

TEXAS LIMITED LIABILITY COMPANIES: RESCISSION OF MANAGEMENT AGREEMENT; FAIR MARKET VALUE OF A WITHDRAWING MEMBER'S INTEREST; JOINT AND SEVERAL LIABILITY OF MEMBERS WITH THE LLC

By Jerel W. Ehlert II*

Kennebrew v. Harris, 425 S.W.3d 588 (Tex. App.—Houston [14th Dist.] 2014, pet. denied)

Case Summary

A withdrawing member, Michael Harris, of a Texas Limited Liability Company, Elite Protective Services, LLC, sued the company and remaining member, Charles Kennebrew, Sr., for the value of his membership interest in the company and to recover funds expended on the company's behalf as allowed in a Management Agreement.¹ At a bench trial, the court (i) rescinded the Management Agreement, (ii) ordered the return of Harris's capital contribution, (iii) found there was an oral loan agreement between the withdrawing member (Harris), the company, and Kennebrew, (iv) determined the company and Kennebrew breached that agreement by not repaying funds Harris had expended on behalf of the company, and (v) awarded damages and attorney's fees against Kennebrew and the company jointly and severally.² All parties appealed.³

Holding

The Court of Appeals held:

- There was no evidence of an oral loan agreement;⁴
- Rescission of the Management Agreement was not available as a remedy;⁵
- Failure of the withdrawing member to register under a state statute, even if required under the Management Agreement, did not render the agreement unenforceable;⁶
- A member of a limited liability company, permitted to withdraw under the company agreement, is entitled to the fair market value of that member's interest in the company;⁷
- Remaining member was not jointly and severally liable with the company for the

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¹ *Kennebrew v. Harris*, 425 S.W.3d 588, 592-93 (Tex. App.—Houston [14th Dist.] 2014, pet. denied).

² *Id.* at 593.

³ *Id.*

⁴ *Id.* at 594-95.

⁵ *Id.* at 595-96.

⁶ *Id.* at 597-98.

⁷ *Id.* at 598 and n.2.

judgment amount.⁸

Rescission of the Management Agreement

Rescission, short for rescission and restitution,⁹ is an equitable remedy available where monetary damages alone will not suffice.¹⁰ The party seeking rescission must prevail on a cause of action for which that is a remedy,¹¹ and the company did not prevail on any such cause of action against the withdrawing member.¹²

The LLC claimed the withdrawing member breached the Management Agreement by failing to register with a state agency while part of the company, as the agreement allegedly required, thus the Management Agreement never became effective, making rescission appropriate.¹³ In Texas where the legislature supplies criminal or civil penalties sufficient to compel obedience with a mandatory statute, failure to comply does not render the contract void or voidable.¹⁴ Failure to register under the applicable statute was punishable as a misdemeanor criminal violation and by a civil fine, which the court reasoned were sufficient to deter violations. Therefore, failure of the withdrawing member to comply with such a provision in the Management Agreement would not render the contract unenforceable.¹⁵

The party requesting rescission must comply with common law preconditions.¹⁶ The party must first, give timely notice that the contract is being rescinded, and second, return or offer to return the property and the value of any benefit derived from its possession.¹⁷ Failure to comply with the preconditions for rescission by keeping the property precludes availability of the remedy to that party.¹⁸

The company did not give notice to the withdrawing member and kept the withdrawing member's property. Even if the company had proved grounds for rescission, it would still be unavailable for failure to act like it was rescinding the Management Agreement by meeting the preconditions.¹⁹

Fair Market Value

⁸ *Id.* at 600-01.

⁹ *Id.* at 595 (citing *Cruz v. Andrews Restoration, Inc.*, 364 S.W.3d 817, 825 (Tex. 2012) (quoting RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 54 cmt. a (2011))).

¹⁰ *Id.* (citing *City of The Colony v. N. Tex. Mun. Water Dist.*, 272 S.W.3d 699, 732 (Tex. App.—Fort Worth 2008, pet. dism'd)).

¹¹ *Id.* at 596.

¹² *Kennebrew*, 425 S.W.3d at 596.

¹³ *Id.* at 597.

¹⁴ *Id.* at 597 (citing *New Bos. Gen. Hosp., Inc. v. Tex. Workforce Comm'n*, 47 S.W.3d 34, 40 (Tex. App.—Texarkana 2001, no pet.) (op. on reh'g)).

¹⁵ *Id.* at 597-98.

¹⁶ *Id.* at 596.

¹⁷ *Id.* (citing *Cruz*, 364 S.W.3d at 824).

¹⁸ *Id.*; see *Carrow v. Bayliner Marine Corp.*, 781 S.W.2d 691, 696 (Tex. App.—Austin 1989, no writ)).

¹⁹ *Id.* at 596.

Members in a Texas Limited Liability Company do not have a statutory right of withdrawal.²⁰ In the case before the court, however, both the Company Agreement and the Management Agreement, allowed members to withdraw from the company.²¹

Having the contractual right of withdrawal, the member gave notice to the company and the remaining member.²² The notice was acknowledged in a timely manner.²³ Having exercised a valid withdrawal, the member was entitled by statute to the fair market value of his membership interest in the company.²⁴

The trial court found, and both parties agreed, that owners' equity was the value of all the assets the company owned, less all the liabilities the company owed.²⁵ On appeal, the remaining member argued that this value should be reduced by the members' contributions.²⁶ The court dismissed this argument, saying that it conflates "distribution to a withdrawing member of the value of his interest" with "a return of capital."²⁷

Joint and Several Liability

The trial court held Kennebrew, the remaining member of the LLC, was jointly and severally liable for the judgment, along with the company.²⁸ On appeal, the court found this to be error.²⁹ A member or manager of an LLC is not liable for the company's debts, obligations, or judgment unless the company agreement specifically provides otherwise.³⁰ Both the Company Agreement and the Management Agreement provided that no member or manager would be liable for company debts or liabilities, including a judgment.³¹ Where a party prevails in a suit against the company and its members, and the causes of action on which the party prevails are on obligations of the company and not on obligations of the members, the company is solely responsible for satisfaction of the judgment.³²

The withdrawing member prevailed on his claim for breach of contract of the Membership Agreement by the LLC in failing to repay money properly expended on the company's behalf and failure to distribute fair value of the membership interest, and he was awarded attorney's fees.³³ Both claims derive from contractual obligations of the company in the Management Agreement. No evidence showed the remaining member had any duty to perform in his personal

²⁰ TEX. BUS. ORGS. CODE § 101.107 (West 2012).

²¹ *Kennebrew*, 425 S.W.3d at 598.

²² *Id.*

²³ *Id.*

²⁴ *Id.* at 598-99; *see also* TEX. BUS. ORGS. CODE § 101.205 (West 2012).

²⁵ *Id.*

²⁶ *Id.* at 599.

²⁷ *Id.*

²⁸ *Id.* at 600.

²⁹ *Id.*

³⁰ *See* TEX. BUS. ORGS. CODE § 101.114 (West 2012).

³¹ *Kennebrew*, 425 S.W.3d at 600.

³² *Id.*

³³ *Id.*

capacity.³⁴ The court held it was improper to hold the member liable for a judgment against the LLC or attorney's fees where the grounds of recovery were against the LLC only.³⁵

³⁴ *Id.*

³⁵ *Id.* at 600-01.