

# PUBLICATION

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## Franchisee's Disregard of LLC Formalities Creates Exposure for LLC Debts,

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The limited liability company or LLC has largely replaced the corporation and limited partnership as a preferred form of business entity. Although the LLC requires fewer formalities than either of these more traditional forms of business entities, its members and managers are not free to ignore formality entirely. But franchisors who fail to understand the organizational chart of their multi-unit operators may find themselves without a practical means of collection. Recently, the Mississippi Court of Appeals opined on the standard for piercing the veil of an LLC in *Restaurant of Hattiesburg, LLC v. Hotel & Restaurant Supply, Inc.*, 84 So. 3d 32 (Miss. App. 2012). In a well-written opinion, the court held that the same test to pierce the veil of a corporation applied to LLCs and to "pierce the veil of an LLC the complaining party must prove LLC membership [of the defendant individual] as well as (a) some frustration of contractual expectations, (b) flagrant disregard of LLC formalities by the LLC members, and (c) fraud or misfeasance by the LLC member." *Id.* at 40 (citing *Gray v. Edgewater Landing, Inc.*, 541 So. 2d 1044, 1047 (Miss. 1989)). The court also noted that in almost all the corporate-veilpiercing cases in Mississippi, the plaintiff brought the underlying contract or tort claim in the same action as the veil-piercing claim. But the court clarified that Mississippi law does not require this approach and a plaintiff can file a second suit for piercing the veil after a judgment is obtained against the entity.

In 2005, two individuals named Schafer and Brick opened various restaurants as Copeland's franchises. Schafer and Brick formed three separate LLCs: (1) Restaurant of Hattiesburg, LLC to operate a Copeland's in Hattiesburg, Mississippi, (2) Restaurant of Jackson, LLC to operate a Copeland's in Jackson, Mississippi and (3) SouthEastern Restaurant LLC, to manage the accounting and payroll of both restaurants. This is a common multi-unit franchisee structure, with a holding/services company sitting on top of the unit operating entities, allowing the efficient use of shared services and personnel with appropriate service fees paid by the operating entities. A supplier, Hotel & Restaurant Supply (HRS), delivered restaurant supplies to the Jackson Copeland's, which closed in 2006, owing HRS more than \$29,000.

Later that year, HRS sued Restaurant of Jackson and SouthEastern. The trial court found Restaurant of Jackson and SouthEastern jointly liable to HRS for \$36,816. HRS garnished SouthEastern's bank account, which contained a grand total of \$36. Undeterred, HRS initiated post-judgment discovery. HRS then filed suit against Restaurant of Hattiesburg, Schafer and Brick. HRS sought to "pierce the veil" of SouthEastern and Restaurant of Jackson to the member level and hold the three defendants jointly and severally liable for the judgment against the affiliated but insolvent LLCs.

The trial court denied the defendants' motion for summary judgment and instead granted HRS' motion for summary judgment, finding that Restaurant of Hattiesburg, Schafer and Brick were jointly and severally liable for the \$36,816 judgment, plus expenses of postjudgment discovery, plus attorney's fees and interest. Restaurant of Hattiesburg, Shafer and Brick appealed.

On appeal, the Mississippi Court of Appeals reversed the trial court and remanded the case for trial on the merits. The court noted that "[l]ike a corporation, an LLC is purely a creature of statute." The Mississippi Limited Liability Company Act is clear that a member cannot be personally liable for an LLC debt solely by reason of being a member. The court also noted that on January 1, 2011, the Revised Mississippi Limited Liability Company Act went into effect. The Revised LLC Act was adopted to provide greater clarity of existing

LLC statutory requirements, to set up more default rules for LLCs without operating agreements, and to incorporate language from Delaware's LLC Act to enable Mississippi courts to look to Delaware law when interpreting the Mississippi's Revised LLC Act.

The Court of Appeals found the trial court used the right precedent for what a plaintiff must prove to hold an LLC member liable for the LLC's debt. The court held that HRS must prove the first test prong, frustration of contractual expectations. The court observed that without seeking a personal guarantee from Schafer or Brick, HRS continued to tender goods to Restaurant of Jackson, which it knew to be an LLC. The court noted that Schafer and Brick's ownership of the three LLCs is not enough in itself to treat the three LLCs as one. The court also noted SouthEastern, which managed both operators' accounts, wrote checks to HRS for Restaurant of Jackson's invoices. But the court noted that on remand, in order to hold Restaurant of Hattiesburg liable for the debt of the two other LLCs, HRS has to show actual frustration of identity due to the shared bank account. The shared bank account, by itself, was not sufficient to meet this prong.

The court also stated that analyzing the second prong (the flagrant disregard of LLC formalities by the LLC members) is more difficult with an LLC than a corporation because the LLC statute imposes fewer formalities on LLC members. The court held that like Texas, Mississippi declined to adopt a rule that LLCs sharing a bank account is per se an abusive practice. Citing *SSP Partners v. Gladstrong Investments*, 275 S.W.3d 444, 455 (Tex. 2008). There was evidence to create a factual dispute on this test.

With respect to the third prong, a demonstration of fraud or other equivalent misfeasance on the part of the LLC member, the timing of Restaurant of Hattiesburg's opening its own bank account and ceasing to use SouthEastern's account created another fact issue. The Court of Appeals noted that while it is not fraudulent to limit the liabilities of each restaurant to its own debts, SouthEastern did conveniently claim the income of Restaurant of Hattiesburg until it was hit with a \$36,000 judgment.

This result was fact-specific, but the opportunity for clarification is welcome since the laws relating to LLCs are still evolving. The bottom line for franchisors or suppliers is that a personal guarantee on the front end is critical to credit support for a multi-unit operator. Piercing the veil of an LLC still appears to be difficult, despite a lack of formality and casual observance of banking protocols for separate accounts. For any LLCs, particularly multiple LLCs that have common member ownership, the managers must maintain the formality of the separate LLCs and keep good transactional and accounting records. For any distributions to members, documentation to explain the disbursement (e.g. repayment of loan) is critical. Keeping proper formalities and documentation could mean the difference between being dismissed before trial or having a jury decide whether the veil of the LLC should be pierced. More leeway for common asset management is allowed than for corporations, but the leeway has a still to be defined limit.