MESSAGE FROM THE CHAIR

Mitchell L. Bach*

I thought I should take this opportunity to introduce myself. I hope to meet many of you during this exciting year, as I have the privilege of serving as Chair of the Philadelphia Bar Association’s Business Law Section. I also want to share with you some perspectives about the Section’s new leadership.

I became involved in the Section about six or seven years ago, as a result of my work with Bar Association leaders who shared my interest in establishing a business court in Pennsylvania. Former Chancellor Mark Aronchick asked me to act as one of the original Chairs of a newly-formed Business Litigation Committee which became part of the Business Law Section. This Committee’s work was instrumental in the formation of the Philadelphia’s Commerce Case Management Program. Former Section Chair Len Bernstein who had worked with me in that effort asked me to join the Section’s Executive Committee, where I have worked closely with Len and his successors: Greg Mathews, Audrey Talley, Ann Mulé, John Wright and Merritt Cole.

It is a humbling experience to step into the shoes of these great leaders. As I announced at the Section Reception in January, one of my first acts as Section Chair was to form an Advisory Committee consisting of these six former Chairs with whom I have served, as well as Len’s predecessor, Justin Klein. All of these seven former Section Chairs were very enthusiastic about their agreement to serve in this new capacity. I am certain that they will be extremely helpful to me, the other Section officers and our current Executive Committee in charting this year’s activities and the future of the Section.

I am fairly certain that no other litigator has ever held this position. As explained above, it hasn’t been that long that commercial litigators have had a formal role in the Section. To me, this was a natural development because I learned long ago that commercial litigators are business lawyers too.

I was very fortunate to start my career with a small group of talented lawyers whom some of you may remember as Goodman & Ewing. My friend and classmate as a Wharton School undergraduate, Steve Foxman, had introduced me to this firm, and we started around the same time, in 1973. At first, our practices were very much alike. I was dabbling in securities law and other types of transactional work, while learning from my litigation mentor, Neil Epstein; and Steve’s practice had the same kind of variety. Eventually, I began specializing in commercial litigation, and Steve became one of our great transactional lawyers. It has always been quite clear to me that these were branches of the same tree, and that both of our practices were rooted in the same body of business law.

After heading my own law firm for more than 15 years, I recently rejoined Steve Foxman, Neil Epstein and many of my former partners who now form the Philadelphia office of Eckert Seamans Cherin & Mellott. Steve and one of my new Eckert partners, Deborah Weinstein, are members of the Section’s Executive Committee; along with CIGNA’s Pauline Candaux and Dechert’s Brian Vargo. I am especially excited about the three new members of our Executive Committee: Eric Milby of the Lundy firm, Sandra Jeskie of Duane Morris and Ray Walheim of Ballard, who have brought new energy and a fresh perspective to the Section’s leadership. Finally, my fellow officers, Kate Shay of Duane Morris (Vice Chair), Al Dandridge of Schnader (Treasurer) and Bill Clark of Drinker (Secretary), assure that the Section’s leadership will be in capable hands for years to come.

Please feel free to contact me if you have any questions or concerns about the Section, or if you have any ideas about how the Section can best serve you and all of its members. I urge you to become involved in the Section and at least one of its Committees. Thanks for your involvement and support.

*Mitchell L. Bach is the Chair of the Business Law Section and a partner at Eckert Seamans Cherin & Mellott, LLC.
PREPARE YOUR PENNSYLVANIA LLC DOCUMENTS WITH CARE

Michael A. Budin*

Limited liability company acts are relatively new. As a result, they are still going through a shake out period. Undesirable provisions and provisions that are no longer needed are being eliminated and ambiguities and inconsistencies are being corrected. But this process is ongoing, with revisions being made as issues are discovered. The Pennsylvania Limited Liability Company Act (the “PA LLC Act”) is no exception. As a result, those preparing the LLC documents (i.e., the certificate of organization and the operating agreement) for a Pennsylvania LLC must be careful in order to avoid potentially undesirable results.

The need for care in drafting comes from three fronts: (1) provisions that must be in the certificate of organization to be effective, (2) ambiguous and potentially inconsistent provisions and (3) areas where the LLC act has no applicable provision. As with most LLC acts, a basic principle of the PA LLC Act is the freedom of contract as regards the internal affairs of the LLC, subject to a few limitations. This freedom of contract allows for the avoidance of many potential problems. Indeed, given the relative lack of decisional guidance, if there is doubt as to the applicability or meaning of a particular statutory provision, it generally would be advisable to specifically deal with that issue in the certificate of organization or the operating agreement, as applicable and to the extent possible. A general maxim that should be followed when drafting LLC documents is “When in doubt, spell it out.”

Significant among the matters that must be in the certificate of organization of a Pennsylvania LLC to be effective are an override or limitation of Section 8904(a) (relating to application of the Pennsylvania Uniform Partnership Act (the “UPA”) and the Pennsylvania Revised Uniform Limited Partnership Act (the “LPA”)) and a statement that the LLC is to be managed by managers if that is to be the case. (See § 8913(3) and 8941(b).)

Section 8904(a) provides as follows:

“(a) General Rule.-Unless otherwise provided in the certificate of organization, in any case not provided for in this chapter:

(1) If the certificate of organization does not contain a statement to effect that the limited liability company shall be managed by managers, the provisions of Chapters 81 (relating to general provisions) and 83 (relating to general partnerships) govern, and the members shall be deemed to be general partners for purposes of applying the provisions of those chapters.

*Michael A. Budin is Chief Counsel at the Pennsylvania State Employees’ Retirement System.
NEW JERSEY’S ANTI-PREDATORY LENDING LAW TAKES EFFECT: ARE YOU READY?

