CHAPTER 2

PARTNERSHIP AND LLC BASICS

A. THE CHALLENGE

A lawyer needs to know the basics of partnerships (there are four types) and limited liability companies. These entities are essential planning tools for many successful businesses and families. Although LLCs continue to grow in popularity, a partnership option still emerges as the preferred candidate in many choice-of-entity analyses. An extended choice-of-entity planning discussion is provided in section B. of Chapter 5.

The statutory schemes for the various entity types are an essential starting point. Since 1914, uniform acts have been developed as needed to help states enact comprehensive acts dealing with partnerships and LLCs. Although states typically modify select uniform act provisions during the legislative process, this ongoing uniform act effort has had a powerful impact in promoting consistency between the states.

The following section of this chapter summarizes the latest uniform act provisions for LLCs and the various types of partnerships. The hope is that this summary discussion, coupled with Case Problems 2-1 through 2-4, will help students understand the core legal underpinnings of the various entity types and the primary differences between them.

Sections C though G of this chapter present court opinions, commentary, and case problems dealing with entity formation challenges, third party claims, fiduciary duties, authority and management disputes, and dissolution challenges. These sections illustrate, in the context of partnerships and LLCs, the types of legal challenges that often surface when parties join together to form and operate a business. Beyond enriching a student's understanding of partnerships and LLCs, these sections are designed to provide a foundation for more extensive corporate-based discussions in later chapters that address many of the same issues: defective organizations; pre-formation transactions; the value of organizational document customization; owner and manager personal liabilities; piercing-the-veil claims; derivative action obstacles; director and officer fiduciary duties; the value and limits of exculpatory provisions; allocations of authority between owners and managers; and more.

Section H of this chapter focuses on the all-important operating agreement between the partners or LLC members. With limited exceptions, this document

can establish the entire deal between the parties and preempt all statutory default rules. The smart customization of this document is the primary planning challenge during the organizational process. From the lawyer's perspective, it requires an understanding of core legal principles, the ability to help parties identify and prioritize operational issues of concern, and careful attention to detail. The ignorant use of forms can be dangerous. That said, this section illustrates this planning challenge by discussing the purposes and options of key provisions of the LLC operating agreement form that is included in Chapter 17.

Family partnerships and LLCs are the subject of the final section of this chapter, partly in recognition of the fact that most businesses in the U.S. are dominated by a single family.[1] As illustrated in the discussion, partnerships and LLCs often are used to accomplish niche objectives as part of an overall business and family plan to protect and transition wealth.

B. ENTITY STATUTORY PROVISIONS

1. PARTNERSHIPS

The partnership is the oldest form of business entity between multiple parties. Its history predates corporations and business trusts. And it is the historical foundation for all the "limiteds": limited partnership, limited liability partnership, limited liability limited partnership, and limited liability company. Partnership statutes have been around for over 2,000 years, being tracked to King Khammurabi of Babylon.[2]

A partnership is formed when there is "an association of two or more persons to carry on as co-owners a business for profit…, whether or not the persons intend to form a partnership."[3] Two distinct theories have been forever advanced to explain the nature of a partnership: an "entity" theory that focuses on a partnership being separate and apart from its owners, and an "aggregate" theory that views a partnership as an amalgamation of owner rights and interests and deemphasizes the separateness of the entity.

Focusing on the underpinnings and reach of these theories does little to advance one's understanding of partnership law because both theories are evidenced in state statutory schemes. The reason is that all states, except Louisiana, have based their partnership statutes on the Uniform Partnership Act ("UPA"), first published in 1914. The latest version, known as the Revised Uniform Partnership Act ("RUPA"), was released in 1997 and has been adopted by 37 states. While the RUPA favors the entity theory, evidence of the aggregate theory shows up throughout the RUPA in issues dealing with owners' liability for a partnership's debts, the impact of an owner's disassociation from a partnership,

1. Some estimate that nearly 80 percent of U.S. businesses are family-dominated. See, generally, R. Duman, "Family Firms Are Different," Entrepreneurship Theory and Practice, 1992, pp. 13–21; and M. F. R. Kets de Vries, "The Dynamics of Family Controlled Firms: The Good News and the Bad News," Organizational Dynamics, 1993, pp. 59–71; W. G. Dyer, Cultural Change in Family Firms, Jossey–Bass, San Francisco, 1986; and P. L. Rosenblatt, M. R. Anderson and P. Johnson, The Family in Business, Jossey–Bass, San Francisco, 1985; Arthur Anderson/Mass Mutual, American Family Business Survey, 2002.

2. 1 Reed Rowley, Rowley on Partnership 2 (2d ed. 1960)

3. RUPA § 202(a).

and more.

Following Case Problem 2-1 is a recap of the key provisions of the RUPA that have been adopted in most states.

CASE PROBLEM 2-1

Son developed a unique internet marketing strategy (the "Strategy") that could be worth millions. He asked Dad to "invest" $50,000 to "get the business going." Dad transferred the $50,000 to Son, and Son insisted that Dad sign a document that simply stated, "I will run the whole show, but we are now partners in the OuterNet Company partnership." As to this venture:

1. Does Dad have any property rights in Strategy?

2. How will the profits of the enterprise be allocated between Dad and Son?

3. Will Dad bear the first $50,000 of losses?

4. Does Dad have the power to bind the enterprise to contracts with third parties? Does Son?

5. What duties do Dad and Son owe each other?

6. What would be the capital accounts of Dad and Son if the partnership loses the $50,000 and then shuts down after six months because future marketing prospects look hopeless and the entity has no assets? At the time of the shut down, would Dad or Son have a financial obligation to the partnership?

7. Would Dad have any personal liability exposure if Son borrowed $150,000 in the name of OuterNet Company from a local bank, the bank had no knowledge of Dad's involvement, and Dad did not know of the loan?

a. The Partnership Agreement

A core feature of state partnership statutes is that they exalt the agreement between the partners as the primary governing source for the entity. With limited exceptions (all important), the agreement will preempt state statutory provisions, which kick in only when the partnership agreement does not address a specific issue.[4] This puts a huge premium on the development of a smart partnership agreement during the planning process. Typically, a partnership agreement may not:[5]

- Vary the statutory rights of the partnership or a partner to file a statement with the secretary of state or other designated state agency to define or limit the rights of individuals to deal with partnership real estate or take other actions on behalf of the partnership.

- Unreasonably restrict a partner's right of access to books and records.

- Eliminate a partner's duty of loyalty, but, if not manifestly unreasonable, the partnership agreement may identify specific types or categories of activities that do not violate the duty of loyalty, and the partnership agreement may provide

4. RUPA § 103(a).
5. RUPA § 103(b).

that all of the partners or a number or percentage specified in the partnership agreement may authorize or ratify, after full disclosure of all material facts, a specific act or transaction that otherwise would violate the duty of loyalty.

- Unreasonably reduce a partner's duty of care.

- Eliminate a partner's obligation of good faith and fair dealing, but the partnership agreement may prescribe the standards by which the performance of the obligation is to be measured, if the standards are not manifestly unreasonable.

- Vary the power of a partner to dissociate as a partner, except the partnership agreement may require that a notice to dissociate be in writing.

- Vary the right of a court to expel a partner who (1) has engaged in wrongful conduct that adversely and materially affects the partnership's business, (2) has willfully and persistently committed a material breach of the partnership agreement or a duty owned to the partnership or other partners, or (3) has engaged in conduct that makes it not reasonably practicable to carry on the partnership's business.[6]

- Vary the requirement to wind up the partnership's business if (1) continuation of all or substantially all of the partnership's business is unlawful, (2) a partner seeks a judicial determination that the economic purpose of the partnership is unreasonably frustrated, a partner has engaged in conduct that makes it not reasonably practicable to carry on the partnership's business, or it is not reasonably practicable to carry on the partnership's business in accordance with the partnership agreement, or (3) a transferee of a partner's interest seeks a judicial determination that the partnership's term or undertaking has expired or that the partnership's term was at will.[7]

- Vary the manner in which the state's law is applicable to a limited liability partnership.

- Restrict rights of third parties.

b. Property Rights

Property acquired by a partnership is property of the partnership, not property co-owned by the individual partners.[8] A partner does not have an interest in partnership property that can be transferred, either voluntarily or involuntarily.[9] Property is presumed to be partnership property if purchased with partnership assets, even if not acquired in the name of the partnership.[10] Property acquired in the name of a partner, without use of partnership funds and a reference that the partner is acting on behalf of the partnership, is presumed to be separate property of the partner.[11]

c. Agency Authority

6. RUPA §§ 103(b)(7), 601(5).
7. RUPA §§ 103(b)(8), 801(4)(5)(6).
8. RUPA §§ 203, 501.
9. RUPA § 501.
10. RUPA § 204(c).
11. RUPA § 204(d).

Each partner is an agent of the partnership with authority to bind the partnership in the ordinary course of the partnership's business or business of the kind carried out by the partnership, unless the partner had no authority to act for the partnership and the third person with whom the partner dealt knew or had reason to know that the partner had no such authority.[12] A partnership may file a statement (good for five years) with the secretary of state (or, in the case of real estate, with the county recorder) that states the authority, or limitations on the authority, of specific partners to enter into transactions on behalf of the partnership. Such grant of authority is conclusive in favor of a third party who gives value in reliance of the statement.[13] A person named in any such statement may file a written denial of the person's authority or status as a partner.[14]

d. Liabilities.

