No. 90891-5
Court of Appeals No. 31491-0-III

THE SUPREME COURT
STATE OF WASHINGTON

NORTHWEST WHOLESALE, INC., a Washington corporation,

Plaintiff,

v.

PAC ORGANIC FRUIT, LLC, a Washington limited liability company; GREG HOLZMAN, INC., a foreign corporation authorized to do business in the State of Washington; and HAROLD OSTENSON and SHIRLEY OSTENSON,

Defendants.

HAROLD OSTENSON and SHIRLEY OSTENSON, on behalf of PAC ORGANIC FRUIT, LLC, a Washington limited liability company,

Petitioners,

v.

GREG HOLZMAN, an individual, TOTAL ORGANIC, LLC, a Washington limited liability company; and GREG HOLZMAN, INC., a foreign corporation authorized to do business in the State of Washington,

Respondents.

ANSWER TO PETITION FOR REVIEW

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I. IDENTITY OF RESPONDENTS

Respondents Greg Holzman, Greg Holzman, Inc. ("GHI", now known as Purity Organic Holdings, Inc.), and Total Organic, LLC (collectively "Holzman Parties") ask the Court to deny Harold and Shirley Ostensons' Petition for Review of the Court of Appeals' decision terminating review in this case. *See Nw. Wholesale, Inc. v. PAC Organic Fruit, LLC*, ___ Wn. App. ___, 334 P.3d 63 (Wash. Ct. App. 2014).

II. INTRODUCTION

The Ostensons seek this Court's review of a well-reasoned and well-written opinion by Judge Fearing (joined by Chief Judge Siddoway and Judge Brown) affirming Chelan County Superior Court Judge Lesley Allan's dismissal of a derivative claim against the Holzman Parties asserted by the Ostensons on behalf of an entity called Pac Organic, LLC, of which both the Ostensons and GHI were members at one time. Judge Allan dismissed this claim because the Ostensons were not members of Pac Organic when they brought the derivative claim, as required by RCW 25.15.375,[1] having been disassociated under RCW 25.15.130(1)(d) by petitioning for bankruptcy some time earlier.

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[1] The relevant portions of the statutes cited herein are set forth in the Appendix.

[2] These facts are not relevant to the issues in the petition but are included merely to show that the Ostensons' bloated version of the underlying case is incorrect.

[3] While any preemption issue is predicated on the Supremacy Clause of the U.S. Constitution, art. VI, cl. 2, the particular question turns on whether Congress intended a

The Court of Appeals properly reasoned that federal bankruptcy law does not preempt state law in this scenario. Further, it skillfully applied this Court's precedent to conclude that CR 41(b)(3) does not require—as the Ostensons contend—wasting judicial resources by remanding for completion of the trial only to have the same legal issue decided on the same undisputed facts.

The Court of Appeals' opinion does not conflict with any Washington precedent, does not decide any constitutional questions, and does not delve into an issue of public interest. In short, there is no error to correct, there is no conflict to resolve, and the legal issues do not raise significant questions of constitutional law or of substantial public interest. *See* RAP 13.4(b). This Court should deny review.

III. RESTATEMENT OF ISSUES PRESENTED FOR REVIEW

1. Did the Court of Appeals correctly rule that federal bankruptcy law does not preempt state law disassociating the Ostensons as members of Pac Organic, thereby preventing them from bringing a derivative claim against the Holzman Parties?

2. Did the Court of Appeals correctly determine this Court's precedent does not require completion of the trial before the trial court can rule on a CR 41(b)(3) motion when the relevant facts are undisputed and the issues of law are properly briefed and presented?

IV. STATEMENT OF THE CASE

Given the thorough recitation of facts in the Court of Appeals' opinion, only the highlights are included here: The Ostensons and GHI formed Pac Organic on June 1, 1998, with GHI owning 51% and the Ostensons 49%. CP 2045; Ex. P-26. On January 9, 2007, the Ostensons voluntarily filed for Chapter 11 bankruptcy protection. CP 2045. In this proceeding, the Ostensons and the Holzman Parties negotiated a settlement of the various claims they had against each other, generally releasing all claims with a few specific exceptions. Ex. D-5. Included in this Stipulation was the right of Pac Organic to assert certain purported claims against the Holzman Parties. *Id.* (¶ 7).

