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Daniel S. Kleinberger

Carter G. Bishop

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Diversity Jurisdiction for LLCs? Basically, Forget About It

By Carter G. Bishop (Suffolk University Law School), Daniel S. Kleinberger (William Mitchell College of Law)

Is an LLC more like a corporation or a partnership?

In the early days of the modern U.S. limited liability company, lawyers and judges often had to examine that question. Although the question has different answers in different legal contexts, for most contexts, it is now settled.

Nowhere is the question more emphatically settled than in the context of federal diversity jurisdiction, whose purpose is to protect out-of-state parties from potential prejudice in local courts. In *Belleville Catering Co. v. Champaign Marketplace, LLC*, 350 F.3d 691, 692 (7th Cir. 2003), a case involving an Illinois corporation and a Delaware LLC, the Seventh Circuit bluntly chastised the lawyers for both parties for a jurisdictional statement that was "transparently incomplete and incorrect" and for an "insouciance toward the requirements of federal jurisdiction [which] has caused a waste of time and money."

Vacating the district court judgment (which had followed a jury trial) and remanding "with instructions to dismiss ... for want of subject-matter jurisdiction," the court also admonished the lawyers that:

> The costs of a doomed foray into federal court should fall on the lawyers who failed to do their homework, not on the hapless clients The best way for counsel to make the litigants whole is to perform, without additional fees, any further services that are necessary to bring this suit to a conclusion in state court, or via settlement. That way the clients will pay just once for the litigation. This is intended not as a sanction, but simply to ensure that clients need not pay for lawyers' time that has been wasted for reasons beyond the clients' control.
> *Belleville Catering at 694.*

In some respects, the *Belleville Catering* decision is easy to understand. The Seventh Circuit had addressed the LLC diversity issue five years earlier, stating unequivocally and definitively that "the citizenship of an LLC for purposes of the diversity jurisdiction is the citizenship of its members." *Cosgrove v. Bartolotta*, 150 F.3d 729, 731 (7th Cir. 1998). Four years later, a district court in the Seventh Circuit had chided counsel that "it has been clear for more than four years that the place of organization and principal place of business of a limited liability company are irrelevant." *Trowbridge v. Dimitri's 50's Diner L.L.C.*, 208 F. Supp. 2d 908, 910 (N.D. Ill. 2002)

But to fully understand the Seventh Circuit's ire requires understanding some important concepts

of federal diversity jurisdiction, and to protect clients from *Belleville Catering*'s long shadow requires knowing how those concepts apply to LLCs. This article will begin with a brief history and explanation of federal diversity jurisdiction and then focus on recent court pronouncements concerning diversity jurisdiction and noncorporate business entities. The article will conclude by considering whether those pronouncements make policy sense and then by explaining some key practical implications of the law as it stands for LLCs.

The federal courts, like the federal government in general, have only those powers conferred or contemplated by the Constitution. Article III, § 2, clause 1 provides that "The judicial power shall extend to all cases ... between citizens of different states," and federal courts have had diversity jurisdiction since 1789 when the Judiciary Act made exceeding $500 the "amount in dispute" requirement. Some 20 years later, the Supreme Court decided that diversity meant complete diversity -- that is, that diversity jurisdiction is not available if any party to a case has the same citizenship as any adverse party. *Strawbridge v. Curtiss*, 7 U.S. (3 Cranch) 267 (1806). Today, the "amount in controversy" requirement is to exceed $75,000, but the complete diversity doctrine remains in place. *See* 28 U.S.C. § 1332(a).

The diversity requirement pertains to a federal court's subject matter jurisdiction and therefore cannot be waived by the parties. Diversity can be challenged by any party and by the court itself at any time before final judgment (including during an appeal) but is determined "upon the state of things at the time of the action brought." *Mollan v. Torrance*, 22 U.S. (9 Wheat) 537, 539 (1824). This "time-of-filing" rule means that a party cannot cure a diversity problem by changing its citizenship after a lawsuit has begun.

A cure can be achieved by dismissing any nondiverse party from the lawsuit. *Grupo Dataflux v. Atlas Global Group, LP*, 124 S.Ct. 1920, 1924-25 (2004). However, this cure presupposes that the nondiverse party is not indispensable -- that is, that "in equity and good conscience" dismissal will not unduly prejudice either the dismissed party or the remaining parties and will not unduly undermine the adequacy of the remedies available in the lawsuit. Fed. R. Civ. P. 19(b).