Robert M. Jaworski
Leonard A. Bernstein*

New Jersey’s anti-predatory lending law, officially known as the “New Jersey Home Ownership Security Act of 2002, c.64, P.L. 2003” (the “NJ Act”), became effective on November 27, 2003. Briefly, the NJ Act places restrictions on “home loans,” “covered home loans” and “high cost home loans,” with the latter two categories including loans which exceed either an APR or a “points and fees” threshold. Because the NJ Act is in many respects vague and ambiguous, imposes severe penalties and in some situations can extend potentially unlimited or at least quantifiable liability upon loan purchasers, it could significantly damage the New Jersey market for non-prime lending.

Key Definitions

“Home loans” are defined in the NJ Act as closed- or open-end, purchase-money or refinance, first- or subordinate-lien loans (other than reverse mortgage loans), that are secured by real estate on which is located or is to be located a 1-6 family dwelling or a manufactured home that the borrower occupies or will occupy as his/her principal dwelling, the proceeds of which are used for personal, family or household purposes. Business purpose loans, reverse mortgage loans and loans secured by a vacation home are not covered by the NJ Act.

“High-cost home loans” are defined as home loans not in excess of $350,000 (adjusted annually) meeting either of the two prescribed thresholds described below:

Rate threshold - equivalent to the APR Threshold under HOEPA, currently 8 percentage points above the comparable Treasury yield for first-lien loans, and 10 percentage points above the comparable Treasury yield for subordinate-lien loans;

Total points and fees threshold - triggered when “points and fees” (defined to exclude a “conventional prepayment penalty” or up to two “bona fide discount points” as discussed below) exceed 5 percent of the total loan amount for loans equal to or more than $40,000 in amount; 6 percent of the total loan amount for loans equal to or more than $20,000 but less than $40,000 in amount; or the lesser of 6 percent of the total loan amount or $1,000 for other loans.

“Covered home loans” are home loans in which the total points and fees, excluding a “conventional prepayment penalty” or up to two “bona fide discount points,” exceed 4 percent of the total loan amount for loans in excess of $40,000, or 4.5 percent for loans under $40,000 or FHA-VA loans. In addition, all high-cost home loans are “covered home loans.”

“Points and fees” include: (1) all items (except interest) listed as “finance charges” in 15 U.S.C. § 1605(a)(1) through (4) of the Truth-in-Lending Act (“TILA”) - points, service or carrying charges, loan fees, finder’s fee, or similar charges, and fees for an investigation or credit report; (2) all charges listed in 15 U.S.C. § 1605(e) even though these items are excluded by TILA from the computation of finance charges - title insurance premiums, fees for preparation of loan-related documents, escrows for future payments of taxes and insurance, fees for notarizing deeds and other documents, appraisal fees, including fees related to any pest infestation or flood hazard inspections conducted prior to closing, and credit reports; (3) all direct and indirect mortgage broker compensation; (4) all premiums for credit life, credit disability, credit unemployment or credit property insurance, or any other life or health insurance, or any payments for debt cancellation, which are paid out of the loan proceeds, i.e., financed single premium insurance; (5) the maximum prepayment fee that may be charged to the borrower if the loan is prepaid; and (6) any prepayment fee the borrower has to pay on a prior loan being refinanced with the proceeds of a high-cost home loan made by the same creditor or an affiliate.

Notwithstanding the above, specifically excluded from “points and fees” are: taxes, filing fees, and recording fees paid to public officials to determine the existence of or to perfect, release or satisfy a security interest; title insurance and title examination fees paid to a licensed title insurance producer. Also excluded, but only if reasonable in amount and paid to someone other than the creditor or mortgage broker or an affiliate of either, are tax service fees, flood certification fees, pest inspection fees, appraisal fees, pre-closing inspection fees, credit report fees, survey fees, attorneys’ fees, notary fees, escrow charges, and fire and flood insurance premiums (provided TILA requirements for exclusion from the finance charge are met).

“Bona fide discount points” are points knowingly paid by the borrower to buy down the interest rate on a home loan and which in fact reduce the interest rate (the “Start Rate”) such that the amount of the bona fide discount points will be recouped over at most five years of scheduled monthly payments. Bona fide discount points may be excluded from “points and fees” only if the Start Rate is less than or equal to the “conventional mortgage rate” for a first-lien home loan published in FRB Statistical Release H.15 plus 2 percent for a first-lien loan or 3-1/2 percent for a junior lien loan.

*Robert M. Jaworski and Leonard A. Bernstein are partners at Read Smith LLP.

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“Conventional prepayment penalty” means a prepayment fee that may not exceed 2 percent of the amount prepaid and is otherwise permitted by law. A prepayment penalty only qualifies as a “conventional prepayment penalty” if the interest rate on the mortgage itself does not exceed the published conventional mortgage rate (as referenced above) by more than two percentage points. (Note: Prepayment penalties are prohibited under New Jersey law. Only institutions entitled to federal preemption may charge them and only to the extent permitted under the applicable federal law.)

The definition of points and fees is obviously of critical importance in determining whether or not a loan is a high-cost home loan or a covered home loan. Yet, the definition is extremely complex, and raises serious questions as to what is included or excluded. For example, should tax escrows - an item listed in 15 U.S.C. § 1605(e) - be counted as points and fees? How about closing agent fees paid to a title insurance agent?

Prohibited Practices: All Home Loans

The NJ Act impacts all home loans, not just non-prime loans. Consequently, stiff penalties could result even from a violation of the NJ Act which relates only to a home loan.

The NJ Act prohibits, as to all home loans:

1. **Credit Insurance**: the financing of single premium credit insurance or debt cancellation agreements.

2. **Encouraging Defaults**: recommending or encouraging default on an existing loan.

3. **Late Charges**: charging late fees in excess of 5 percent of the payment in default or for a payment that is past due less than 15 days, or where the creditor does not send the borrower written notification of the imposition of the late fee within 45 days.