On July 25, 2008, the Ostensons filed claims in this case, asserting seven causes of action against Pac Organic and a single derivative cause of action on behalf of Pac Organic against the Holzman Parties. CP 38-53; CP 476-93. Trial began July 11, 2011. Following two days of testimony, the Ostensons rested. RP 580. The Holzman Parties moved for dismissal of the Ostensons' derivative claim under CR 41(b)(3). RP 580-603. The trial court took the motion under advisement and testimony continued. RP 602-03. The Holzman Parties called three witnesses but did not finish their case. RP 830. Trial was to be completed at a later date. *E.g.*, CP 1746-48.

A few key facts from the trial:[2]

1. Pac Organic lost money from is formation in 1998 to 2003, showing an ordinary income loss of over $490,000 in 2003 alone. Ex. D-41, RP 708-12, 715-16. After learning of this loss in the spring of 2004, the principals of GHI, including Mr. Holzman, continued to work with Mr. and Mrs. Ostenson to make the business a success. RP 714.

2. As trust broke down between Mr. Holzman and the Ostensons in 2004-2005, Mr. Ostenson began threatening to shut Pac Organic down if his demands were not met. RP 721-26, Exs. D-27, D-17. Further, Mr. Ostenson proved recalcitrant. Fruit was difficult to sell because he refused offers to purchase it, the fruit sat past its prime, and the buyers demanded credits for the substandard fruit that was delivered, all of which resulted in lost revenue to Pac Organic. RP 726-30.

3. The Holzman Parties never sought to steal Pac Organic from the Ostensons; rather, the business was worthless. RP 735-37.

4. The promissory note Pac Organic executed in favor of GHI was legitimate and, if anything, understated the amount Pac Organic owed to GHI. RP 808-13, Ex. P-9 (same as Ex. D-3).

Before trial resumed, the court decided the 41(b)(3) motion (after full briefing and a hearing), ruling in favor of the Holzman Parties and

[2] These facts are not relevant to the issues in the petition but are included merely to show that the Ostensons' bloated version of the underlying case is incorrect.

dismissing the Ostensons' derivative claim. RP (09/07/12) 60-64. Formal findings of fact, conclusions of law, and judgment dismissing the claims against the Holzman Parties were entered October 3, 2012. CP 2043-51.

Based on the factual findings and applicable law, the trial court concluded that the Ostensons were disassociated from Pac Organic upon filing for bankruptcy on January 7, 2007. CP 2048. Because state law requires a person to be a member of a limited liability company when filing a derivative action, the Ostensons had no authority to file derivative claims on behalf of Pac Organic. CP 2048-49.

The Ostensons moved for reconsideration, for the first time advancing the argument that federal bankruptcy law preempted state law. CP 2059-62. The trial court denied the motion. CP 2400-04. The Ostensons appealed, CP 2423-40, and the Court of Appeals affirmed. *See* 334 P.3d 63.

V. ARGUMENT

In a thorough opinion, the Court of Appeals carefully analyzed each of the issues raised in the Ostensons' petition, namely, federal bankruptcy preemption of state law governing limited liability companies and the propriety of the trial court's ruling on a CR 41(b)(3) motion after the defendants presented evidence at trial. On the former issue, in the absence of binding precedent, the court reasoned from similar cases

decided by federal bankruptcy courts and determined that neither bankruptcy statute cited by the Ostensons preempts RCW 25.15.130, which disassociates LLC members upon their filing for bankruptcy. 334 P.3d at 75-79. On the latter issue, the court correctly applied this Court's precedent, concluding that CR 54(b) grants a trial court the authority to revise and decide a motion that may have been denied earlier. *Id.* at 72-73.