Partner-Created Liabilities. A partnership is liable for any actionable loss or injury caused by a partner while acting within the ordinary course of the partnership's business or within the partner's authority.[15] Similarly, a partnership is liable if a partner, while acting in the course of the partnership's business or within the scope of authority, misapplies money or property that the partner receives or causes the partnership to receive from a third party.[16]

Entity Obligations. Partners are jointly and severally liable for all obligations of the partnership unless otherwise agreed to by the claimant or provided by law. Exceptions apply for a newly admitted partner's responsibility for pre-admission obligations and (as described below) for the partners of a limited liability partnership.[17]

Purported Partner Liabilities. A person who, through word or action, purports to be a partner or consents to being represented by another as a partner is liable as a partner to any third party who relies on any such representation. If the purported partner representation is made in a public announcement, liability may attach even if the purported partner had no knowledge of the specific claimant. Personal liability under this purported liability rule is not triggered simply because a person is incorrectly named in a statement of partnership authority.[18]

e. Rights Between Partners. Unless the partnership provides otherwise, the following provisions apply to the partners:

Capital Accounts. Each partner's capital account is increased by the amount of money and the value of any property (net of liabilities) contributed to the partnership and the partner's share of any partnership profits. Each partner's capital account is decreased by the amount of money and the value of any property (net of liabilities) distributed to the partner and the partner's share of

12. RUPA § 301.
13. RUPA § 303.
14. RUPA § 304.
15. RUPA § 305(a).
16. RUPA § 305(b).
17. RUPA § 306.
18. RUPA § 308.

any partnership losses.[19]

Profits and Losses. Partnership profits and losses are allocated equally among the partners.[20]

Partner Advances. A partnership is obligated to indemnify a partner for payments made and liabilities incurred in the ordinary course of business or to preserve the partnership's business or property. Any such payment constitutes a loan to the partnership that accrues interest.[21]

Excessive Contributions. A partnership is obligated to reimburse a partner for any contribution to the partnership that exceeds the partner's contribution obligation. Any such excessive contribution constitutes a loan to the partnership that accrues interest.[22]

Management Rights. Each partner has an equal right to manage and conduct the partnership's business.[23]

Use of Property**.** A partner may use or possess partnership property only on behalf of the partnership.[24]

Partner Compensation. A partner is not entitled to any compensation for services rendered to the partnership, except for reasonable compensation for services rendered in winding up the affairs of the partnership.[25]

New Partners**.** A person may become a partner only with the consent of all existing partners.[26]

Dispute Resolution. A majority of the partners may resolve any dispute that involves a matter within the ordinary course of the partnership's business. A matter outside the ordinary course or any amendment to the partnership agreement requires the unanimous consent of the partners.[27]

In-Kind Distributions**.** No partner has a right to receive, and may not be required to accept, a distribution in kind of partnership property.[28]

Records Inspection Access**.** A partner and the partner's agents and attorneys has access to the books and records of the partnership, which the partnership is obligated to maintain and keep at the partnership's chief executive office. The same rights extend to former partners and the legal representatives of a deceased and disabled partner. The partnership may impose reasonable charges for the costs (both labor and materials) of document copies.[29]

Duty of Loyalty**.** A partner's duty of loyalty to the partnership and other partners is limited to (1) accounting and holding as trustee any property, profit or

19. RUPA § 401(a).
20. RUPA § 401(b).
21. RUPA § 401(c).
22. RUPA § 401(d).
23. RUPA § 401(f).
24. RUPA § 401(g).
25. RUPA § 401(h).
26. RUPA § 401(i).
27. RUPA § 401(j).
28. RUPA § 402.
29. RUPA § 403.

benefit derived by the partner in the conduct or winding up of the partnership's business or from the use of partnership property, including the appropriation of partnership opportunity, (2) refraining from dealing with the partnership as, on behalf of, a person having an interest adverse to partnership, and (3) refraining from competing with the partnership.[30] A partner does not violate this duty or any other duty merely because the partner's conduct furthers the partner's own interests, nor is a partner prohibited from loaning money to a partnership or transacting other business with a partnership.[31]

Duty of Care. A partner's duty of care to the partnership and the other partners is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a known violation of law.[32]

Duty of Good Faith. A partner is required to discharge duties to the partnership and other partners and exercise any rights in a manner that reflects good faith and fair dealing.[33]

Enforcement Actions. A partnership may maintain an action against a partner for violation of the partnership agreement or a violation of a duty owned to the partnership. A partner may maintain an action against the partnership or other partners for legal and equitable relief to enforce rights under the partnership agreement or state law and to enforce other interests of the partner.[34]

Partner's Transferable Interest. The only transferable interest of a partner is the partner's share of profits and losses and the right to receive distributions. This interest is personal property.[35] A partner's transfer of such interest (1) is permissible, (2) does not itself cause a dissolution or winding up of the partnership, (3) does not entitle the transferee to participate in the management or conduct of the partnership's business, to require access to information about partnership transactions, or to inspect or copy partnership books and records, and (4) entitles the transferee only to distributions and net dissolution amounts that otherwise would have been paid to the transferor partner and to seek a judicial determination that it is equitable to wind up the partnership's business.[36]

Partner's Third Party Debts. The creditor of a partner may seek a judicial charging order that constitutes a lien on the partner's transferable interest in the partnership. The court may appoint a receiver and enter other orders to enforce the charging order and may order a foreclosure of the interest. The acquirer at any such foreclosure sale receives only the rights of a transferee. Statutes usually specifically provide that this is the "exclusive remedy" of a partner's judgment creditor who seeks to satisfy a claim out of the partner's interest in the partnership.[37]

f. Partner's Termination (Dissociation).

30. RUPA § 404(b).
31. RUPA § 404(e),(f).
32. RUPA § 404(c).
33. RUPA § 404(d).
34. RUPA § 405.
35. RUPA § 502.
36. RUPA § 503.
37. RUPA § 504.

At Will Termination. A partner may dissociate from a partnership by notice expressing a will to withdraw as a partner. When the partnership is at will, such a withdrawal will trigger a dissolution and winding up of the partnership.[38] A partnership is at will when the partners have not agreed to remain partners until the expiration of a definite term or the completion of a particular undertaking.[39]

Other Triggers. Statutes typically provide that a partner's interest also may be terminated by the:

1) Occurrence of a dissociation event specified in the partnership agreement;

2) Expulsion of a partner pursuant to the partnership agreement;

3) Unanimous vote of the other partners if (a) it is unlawful to carry on business with the partner, (b) there has been a transfer of substantially all of a partner's interest in the partnership, (c) the partner is a corporation that has filed a certificate of dissolution or has had its charter revoked or its right to conduct business suspended, or (4) the partner is a partnership that has been dissolved;

4) A judicial determination of expulsion due to the partner's wrongful conduct, willful and persistent breach of the partnership agreement or duties owed, or conduct that makes it not reasonably practical to carry on the business with the partner;

5) Partner becoming a debtor in bankruptcy, executing an assignment for the benefit of creditors, or having a trustee, receiver or liquidator appointed to handle the partner's property;

6) Partner dying, having a guardian or conservator appointed to handle the partner's property, or being judicially determined to be incapable of performing the partner's duties under the partnership agreement;

7) Transfer of the partner's interest in the partnership by a trustee or a personal representative of an estate holding the partnership interest; and

8) Termination of any partner who is not an individual, partnership, corporation, trust, or estate.[40]

Purchase of Interest. Typically, a partner's dissociation does not force a dissolution and winding up of the partnership unless the dissociation is due to the death of a partner or one of the triggers described in items (5) through (8) above and over half of the partners approve a winding up of the partnership. Absent such circumstances, the interest of the departing partner is purchased for a price equal to the greater of the liquidation value of the partner's interest or the value based on a sale of the business as a going concern. State statutes usually specify the procedures for establishing the value.[41]

Dissociated Partner's Liabilities. A dissociated partner remains liable: (1) to the partnership and other partners for any damages or losses resulting from a

38. RUPA §§ 601(1), 801(1).
39. RUPA § 101(8).
40. RUPA § 601.
41. RUPA §§ 603, 701.

withdrawal that violated the partnership agreement or actions taken by the dissociated partner after the dissociation; and (2) to third parties for joint and several exposure obligations and liabilities arising prior to the dissociation. The dissociated partner's exposure on such a pre-dissociation obligation may be eliminated by agreement with the creditor and the other partners or by a material change in the terms of the obligation with the creditor having notice of the dissociation. Continued use of a dissociated partner's name in the partnership's name does not expose the dissociated partner to obligations of the partnership incurred after the dissociation.[42]

Third Party Protection. The partnership may be liable to third parties who reasonably believed that a dissociated partner was still a partner for actions taken by the dissociated partner within two years of the dissociation, provided the partnership may cut off this exposure 90 days after filing a notice of dissociation with the secretary of state.[43]

g. Dissolution and Winding Up

Triggering Events. A partnership is dissolved, and its business must be wound up when (1) a partner gives notice to withdraw in an at will partnership; (2) a majority of partners approve winding up when a partner dies or dissociates for one of the reasons described in items (5) though (8) above; (3) the partners all agree to a winding up of the business; (4) the partnership's specified term or undertaking has expired or been completed; (5) a dissolution event specified in the partnership agreement occurs; (6) an event (not curable in 90 days) occurs that makes it unlawful to carry on substantially all of the partnership's business; (7) on application of a partner, a court determines that the economic purpose of the partnership is unreasonably frustrated, a partner has engaged in conduct that makes it not reasonably practicable to carry on the partnership's business, or it is not reasonably practicable to carry on the partnership's business in accordance with the partnership agreement, or (8) on application of the transferee of a partner's interest, a court determines that it would be equitable to windup the affairs of the partnership.[44]

Winding Up. A partnership continues after dissolution only for purposes of winding up the business. At any time after dissolution, the partners may unanimously agree to terminate the winding up and resume the partnership's business activities.[45] Any partner who has not wrongfully dissociated from the partnership may participate in the winding up, subject to a court's power to order judicial supervision of the winding up. A person winding up a partnership may seek to preserve the business as a going concern for a reasonable time, prosecute and defend actions, settle and close the partnership's business, dispose of assets, pay liabilities, resolve disputes, bind the partnership for acts taken in connection with the winding up, and make distributions to partners.[46]

Statement of Dissolution. Any partner who has not dissociated may file a

42. RUPA §§ 702, 703.
43. RUPA §§ 702(a), 704.
44. RUPA § 801.
45. RUPA § 802.
46. RUPA § 803.

statement of dissolution which is deemed to give any third party notice of the dissolution and limitation on the partners' authority 90 days after filing.[47]

Account Settlement and Deficit Restoration Obligations. Proceeds from the winding up must first be used to discharge obligations to creditors. Remaining proceeds are distributed to the partners in accordance with the respective positive balances in their capital accounts. Any partner who has a negative capital account balance must make a contribution to the partnership in an amount equal to the negative balance. If such partner fails to restore the negative balance, any amount needed by the partnership to pay partnership debts as a result of such failure must be paid by the other partners in proportion to their loss sharing percentages, and such other partners may seek to recover such additional contributions from the defaulting partner. Any partnership obligations that surface after the settlement of all partner accounts must be paid by the partners making additional contributions in proportion to their loss allocation percentages.[48]

h. Choice of Law

State statutes typically provide that the laws of the jurisdiction where the partnership maintains its chief executive office will govern relationships among the partners and between the partners and the partnership.[49]

CASE PROBLEM 2-2

Jake and Luke formed a general partnership to sell a special yacht that would be designed and built in Italy. Jake's sole obligation was to provide the start-up capital of $125,000. He spent the balance of his time teaching law school.