4. **Posting of Payments**: posting a payment other than on the same date that it was received (arguably, even if the lender receives the payment after the close of its business day), provided it was sent to the address identified by the creditor.

5. **Acceleration**: accelerating the indebtedness at the creditor’s sole discretion.

6. **Payoff Requests - Fees & Timing**: charging a fee for information concerning a borrower’s payoff balance or to provide a release upon prepayment, or providing a requested payoff quote more than seven business days after the request is received. (“Business day” is not defined.)

**Prohibited Practices: Covered Home Loans**

The NJ Act prohibits “flipping.” “Flipping” occurs upon the refinancing of an existing home loan within five years by a covered home loan under circumstances where there is no “reasonable tangible net benefit” to the borrower. The NJ Act includes no definition of reasonable tangible net benefit, but merely directs that various circumstances be considered, including the terms of the new and the old loan, the “economic and noneconomic circumstances,” the loan purpose, the cost of the new loan, and the borrower’s circumstances. Worse, the NJ Act does not appear to delegate rulemaking power to the New Jersey Department of Banking and Insurance (“NJDOBI”) to further define this vague test, which will leave lenders wondering whether or not they can safely make or purchase covered home loans that are refinance loans.

The NJ Act also provides: “In addition, the following home loan refinancings shall be presumed to be flipping if (either one of two sets of circumstances exists).” These circumstances are where: (1) the “primary tangible benefit” of the new loan as compared to the refinanced loan is a lower interest rate, and “it will take more than four years for the borrower to recoup the costs of the points and fees and other closing costs through savings resulting from the lower interest rate;” and (2) the new home loan refinances an existing home loan that is a “special mortgage” (subsidized or guaranteed by a government agency or a non-profit that bears a below-market interest rate or beneficial non-standard payment term) such that the borrower loses the below market interest rate or one or more of the beneficial non-standard payment terms of the special mortgage.

Although the NJDOBI has issued interpretive “guidance,” discussed further below, that the above presumptions only apply where the new loan is a covered home loan, the fact that this paragraph begins with the phrase “[i]n addition,” and nowhere references the term covered home loan, raises an issue as to whether or not these presumptions can be read to apply even where the new loan is not a covered home loan. We would argue strongly to the contrary, but do not presume to predict how a court might decide the issue in the context of an actual case.

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Prohibited Practices: All High-Cost Home Loans

The NJ Act prohibits in connection with all high-cost home loans: (1) the financing of points or fees in excess of 2 percent of the total loan amount; (2) balloon payments; (3) negative amortization; (4) default interest rates; (5) requiring more than two advance payments at closing; (6) mandatory arbitration clauses if the result will be “less convenient, more costly, or more dilatory” for the resolution of a dispute than suing in court. (Note that this prohibition applies whether a borrower plans to act “individually or on behalf of others similarly situated,” an ominous phrase for those fearful that class actions may be permitted under the NJ Act.)

The NJ Act also prohibits the making of any high-cost home loan: (7) without giving the borrower, at least three business days before closing, a prescribed form of cautionary notice that must be acknowledged by the borrower; and (8) in cases where the borrower is financing points or fees, without receiving from the borrower a certification that the borrower has received advice from an approved nonprofit credit counselor.

Finally, the NJ Act prohibits in connection with all high-cost home loans: (9) paying home improvement contractors out of the loan proceeds by means of a one-party check; (10) charging modification or deferral fees; (11) charging points and fees in connection with the refinancing of an existing high-cost home loan with a new high-cost home loan “held by the same creditor or note holder”; and (12) using a non-judicial foreclosure procedure when the creditor has a legal right to foreclose.

Assignee Liability

The NJ Act applies to a “creditor,” which is defined to include those who extend consumer credit and “to whom the obligation is payable at any time.” Although assignees are expressly excluded from the definition of “creditor,” that does not mean that they take high-cost home loans free and clear of claims the borrower may have against the creditor.

Section 6(a) of the NJ Act applies to home loans made or referred by a manufactured home seller or a home improvement contractor, and gives borrowers of such loans the right to assert against the creditor to whom the borrower was referred, and any assignee or holder of the home loan, “all affirmative claims and defenses” that the borrower may have against the seller or contractor. Liability under this provision is limited to amounts required to reduce or extinguish the borrower’s liability under the home loan, plus the total amount paid by the borrower in connection with the loan, plus costs and reasonable attorney’s fees. (Although the language in Section 6(a) is similar to the FTC’s Trade Regulation Rule regarding the Preservation of Consumer’s Claims and Defenses, the omission of any reference in the NJ Act to this FTC rule has caused some concern about cash-out refinance loans and subordinate-lien loans, the proceeds of which may be used for home improvement purposes, as discussed below.)

Section 6(b) of the NJ Act makes purchasers or assignees of high-cost home loans subject to “all affirmative claims and any defenses” with respect to the loan that the borrower could assert against the original creditor or broker of the loan, unless the purchaser or assignee can demonstrate by a preponderance of the evidence that a reasonable person exercising reasonable due diligence could not have determined the loan was a high-cost home loan. This section also establishes a presumption that a purchaser or assignee has exercised due diligence if it has a policy in place at the time of purchase or assignment that expressly prohibits the purchase or acceptance of assignment of a high-cost loan, it requires the persons from whom it acquires loans to represent and warrant in their purchase contracts that they will not sell or assign high-cost home loans, and it exercises reasonable due diligence to make sure that the loans it acquires or has acquired are not high-cost home loans. (Note that, per Section 6(e), this limitation on assignee liability only applies to claims made by a borrower acting under Section 6(b).)

Section 6(c) of the NJ Act enables a borrower “acting only in an individual capacity” to assert against any creditor “or any subsequent holder or assignee” any defense, claim or counterclaim based on a violation of the NJ Act subject to the following limitation periods:

- if in connection with a covered home loan, as an original action brought by the borrower, or in an action brought by the assignee to collect on the loan or foreclose on the property, within six years of the loan closing, or
- if in connection with a high-cost home loan, at any time during the loan term after a foreclosure action has been undertaken or the loan has been accelerated or become more than 60 days in default.