Diversity analysis turns on a litigant's state citizenship, and, for diversity purposes, domicile determines the state citizenship of U.S. citizens who are human beings. It was initially unclear, however, what citizenship means when applied to a party other than a human being. That was hardly surprising, given that the framers of the Constitution had in mind human beings when they provided for diversity jurisdiction. (Only 30 private corporations existed in the United States before 1790.)

The Supreme Court's first opinion on diversity jurisdiction for entities stated that "the term 'citizen' ought to be understood as it is used in the Constitution, [t]hat is, to describe the real persons who come into court." *Bank of the United States v. Deveaux*, 9 U.S. (5 Cranch) 61, 86-91 (1809). Accordingly, "[t]hat invisible, intangible, and artificial being, that mere legal entity, a corporation aggregate, is certainly not a citizen; and, consequently, cannot sue or be sued in the courts of the United States, unless the rights of the members, in this respect, can be exercised in their corporate name." Therefore, the corporate plaintiff had the citizenship of each of the human beings that "composed" it.

In 1844, the Supreme Court reversed itself and declared a corporation to be a citizen of its state of incorporation, at least where the corporation did business in its state of incorporation. "[A] corporation created by and doing business in a particular state, is to be deemed to all intents and purposes as a person, although an artificial person, an inhabitant of the same state, for the purposes of its incorporation, capable of being treated as a citizen of that state, as much as a natural person." *Louisville, C. & C.R. Co. v. Letson*, 43 U.S. 497, 558 (1844).

In 1958, Congress narrowed the diversity aperture for corporations, declaring that "a corporation shall be deemed to be a citizen of any state by which it has been incorporated and of the state where it has its principal place of business." 28 U.S.C. § 1332(c)(1). The statute does not define "principal place of business," and many courts use the so-called "nerve center" test to make the determination.

By its terms, Section 1332(c)(1) applies only to "a corporation" and leaves unaffected a long line of cases (some decided before 1958 and some after) holding that, for diversity purposes, an unincorporated organization has the citizenship of each of its members or owners and that the organization's state of formation and principal place of business are irrelevant. For LLC purposes, the most important of these cases is *Carden v. Arkoma Associates*, 494 US 185, 195 (1990), which involved a limited partnership's suit against a lease guarantor and whose rationale was recently re-confirmed in *Grupo Dataflux*.

Carden held that, for diversity purposes, a limited partnership partakes of the citizenship of every one of its general and limited partners. A vigorous dissent argued that limited partners are not "real parties in interest" and are therefore irrelevant to the diversity analysis. The dissent relied heavily on *Navarro Savings Ass'n. v. Lee*, 446 U.S. 458 (1980), which had used the "real party in interest" analysis to hold that the trustees of a Massachusetts common law business trust could bring a diversity claim without regard to the citizenship of the trust beneficiaries.

The *Carden* majority rejected the "real party in interest" analysis, the dissent's reliance on *Navarro*, and the asserted analogy to a business trust. The majority acknowledged that it is "undoubtedly correct" that limited partnerships are "functionally similar" to other entities that have greater access to the federal courts, but rejected a functional approach as inappropriate given Congress' use of the word "corporation."

The majority opinion spent considerable time recapitulating and reaffirming precedent. From the standpoint of LLCs, the most instructive part of that discussion is the opinion's treatment of two cases, *Chapman v. Barney*, 129 U.S. 677 (1889) and *Puerto Rico v. Russell & Co.*, 288 U.S. 476 (1933). *Chapman* concerned the United States Express Co., a New York joint stock company. Russell involved a Puerto Rico *sociedad en comandita*.

The *Chapman* court flatly rejected assertions that the Express Co. was a citizen of New York, and in doing so rejected any expansive reading of the notion of corporation:

> [T]he express company cannot be a citizen of New York, within the meaning of the statutes regulating jurisdiction, unless it be a corporation. The

> allegation that the company was organized under the laws of New York is not an allegation that it is a corporation. In fact the allegation is that the company is not a corporation, but a joint- stock company -- that is, a mere partnership.
> *Chapman, at 682.*

In contrast, *Russell* held that a Puerto Rico *sociedad en comandita* had a juridical personality so complete under foreign law that there was "no adequate reason" for according the *sociedad* a different status than a U.S. corporation.
Russell, at 480-82.