Luke was the driving force behind the effort. He lined up a design and manufacturing firm in Italy, developed super-slick marketing materials, and started hustling customers for pre-orders. He ultimately collected $1.4 million in "advances" from nine customers located in seven different states. Luke regularly advised Jake that Jake's investment and the pre-order advances provided all the capital that was required to launch the business. He would exclaim, "Once the yachts start arriving, we will be gold."

Last month, Luke's wife and young daughter died in a tragic automobile accident. Devastated, Luke left the country and absconded with roughly $1.3 million, having spent only $225,000 on advances to the Italian company and marketing related expenses. The yacht venture instantly collapsed.

The nine customers soon learned of Luke's departure. They are claiming that Jake must repay them the amount of their advances, plus interest. If they are right, Jake will be forced into bankruptcy.

Is Jake personally liable to the nine customers? Would he be personally liable if Jake and Luke had formed a limited liability company? How about a

47. RUPA § 805.
48. RUPA § 806.
49. RUPA § 706(a).

limited partnership, with Luke as the general partner and Jake as the limited partner? How about a limited liability partnership?

2. LIMITED LIABILITY PARTNERSHIPS

A limited liability partnership ("LLP") is a partnership that has filed a statement of qualification (sometimes called an "application") with the state's secretary of state and that does not have a similar statement in effect in another jurisdiction.[50] The terms and conditions on which a partnership becomes an LLP must be approved by a vote necessary to amend the partnership agreement, but if the partnership agreement contains provisions that expressly consider obligations to contribute to the partnership, it must be approved by the vote necessary to amend such provisions.[51]

a. Qualification Statement. The statement of qualification usually must state the name of the partnership, the location of a registered office, the address of its principal office; and a statement that the partnership elects to be an LLP.[52] Some states require that the qualification statement also include the number of partners and a brief statement of the business in which the partnership engages. Typically, a majority of the partners, or one or more authorized partners, must execute documents submitted to the secretary of state. The LLP's registration is effective immediately after the date the application is filed, or at such later date specified in the application.[53]

b. Name. The name of an LLP must end with the words "Registered Limited Liability Partnership," "limited liability partnership" or the abbreviation "R.L.L.P.," "RLLP," "L.L.P.," or "LLP."[54]

c. Annual Report. An LLP must file an annual report with the secretary of state and pay an annual fee. The annual report must update the contact information for the LLP's chief executive office and registered agent.[55] Some states also require updated information on the number of partners currently in the partnership and whether there are any material changes in the information contained in the partnership's qualification statement.

d. Liability of Partners. A partner of an LLP is not personally liable for an obligation of the partnership incurred while the partnership is an LLP, whether arising in contract, tort, or otherwise, by reason of being a partner. This limited liability exists even if the partnership agreement contained inconsistent provisions before making the election to become an LLP.[56] This is the big advantage of an LLP over a general partnership.

e. Applicable Law. State statutes typically provide that the law under which a foreign LLP is formed governs relations among the partners and between

50. RUPA § 101(5).
51. RUPA § 1001(b).
52. RUPA § 1001(c).
53. RUPA § 1001(e).
54. RUPA § 1002.
55. RUPA § 1003.
56. RUPA § 306(c).

the partners and the partnership, and the liability of partners for obligations of the partnership.[57] States require a foreign LLP to file a statement of foreign qualification before transacting business in the state and typically provide that such a statement does not authorize a foreign LLP to engage in any business or exercise any power that a partnership in the state could not engage in or exercise as an LLP.[58] Absent the filing of such statement, a foreign LLP usually cannot maintain an action or proceeding in the state.[59]

f. Professional Service Providers. LLPs are often used by providers of professional services. Licensed partners of a professional provider LLP may be liable under state law for the partnership's debts if the partnership fails to maintain professional insurance coverage required by state law.

3. LIMITED PARTNERSHIPS

A limited partnership is an entity that has one or more general partners ("GP") and one or more limited partners ("LP") and is formed under a state's limited partnership act.[60] GPs have the authority to manage and conduct the business of the partnership and are personally liable for the debts and obligations of the partnership.[61] LPs typically are investors who have limited or minimal control over daily business decisions and operations of the partnership and have no personal liability for the obligations of the partnership beyond their capital contributions to the partnership.[62] If properly organized and managed, the limited partnership form of business organization allows persons to contribute capital to a business enterprise and share in its profits and losses without having liability exposure to the creditors of the business.

Limited partnerships did not exist at common law; they are creatures of state statutory law. The Uniform Limited Partnership Act ("ULPA"), with origins dating back to 1916 and most recently revised in 2001, has served as the basic framework for limited partnership statutes in 49 states. The 2001 version of the ULPA differs from prior versions in two significant respects. First, it no longer "links" its provisions to the Uniform Partnership Act. It is a "stand-alone" act that is considerably longer than the prior versions. Second, its revisions are targeted at those situations where a limited partnership is often the preferred entity form – sophisticated, manager-entrenched commercial deals whose participants commit for the long term and family limited partnerships used for estate planning purposes. The management powers of the GPs are increased; the management role and exit rights of LPs are decreased.

Although the 2001 version is not linked to the Revised Uniform Partnership Act, many state limited partnership acts remain linked to their versions of the Uniform Partnership Act. State adoption of the 2001 stand-alone version proceeds slowly.

57. RUPA § 1101(a).
58. RUPA §§ 1101(c), 1102.
59. RUPA § 1103(a).
60. ULPA §102(11) (2001).
61. ULPA §§ 402, 404 (2001).
62. ULPA §§ 302, 303 (2001).

CASE PROBLEM 2-3

Assume Son and Dad in Case Problem 2-1 form a limited partnership in a state that has adopted the Uniform Limited Partnership Act (2001), with Son as the general partner and Dad as the limited partner.

1. Does Dad have any property rights in Strategy?

2. How will distributions be allocated to Son and Dad if there is no specific agreement between the parties?

3. Would there be limits on the amount of distributions to Son and Dad?

4. Does Dad have the power to bind the enterprise to contracts with third parties? Does Son?

5. What duties do Dad and Son owe each other?

6. Would Dad have any personal liability exposure if Son borrowed $150,000 in the name of OuterNet Company from a local bank, the bank had no knowledge of Dad's involvement, and Dad did not know of the loan?

a. Entity Characteristics

A limited partnership is an entity distinct from its partners and may be organized for any lawful purpose and for a perpetual duration.[63] It has the power to do all things necessary and convenient to carry on its business, including the power to sue, be sued and defend in its own name.[64] The partnership agreement governs the operation of the entity, but, as in the case of a general partnership, there is a list of statutory provisions that cannot be changed by agreement. In most states, such list is substantively identical (or nearly so) to the list applicable to a general partnership,[65] as are the provisions relating to when a person will be deemed to have constructive notice of a fact regarding a limited partnership.[66] The name of the entity must contain the phrase "limited partnership," "L.P.," or "LP."[67]

b. Formation

A limited partnership is formed by filing a certificate of limited partnership with the state's secretary of state. At a minimum, state statutes require the certificate to state: the name of the limited partnership; the street and address of the entity's initial designated office; and the name, street and mailing address of each general partner and the entity's initial registered agent for service of process.[68] A limited partnership is actually formed when the secretary of state files the certificate.[69] Limited partnerships typically are required to file annual reports with the state's secretary of state.

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63. ULPA § 104 (2001).
64. ULPA § 105 (2001).
65. ULPA § 110 (2001).
66. ULPA § 103 (2001).
67. ULPA § 108(b) (2001).
68. ULPA § 201 (2001).
69. ULPA § 201(c) (2001).

c. Rights and Liabilities of GPs and LPs

Agency and Management Authority. An LP has no power to act for or bind the entity.[70] A GP is an agent of the limited partnership with full authority to manage and conduct the affairs of the limited partnership and bind the entity.[71] Each GP has equal management rights, and any matter relating to the entity's activities may be exclusively decided by the GP or, if there is more than one GP, by a majority of the GPs.[72] A GP has the same reimbursement rights for advances and excessive contributions as a partner of a general partnership.[73] Absent a provision in the partnership agreement, a GP is not entitled to any remuneration for services rendered to the partnership.[74]

Liability for Entity Obligations. GPs are jointly and severally liable for the obligations of a limited partnership.[75] LPs have no personal liability for the entity's obligation.[76]

Fiduciary Obligations. A GP has the same duties of loyalty, care, good faith and fair dealing as a partner of a general partnership.[77] An LP has no fiduciary duties to the limited partnership or the other partners, but does have a good faith and fair dealing requirement in exercising rights under the limited partnership agreement.[78]

Dual Capacity Partner. A person may be both a GP and an LP and have the rights, duties and liabilities of each of those capacities.[79]

Information and Inspection Rights. An LP typically has an unlimited right to inspect and copy select core documents (specified by statute) during normal business hours, at an office designated by the entity, and on limited advance notice (normally 10 days). Other LP document requests relating to the activities or financial condition of the entity require a written request that must state a purpose reasonably related to the partnership, describe with particularity the information sought, and demonstrate that the information sought is related to the purpose. The GPs then decide whether to honor the request and may impose restrictions on the use of the information and charge the requesting LP any cost (labor and materials) incurred in connection with the request.[80] A GP has much broader information and inspection rights, being entitled to receive all information and documents reasonably required for the exercise of the GP's management rights and authority.[81]

Contributions. A partner's contribution may consist of tangible and intangible property, including promissory notes, services performed, and services

