short, Potter creates an unnecessary trap for the unwary.

In Potter, the Court of Special Appeals concluded that the LLC Act did not include provisions providing that an operating agreement may include provisions regarding the disposition of membership interests in a Maryland LLC upon a member's death. The proposed amendments to Section 4A-402(a)(9)⁴ would make clear that an operating agreement may include these types of provisions. As a result, operating agreements of Maryland LLCs with these types of provisions would not need to meet the requirements of a Maryland will.

The other proposed amendments to the LLC Act are companion amendments to the proposed amendment to Section 4A-402. Sections 4A-101(q) and 4A-203(15) are proposed to be amended so that their descriptions of the content and/or purpose of operating agreements is consistent with Section 4A-402. Section 4A-603(d) is proposed to be amended to address possible inconsistencies with Section 4A-402 as a result of the amendment to Section 4A-402(a)(4).

2. AMENDMENTS TO SECTION 9A-503 OF THE MARYLAND REVISED UNIFORM PARTNERSHIP ACT AND SECTION 10-702 OF THE MARYLAND LIMITED PARTNERSHIP ACT

These amendments make similar changes for general partnerships and limited partnerships.

3. AMENDMENTS TO SECTION 1-401(C) OF ESTATES AND TRUST ARTICLE

This is a companion provision to the amendments to the LLC Act and makes clear that the transfers described above are not testamentary.

³ See Exhibit A.

⁴ Section 4A-402 is the section of the Act governing operating agreements. The amendments to Section 4A-402(a)(9) references "any of the events described in Section 4A-606". Section 4A-606 provides that, unless otherwise agreed by the members (typically in an operating agreement), a member ceases to be a member of an LLC and only has economic rights in the LLC upon certain events, including withdrawal, removal, bankruptcy, death, incompetency or dissolution (in the case of an entity). While the issue in Potter relates to the death of a member, and while there should be no doubt that an operating agreement can provide for assignment of a member's interest upon the occurrence of these other events (subject in the case of bankruptcy to any Federal bankruptcy law), we believe referencing all of 4A-606 (instead of 4A-606(5)(i) (which relates to the death of a member) avoids any negative inference regarding the transfer of a membership interest upon the occurrence of these other events.

EXHIBIT A

Below are cases in which other states' courts that have held that provisions similar to the one in Potter are not testamentary and are enforceable under contract law principles.

In *Blechman v. Estate of Blechman*, 160 So. 3d 152 (Fla. Dis. Ct. App. 2015), which was noted by the Court of Special Appeals in Potter, the operating agreement contained restrictions on transferability that provided that in the event of the death of a member, the membership interest passed to the deceased member's children *per stirpes*. 160 So. 3d at 153. The Florida court applied New Jersey law based on the internal affairs doctrine and held that the provision was enforceable.

In *the Matter of the Estate of Cook*, 2020 Ark. App. 292, 601 S.W.3d 453 (2020), the court enforced the provisions of an operating agreement that provided that the interest of the deceased member would devolve to the remaining member without payment of any consideration. The court noted that the operating agreement provided adequate consideration for such a provision. *Id.* at 457-458.

There are numerous older cases in other states dealing with partnership and other agreements that are contrary to the Potter holding. For example:

- In *More v. Carnes*, 309 Ky. 41, 214 S.W.2d 984 (1948), the court held that a partnership agreement which provided that upon the death of a partner the decedent's partnership interest became the property of the other partner was not testamentary and was enforceable.
- In *Netz v. Howe*, 31 Cal. 2d 395, 189 P.2d 5 (1948), an agreement between Howe, the owner of a business, and his manager, Netz, which provided that upon Howe's death the business would be transferred to Netz as additional consideration for his services, was enforced and was held not to be a testamentary disposition but rather an enforceable contract.
- In *Faggelle v. Marena*, 131 Conn. 277, 38 A.2d 791 (1944), a partnership agreement that provided for a deceased partner's share to pass to his widow upon death was held to be enforceable and was not a testamentary disposition against a challenge from the remaining partner.
- In *Michaels v. Donato*, 4 N.J. Super. 570, 67 A.2d 911 (1949), a clause in a partnership agreement providing for a deceased partner's share in the business to devolve to the remaining partner for a fixed price of \$1,000 was held to be enforceable and not testamentary.