The *Carden* majority embraced *Chapman* and its formalist, per se rule, while essentially limiting *Russell* to its facts. The majority noted that a previous case, *United Steelworkers v. R.H. Bouligny*, had explained *Russell* as an exercise in "fitting an exotic creation of the civil law... into a federal scheme which it knew not." *Carden*, at 190 (quoting *United Steelworkers v. R.H. Bouligny Inc.*, 382 U.S. 145, 151 (1965)). The majority also characterized *Bouligny* as specifically rejecting any analysis that looks to an entity's organization and structure.

In short, the Supreme Court's opinion in *Carden* states a rule remarkably similar to the approach used by the IRS in its 1997 "check-the-box" regulations on the tax classification of business entities: If it's a corporation, it's a corporation; if it's not, it's not. *Carden* thus dictates that, when federal diversity is the issue, LLCs are treated like any other unincorporated business organization. Corporate tests are irrelevant, and an LLC has the citizenship of each of its members.

In 1996, three unreported federal district court decisions suggested that the corporate tests do apply to LLCs, but since then every reported decision at both the district and circuit court levels has acknowledged that *Carden* controls. A recent Eight Circuit opinion is illustrative: "We recognize numerous similarities exist between a corporation and an LLC, but Congress is the appropriate forum to consider and, if it desires, to apply the same 'citizenship' rule for LLCs as corporations for diversity jurisdiction purposes. This issue appears resolved by Justice Antonin Scalia's analysis in *Carden*." *GMAC Commercial Credit LLC v. Dillard Department Stores Inc.*, 357 F.3d 827, 828 (8th Cir. 2004).

Is *Carden* good policy? The implication of the case is that a name (corporate or not) matters and function and structure do not, and the case can easily be criticized as the triumph of labels over substance. But this criticism disregards the decision's key "separation of powers" point. In the early days of the republic, Congress left open the question of the citizenship of entities. Since 1958, however, a statute has provided a rule applicable to a "corporation." Congress having legislated on the matter, it is for Congress, not the courts, to revise that term in light of contemporary business practices.

The *Carden* dissent should not attract those who advise or use LLCs. To make its "real party in interest" argument, the dissent must engage in a type of "veil piercing" that goes far beyond the majority approach (which attributes the citizenship of each partner to the limited partnership). The dissent must not only look through the limited partnership but must also attempt to conflate

those who manage the entity with the entity itself. That is precisely the type of exercise attempted by creditors of an LLC when seeking to hold members liable for the debts of the entity.

In any event, *Carden* is the law and the case's applicability to LLCs is now beyond doubt and possibly even beyond "a nonfrivolous argument for the extension, modification, or reversal of existing law." Fed. R. Civ. P. 11(b)(2). This state of the law has some important practical consequences. In general:

- In any suit between an LLC and a third party (that is, not a member), diversity jurisdiction depends on the citizenship of each LLC member at the time the lawsuit is filed.
- In any suit between an LLC and a member, diversity jurisdiction is impossible.
- In an LLC-related suit among members of an LLC, diversity jurisdiction depends on whether the LLC is an indispensable party (even assuming the litigating members are diverse).
- In any derivative lawsuit brought on behalf of an LLC, diversity jurisdiction depends on the citizenship of each LLC member at the time the lawsuit is filed and is impossible in all but very limited circumstances.

Some of the particular consequences relate to the conduct of a lawsuit asserting diversity jurisdiction. Most obviously, litigators who make a *Belleville Catering* mistake risk sanctions, orders reducing or eliminating their fees in the federal suit, and, if harm is shown (such as a missed statute of limitations), malpractice liability. Perhaps less obviously, an LLC that invokes or challenges federal jurisdiction must be prepared to disclose -- at minimum to the court in camera -- the identity and citizenship of each of the LLC's members.

Obversely, because LLC membership information is rarely a matter of public record, a third party that invokes diversity jurisdiction against an LLC may have to proceed first "on information and belief" and then promptly obtain the court's assistance to determine the citizenship of each LLC member.

A change in an LLC's membership occurring after the lawsuit begins will not affect the diversity analysis. Diversity is determined as of the start of the suit. Grupo *Dataflux*. Likewise, a corporation properly sued in federal court *36 cannot escape to state court by merging or converting into an LLC, "checking the box" (to continue to be taxed as a corporation so as to avoid horrendous tax consequences), and using the citizenship of its members (formerly its shareholders) to destroy diversity. The die is cast when the lawsuit begins.