70. ULPA § 302 (2001).
71. ULPA § 402 (2001).
72. ULPA § 406(a) (2001).
73. ULPA § 406(c),(d),(e) (2001).
74. ULPA § 406(f) (2001).
75. ULPA § 404 (2001).
76. ULPA § 303 (2001).
77. ULPA § 408 (2001).
78. ULPA § 305 (2001).
79. ULPA § 113 (2001).
80. ULPA § 304 (2001).
81. ULPA § 407 (2001).

to be performed. A partner's contribution obligation is not excused by death, disability, or other inability to perform and may be compromised only be the consent of all partners. Any creditor who extends credit in reliance on a contribution obligation of a partner, with no notice that the obligation has been compromised, may enforce the original obligation.[82]

Distributions. Absent a contrary provision in the limited partnership agreement (which usually exists), distributions by a limited partnership are allocated among partners on the basis of the relative value of their contributions to the entity.[83] This default rule is significantly different from the corresponding default rule for general partnerships. A partner has no right to a distribution before the dissolution and winding up of the entity, nor does a partner have the right to demand or receive a distribution in any form other than cash. A limited partnership may elect to make a distribution of an asset in kind so long as each partner receives a proportionate share of the asset based on the partner's share of distributions. A partner who is entitled to receive a distribution under the partnership agreement has the rights of a creditor, subject to offset rights of the partnership for any amounts owed by the partner to the partnership. A limited partnership is prohibited from making a distribution in violation of the partnership agreement.[84]

Transferee Rights and Charging Orders. A state's limited partnership statutory provisions dealing with the "personal property" nature of a partner's interest, the rights to transfer a partnership interest, the rights of a transferee of a partnership interest, and the rights of a partner's creditors to obtain and foreclose on a charging order are usually substantially identical to the corresponding statutory provisions for general partnerships.[85] The personal representative of a deceased limited partner may exercise the rights of a transferee or the rights of an existing limited partner, as applicable.[86]

d. Prohibited Distributions

Statutory Limitations. A limited partnership usually is prohibited from making a distribution if, after the distribution, (1) the entity is unable to pay its debts as they become due in the ordinary course of business or (2) the entity's total assets have a value that is less than the sum of the entity's total liabilities plus the amount of any superior preferable distributions that would be due to other partners if the entity was dissolved and wound up. In applying this limitation, the limited partnership may value its assets based on financial statements prepared in accordance with accounting principles that are reasonable in the circumstances or on a fair valuation of the assets. Any indebtedness issued by a limited partnership to partners as part of a distribution is not considered a liability for purposes of the limitation calculation if, and only if, any payments of principal or interest on such indebtedness are to be made only if they would be permissible distributions at the time made.[87]

82. ULPA §§ 501, 502 (2001).
83. ULPA § 503 (2001).
84. ULPA §§ 504 through 507 (2001).
85. ULPA §§ 701 through 703 (2001).
86. ULPA § 704 (2001).
87. ULPA § 508 (2001).

Related Partner Liabilities. A GP who consents to a distribution that exceeds the statutory limitations on distributions is personally liable to the limited partnership for any excess distribution if it is established that the GP violated a duty of loyalty, care, good faith or fair dealing to the entity. Any partner or transferee who knowingly receives a distribution in excess of the statutory limits is personally liability to the entity for the amount of such excess.[88]

e. Partner Termination (Dissociation)

Limited Partners. Limited partners generally have no power to dissociate from a limited partnership prior to the termination of the limited partnership unless they are granted specific termination rights in the limited partnership agreement.[89] State limited partnership statutes that specify the circumstances in which a limited partner's interest may be terminated usually are substantively identical to the corresponding provisions for terminating a partner's interest in a general partnership.[90] The dissociation of a limited partner's interest terminates the rights of the dissociated partner, but does not terminate the entity, the dissociated partner's duties of good faith and fair dealing, or any obligation that the dissociated partner owes to the partnership or the other partners.[91]

General Partners. A GP may choose to dissociate from a limited partnership at any time, rightfully or wrongfully, by expressed will.[92] State limited partnership statutes that specify the circumstances in which a GP's interest may be terminated usually are substantively identical to the corresponding provisions for terminating a partner's interest in a general partnership.[93] A GP's dissociation is wrongful only if it violates the partnership agreement or, unless the agreement provides otherwise, it occurs before the partnership terminates and the dissociation is due to a voluntary withdrawal, a judicial expulsion, a bankruptcy of the GP, or the GP ceasing to exist as an entity.[94] A GP who wrongfully dissociates is liable to the limited partnership for any damages caused by the dissociation. The dissociation of a GP's interest terminates all managing rights, ongoing duties of loyalty and care, and (with very limited exceptions) the dissociated GP's liability for partnership obligations incurred after the dissociation. A dissociated GP remains personally liable for partnership obligations incurred prior to the dissociation unless the dissociated partner's exposure for a pre-dissociation obligation is eliminated by agreement with the creditor and the other partners or by a material change in the terms of the obligation with the creditor having notice of the dissociation.[95]

f. Dissolution and Winding Up

Triggering Events. Statutory provisions generally provide that a limited partnership must be dissolved and wound up on: (1) the occurrence of a

88. ULPA § 509 (2001).
89. ULPA § 601(a) (2001).
90. ULPA § 601(b) (2001).
91. ULPA § 602 (2001).
92. ULPA § 604(a) (2001).
93. ULPA § 603 (2001).
94. ULPA § 604(b) (2001).
95. ULPA § 607 (2001).

dissolution event specified in the partnership agreement; (2) the consent of all the GPs and LPs who own a majority of the distribution rights; (3) the dissociation of a GP with at least one remaining GP, and LPs who own a majority of distribution rights consent to the dissolution; (4) the dissociation of a GP with no remaining GP, unless within 90 days a GP is admitted and LPs who own a majority of distribution rights consent to continue business activities; (5) 90 days after the dissociation of the last LP, unless a new LP is admitted during such period; (6) a declaration of dissolution by the state's secretary of state for failure to file an annual report or pay required fees; or (7) by order of a court based on a determination that it is not reasonably practicable to carry on the activities of the limited partnership in accordance with the partnership agreement.[96]

Impacts. The statutory impacts of winding up a limited partnership are very similar to those of a general partnership with the clarification that if the entity does not have a GP, LPs who own a majority of the distribution rights may appoint a person to wind up and dissolve the entity. A GP who causes a limited partnership to incur inappropriate obligations during a winding up is liable to the limited partnership for such obligations.[97]

g. Litigation Rights

Some state statutes specifically authorize a partner of a limited partnership to bring a direct action against the partnership or other partners for legal or equitable relief to enforce the partner's rights under the partnership agreement or applicable law. The partner must plead and prove an actual or threatened injury to the partner, not the partnership. A right to an accounting upon a dissolution and winding up does not revive a claim barred by law.[98] Such statutes also usually permit a limited partner to maintain a derivative action on behalf of the limited partnership only if (1) the partner first makes a demand on GP's to bring the action or pleads with particularity why such a demand would be futile and (2) any recovery from the litigation is paid to the limited partnership. If such a derivative action is successful, the court may award a reimbursement of the plaintiff's attorney fees and costs from the recovery.[99]

4. LIMITED LIABILITY LIMITED PARTNERSHIPS

The limited liability limited partnership ("LLLP") is to a limited partnership what an LLP is to a general partnership. Its role is to eliminate the personal liability exposure that general partners have for the obligations of a limited partnership. It's a relatively new entity form that has been adopted in roughly half the states.

The LLLP statutory provisions are additions to each state's version of the Uniform Limited Partnership Act that mirror the LLP additions to the state's version of the Uniform Partnership Act. They include statutory requirements to elect LLLP status in the limited partnership's filed certificate[100] and use of a

96. ULPA §§ 801, 802 (2001).
97. ULPA §§ 803 through 805 (2001).
98. ULPA § 1001 (2001).
99. ULPA §§ 1002 through 1004 (2001).
100. ULPA § 201(a)(4) (2001).

name that includes the phrase "limited liability limited partnership," "LLLP," or "L.L.L.P."[101]

With LLLP status, a general partner is not personally liable for an obligation of the limited partnership incurred while the partnership is an LLLP, whether arising in contract, tort, or otherwise. This limited liability exists even if the partnership agreement contained inconsistent provisions before making the election to become an LLLP.[102]

5. LIMITED LIABILITY COMPANIES

CASE PROBLEM 2-4

Assume Son and Dad in Case Problem 2-1 form a limited liability company in a state that has adopted the Revised Uniform Limited Liability Company Act. How would you answer questions 1 through 6 of Case Problem 2-3 if the LLC is a member-managed LLC? How would your answers change if the LLC is a manager-managed LLC with Son as the manager?

a. LLC Characteristics

The limited liability company ("LLC") has emerged as the most popular form of non-corporate entity. It offers limited liability protection for the LLC's members and the flexibility of having an entity that is managed by designated managers or by the members generally. The framework for state LLC laws is the Uniform Limited Liability Company Act, originally adopted in 1995 and most recently amended in 2006.

A limited liability company is an entity distinct from its members and may be organized for any lawful purpose and for a perpetual duration.[103] It has the power to do all things necessary and convenient to carry on its business, including the power to sue, be sued and defend in its own name.[104] The LLC operating agreement governs: the relations among the members as members and between the members and the limited liability company; the rights and duties of a person in the capacity of manager; the activities of the company and the conduct of those activities; and the means and conditions for amending the operating agreement.[105]

As in the case of a partnership or limited partnership, there is a list of statutory provisions that cannot be changed by agreement. In most states, such list is similar in many respects to the list applicable to partnerships.[106] The name of the entity must contain the phrase "limited liability company," "limited company," "L.L.C.," "LLC," "L.C.," or "LC." The word "limited" may be abbreviated as "Ltd," and "company" may be abbreviated as "Co."[107]

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101. ULPA § 108(c) (2001).
102. ULPA § 404(c)(2001).
103. RULLCA § 104
104. RULLCA § 105
105. RULLCA § 110(a).
106. RULLCA § 110(c).
107. RULLCA § 108(a).

b. Formation

A limited liability company is formed by one or more organizers filing a certificate of organization with the state's secretary of state. At a minimum, state statutes require the certificate to state: the name of the LLC; the street and address of the entity's initial designated office; the name, street and mailing address of the LLC's initial registered agent for service of process; and a statement that the LLC has no members if there are no members at time of filing.[108] If the LLC certificate states there are no members at time of filing, the certificate will lapse and be void if, within 90 days of filing, a follow-up filing is not made confirming that the LLC has at least one member.[109] An LLC is actually formed when the secretary of state files the certificate and the LLC has at least one member.[110] LLCs typically are required to file annual reports with the state's secretary of state.

c. Operating Agreement Limiting Provisions

State statutes often provide that, if not manifestly unreasonable, an LLC's operating agreement may:[111]

1. Restrict or eliminate a member's duty of loyalty.

2. Identify specific types or categories of activities that do not violate the duty of loyalty.

3. Alter the duty of care, except to authorize intentional misconduct or a known violation of law.

4. Alter any other fiduciary duty, including eliminating particular aspects of that duty.

5. Prescribe the standards by which to measure the performance of the obligations of good faith and fair dealing.

6. Specify the method by which a specific act or transaction that would otherwise violate the duty of loyalty may be authorized or ratified by one or more disinterested and independent persons after full disclosure of all material facts.

