

Business Law Practice Tip
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In Mission Residential, LLC v. Triple Net Properties, LLC, 275 Va. 157; 654 S.E.2d 888 (2008), the Virginia Supreme Court confirmed two long-standing positions: (1) "A party cannot be compelled to submit to arbitration unless he has first agreed to arbitrate," citing Doyle & Russell, Inc. v. Roanoke Hospital Ass'n, 213 Va. 489, 494, 193 S.E.2d 662, 666 (1973), and (2) "...a limited liability company is a legal entity entirely separate from the...members who compose it," citing Va. Code §§ 13.1-1009 – 1019 and C.F. Trust, Inc. v. First Flight Ltd. P'ship, 266 Va. 3, 9, 580 S.E.2d 806, 809 (2003).

Many limited liability company operating agreements contain provisions requiring the members to arbitrate disputes between them. Such was the case when Mission Residential, LLC ("Mission") formed a limited liability company with Triple Net Properties, LLC ("Triple Net") as a joint venture to further the respective businesses of the two members in relation to Section 1031 tax-deferred exchange transactions. Mission and Triple Net each owned fifty percent of the membership interests in NNN/Mission Residential Holdings, LLC ("Holdings"). Triple Net subsequently commenced an arbitration claim against Mission in which it asserted both a direct claim for breach of contract and a derivative claim on behalf of the newly-formed Holdings. Holdings' operating agreement contained the following provision:

Disputes. The Members shall in good faith use their best efforts to settle disputes regarding their rights and obligations hereunder. All disputes that the parties have failed to resolve shall be submitted to arbitration. All arbitration to resolve a dispute shall be conducted in accordance with the provisions of this Section 13.9 and to the extent not inconsistent therewith, the Commercial Arbitration Rules of the American Arbitration Association ("AAA")...The arbitrator's award shall be final, binding and not subject to appeal.

Mission asserted that the derivative claim was not arbitrable, but the arbitrator ruled otherwise, citing the provision of the operating agreement set forth above. The arbitrator also ruled that Triple Net lacked standing to assert the direct claim, which left the derivative claim as the sole remaining dispute. Mission sought an order to stay the arbitration of the derivative claim, but the Circuit Court denied the motion, and Mission appealed from that ruling. The Supreme Court reversed the Circuit Court's ruling, noting that derivative action belonged to Holdings, not to Triple Net. The Court held that because Holdings was a separate legal entity and was not a party to the operating agreement, there was no contractual undertaking by which Holdings could be required to arbitrate.

This case suggests strongly that the limited liability company must be made a party to the operating agreement if the members desire to have all disputes, including ones that constitute derivative claims, resolved by an alternative dispute resolution procedure. Be aware, however, that in making the entity a party to the operating agreement, you may risk impacting certain rights, such as the ability to enforce a mandatory distribution to members to cover tax liabilities. There are also ethical issues arising from the inevitable conflict of interest if the same attorney is representing both a member and the company.

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