

Protecting Your Interests in a Deadlocked or Mismanaged LLC

~ M. Lewis Hall III

Are you a member of a Florida limited liability company? Or perhaps a shareholder of a closely held Florida corporation in financial trouble? Do you suspect the management of fraud or mismanagement? If so, you should know about some aggressive remedies available in our Florida Statutes.

During the great recession, many LLCs holding a single asset, usually real estate, experienced financial difficulties. There was little the owners could do to salvage the investment unless they were willing to advance money to keep the bankers and tax collector at bay. However, where the company was an active business generating income, the story was different.

Let's consider another all-too-often occurrence: An LLC with two members owns a franchise business. The asset value is \$2 million, with each member owning one half of the business. The managing member becomes involved in a hotly contested divorce and uses company money to defend himself in the divorce action. The ex-wife receives a one-half interest in the company in her property settlement. The situation becomes untenable, causing a strain on a long-term friendship. What legal recourse does the other member have?

Typically, the non-wrongdoing member of an LLC facing this dilemma either negotiates a resolution with the offending party or sues the offending party. But suing the wrongdoer may cause the business to suffer. The wrongdoing member, now involved with litigation on two fronts, may not give the business the attention it demands. And because a business with declining income is difficult to sell, bankruptcy or shutting down the business may be the outcome of either of the remedies available to the non-wrongdoing member.

A **receiver** may dispose of all or a part of the assets of the limited liability company, wherever located, by public or private sale if authorized by the court.

A Real-Life Case Study

Before we go any further, let's look at a real-life example of a typical controversy and how it was resolved under the new provisions of the Statute, using a court-appointed custodian and receiver. Then we'll examine the Statute itself and how the process works.

Let's say you are one of three family members involved in a closely held corporation that owns a sizable tract of land. While the land was once used for farming, it no longer has any income-producing operation. You have a shareholder agreement that requires all of you to agree to any businesses operating on the property. One of your family members started a business on the property, made improvements using her money, and held charitable events on the property without the consent of you and the other shareholder. Management of the corporation is at an impasse since your agreement requires unanimous consent for any business to operate on the property. Remember that, until recently, your options would have been limited to negotiating with or suing the wrongdoer in the family.

If you think outside the box, you will find a different remedy available. You and your other family member can file a complaint with the court alleging a deadlock in management (one of two allegations that can trigger an action by the court) and requesting the appointment by the court of a custodian or a receiver. Rather than sue or enter into negotiations that may not resolve the controversy, you initiate a lawsuit, requesting the appointment of a custodian. The court appoints a custodian who immediately takes control of the day-to-day operations, stops the business started by the independently acting shareholder, and puts in new management and controls. After a period of time, the custodian reports to the court he or she cannot make the corporation profitable and suggests that the custodianship be changed to a receivership so all assets owned by the corporation can be sold. The court authorizes the change to a receivership and also authorizes the receiver to market and sell the assets of the closely held corporation. The receiver then engages a listing broker and establishes and implements a marketing plan to obtain the highest price for the assets. Ultimately, when the property sells, the receiver distributes the money to the owners of the corporation, after expenses. Your dispute has been resolved.

A **custodian** is a person appointed by the court to manage the business and affairs of the corporation until the court can straighten out the mess and right the wrongs.

A Closer Look at How the Statutes Work: Appointing Custodians and Receivers

Effective January 1, 2015, all limited liability companies are governed by Chapter 605 of the Florida Statutes. Chapter 605 gives the non-wrongdoing member or shareholder a statutory remedy allowing a change in management regardless of when the limited liability company was formed. The remedy is the appointment of a custodian or receiver. The procedure is virtually the same whether the entity is an LLC or a closely held corporation. To initiate the procedure, a member or shareholder must sue, alleging (i) the members/shareholders are deadlocked in the management of the company affairs or (ii) the company's assets are being misappropriated or wasted, and request the appointment of a custodian or receiver, or both. A receiver may dispose of all or a part of the assets of the limited liability company, wherever located, by public or private sale if authorized by the court. A custodian is a person appointed by the court to manage the business and affairs of the corporation until the court can straighten out the mess and right the wrongs. After suing, the parties may stipulate to the custodian or receiver. Otherwise, the court will appoint a qualified person, often an accountant, to become the receiver or custodian. The court will compensate the receiver or custodian based on his or her hourly rate, usually \$300 to \$450 per hour. All fees are subject to court review and approval.