7. Eliminate or limit any fiduciary duty that would have pertained to a responsibility that a member has been relieved of under the LLC operating agreement.

8. Alter or eliminate any indemnification rights of a member or manager.

9. Eliminate or limit a member or manager's liability to the LLC and members for money damages, except for a breach of the duty of loyalty, a financial benefit received by a member or manager to which the member or manager is not entitled, a breach of a duty for unauthorized distributions, intentional infliction of harm on the company or a member, or an intentional violation of criminal law.

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108. RULLCA § 201(b).
109. RULLCA § 201(e)(1).
110. RULLCA § 201(d)(1).
111. RULLCA § 110.

d. Agency and Management Authority

A member is not an agent of an LLC by reason of being a member.[112] An LLC is deemed to be a member-managed LLC unless the operating agreement expressly provides that it will be "manager-managed" or includes words of similar import.[113]

Member-Managed LLC. In a member-managed LLC: the management and conduct of the company are vested in the members; each member has equal rights in the management and conduct of the company's activities; any difference arising among members as to a matter in the ordinary course of the activities of the LLC may be decided by a majority of the members; an act outside the ordinary course of the activities of the LLC may be undertaken only with the consent of all members; and the operating agreement may be amended only with the consent of all members.[114]

Manager-Managed LLC. In a manager-managed LLC: any matter relating to the activities of the company is decided exclusively by the managers unless a statute specifically provides otherwise; each manager has equal rights in the management and conduct of the activities of the LLC; and a difference arising among managers as to a matter in the ordinary course of the activities of the LLC may be decided by a majority of the managers. Also, consent of all members is required to: sell or otherwise dispose of all, or substantially all, of the company's property; approve a merger, conversion, or domestication; undertake any other act outside the ordinary course of the company's activities; and amend the operating agreement.[115]

Manager Selection and Removal. A manager may be chosen at any time by the consent of a majority of the members and remains a manager until a successor has been chosen, unless the manager at an earlier time resigns, is removed, or dies, or, in the case of a manager that is not an individual, ceases to exist. A manager may be removed at any time by the consent of a majority of the members without notice or cause.[116] A person need not be a member to be a manager, but the dissociation of a member who is also a manager removes the person as a manager. If a person who is both a manager and a member ceases to be a manager, that cessation does not by itself dissociate the person as a member.[117] A person who wrongfully causes dissolution of the company loses the right to participate in management as a member and a manager.[118]

Written Consent. An action requiring the consent of members may be taken without a meeting by use of a written consent. A member may appoint a proxy or other agent to consent or otherwise act for the member.[119]

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112. RULLCA § 301(a).
113. RULLCA § 407(a).
114. RULLCA § 407(b).
115. RULLCA § 407(c).
116. RULLCA § 407(c)(5).
117. RULLCA § 407(c)(6).
118. RULLCA § 407(e).
119. RULLCA § 407(d).

Compensation. A member is not entitled to remuneration for services performed for a member-managed LLC, except for reasonable compensation for services rendered in winding up the activities of the company.[120]

Indemnification. An LLC must reimburse for any payment made and indemnify for any debt, obligation, or other liability incurred by a member of a member-managed company or the manager of a manager-managed company in the course of the member's or manager's activities on behalf of the LLC unless the action involved a violation of a fiduciary duty or a prohibited distribution.[121]

Insurance. A limited liability company may purchase and maintain insurance on behalf of a member or manager of the LLC against liability asserted against or incurred by the member or manager.[122]

Statement of Authority. An LLC may file a statement (good for five years) with the secretary of state (or, in the case of real estate, with the county recorder) which states the authority, or limitations on the authority, of specific persons to enter into transactions on behalf of the LLC. Such grant of authority is conclusive in favor of a third party who gives value in reliance of the statement.[123] A person named in any such statement may file a written denial of the person's authority.[124]

e. LLC Member Rights and Duties

Liability for Entity Obligations. LLC members have no personal liability for the entity's obligation, whether arising in contract, tort or otherwise. The failure of an LLC to observe any particular formalities relating to the exercise of its powers or management of its activities is not a ground for imposing liability on the members or managers for the debts, obligations, or other liabilities of the LLC.[125]

Fiduciary Obligations in Member-Managed LLC. A member of a member-managed LLC owes to the LLC and other members a duty of loyalty to: account to the LLC and to hold as trustee for it any property, profit, or benefit derived by the member in the conduct or winding up of the company's activities; refrain from dealing with the LLC as or on behalf of a person having an interest adverse to the company (subject to a defense of fairness to the LLC); and refrain from competing with the LLC. All members may authorize or ratify, after full disclosure of all material facts, a specific act or transaction that otherwise would violate this duty of loyalty. Such member also has a contractual obligation of good faith and fair dealing and, subject to the business judgment rule, has a duty of care to act with the care that a person in a like position would reasonably exercise under similar circumstances and in a manner the member reasonably believes to be in the best interests of the LLC. In discharging this duty, a member may rely in good faith upon opinions, reports, statements, or other information provided by another person that the member reasonably believes is a competent

120. RULLCA § 407(f).
121. RULLCA § 408(a).
122. RULLCA § 408(b).
123. RULLCA § 302.
124. RULLCA § 303.
125. RULLCA § 304.

and reliable source for the information.[126]

Fiduciary Duties in Manager-Managed LLC. In a manager-managed LLC, members do not have any fiduciary duties to the LLC by reason of being a member, but do have a contractual obligation of good faith and fair dealing. Managers have the fiduciary duties of loyalty and care described above, along with a contractual obligation of good faith and fair dealing. Any approval or ratification of an act that violates the duty of loyalty requires the approval of all members.[127]

Information and Inspection Rights. In a member-managed LLC, a member typically has unlimited document inspection rights relating to the LLC's activities and financial condition. In a manager-managed LLC, such rights are reserved to the managers, and members must submit an inspection request that states a purpose material to the member's interests in the LLC, describes with particularity the information sought, and demonstrates that the information sought is related to the purpose. The LLC may then decide whether to honor the request, impose restrictions on the use of the information, and charge the requesting member the costs (labor and materials) incurred in connection with the request.[128]

Contributions. An LLC member's contribution may consist of tangible and intangible property, including promissory notes, services performed, and services to be performed. A member's contribution obligation is not excused by death, disability, or other inability to perform and may be compromised only by the consent of all members. Any creditor who extends credit in reliance on a contribution obligation of a member, with no notice that the obligation has been compromised, may enforce the original obligation.[129]

Distributions. Absent a contrary provision in the LLC operating agreement (which usually exists), distributions by an LLC prior to a dissolution and winding up must be in equal shares among the members. A member has no right to a distribution before the dissolution and winding up of the entity, nor does a member have the right to demand or receive a distribution in any form other than money. An LLC may elect to make a distribution of an asset in kind so long as each member receives a proportionate share of the asset based on the member's share of distributions. A member who is entitled to receive a distribution under the operating agreement has the rights of a creditor.[130]

Transferee Rights and Charging Orders. A state's LLC statutory provisions dealing with the "personal property" nature of a member's LLC interest, the rights to transfer an LLC interest, the rights of a transferee of an LLC interest, and the rights of an LLC member's creditors to obtain and foreclose on a charging order are usually substantially identical to the corresponding statutory provisions for partnerships. The personal representative of a deceased member may exercise the rights of a transferee or the rights of an existing member, as

126. RULLCA § 409(a)-(f).
127. RULLCA § 409(g).
128. RULLCA § 410.
129. RULLCA §§ 402, 403.
130. RULLCA §§ 404. RULLCA § 406.

applicable.[131]

f. Prohibited Distributions

Statutory Limitations. An LLC usually is prohibited from making a distribution if, after the distribution, (1) the entity in unable to pay its debts as they become due in the ordinary course of business or (2) the entity's total assets have a value that is less than the sum of the entity's total liabilities plus the amount of any superior preferable distributions that would be due to other partners if the entity was dissolved and wound up. In applying this limitation, the LLC may value its assets based on financial statements prepared in accordance with accounting principles that are reasonable in the circumstances or on a fair valuation of the assets. Any indebtedness issued by an LLC to members as part of a distribution is not considered a liability for purposes of the limitation calculation if, and only if, any payments of principal or interest on such indebtedness are to be made only if they would be permissible distributions at the time made.[132]

Related Member and Manager Liabilities. A member of a member-managed LLC or a manager of a manager-managed LLC who consents to a distribution that exceeds the statutory limitations on distributions is personally liable to the LLC for any excess distribution if it is established that the member or manager violated a duty of loyalty, care, good faith or fair dealing to the entity. A person who knowingly receives a distribution in excess of the statutory limits is personally liable to the entity for the amount of such excess.[133]

g. Member Dissociation

Dissociation Rights. A member may choose to dissociate from an LLC at any time, rightfully or wrongfully, by expressed will. State LLC statutes that specify the circumstances in which a member's interest may be terminated usually are very similar to the corresponding provisions for terminating a partner's interest in a general partnership. A member's dissociation is wrongful only if it violates the LLC agreement or, unless the agreement provides otherwise, it occurs before the LLC terminates and the dissociation is due to a voluntary withdrawal, a judicial expulsion, a bankruptcy of the member, or the member being dissolved or terminated. A member who wrongfully dissociates is liable to the LLC and to other members for any damages caused by the dissociation.[134]