Before defending the merits of the Court of Appeals' decision, the Holzman Parties first note that this opinion does not conflict with any decisions of this Court nor of the other divisions of the Court of Appeals. Thus, RAP 13.4(b)(1) and (b)(2) do not apply. Nor do the issues presented involve significant questions under either the United States or Washington Constitutions.[3] RAP 13.4(b)(3) does not apply. Finally, the issues are not of substantial public interest; indeed, as the Court of Appeals stated, the preemption issue is rather "esoteric," 334 P.3d at 75,[4] rendering RAP 13.4(b)(4) inapplicable. As no grounds for review are present, this Court should deny the Ostensons' petition.

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[3] While any preemption issue is predicated on the Supremacy Clause of the U.S. Constitution, art. VI, cl. 2, the particular question turns on whether Congress intended a federal statute to preempt a state law, as is the case here. Thus, a preemption issue is not constitutional in nature.

[4] Indeed, the preemption issue it still percolating through the federal bankruptcy and district courts. It would be premature for a court of discretionary review to decide the issue at this time.

A. The Court of Appeals Correctly Determined that Federal Bankruptcy Law Does Not Preempt State Law.

The Ostensons argue that two provisions of the U.S. Bankruptcy Code, 11 U.S.C. §§ 365(e)(1) and 541(c)(1), preempt Washington law[5] and prevent their disassociation upon filing for bankruptcy protection. The proper answer to this question—as determined by the better-reasoned cases on the topic—is that the member is disassociated by operation of state law, and then all of these rights become part of the bankruptcy estate.

1. 11 U.S.C. § 541(c)(1) Does Not Preempt RCW 25.15.130.

When a petition for bankruptcy is filed, a bankruptcy estate is created by operation of law. 11 U.S.C. § 541(a). With certain exceptions, the estate consists of all of the debtor's property, as defined by state law,

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[5] The mechanics of Washington LLC law are clear and undisputed. RCW 25.15.130(1) states that a "person ceases to be a member of a limited liability company" if, *inter alia*, the person "files a voluntary petition in bankruptcy." The disassociated person is then treated as an assignee, who maintains the right to "share in such profits and losses, to receive such distributions, and to receive such allocation of income, gain, loss, deduction, or credit or similar item to which the assignor was entitled, to the extent assigned." RCW 25.15.250(2)(a). In other words, the disassociated person cannot participate in management, RCW 25.15.250(1), but still receives the full economic benefit of his or her interest in the LLC.

Separate statutes define who may bring a derivative claim on behalf of the LLC. RCW 25.15.370 states that a "member may bring an action . . . in the right of a limited liability company to recover a judgment in its favor if managers or members with authority to do so have refused to bring the action or if an effort to cause those managers or members to bring the action is not likely to succeed." RCW 25.15.375 further requires the plaintiff to be "a member at the time of bringing the action" and at the time of the events in question.

The Ostensons filed for bankruptcy on January 9, 2007, and by operation of Washington law were disassociated from Pac Organic. No longer members of Pac Organic, the Ostensons lacked authority to bring a derivative claim on its behalf, as they tried to do on July 25, 2008 when they filed such a claim against the Holzman Parties in this action.

at that time. § 541(a)(1). Further, the Code overrides state law or contractual provisions that restrict the transfer of assets to the estate or that work to forfeit, modify, or terminate the debtor's interest. § 541(c)(1).

As the Court of Appeals recognized, a bedrock rule of bankruptcy is that state law defines a debtor's property interests:

> Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding.

Butner v. United States, 440 U.S. 48, 55, 99 S. Ct. 914, 59 L. Ed. 2d 136 (1979) (quotation marks omitted). After state law defines the property interests, federal law determines whether that interest is included in the bankruptcy estate. *See* 11 U.S.C. § 541(a), (b). But federal law does not broaden or expand the debtor's interest in his property. *In re Farmers Markets, Inc.*, 792 F.2d 1400, 1402 (9th Cir. 1986).

The Court of Appeals first considered the primary case the Ostensons cite in favor of their position: *In re Daugherty Const., Inc.*, 188 B.R. 607 (Bankr. D. Neb. 1995). In *Daugherty*, upon one member filing for bankruptcy, the LLC dissolved; that is, under Nebraska law, the bankruptcy filing terminated the LLC. 118 B.R. at 611. As a result, the member's interest itself terminated. *Id.* at 609-10. In the context of the rather harsh operations of Nebraska law—which are very different from

Washington law—the *Daugherty* court concluded that § 541(c)(1) preempted the state law. 118 B.R. at 611.