Such individual actions under Section 6(c) are limited to amounts required to reduce or extinguish the borrower’s liability under the home loan, plus costs and reasonable attorney fees.

The uncertainty evident in the combination of these provisions concerning potential assignee liability will likely create problems in the secondary market, perhaps leading to a contraction of that market, as happened in Georgia. All of the rating agen-
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cies, including, most recently, Standard & Poors, have indicated that they will not allow New Jersey high cost home loans to be included in their rated structured finance transactions and will allow covered home loans, manufactured home loans and home improvement loans only if accompanied by a Compliance Representation (by a creditworthy entity with sufficient financial strength to repurchase loans that are in breach of this representation at a price that will make the securitization issuer whole, including any costs and damages incurred by the issuer in connection therewith.)

Fannie Mae and Freddie Mac have similarly declared that they will not purchase New Jersey high cost home loans and may impose special documentation requirements with respect to manufactured home loans, home improvement loans and certain refinance loans. The Federal Home Loan Bank of New York has gone even further, indicating, on November 25, 2003, (similar to a position previously taken by Standard & Poors, which it subsequently modified as stated above) that it will not make advances based on collateral that includes New Jersey high cost home loans, covered home loans, manufactured home loans and home improvement loans (including cash-out refinance loans and subordinate-lien loans).

Some New Jersey lenders have indicated that they will not make any cash-out refinance loans or subordinate lien loans after November 27, 2003. For lenders wishing to make such loans, it may be prudent to have the borrower document either that the loan proceeds are not going to be used for home improvement purposes or that the loan was not arranged or referred by a home improvement contractor or manufactured home seller.

Remedies, Penalties: Class Actions?

The remedies and penalties provided for in the NJ Act are as follows:

Section 8(a) of the NJ Act says that violations of any of the provisions of the NJ Act are also violations of the New Jersey Consumer Fraud Act (CFA), for which substantial fines may be assessed by the Attorney General and a private right of action may be brought. The CFA allows for recovery of treble damages, attorney's fees and court costs. While the CFA does not prohibit class actions as further discussed below, Section 6(c) of the NJ Act speaks to a private right of action by borrowers in their individual capacity only. We would vigorously argue that class actions were not intended under the NJ Act; however, Section 8(a) does not address the issue.

Section 8(b) of the NJ Act provides that, as an alternative to the CFA remedies, borrowers can recover statutory damages for "material violations" equal to the amount of all finance charges plus 10 percent of the amount financed. For malicious or reckless violations, the borrower can also recover punitive damages plus attorney's fees and court costs. Again, while the limits on assignee liability in Section 6 are incorporated, there is no mention of class action liability.

Violations of the NJ Act can also lead the NJDOBI to impose: (i) fines up to $10,000 per violation; (ii) license suspensions or revocations; (iii) cease and desist orders; and (iv) in extraordinary situations, emergency restraints.

Brokers can incur liability under the NJ Act only for violations committed by the broker in the course of providing mortgage brokering services in connection with a home loan, or for acts that are related to the purchasing or making of a home loan and are otherwise prohibited under the NJ Act.

Good Faith Errors, Corrective Actions

The NJ Act allows a creditor who commits a violation when acting in good faith to avoid liability if restitution and appropriate adjustments are made within 45 days after closing. The NJ Act also establishes a "bona fide error" defense for a creditor who, within 90 days after closing and before receipt of any notice from the borrower of a compliance failure, makes restitution and appropriate adjustments, so long as the failure was unintentional and occurred despite reasonable procedures to prevent it. This "bona fide error" defense is not available to cure an error of legal judgment.

Consumer Education

As stated above, the NJ Act requires counseling in the context of a high-cost home loan where points or fees are financed. It also directs the NJDOBI, the New Jersey Division of Consumer Affairs and the New Jersey Division on Civil Rights to develop and implement a program of consumer counseling and awareness to protect vulnerable consumers against predatory lending practices. A proposed regulation to accomplish this was published in the New Jersey Register on September 15, 2003.

Preemption Issues

Local Laws Preempted - Perhaps the only good news in the NJ Act for lenders is that it preempts local governmental authorities from enacting laws or regulations related to the NJ Act or to abusive home loan lending practices generally.

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Preemption as to Loans Made by Federally Chartered Depositories - On July 23, 2003, the General Counsel of the Office of Thrift Supervision ("OTS") issued an opinion concluding that portions of the NJ Act are preempted as to federal thrifts and their operating subsidiaries (OTS Op. Chief Counsel, P-2003-4). In addition, the OCC has declared that portions of Georgia’s original predatory lending law (which has since been substantially amended but which before amendment was similar in many respects to the NJ Act) are preempted with respect to national banks and their operating subsidiaries, making OCC preemption of the NJ Act likely.

NJDOBI Guidance

Pursuant to its enforcement authority under the NJ Act, the NJDOBI has issued written guidance to industry members concerning some of the NJ Act’s provisions. This guidance is in the form of two departmental Bulletins, Bulletins 03-15 (July 24, 2003) and 03-30 (November 18, 2003).

Unfortunately, since the NJDOBI was given extremely limited rulemaking authority under the NJ Act, courts are under no obligation to defer to the NJDOBI’s interpretations, thus leaving brokers, lenders and loan purchasers at risk of conflicting judicial interpretations.

Conclusion

All residential mortgage lenders, purchasers and servicers operating in New Jersey need to review the portions of the NJ Act that are applicable to all home loans. These provisions may sneak up on the conforming residential mortgage loan industry and bite with harsh penalties.