There are also consequences as to which LLC-related lawsuits are excluded from diversity jurisdiction. As *Belleville Catering* illustrates, federal diversity jurisdiction extends to a suit between an LLC and a third party only if that third party is diverse vis-à-vis every member of the LLC. Moreover, if an LLC has a member that is itself an unincorporated organization, the LLC has the citizenship not only of that member but also of every member of that member.

Thus, for example, if a two-member LLC has as one of its members a publicly traded limited partnership whose limited partners include citizens of each state, the District of Columbia, Puerto

Rico and each U.S. territory, federal diversity jurisdiction will never extend to a suit involving the LLC.

Matters are more complex with regard to lawsuits "within" an LLC. Most fundamentally, federal diversity jurisdiction will never exist in a suit between an LLC and any of its members. For example, whether an LLC sues a member for a promised contribution or a member sues the LLC for a distribution due under the operating agreement, the parties are not diverse. The member and the LLC are adverse parties, and the LLC has the citizenship of the member.

A suit among LLC members can qualify for diversity jurisdiction only if the litigating members are diverse and the LLC is not an indispensable party to the suit. Where joinder of a party would defeat diversity jurisdiction, Rule 19(b) of the Federal Rules of Civil Procedure requires the federal court to "determine whether in equity and good conscience the action should proceed among the parties before it, or should be dismissed, the absent person being thus regarded as indispensable." The analysis is flexible and pragmatic and permits a court to sculpt remedies so as to retain jurisdiction, provide an adequate judgment for the litigants, and avoid or lessen prejudice to the absent person.

Suppose, for example, that member X of an LLC claims that member Y agreed to transfer one-half of member Y's economic rights in the LLC to member X. The LLC is probably not an indispensable party to the X-Y litigation. Unless the LLC itself had some direct stake in the allocation of those rights, "protective provisions in the judgment ... the shaping of relief, or other measures" could prevent any prejudice to the LLC. Fed. R. Civ. P. 19(b).

Often, however, a dispute among LLC members will deeply and inextricably implicate the rights or obligations of the LLC. In that event, the LLC will be an indispensable party. The clearest example is a derivative suit brought by an LLC member against another member. The LLC's rights are obviously in play, and the suit will determine those rights. Whether the LLC is considered aligned with the derivative plaintiff or the defendant, the LLC shares citizenship with an adverse party. Such a derivative suit simply cannot qualify for diversity jurisdiction.

Similarly, if an LLC member sues an LLC manager for acts in the manager's official capacity, the suit is unlikely to qualify for diversity jurisdiction. Even if the member and manager are diverse, a judgment against the manager would have serious legal ramifications for the LLC. The LLC is therefore likely to be an indispensable party, adverse to and nondiverse from the plaintiff member.

As for a suit to enforce an LLC operating agreement, diversity jurisdiction is at best problematic (even assuming complete diversity among the members). The LLC may be an indispensable party as either a party to, or a third- party beneficiary of, the agreement.

There is some precedent from limited partnership law to suggest that, if all the members of an LLC are diverse and parties to the litigation, a federal court might manage a nonderivative case so as to dispense with the LLC. For example, in *HB General Corp. v. Manchester Partners, L.P.*, 95 F.3d 1185, 1191 (3d Cir. 1996), the court held that a limited partnership was not an indispensable party

in a suit among the partners, because, *inter alia*, the limited partnership could be prevented from later bringing an identical claim: "The partnership, like a marionette, cannot make a move unless some human being pulls the strings. And all the people who, under the partnership agreement, have the power to cause the partnership to bring suit ... are before the court."

Whether this reasoning should and will apply to LLCs is doubtful, however. Recent federal court decisions involving LLCs have emphasized the separate legal status of the LLC and have not followed the limited partnership precedents. *See, for example, Trademark Retail Inc. v. Apple Glen Investors, LP*, 196 F.R.D. 535, 540 (N.D.Ind. 2000).

Defects in federal subject matter jurisdiction are not waivable, and a federal court has a duty even sua sponte to dismiss a case for which it lacks subject matter jurisdiction. To ask a court to overlook a subject matter flaw is to ask the court to engage in "dereliction combined with usurpation." *Belleville Catering* at 93. Lawyers who deal with LLCs must, therefore, learn with care the limited contours of LLC diversity jurisdiction. Those contours effectively relegate to state court most LLC litigation that does not involve a federal question.