The Court of Appeals correctly distinguished Washington law from the Nebraska law applied in *Daugherty*. 334 F.3d at 76. RCW 25.15.130(1)(d) does not suggest that the Ostensons' interests in Pac Organic were terminated by their disassociation. Nor was Pac Organic dissolved by the disassociation. *See* RCW 25.15.270.

Instead, based on the similarities between RCW ch. 25.15 and the parallel Virginia statutes, the Court of Appeals found persuasive a bankruptcy court decision examining this preemption question in that context. *See In re Garrison-Ashburn, L.C.*, 253 B.R. 700 (Bankr. E.D. Va. 2000). There, the member of an LLC filed for bankruptcy and then sought to execute a real estate contract on behalf of the LLC. 253 B.R. 704. The other member disputed the bankrupt member's right to bind the LLC, noting that under Virginia law a member is disassociated upon filing for bankruptcy. *Id.* at 707. Thus, the bankrupt member retained his economic interest in the LLC to share in the profits and losses, but could not longer participate in management. *Id.* The court held that § 541(c)(1) did not change the analysis:

> This result does not offend the Congressional intention behind Sections 541(c) and 365(c) and (e). These provisions were intended to expand the bankruptcy estate to

> the maximum feasible extent and to prevent the loss of valuable assets by the operation of *ipso facto* clauses that terminate valuable leases and other rights upon bankruptcy. Here the estate received the entire interest of the debtor in Garrison–Woods including its burdens and restrictions. The economic interest, that is the membership interest, remains in the estate and is available for the benefit of creditors. The enforcement of Chapman's statutory dissociation does not cause a forfeiture of those rights or impair the legal capacity of the company to continue in business.

Id. at 709.[6]

The Court of Appeals adopted the better reasoning of *Garrison-Ashburn*, recognizing that state law defines what the debtor's interests are, including disassociation, then § 541 brings them into the estate, burdened by whatever state law requires. In short, § 541(c)(1) does not preempt RCW 25.15.130, and the Ostensons were disassociated from Pac Organic when they filed for bankruptcy.

2. 11 U.S.C. § 365(e)(2) Allows Other Members of an LLC to Refuse Performance from an Assignee.

11 U.S.C. § 365(e)(1) provides that an executory contract "of the debtor may not be may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on . . . the

[6] Other cases are to the same effect. *See, e.g.*, *In re Albright*, 291 B.R. 538, 541 n.7 (Bankr. D. Colo. 2003); *In re A-Z Electronics, LLC*, 350 B.R. 886, 890 n.12 (Bankr. D. Idaho 2006); *Fotouhi v. Mansdorf*, 427 B.R. 798, 802 (N.D. Cal. 2010); *Milford Power Co., LLC v. PDC Milford Power, LLC*, 866 A.2d 738, 759-61 (Del. Ch. 2004).

commencement of a case under this title . . . ." Section 365(e)(2) modifies § 365(e)(1), creating an exception if "applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to the trustee or to an assignee of such contract." § 365(e)(2); *see also In re Warner*, 480 B.R. 641, 650 (Bankr. N.D.W. Va. 2012) ("Section 365(e)(2) allows non-debtor parties to enforce transfer restrictions contained in an executory contract against a trustee and to excuse them from accepting or rendering performance to the trustee.").

The Court of Appeals did not decide if the Pac Organic operating agreement is an executory contract as the Ostensons contend, determining that even if it were such a contract, § 365(e)(2) allows GHI to refuse performance from an assignee of the contract. *See* 334 P.3d at 77 (citing *In re First Protection, Inc.,* 440 B.R. 821, 832 (9th Cir. BAP 2010); *C.O.P Coal Dev. Co. v. C.W. Mining Co.,* 422 B.R. 746, 761 (10th Cir. BAP 2010)). Based on the similarity between LLCs and partnerships in this context, the court examined Washington law on partnerships to assist its analysis.