Those making high-cost loans should proceed with extreme caution. Where covered home loans are made and, perhaps in the case of all refinances, procedures should be put in place to determine that flipping is not occurring.

Where loans are being purchased, potential assignee liability should be analyzed and procedures established to prohibit the purchase of high-cost home loans (if that is the policy decision); representations, warranties and buy-back requirements should be obtained from the seller of such loans to protect against assignee liability; and due diligence reviews of loans to be purchased should be conducted to prevent the inadvertent purchase of high-cost home loans (unless a program to purchase such loans is knowingly entered into with adequate safeguards to insure all the requirements relating to high-cost home loans have been met).

Finally, those seeking to obtain clarification on the myriad ambiguous and/or vague provisions included in the NJ Act, including provisions covering both class action and assignee liability, should work with firms with government affairs units to secure necessary amendments to the NJ Act as soon as possible. We understand that at least three bills to amend the NJ Act have already been or are about to be introduced.

ARTICLES WANTED!

Please send any articles or news that would be of interest to the Business Law Section to: Ellen Jerrehian at jerre@ballardspahr.com

***The next deadline is July 16, 2004***

PREPARE YOUR PENNSYLVANIA LLC DOCUMENTS WITH CARE

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Once the decision is made that the Pennsylvania LLC will be managed by managers and that is stated in the certificate of organization, absent a contrary or limiting provision in the certificate of organization, to the extent that the PA LLC Act does not have a controlling provision, the LPA would control (with the managers having the authority of general partners and the members of the LLC deemed to be limited partners for purposes of applying the provisions of the LPA). And if there is no statement in the certificate of organization that the LLC will be managed, the UPA would control to the extent that the PA LLC Act does not have a controlling provision (with the members deemed to be general partners for purposes of applying the provisions of the UPA). But does the application of provisions of the UPA or the LPA make sense in situations other than when the LLC is structured essentially like a general partnership or a limited partnership? E.g., should the provisions of those acts apply (to the extent there is no controlling provision in the PA LLC Act) in the case of an LLC (1) that is structured in essentially a corporate form, (2) that is a single member LLC or (3) where only some management responsibilities are given to managers? In those situations it would generally be prudent to include a provision in the certificate of organization overriding the effect of § 8904(a). Even when the LLC is structured essentially as a general partnership or a limited partnership, it may be desirable not to have all the provisions of the UPA or the LPA that otherwise would be made applicable by § 8904(a) apply to the particular LLC. Also, as discussed below, there may be uncertainty as to whether or not the PA LLC Act has a controlling provision. In that case, failure to override or limit § 8904(a)
when the UPA or the LPA has a provision contrary to what is an
uncertain or possibly unclear provision of the PA LLC Act could
produce an undesirable result.

The following examples illustrate the foregoing point:

Example 1

What happens if a member of an LLC which the certificate of
organization indicates is to be manager managed transfers such
member's entire interest in the LLC and the transferee is not
admitted as a member by the other members of the LLC (whether
because the requirements for such admission under the LLC
documents are not satisfied or, in the absence of such provi-
sions, one of the other members does not give the approval
required under § 8924(a) for such admission as a member)? Does
the transferring member continue to be a member having only
governance rights or does the transferring member cease to be a
member? § 8924 does not answer this question; but the Com-
mittee Comment to that section indicates that, in that situation,
the transferring member would continue to be a member retain-
ing the "right to participate in the management of the com-
pany." Although the Committee Comments are intended to be
considered by the courts in interpreting the provisions of the
PA LLC Act,5 they are not statutory provisions. Accordingly,
an explicit statutory provision to the contrary should control
and, since § 8904(a) would incorporate the provisions of the
UPA and the LPA unless overridden in the certificate of organi-
sation, § 8562(a)(4) would appear to be such an applicable con-
trary statutory provision. That section of the LPA provides
that unless otherwise provided in the partnership agreement,
"a partner ceases to be a partner and to have the power to
exercise any rights or powers of a partner upon assignment of
all of his partnership interest."

Example 2

In many general partnerships the partners may delegate certain
management authority to a subset of the partners. If an LLC is
to have a structure like such a general partnership, perhaps a
provision should be included in the certificate of organization
regarding the management by managers (see § 8913(3) and
§ 8941(b)). In that case, unless some override or qualification
as to the application of § 8904(a) is included in the certificate of
organization, the UPA and the LPA would apply to the LLC
when there is no controlling provision in the PA LLC Act and
the managers would have the authority of general partners un-
der those acts and the members would be deemed to be limited
partners for purposes of applying those provisions. This could
lead to undesirable results as regards control and general au-
thority of members who are not designated as managers. Argu-
ably in this situation the certificate of organization might indi-
cate that the LLC will be managed by the members and by
managers (possibly indicating the areas of management respon-
sibility for each group or referencing the operating agreement
for that division of management authority - § 8941(b) contem-
plates such a partial vesting of management in managers; but
then it is unclear how § 8904(a) applies).5

The foregoing examples are intended to be illustrative and not
inclusive of all problems related to § 8904(a) and the combina-
tion of § 8913(3) and § 8941(b). The important point is to deter-
mine whether the incorporation or potential incorporation of
provisions of the UPA and LPA are appropriate/desirable and, if
not, to insert appropriate negating, overriding or limiting provi-
sions in the certificate of organization and appropriate control-
ling provisions (to the extent permitted under the PA LLC Act)
in the LLC documents.