Dissociation Impacts. The dissociation of a member interest terminates all managing rights, and, if the LLC is member-managed, all ongoing duties of loyalty and care end with regard to matters arising after the dissociation.[135]

h. Dissolution and Winding Up

Triggering Events. Statutory provisions generally provide that an LLC

131. RULLCA §§ 501 through 504.
132. RULLCA § 405.
133. RULLCA § 406.
134. RULLCA §§ 601, 602.
135. RULLCA § 603.

must be dissolved and wound up on: (1) the occurrence of a dissolution event specified in the LLC operating agreement; (2) the consent of all the members; (3) the passage of 90 days during which the LLC has no members; and (4) the entry of a court order dissolving the LLC on grounds that the LLC's activities are illegal or cannot be carried on in a reasonably practicable manner in accordance with the partnership agreement or that the managers or members in control have acted illegally or fraudulently or in an oppressive manner that has directly harmed the member initiating the proceeding.[136]

Winding Up. A dissolved LLC continues after dissolution only for the purpose of winding up. In winding up its activities, an LLC must discharge its debts and obligations, settle and close the LLC's activities, and marshal and distribute the assets of the LLC. It may deliver to the secretary of state a statement of dissolution, preserve the LLC's activities and property as a going concern for a reasonable time, prosecute and defend actions and proceedings, transfer the LLC's property, settle disputes by mediation or arbitration, file a statement of termination stating that the LLC is terminated, and take all other action necessary or appropriate to wind up the LLC. If a dissolved LLC has no members, the legal representative of the last person to have been a member may wind up the activities of the company.[137]

Notices Barring Claims. A dissolved LLC may notify its known creditors of the dissolution, specifying the required information and mailing address for a claim, stating the deadline for receipt of the claim (not less than 120 days after receipt of the notice date), and indicating that a claim will be barred if not received by the deadline. A claim against an LLC is barred if the notice is given and the claim is not received by the specified deadline. A timely received claim will be barred if the LLC rejects the claim and the claimant does not commence an action within 90 days of being notified of the rejection and the 90 day deadline for commencing an action.[138] In addition, a dissolved LLC may publish notice of its dissolution and request persons having claims against the LLC to present the claims in accordance with the notice, stating that a claim against the LLC will be barred if an enforcement action is not taken within five years to enforce the claim. If the notice is published in accordance with the statutory requirements, an unenforced claim not previously barred will be barred after such five-year period.[139]

Enforcement of Claims. A claim that has not been barred may be enforced against a dissolved LLC to the extent of its undistributed assets and, if assets of the LLC have been distributed after dissolution, against a member or transferee, but a person's total liability for such claims may not exceed the total amount of assets distributed to the person after dissolution.[140]

Final Distributions. After discharging its obligations to creditors, a dissolved LLC must first distribute any surplus proportionately to persons

136. RULLCA § 701.
137. RULLCA § 702.
138. RULLCA § 703.
139. RULLCA § 704.
140. RULLCA § 704(d).

owning a transferable interest based on the amount of their respective unreturned contributions and then distribute any remaining surplus in equal shares among members and dissociated members. All distributions must be paid in money.[141]

i. Litigation Rights

State statutes usually authorize a member of an LLC to bring a direct action against the LLC or other members for legal or equitable relief to enforce the partner's rights under the operating agreement or applicable law. The member must plead and prove an actual or threatened injury to the member, not just the LLC.[142]

Such statutes also typically permit a member to maintain a derivative action on behalf of the LLC if (1) the member first makes a demand on the manager in a manager-managed LLC, or the other members in a member-managed LLC to bring the action or pleads with particularity why such a demand would be futile and (2) any recovery from the litigation is paid to the LLC. If such a derivative action is successful, the court may award a reimbursement of the plaintiff's attorney fees and costs from the recovery.[143] Some statutes specifically authorize an LLC to appoint a special litigation committee made up of independent, disinterested persons (who may be members) to represent the interests of the LLC in a derivative proceeding.[144]

j. Mergers

State statutes generally authorize the merger of an LLC with another LLC, a partnership, a limited partnership, or a corporation, domestic or foreign.[145] Usually such merger statutes are patterned after the state's corporate merger statutes.

Documents and Process. A plan of merger must be approved by the members. The plan of merger usually sets forth the name of each party to the merger and the name of the surviving entity, the terms and conditions of the merger, the manner and basis of converting interests in each merging entity into the surviving entity or into cash or other property, and any required amendment's to the surviving entity's organizational documents.[146] Absent specific provisions in the governing LLC agreement, the plan must be approved by all members of the LLC.[147] Following approval of the plan of merger, the surviving entity files the articles of merger with the appropriate secretary of state offices. The articles of merger set forth, among other things: the plan of merger; the date the merge is effective; a statement that the merger was approved by each party to the merger as required by its governing statute; and any other information required by the governing statute of any party to the merger.[148]

Effect of Merger. Following the filing of the articles of merger, all entities

141. RULLCA § 708.
142. RULLCA § 901.
143. RULLCA §§ 902-904, 906.
144. RULLCA § 905.
145. RULLCA § 1002.
146. RULLCA § 1002(b).
147. RULLCA § 1002.
148. RULLCA § 1004.

that were parties to the merger, other than the surviving entity, cease to exist. Title to all property previously owned by each merged entity vests in the surviving entity, and the surviving entity is responsible for all liabilities of all other entities in the merger. If there is a legal proceeding pending against any party to the merger, it may either be continued as if the merger did not occur or the surviving entity may be substituted as the party in the proceeding. The governing instrument of the surviving entity (whether a certificate of formation, a certificate of limited partnership, or articles of incorporation) is deemed amended to the extent provided in the plan of merger.[149]

C. ENTITY FORMATION CHALLENGES

1. UNDEFINED, UNDOCUMENTED PARTNERSHIPS

CASE PROBLEM 2-5

There are three components to a golf club; the grip, the shaft, and the head. Tool Swing Inc. ("Tool"), owned by Pete Mack, is a specialty manufacturer of clubs. Many around Pete consider him "rich."

Duke, Pete's neighbor, is a struggling scientist. Pete describes Duke as "a materials nut who has never swung a golf club but who has developed the perfect plastic composite for a golf grip." Pete claims that Duke's grip produces a "feel" unlike anything on the market, weighs "virtually nothing," and has a natural "tackiness" that assures no slippage in rain or in the toughest competition.

Pete calls Duke's discovery the "Ghost Grip". With Duke's permission, Pete has tested the "Ghost Grip" with 30 top professionals. All of the professionals enthusiastically endorsed the grip on the spot and requested permission to use it on their clubs.

Pete provided Duke $62,000 to cover third-party expenses incurred in developing the Ghost Grip. Pete also paid an additional $24,000 to test the grip with industry experts and professionals. Duke has always provided Pete with an accounting for all sums spent and has regularly asked Pete about documenting the money advances. Pete would always respond by saying, "Let's not get tangled up in paperwork now. Once this thing is perfected, I will take it to the moon, and we will both make a killing."

Pete and Duke never signed any document or discussed the specifics of their relationship.

Last Monday, Duke visited Pete's home and delivered Pete a check for $92,000. The memo on the check read, "Loan repayment in full, plus interest at a rate of 12% per annum." Duke thanked Pete and explained that he had just sold all rights in the Ghost Grip to Nike for $7.8 million. Pete went berserk and mutilated the check in a rage.

Was a partnership created between Duke and Pete? What additional facts

149. RULLCA § 1005.

might help in making a determination? If a partnership was created, what are Pete's rights?

HOLMES v. LERNER

88 Cal.Rptr.2d 130 (Cal.App. 1999)

MARCHIANO, J.

This case involves an oral partnership agreement to start a cosmetics company known as "Urban Decay." Patricia Holmes prevailed on her claim that Sandra Kruger Lerner breached her partnership agreement and that David Soward interfered with the Holmes-Lerner contract, resulting in Holmes's ouster from the business. Lerner and Soward appeal from the judgment finding them liable to Holmes for compensatory and punitive damages of over $1 million. Holmes appeals from the portion of the judgment imposing joint and several liability for the award of compensatory damages, and the court's order granting a nonsuit on various causes of action against Soward.

Sandra Lerner is a successful entrepreneur and an experienced business person. By the time of trial in this matter, Lerner was extremely wealthy. Patricia Holmes met Lerner in late 1993, when Lerner visited Holmes's horse training facility to arrange for training and boarding of two horses that Lerner was importing from England.

On July 31, 1995, the two women returned from England and stayed at Lerner's West Hollywood condominium while they waited for the horses to clear quarantine. While sitting at the kitchen table, they discussed nail polish, and colors. Len Bosack, Lerner's husband, was in and out of the room during the conversations. For approximately an hour and a half, Lerner and Holmes worked with the colors in a nail kit to try to create a different shade of purple. Holmes then said that she wanted to call the purple color she had made "Plague." Holmes had been reading about 16th-century England, and how people with the plague developed purple sores, and she thought the color looked like the plague sores. Lerner and Holmes discussed the fact that the names they were creating had an urban theme, and tried to think of other names to fit the theme. Len Bosack walked into the kitchen at that point, heard the conversation about the urban theme, and said "What about decay?" The two women liked the idea, and decided that "Urban Decay" was a good name for their concept.

Lerner said to Holmes: "This seems like a good [thing], it's something that we both like, and isn't out there. Do you think we should start a company?" Holmes responded: "Yes, I think it's a great idea." Lerner told Holmes that they would have to do market research and determine how to have the polishes produced, and that there were many things they would have to do. Lerner said: "We will hire people to work for us. We will do everything we can to get the company going, and then we'll be creative, and other people will do the work, so we'll have time to continue riding the horses." Holmes agreed that they would do those things. They did not separate out which tasks each of them would do, but planned to do it all together.

Although neither of the two women had any experience in the cosmetics

business, they began work on their idea immediately. In early August, they met with a graphic artist, Andrea Kelly, and discussed putting together a logo and future advertising work for Urban Decay.