The Ostensons object to the court's citation to *Finkelstein v. Sec. Properties, Inc.*, 76 Wn. App. 733, 888 P.2d 161 (1995), arguing that this case is inapplicable. But *Finkelstein* is actually quite helpful, accurately stating that "partnership agreements are purely consensual and the

freedom of the partners to associate and dissociate is the heart of partnership law." *Id.* at 738. Because of this bedrock principle of partnership law, § 365(e)(2) applies to prevent the remaining partners from accepting the performance of a bankruptcy trustee or other assignee against their will. *Id.* at 737-38.

The Ostensons dispute this conclusion, arguing that partnerships and LLCs are not alike. In this respect, however, they are exactly alike. RCW 25.15.130(1) and 25.15.250(1) provide the non-debtor members of a LLC with authority to refuse consent to the membership status of an assignee. In other words, absent consent of the other members, an assignee has no rights to participate in the management of the LLC, exactly as in a partnership. *Cf. Sumlin Const. Co., L.L.C. v. Taylor*, 850 So.2d 303, 312 (Ala. 2002).

The Court of Appeals carefully examined the Ostensons' preemption arguments and properly concluded they lack merit. There is nothing in its decision that contravenes this Court's precedent nor other state or federal law (the Ostensons' hyperbole notwithstanding). The Court of Appeal' opinion is sound, and this Court need not review it.

B. The Superior Court Properly Considered and Ruled on the Holzman Parties' CR 41(b)(3) Motion.

Civil Rule 41(b)(3) allows a defendant, after a plaintiff has presented its case in a bench trial, to move for dismissal of the plaintiff's case "on the ground that upon the facts and the law the plaintiff has shown no right to relief." *See Commonwealth Real Estate Servs. v. Padilla*, 149 Wn. App. 757, 762, 205 P.3d 937 (2009).

The Ostensons argue that *Hector v. Martin*, 51 Wn.2d 707, 321 P.2d 555 (1958) establishes a bright line rule applicable to all motions to dismiss brought under CR 41(b)(3) (though that case never cited this rule). But as the Court of Appeals reasoned, the purpose of the rule is to afford the reviewing court the benefit of considering all evidence presented at trial when deciding if the trial court properly denied a motion to dismiss for insufficient evidence. 334 P.3d at 72. In other words, the defendant cannot seek, on appeal, to rewind the clock and limit the reviewing court's consideration to the plaintiff's evidence alone when the trial court denied the defendant's motion to dismiss. Such a move "would deny both parties the benefit of all the evidence in the case to which they are both entitled." *Hector*, 51 Wn.2d at 710.

But if the trial court later grants such a motion, having considered all evidence presented to that time, there is no prejudice to the plaintiff,

who has the benefit of arguing from all the evidence thus far admitted. For this reason, if the trial court takes a CR 41(b)(3) motion under advisement and does not rule on it, the court still has the authority under CR 54(b) to revisit the issue and grant the motion at a later time, considering, of course, all evidence presented. *Id.* at 73.

Hector is not to the contrary, for that case did not consider these facts, where the trial court later granted the motion on the basis of undisputed facts, as it had authority to do. The Court of Appeals properly understood and applied *Hector* in this matter. Further, the Ostensons do not contend—for they cannot—that additional evidence would alter the result in the trial court and on appeal. Here, the relevant facts are undisputed; the issue is purely legal, which the trial court properly resolved in favor of the Holzman Parties, as was proper under CR 41(b)(3).

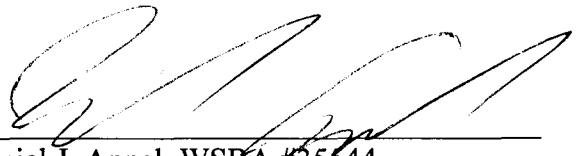
Despite the Ostensons' contentions to the contrary, the Court of Appeals' opinion does not conflict with this Court's precedent. Rather, the Court of Appeals carefully and correctly applied *Hector* and other precedent to the facts of this case. As this issue is not substantially important to the public interest, no grounds exist requiring this Court's consideration. The Court should deny the Ostensons' petition.