Turning to the category of ambiguous and potentially in-
consistent provisions, consider § 8933 (dealing with distributions
upon an event of dissociation), § 8942 (regarding voting), § 8948
(regarding limitation on dissociation or assignment) and
§ 8971(a)(4) (specifying certain events of dissolution if not made
inapplicable either by a provision in the LLC documents or by
virtue of the LLC having perpetual existence) and the following
questions:

- What vote is required to admit a member (unrelated to
the question of a transferee of a member's interest
being admitted as a member, which is dealt with in
§ 8924)? Specifically, assuming no other provision in
the LLC documents, does § 8942 control and only re-
quire approval by a majority of the members or, if the
provisions of the UPA or LPA are applicable to the
LLC, is this a case not provided for in the PA LLC Act,
so that § 8331(7) or § 8321(b)(1) would apply and would
require the consent of all members.6

- What vote is required to add a provision to a written
operating agreement on a matter not covered by such
agreement (i.e., does this "amend . . . any written pro-
vision of the operating agreement" so that the affirma-
tive vote or consent of all members is required pursu-
ant to § 8942(b) or can it be added with the vote or
consent of a majority of the members)?7

- If there is no written operating agreement can any
provision of an oral operating agreement be amended
or any provision be added with just the vote or con-
sent of a majority of the members?8
If § 8971(a)(4) does not create an event of dissolution (e.g., if it is inapplicable because the certificate or organization provides for perpetual existence), are each of the events listed therein events of dissociation triggering § 8933 and which of them are voluntary so that they can be precluded in the operating agreement pursuant to § 8948? In this regard, what does "retirement" mean and why should it be relevant in an LLC where the members are akin to limited partners? Similarly, what constitutes "insanity" (i.e., does it require a final court determination or something else and what is the effective date)? Also, is the dissolution of a member that is itself an LLC a voluntary dissociation (noting that such dissolution could be pursuant to a court order) and, if so, what is to happen if the operating agreement precludes such voluntary dissociation but that member dissolves?

In analyzing what the answers to these questions should be, consider whether it should be different depending on whether the LLC is patterned after a general partnership, a limited partnership or a corporation. Rather than take a chance as to how a court might decide these questions, appropriate provision should be made in the LLC documents to assure the desired result.

The final area of concern is where there is no apparent controlling provision. In the case of voting, for example, § 8942(e) provides:

"(e) Procedures.-The operating agreement may set forth provisions relating to notice of the time, place or purpose of any meeting at which any matter is to be voted on by any members or managers, waiver of the notice, action by consent without a meeting, the establishment of a record date, quorum requirements, voting in person or by proxy or any other matter with respect to the exercise of any such right to vote."

But if the operating agreement (or the certificate of organization) has no provision regarding these matters, what result obtains?

As to matters that can be decided by affirmative vote or consent of a majority of members, can such a majority act without notice to the other members, can they act by consent without a meeting and what record date applies in either case?

Can a member give a proxy to someone else? If a member in an LLC with managers, where the members truly are like limited partners in a limited partnership and have no management authority, can give an irre-
Wyoming adopted the first limited liability company act in 1977. The adoption of such acts by other states occurred in various waves as the IRS position on taxation of such entities varied (in Priv. Ltr. Rul 8106-082 (Nov. 17, 1980), the IRS classified a Wyoming LLC as a partnership for tax purposes, but it then proposed regulations that would classify an entity whose members were not liable for its debts as a corporation (see 45 Fed. Reg. 75,709 (proposed Nov. 17, 1980)), and in another shift ruled that an LLC could be taxed as a partnership (see Rev. Rul. 88-76, 1988-2 C.B. 360), and most recently promulgated the "check-the-box" regulations (61 Fed. Reg. 66, 584 (1996), corrected at 62 Fed. Reg. 11769 (Mar. 13, 1997))). Pennsylvania adopted its limited liability company act on December 7, 1994.

Amendments to the PA LLC Act were adopted on December 3, 1998 and June 22, 2001 (effective 60 days thereafter in each case) and additional amendments are currently being contemplated by Pennsylvania’s Title 15 Task Force (comprised of academicians and practitioners), which proposes changes to Title 15 (which includes the PA LLC Act) to the Pennsylvania legislature. Some of the amendments have been in reaction to the "check-the-box" regulations and the elimination of the need to preclude automatic continuity of life of the entity to satisfy one of the criteria to avoid taxation as a corporation.

Section 8913 of the PA LLC Act sets forth the information to be included in the certificate of organization and includes the following:

"(8) Any other provision, whether or not specifically authorized by or in contravention of this chapter, that the members elect to set out in the certificate of organization for the regulation of the internal affairs of the company, except where a provision of this chapter expressly provides that the certificate of organization shall not relax or contravene any provision on a specified subject. But see section 8915 (relating to modification by agreement). A provision included in the certificate of organization under this paragraph shall be deemed to be a provision of the operating agreement for purposes of any provision of this chapter that refers to a rule as set forth in the operating agreement."

And § 8916(b) of the PA LLC Act provided as follows:

“(b) Freedom of contract.–An operating agreement may contain any provision for the regulation of the internal affairs of a limited liability company adopted by the members, whether or not specifically authorized by or in contravention of this chapter, except where this chapter:

(1) refers only to a rule as set forth in the certificate of organization; or

(2) expressly provides that the operating agreement shall not relax or contravene any provision on a specified subject."

The Committee Comment to § 8901 includes the following statement:

"The Committee Comments to Chapter 89 are intended to form part of the legislative history of Chapter 89 and to be citable as such under 1 Pa. C.S. § 1939."

Among the items set forth in § 8913 to be included in the certificate of organization is:

"(5) If management of the company is vested in a manager or managers, a statement to that effect."

And § 8941(b) provides as follows:

“(b) Managers.–The certificate of organization may provide that management of a company shall be vested, to the extent provided in the certificate of organization, in one or more managers."

Presumably, the certificate of organization can indicate the extent of the managers’ management authority or could reference the operating agreement for the extent of such authority. But, unless the certificate of organization either directly, or by reference to the operating agreement, indicates that members other than the managers will have management authority, a court might hold that § 8904(a) limits the rights of such members to those of limited partners in a limited partnership.