A court-appointed custodian or receiver operates the business with significant liability protections from the court. A custodian or receiver is not liable for acts of simple negligence or mistakes in business judgment. Liability can be imposed on a receiver or custodian only for gross negligence or intentional misconduct, such as fraud or theft. To protect all parties, the court usually requires a receiver or custodian to post a bond payable to the parties for gross negligence or intentional misconduct.

The custodian can hire additional employees and managers, fire employees, and manage the business. He or she takes control of the bank accounts and reports to the court periodically but manages the business daily. The custodian usually hires a new manager to operate the business. The custodian files an inventory of the assets of the company and files accountings to the parties at designated times. All of the custodian's actions are fully transparent and subject to review by the court. Inventories and accountings can be useful to a party not receiving accurate information about the operations of the business.

The custodian will determine fairly quickly whether the company can be turned around. If it cannot, the Florida Statutes allow for the appointment of a receiver. A receiver may sell the business and distribute the proceeds of the sale to the members/shareholders after paying creditors and expenses incident to operating the business and the sale.

Where the LLC or closely held corporation can be turned around to become profitable again, the custodian may stay in place, if needed. Once litigation starts, mediation is a helpful tool used by the court to assist the parties in resolving their disputes. It is a non-binding but often effective procedure. The parties choose by agreement a neutral person, usually an attorney certified by the Supreme Court as a mediator, to conduct the mediation. The cost of the mediation is split between the parties. The parties may agree to an early mediation or the court will order the parties into mediation before trial. If the parties fail to resolve the conflict at mediation, the mediator will declare an impasse and the case will proceed to trial. If, however, an agreement is reached at mediation, it could require the parties to amend the operating agreement of the LLC or require the shareholders to enter into a shareholder agreement to cure the mismanagement problems of the past, i.e., a change in management.

When this occurs, the custodian is then discharged by the court and the parties continue to operate under the new arrangement.

However, if the custodian determines the LLC or closely held corporation cannot be turned around to become profitable, he or she will report that conclusion to the court and request the custodianship be changed to a receivership. Again, a custodian only manages the business, whereas a receiver is authorized by the court to sell the assets. Once the assets are sold, the proceeds of the sale are distributed first to creditors, then to the members of the LLC or shareholders. The benefit of a receiver's sale is the receiver has the time, unless the creditors object, to market the assets to obtain the optimum price. In contrast, a sale in bankruptcy or a judicial sale by the court is almost always at a deeply discounted price due to the forced sale of the assets.

How the Law Works in Real Time: A Second Case Study

So now that you have a general knowledge of the law relating to receivers and custodians, let's take another look at how the law works in real time in a different scenario.

Suppose that you are a shareholder in an LLC that owns a marina operating at a significant loss. The marina runs a restaurant, also operating at a loss. The marina also rents storage space to boat owners to store their boats and provides in and out service to its tenants, and it has in-water slips available for lease. You and the other owners suspect the restaurant manager of hiding income. You sue. Faced with a forced appointment of a receiver by the court, you agree to the appointment of a receiver, a local accountant. Upon appointment, the receiver takes control of the bank accounts, initiates accounting controls, interviews the employees, and determines management should be removed. The receiver employs a new manager to oversee operations. The receiver determines the restaurant should no longer be operated by the LLC and leases the restaurant to a third party for \$5,000 a month. Within three months, the receiver turns the operation from a loss position to a profitable one. Now you and the other owners have a going concern worth considerably more than before, with new management and accounting controls. The receiver accomplished all of this with minimum court supervision and the property was returned to you.

The remedy afforded by Florida law to appoint a custodian or receiver for a limited liability company or closely held corporation may not always work. It depends on the circumstances of each case. But it is an effective remedy in the right circumstance. If you find yourself in a problem situation with the managing member of a limited liability company or closely held corporation, consult with an attorney to see if a custodian or receiver is in your best interest.



Lew is a Williams Parker shareholder.

He is a commercial litigator focusing on complex commercial litigation, bankruptcy matters, and construction disputes.