VI. CONCLUSION

For the reasons stated, the Holzman Parties respectfully ask the Court to deny the Ostensons' petition for review.

Dated this 31st day of October, 2014.

LAW OFFICES OF DALE M. FOREMAN, P.S.



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CERTIFICATE OF SERVICE

I hereby declare under penalty of perjury of the laws of the State of Washington that I am over the age of eighteen and not a party to this action, and that on October 31, 2014, I caused to be served a true and correct copy of the foregoing document as indicated below:

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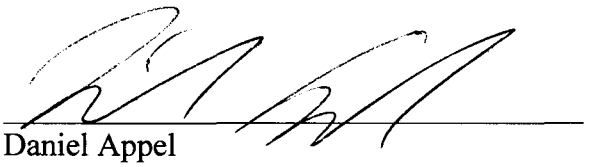
Dated this 31st day of October, 2014.



Daniel Appel

APPENDIX
Text of Relevant Statutes

11 U.S.C. § 365 (portions)

(c) The trustee may not assume or assign any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if—

(1)

(A) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and

(B) such party does not consent to such assumption or assignment . . . .

(e)

(1) Notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract or unexpired lease of the debtor may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on—

(A) the insolvency or financial condition of the debtor at any time before the closing of the case;

(B) the commencement of a case under this title; or

(C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.

(2) Paragraph (1) of this subsection does not apply to an executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if—

(A)

(i) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to the trustee or to an assignee of such contract or lease, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and

(ii) such party does not consent to such assumption or assignment; or

(B) such contract is a contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor, or to issue a security of the debtor.

11 U.S.C. § 541 (portions)

(a) The commencement of a case under section 301, 302, or 303 of this title creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held:

(1) Except as provided in subsections (b) and (c)(2) of this section, all legal or equitable interests of the debtor in property as of the commencement of the case.

. . . .

(b) Property of the estate does not include—

(1) any power that the debtor may exercise solely for the benefit of an entity other than the debtor;

. . . .

(c)

(1) Except as provided in paragraph (2) of this subsection, an interest of the debtor in property becomes property of the estate under subsection (a)(1), (a)(2), or (a)(5) of this section notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law—

(A) that restricts or conditions transfer of such interest by the debtor; or

(B) that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title, or on the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement, and that effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property.

RCW 25.15.130 (portions)

(1) A person ceases to be a member of a limited liability company, and the person or its successor in interest attains the status of an assignee as set forth in RCW 25.15.250(2), upon the occurrence of one or more of the following events: . . .

> (d) Unless otherwise provided in the limited liability company agreement, or with the written consent of all other members at the time, the member (i) makes a general assignment for the benefit of creditors; (ii) files a voluntary petition in bankruptcy . . . .

RCW 25.15.250 (portions)

(1) A limited liability company interest is assignable in whole or in part except as provided in a limited liability company agreement. The assignee of a member's limited liability company interest shall have no right to participate in the management of the business and affairs of a limited liability company except:

> (a) Upon the approval of all of the members of the limited liability company other than the member assigning his or her limited liability company interest; or
> (b) As provided in a limited liability company agreement.

(2) Unless otherwise provided in a limited liability company agreement:

> (a) An assignment entitles the assignee to share in such profits and losses, to receive such distributions, and to receive such allocation of income, gain, loss, deduction, or credit or similar item to which the assignor was entitled, to the extent assigned; and
> (b) A member ceases to be a member and to have the power to exercise any rights or powers of a member upon assignment of all of his or her limited liability company interest.

RCW 25.15.370

A member may bring an action in the superior courts in the right of a limited liability company to recover a judgment in its favor if managers or members with authority to do so have refused to bring the action or if an effort to cause those managers or members to bring the action is not likely to succeed.

RCW 25.15.375

In a derivative action, the plaintiff must be a member at the time of bringing the action and:

(1) At the time of the transaction of which the plaintiff complains; or

(2) The plaintiff's status as a member had devolved upon him or her by operation of law or pursuant to the terms of a limited liability company agreement from a person who was a member at the time of the transaction.