Prior to the first scheduled August meeting, Holmes told Lerner she was concerned about financing the venture. Lerner told her not to worry about it because Lerner thought they could convince Soward that the nail polish business would be a good investment. She told Holmes that Soward took care of Lerner's investment money. Holmes and Lerner discussed their plans for the company, and agreed that they would attempt to build it up and then sell it. Lerner and Holmes discussed the need to visit chemical companies and hire people to handle the daily operations of the company. However, the creative aspect, ideas, inspiration, and impetus for the company came from Holmes and Lerner.

On January 11, 1996, Lerner and Holmes met at a coffee shop. Holmes explained that she wanted “something in writing” and an explanation of her interest and position in the company. Lerner responded that a start-up business is “like a freight train ... you can either run and catch up, and get on, and take a piece of this company and make it your own, or get out of the way.” As a result of this conversation, Holmes decided to double her efforts on behalf of Urban Decay. Because she was most comfortable working at the warehouse, she focused on that aspect of the business. Holmes was reimbursed for mileage, but received no pay for her work.

During January and February, Urban Decay was launching its new nail polish product. Publicity included press releases, brochures, and newspaper interviews with Lerner. An early press release stated: “The idea for Urban Decay was born after Lerner and her horse trainer, Pat Holmes, were sitting around in the English countryside.” Lerner approved the press release. In February of 1996, an article was printed in the San Francisco Examiner containing the following quotes from Lerner. “Since we couldn't find good nail polish, in cool colors there must be a business opportunity here. Pat had the original idea. Urban Decay was my spin.” The Examiner reporter testified at trial that the quote attributed to Lerner was accurate. Lerner was also interviewed in April by CNN. In that interview she told the story of herself and Holmes looking for unusual colors, mixing their own colors at the kitchen table, and that “we came up with the colors, and it just sort of suggested the urban thing.”

Lerner had always notified Holmes whenever there was a board meeting, and she sent Holmes an agenda for the February 20, 1996 meeting. Lerner also sent a memo stating that she thought they should have an “operations meeting“ with the warehouse supervisor first. Lerner's memo continued: “and then have a regular board meeting, including [Zomnir], me, David, and Pat, and no one else.” Holmes understood that the regular board meeting would be for the purpose of discussing general Urban Decay business. At the operations meeting, Holmes made a presentation regarding the warehouse operations. The financial report showed $205,000 in revenues and $431,000 in expenses. The “directors” thought this early sales figure was “terrific.” Soward handed out an organizational chart, which showed Lerner, with the title “CEO” at the top; Soward, as “President” beneath her; and Zomnir, as “COO” beneath Soward. Holmes asked “Where am

I?" Lerner responded by pointing to the top of the chart and telling Holmes that she was a director, and was at the top of the chart, above all the other names.

In March of 1996, Holmes received a document from Soward offering her a 1 percent ownership interest in Urban Decay. Soward explained that Urban Decay had been formed as a limited liability company, which was owned by its members. For the first time, Holmes realized that Lerner and Soward had produced an organizational document that did not include her, and she was now being asked to become a minor partner. When she studied the document, she discovered that it referred to an exhibit A, which was purported to show the distribution of ownership interests in Urban Decay. Soward had given Zomnir a copy of exhibit A when he offered her an ownership interest in Urban Decay. However, when Holmes asked Soward for a copy of exhibit A, he told her it did not exist. By this time, Holmes was planning to consult an attorney about the document.

Despite the deterioration of her friendship with Lerner, and her strained relationship with Soward, Holmes continued to attend the scheduled board meetings, hoping that her differences with Lerner could be resolved. She also continued to work at the warehouse on various administrative projects and on direct mail order sales. As late as the April board meeting, Holmes was still actively engaged in Urban Decay business. She made a presentation on a direct mail project she had been asked to undertake. As a result of Holmes's attendance at a sales presentation when she referred to herself as a cofounder of Urban Decay, Lerner instructed Zomnir to draft a dress code and an official history of Urban Decay. Lerner told Zomnir that it was a "real error in judgment" to allow Holmes to attend the sales presentation because she did not project the appropriate image. The official history, proposed in the memo, omitted any reference to Holmes. Finally, matters deteriorated to the point that Soward told Holmes not to attend the July board meeting because she was no longer welcome at Urban Decay.

On August 27, 1996, Holmes filed a complaint against Lerner and Soward, alleging 10 causes of action, including breach of an oral contract, intentional interference with contractual relations, fraud, breach of fiduciary duty, and constructive fraud. Holmes eventually dismissed some of her claims and the court dismissed others. At the trial, cosmetics industry expert Gabriella Zuckerman testified that Urban Decay was not just a fad. In her opinion, Urban Decay had discovered and capitalized on a trend that was just beginning. She reviewed projected sales figures of $19.9 million in 1997, going up to $52 million in 2003, and found them definitely obtainable. Arthur Clark, Holmes's expert at valuing start-up businesses, valued Urban Decay under different risk scenarios. In Clark's opinion, the value of Urban Decay to a potential buyer was between $4,672,000 and $6,270,000. Lerner's expert, who had never valued a cosmetics company, testified that Urban Decay had $2.7 million in sales in 1996. He estimated the value of Urban Decay as approximately $2 million, but concluded that it was not marketable.

Lerner and Soward claimed that Holmes was never a director, officer, or even an employee of Urban Decay. According to Lerner, she was just being nice

to Holmes by letting her be present during Urban Decay business. Lerner denied Holmes had any role in creating the colors, names, or concepts for Urban Decay. When Holmes asked Lerner about her assets and liabilities in Urban Decay, Lerner thought she was asking for a job. She explained her statements to the press regarding Urban Decay being Holmes's idea as misquotes or the product of her stress.

The jury found in favor of Holmes on every cause of action. The jury assessed $480,000 in damages against Lerner, and $320,000 against Soward. Following presentation of evidence as to net worth, the jury awarded punitive damages of $500,000 against Lerner and $130,000 against Soward. In the judgment, the court declined to add the two amounts together, but stated that the verdict of $320,000 was against Lerner and Soward, jointly and severally, and that the additional $160,000 verdict was against Lerner individually. Lerner and Soward moved for a judgment notwithstanding the verdict, which was denied on December 16, 1997.

Lerner and Soward argue that there was no partnership agreement as a matter of law, that the evidence was insufficient to support the fraud judgment against Lerner, that damages were incorrectly calculated, that the evidence does not support the judgment against Soward and that the judgment for punitive damages must be reversed. In the consolidated appeal, Holmes argues that the trial court erred in granting a nonsuit on various causes of action and in awarding a lesser amount of damages than was reflected in the jury verdict.

Holmes testified that she and Lerner did not discuss sharing profits of the business during the July 31, "kitchen table" conversation. Throughout the case, Lerner and Soward have contended that without an agreement to share profits, there can be no partnership.

The UPA provides for the situation in which the partners have not expressly stated an agreement regarding sharing of profits. Former section 15018 provided in relevant part: "The rights and duties of the partners in relation to the partnership shall be determined, subject to any agreement between them, by the following rules: (a) Each partner shall ... share equally in the profits and surplus remaining after all liabilities, including those to partners, are satisfied." This provision states, subject to an agreement between the parties, partners "shall" share equally in the profits. Lerner and Soward argue that using former section 15018 to supply a missing term regarding profit sharing ignores the provision of former section 15007, subdivision (2). That section, headed "rules for determining existence of partnership," provided that mere joint ownership of common property "does not of itself establish a partnership, whether such co-owners do or do not share any profits made by the use of the property." Lerner and Soward are mistaken. The definition in former section 15006 provides that the association with the intent to carry on a business for profit is the essential requirement for a partnership. Following that definition does not transform mere joint ownership into the essence of a partnership.

The trial court in this case refused to add additional elements to the statutory definition and properly instructed the jury in the language of former section

15006. We agree with the trial court's interpretation of the law. The actual sharing of profits (with exceptions which do not apply here) is prima facie evidence, which is to be considered, in light of any other evidence, when determining if a partnership exists. In this case, there were no profits to share at the time Holmes was expelled from the business, so the evidentiary provision of former section 15007, subdivision (4) is not applicable. According to former section 15006, parties who expressly agree to associate as co-owners with the intent to carry on a business for profit, have established a partnership. Once the elements of that definition are established, other provisions of the UPA and the conduct of the parties supply the details of the agreement. Certainly implicit in the Holmes-Lerner agreement to operate Urban Decay together was an understanding to share in profits and losses as any business owners would. The evidence supported the jury's implicit finding that Holmes birthed an idea which was incubated jointly by Lerner and Holmes, from which they intended to profit once it was fully matured in their company.

Lerner and Soward argue that the agreement between Lerner and Holmes was too indefinite to be enforced. The cases they rely on do not support the argument. For example, in *Weddington Productions*, *Inc*. v. *Flick* (1998) 60 Cal.App.4th 793 [71 Cal.Rptr.2d 265], the court reversed an order enforcing a settlement agreement imposed by a mediator against the will of one of the parties. The issue was the lack of a meeting of the minds as to settlement. The court described the degree of certainty that is necessary to enforce a contract. "The parties' outward manifestations must show that the parties all agreed upon the same thing in the same sense. If there is no evidence establishing a manifestation of assent to the 'same thing' by both parties, then there is no mutual consent to contract and no contract formation." 60 Cal.App.4th at p. 811.) "The terms of a contract are reasonably certain if they provide a basis for determining the existence of a breach and for giving an appropriate remedy." *Ibid.* The evidence produced at trial in this case supplied the requisite degree of certainty described in *Weddington*.

The agreement between Holmes and Lerner was to take Holmes's idea and reduce it to concrete form. They decided to do it together, to form a company, to hire employees, and to engage in the entire process together. The agreement here, as presented to the jury, was that Holmes and Lerner would start a cosmetics company based on the unusual colors developed by Holmes, identified by the urban theme and the exotic names. The agreement is evidenced by Lerner's statements: "We will do ... everything," "[i]t's going to be our baby, and we're going to work on it together." Their agreement is reflected in Lerner's words: "We will hire people to work for us." "We will do ... everything we can to get the company going, and then we'll be creative, and other people will do the work, so we'll have time to continue riding the horses." The additional terms were filled in as the two women immediately began work on the multitude of details necessary to bring their idea to fruition. The fact that Holmes worked for almost a year, without expectation of pay, is further confirmation of the agreement. Lerner and Soward never objected to her work, her participation in board meetings and decision making, or her exercise of authority over the retail warehouse operation. Holmes was not seeking specific enforcement of a single vague term of the

agreement. She was frozen out of the business altogether, and her agreement with Lerner was completely renounced. The agreement that was made and the subsequent acts of the parties supply sufficient certainty to determine the existence of a breach and a remedy.