Section 8942(a) provides as follows:

“(a) General rule.–Subject to subsection (b), the affirmative vote or consent of a majority of the members or managers of a limited liability company entitled to vote on a matter shall be required to decide any matter to be acted upon by the members or managers."
If such admission is "a matter to be acted upon" and does not require an amendment to the certificate of organization or a written provision of the operating agreement, a majority vote would seem to be sufficient. By contrast, § 833.1(7) of the UPA provides that, subject to any agreement between the partners,

"(7) No person can become a member of a partnership without the consent of all the partners."

And § 8521(b)(1) of the LPA provides that a person may be admitted as an additional limited partner.

"(1) In the case of a person acquiring a partnership interest directly from the limited partnership, upon the compliance with the partnership agreement or, if the partnership agreement does not so provide, upon the consent of all partners."

Section 8942(b) provides as follows:

"(b) Unanimous vote required.-Except as provided in subsection (c) or in writing in the operating agreement, the affirmative vote or consent of all of the members shall be required to:

(1) amend the certificate of organization or any written provision of the operating agreement; or

(2) authorize a manager, member or other person to do any act on behalf of the company that contravenes the certificate of organization or a written provision of the operating agreement, including, without limitation, any provision that expressly limits the purpose, business or affairs of the company or the conduct thereof."

If the operating agreement is in writing but is silent on a given subject, is the addition of a provision dealing with that subject an amendment of a written provision, thereby requiring a unanimous vote rather than just a majority vote? Pushing this to the limit, if an LLC has only an oral operating agreement, would unanimous consent of the members be needed to set it out as a written agreement?

Since § 8942(b) would not be involved, § 8942(a) would appear to control (absent some other provision in the certificate of organization or the operating agreement) and would only require the vote of a majority of the members. Similarly, if there is a written operating agreement and it is silent on a particular subject, an oral agreement on that subject presumably could be adopted by the vote of a majority of members.

Sections 8933 and 8948 provide as follows:

"§ 8933. Distributions upon an event of dissociation. Upon the occurrence of an event of dissociation which does not result in the dissolution of the limited liability company, a dissociating member is entitled to receive any distribution to which the member is entitled under the operating agreement on the terms provided in the operating agreement and, within a reasonable time after dissociation, the fair value of the interest of the member in the company as of the date of dissociation based upon the right of the member to share in distributions from the company."

"§ 8948. Limitation on dissociation or assignment of membership interest. Notwithstanding anything to the contrary set forth in this part, an operating agreement may provide that a member may not voluntarily dissociate from the limited liability company or assign his membership interest prior to the dissolution and winding-up of the company, and an attempt by a member to dissociate voluntarily from the company or to assign his membership interest in violation of the operating agreement shall be ineffective."

Given the general freedom of contract which the members have, it would seem that the operating agreement could also override the effect of § 8933 in the event of an involuntary dissociation.

Section 1722(a) of the Pennsylvania Business Corporation Law requires each director of a business corporation to be a natural person, whereas members and managers of an LLC need only be persons (which term includes both natural persons and entities).
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For more information or to volunteer contact:

Philadelphia LawWorks/VIP  
Steven L. Grumm, Esq.  
42 South 15th Street, 4th Floor  
Philadelphia, Pennsylvania 19102  
phone: 215-523-9562  
fax: 215-564-0845  
email: lawworks@phillyvip.com  
www.philadelphialawworks.org
COMMITTEES OF THE BUSINESS LAW SECTION

ANTITRUST LAW

Robert D. Liebenberg
Co-Chair
Fine, Kaplan and Black
1845 Walnut St., 23rd Floor
Philadelphia, PA 19103-4722
(215) 567-6565 (phone)
(215) 568-5872 (fax)
rliebenberg@finekaplan.com

Barbara T. Sicelides
Co-Chair
Pepper Hamilton LLP
3000 Two Logan Square
Philadelphia, PA 19103-2799
(215) 981-4783 (phone)
(215) 981-4750 (fax)
sicelidesb@pepperlaw.com

BANKING & COMMERCIAL FINANCE

Bradley D. O’Brien
Co-Chair
Astor Weiss Kaplan & Mandel
The Bellevue, 6th Floor
200 S. Broad St.
Philadelphia, PA 19102
(215) 893-4962 (phone)
(215) 790-0509 (fax)
obrieni@astorweiss.com

David A. Surbeck
Co-Chair
Reed Smith, LLP
2500 One Liberty Place
1650 Market St.
Philadelphia, PA 19103-7301
(215) 851-8134 (phone)
(215) 851-1420 (fax)
dsurbeck@reedsmith.com

BANKRUPTCY

Adam H. Isenberg
Co-Chair
Saul Ewing LLP
3800 Centre Square West
Philadelphia, PA 19102
(215) 972-8662 (phone)
(215) 972-1833 (fax)
aisenberg@saul.com

Andrew C. Kassner
Co-Chair
Drinker Biddle & Reath LLP
One Logan Square
Philadelphia, PA 19103-6996
(215) 988-2554 (phone)
(215) 988-2757 (fax)
andrew_kassner@dbr.com

BUSINESS LITIGATION

Eric C. Milby
Chair
Lundy Flitter Beldecos & Berger, PC
450 North Narberth Avenue
Narberth, PA 19072
(610) 668-0773 (phone)
(610) 667-0552 (fax)
milby@lfbb.com

Lee Applebaum
Vice-Chair
Fineman, Kreckstein & Harris, P.C.
United Plaza, 18th Floor
30 S. 17th Street
Philadelphia, PA 19103
(215) 893-8702 (phone)
(215) 893-8719 (fax)
lapplebaum@finemanlawfirm.com

BUSINESS ORGANIZATIONS
(CORPORATE LAW)

Ross J. Reese
Chair
Dilworth Paxson LLP
1735 Market Street, Suite 3200
Philadelphia, PA 19103-7599
(215) 575-7056 (phone)
(215) 575-7200 (fax)
reeserj@dilworthlaw.com

Bruce K. Fenton
Vice Chair
Pepper Hamilton LLP
3000 Two Logan Square
Philadelphia, PA 19103-2799
(215) 981-4646 (phone)
(215) 981-4750 (fax)
fentonb@pepperlaw.com

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COMMITTEES OF THE BUSINESS LAW SECTION

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CYBERSPACE AND E-COMMERCE

Frederic M. Wilf
Chair
Morgan Lewis
1701 Market Street
Philadelphia, PA 19103
(215) 963-5453 (phone)
(215) 963-5001 (fax)
fwilf@morganlewis.com

FRANCHISE LAW

Constantine T. Fournaris
Chair
Ballard Spahr Andrews & Ingersoll, LLP
1735 Market Street, 51st Floor
Philadelphia, PA 19103-7599
(215) 864-8112 (phone)
(215) 864-8999 (fax)
fournaris@ballardspahr.com

Jeffrey Zucker
Vice-Chair
Fisher & Zucker LLC
121 South Broad Street, Suite 1200
Philadelphia, PA 19107
(215) 545-5200 (phone)
(215) 545-8313 (fax)
jzucker@fisherzucker.com

HEALTH CARE LAW

Cristina G. Cavalieri
Co-Chair
Pelino & Lentz, PC
One Liberty Place
1650 Market Street, 32nd Floor
Philadelphia, PA 19103
(215) 665-1540 (phone)
(215) 665-1536 (fax)
cgcavalieri@pelino.com

Debbie Datte
Co-Chair
Post & Schell, P.C.
Four Penn Center Plaza
1600 JFK Blvd.
Philadelphia, PA 19103
(215) 587-1001 (phone)
(215) 320-4158 (fax)
ddatte@postschell.com

HUMAN RESOURCES AND EMPLOYEE RELATIONS

Diane Lobell
Co-Chair
UNISYS Corporation
Unisys Way
Blue Bell, PA 19424
(215) 986-4657 (phone)
(215) 986-5721 (fax)
diane.loebebell@unisys.com

Wanda Flowers
Co-Chair
Sunoco, Inc.
1801 Market Street
10 Penn Center
Philadelphia, PA 19103
(215) 977-6148 (phone)
weflowers@sunocoinc.com

INTELLECTUAL PROPERTY

Stephen J. Driscoll
Chair
Synnestsved & Lechner LLP
2600 Aramark Tower
1101 Market Street
Philadelphia, PA 19107-2950
(215) 923-4466 (phone)
(215) 923-2189 (fax)
sdriscoll@synnlech.com

INSURANCE

Edward M. Dunham, Jr.,
Chair
Duane Morris LLP
One Liberty Place, Suite 4200
Philadelphia, PA 19103
(215) 979-1148 (phone)
(215) 979-1020 (fax)
edwunham@duanemorris.com

Robert J. Upton
Vice Chair (Regulatory Matters)
CIGNA Corporation
One Liberty Place
1650 Market Street
P.O. Box 7716
Philadelphia, PA 19192-1520
(215) 761-6242 (phone)
(215) 761-5715 (fax)
robert.upton@cigna.com

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COMMITIES OF THE BUSINESS LAW SECTION

Continued from page 14

INSURANCE (Continued)

Ronald P. Schiller
Vice Chair (Coverage Matters)
Piper Marbury Rudnick & Wolfe, LLP
3400 Two Logan Square
18th & Arch Sts.
Philadelphia, PA 19103
215-656-3330 (phone)
215-656-3301 (fax)
ronald.schiller@piperrudnick.com

INVESTMENT COMPANIES

Brian S. Vargo
Co-Chair
Dechert
4000 Bell Atlantic Tower
1717 Arch Street
Philadelphia, PA 19103-2793
(215) 994-3880 (phone)
(215) 994-2222 (fax)
brian.vargo@dechert.com

John N. Ake
Co-Chair
Ballard Spahr Andrews & Ingersoll, LLP
1735 Market Street, 51st Floor
Philadelphia, PA 19103-7599
(215) 864-8608 (phone)
(215) 864-8999 (fax)
ake@ballardspahr.com

SECURITIES REGULATION

Raymond K. Walheim
Chair
Ballard Spahr Andrews & Ingersoll, LLP
1735 Market Street, 51st Floor
Philadelphia, PA 19103-7599
(215) 864-8529 (phone)
(215) 864-9222 (fax)
walheimr@ballardspahr.com

SMALL BUSINESS

David R. White
Co-Chair
Fineman, Krekstein & Harris
1608 Walnut Street, 19th Floor
Philadelphia, PA 19103
(215) 893-9300 (phone)
(215) 893-6719 (fax)
dwhite@finemanlawfirm.com

Richard C. Smith
Co-Chair
Duane Morris LLP
One Liberty Place, Suite 4200
Philadelphia, PA 19103
(215) 979-1240 (phone)
(215) 979-1020 (fax)
rcsmith@duanemorris.com

TAX EXEMPT FINANCE

Suzanne S. Mayes
Chair
Saul Ewing LLP
3800 Centre Square W.
1500 Market Street, 38th Floor
Philadelphia, PA 19102
(215) 972-1968 (phone)
(215) 972-1858 (fax)
smayes@saul.com

Kevin B. Scott
Vice Chair
Fox Rothschild O'Brien & Frankel
2000 Market Street, 10th Floor
Philadelphia, PA 19103-3291
(215) 299-2070 (phone)
(215) 299-2150 (fax)
Kscott@trof.com

VENTURE CAPITAL

Richard P. Jaffe
Chair
Ballard Spahr Andrews & Ingersoll, LLP
1735 Market Street, 51st Floor
Philadelphia, PA 19103-7599
(215) 864-8901 (phone)
(215) 864-8999 (fax)
jaffe@ballardspahr.com