Non-Partnership Arrangements

A "partnership" will be deemed to exist when there is association of two or more persons who carry on a business as co-owners for profit, whether or not they intend to form a partnership. Property co-ownership alone doesn't meet the definition. Thus, a joint tenancy, tenancy in common, tenancy by the entireties, joint property, or common property arrangement generally is not deemed a partnership even if the co-owners share profits made by the use of the property. Similarly, an arrangement to share gross returns, even when the sharing parties have a joint or common interest in the property that generates the returns, doesn't rise to the level of a partnership. Under the Revised Uniform Partnership Act, a person who receives a share of the profits from a business is presumed to be a partner, but not if the profits are received in payment:

- of a debt by installments or otherwise.
- for services as an independent contractor or of wages or other compensation to an employee.
- of rent.
- of an annuity or other retirement or health benefit to a beneficiary, representative, or designee of a deceased or retired partner.
- of interest or other charge on a loan, even if the amount of payment varies with the profits of the business.
- for the sale of the goodwill of a business or other property by installments or otherwise.

2. DE FACTO ORGANIZATION DOCTRINE

IN RE HAUSMAN

858 N.Y.S.2d 330 (N.Y.A.D. 2008)

WILLIAM F. MASTRO, J.P.

In a probate proceeding in which the executor petitioned to determine the validity of a deed executed by the decedent, Lena Hausman, the appeal is from an order of the Surrogate's Court, Kings County (Seddio, S.), dated May 11, 2007, which granted the petition to the extent of deeming the deed to be valid.

ORDERED that the order is reversed, on the law, with costs, the petition is denied, and the deed is deemed invalid.

On October 16, 2000, the late Lena Hausman (hereinafter the decedent) executed a will dividing her residuary estate between her son George Hausman (hereinafter George), her daughter Susan Ruth Bersani (hereinafter Susan), and seven of her grandchildren. At the time she executed her will, the decedent was

the owner of real property located at 1373 56th Street in Brooklyn. Almost one year later, on October 4, 2001, George Hausman (hereinafter George) executed articles of organization to form 1373 Realty Co. LLC (hereinafter the LLC) for the purpose of owning, operating, and managing the real property. On the same day, George and Susan also signed an operating agreement, which provided that they were to be the sole members of the LLC. On November 2, 2001, the decedent executed a deed transferring ownership of the real property to the LLC. However, the LLC's articles of organization were not filed with the Department of State until November 16, 2001, two weeks after the conveyance. Thus, it is undisputed that the property was purportedly transferred to the LLC before the LLC came into legal existence.

Following the decedent's death, a dispute arose among George, Susan, and the seven grandchildren over whether the deed transferring the real property to the LLC prior to its legal formation was valid. George, in his capacity as executor of the decedent's estate, thereafter filed a petition asking the Surrogate's Court to make a legal determination as to the validity of the deed and its transfer. Based upon the undisputed facts set forth in the petition, the Surrogate's Court concluded that the deed was valid because the LLC was a de facto entity on the date the conveyance was made. We disagree.

As a general rule, a purported entity which is not yet in legal existence cannot take title to real property (*see Kiamesha Dev. Corp. v. Guild Props.,* 151 N.E.2d 214). However, New York has recognized that an unincorporated entity can take title or acquire rights by contract if it is a de facto corporation (*see Kiamesha Dev. Corp. v. Guild Props.,* 151 N.E.2d 214), and we agree with the Surrogate's finding that the de facto corporation doctrine is equally applicable to limited liability companies. However, to establish that an entity is a de facto corporation or limited liability company, there must be a showing that a colorable attempt was made to comply with the statutes governing incorporation or organization prior to the purported acceptance of the deed. Here, while it is undisputed that George executed the LLC's articles of organization on October 4, 2001, there is no evidence that an attempt to file the articles of organization was made prior to the execution of the deed on November 2, 2001. In the absence of a colorable attempt to comply with the statute governing the organization of limited liability companies by filing, we cannot find that the LLC was a de facto entity capably of taking title on the date the deed was executed. *Stone v. Jetmar Props., LLC,* 733 N.W.2d 480 (Minn.App. 2007). Accordingly, the decedent's purported conveyance of the real property was void.

De facto Corporation and Corporation-By-Estoppel Doctrines

These two, closely-related doctrines often surface in the same dispute. As the *Hausman* case illustrates, the de facto corporation doctrine recognizes the existence of a corporation when a colorable, but defective, attempt is made to comply with the state's statutory organizational requirements. As explained in section C of Chapter 6, this doctrine has been rejected by many states. The corporation-by-estoppel doctrine is applied in situations where it would be inequitable to allow a party to deny the existence of a corporation. As illustrated

by the opinion in the 2007 case of *Stone v. Jetmar* (cited in Hausman and set forth in Chapter 6), this doctrine may be recognized in a state that has rejected the de facto corporation doctrine and will be applied to a non-corporate entity.

3. PRE-FORMATION TRANSACTIONS

CASE PROBLEM 2-6

Assume in Case Problem 2-2 that Luke entered into the nine pre-sale yacht contracts before meeting Jake. Luke was the named seller on the contracts. When Luke met Jake, they formed a member-managed limited liability company before Luke's tragedy and departure. Luke transferred the contracts to the LLC. Jake has now determined that the "best strategy to clean up the mess" is to complete the yachts and enforce the contracts. Can the LLC enforce the contracts? What additional facts would you like to have in answering this question?

LAKE STATE FEDERAL CREDIT UNION v. TRETSVEN

2008 WL 2732111 (Minn.App. 2008)

SCHELLHAS, Judge.

Appellant challenges the district court's ruling depriving him of rights to property against which he extended a mortgage. Because we hold that (1) as an individual, appellant has no standing to appeal the district court's ruling; and (2) appellant's claim to rights in the property fails because the alleged mortgagee was an unregistered limited liability company, we affirm.

On October 24, 2004, Defendant Richard Tretsven entered into a purchase agreement for a 160-acre parcel of property near Moose Lake, Minnesota. Later in December, Tretsven applied to respondent Lake State Federal Credit Union (Lake State) for a $148,000 purchase-money mortgage. Lake State agreed to finance the purchase and to allow Agility Title, Inc. (Agility), to handle the closing. Tretsven disclosed that he was an employee of Agility and wanted to use Agility to close on his purchase because, as an employee, he could receive a discount on the closing costs. Lake State then approved a $148,000 purchase-money mortgage to Tretsven. At this time, the president of Agility was Amanda M. Mahn, who apparently later became Tretsven's wife.

Tretsven was the sole signor of the mortgage note and mortgage running in favor of Lake State. Immediately after the closing, Agility provided Lake State copies of the executed warranty deed, settlement statement, promissory note, and mortgage, each document listing only Tretsven as purchaser, borrower, and grantee. Agility promised Lake State that it would immediately record the warranty deed and mortgage, but it failed to do so.

Sometime after the closing, Mahn's name was added to the original warranty deed as an additional grantee. Mahn's typewritten name is not aligned with, and is typed in a different font from, the other text in the warranty deed. On February 11, 2005, using the altered warranty deed, Mahn purported to grant a mortgage

on the property to Hunter Financial, LLC. At that time, the sole shareholder of Hunter Financial was appellant Kenneth D. Woodard, and Hunter Financial was not registered with the Minnesota Secretary of State as a limited liability company (LLC); it was not registered as an LLC until September 13, 2005. Neither the mortgage note nor the mortgage allegedly granted to Hunter Financial, LLC, contains any mention of Woodard. Only Mahn signed the mortgage note and mortgage; Tretsven signed neither document. Woodard allegedly wired $57,000 in mortgage financing to Mahn on February 11, 2005 and recorded the warranty deed in the Carlton County Recorder's Office on March 1, 2005. At that time, Lake State's mortgage had not yet been recorded.

Tretsven failed to make the August, September, October, and November 2005 mortgage payments to Lake State. Thereafter, Lake State discovered that Agility had not recorded the original warranty deed, that the warranty deed had been altered, and that the altered warranty deed had allegedly been used to obtain mortgage financing from Hunter Financial. On December 5, 2005, Lake State commenced a foreclosure action against the property, notified all other lienholders, including Hunter Financial, and joined them as defendants. Lake State obtained summary judgment against Hunter Financial, the district court determining that the alleged mortgage given by Mahn to Hunter Financial was "void, having been obtained as the result of fraud," and ordering that the property be foreclosed and the proceeds from the foreclosure sale awarded to Lake State with any surplus sale proceeds paid into district court. This appeal followed.

Respondent argues that Woodard does not have standing to bring this appeal. "Whether a party has standing is a question of law that appellate courts review de novo." *In re Horton,* 668 N.W.2d 208, 212 (Minn.App.2003). Woodard was not a party to the original case; Hunter Financial, LLC, was the named defendant in the district court action and appeared pro se. This appeal is brought by Woodard, individually and pro se, not by Hunter Financial. Woodard's standing to participate in the district court proceedings was not raised in that court because he was not a party. Here, we address Woodard's standing to pursue this appeal because "the question of standing cannot be waived and may be raised at anytime." *Id.*

Standing is essential to a court's exercise of jurisdiction. A party may acquire standing either by suffering an injury-in-fact or through a legislative act granting standing. The fact that a party is not named in the original action does not necessarily deprive that party of standing to appeal a decision as to that action. "[T]he general rule is that a person may appeal from a judgment that adversely affects his or her rights, even if the person was not a party to the proceeding below." *In re Marriage of Sammons,* 642 N.W.2d 450, 456 (Minn.App.2002).

Lake State argues that Woodard does not have standing to appeal because he was simply a member, albeit the sole member, of the LLC named in the original action. Woodard argues that he is the proper party to this case because he personally issued the funds for the mortgage from his own account before Hunter Financial was registered. Although Woodard did not register Hunter Financial as an LLC until months after Mahn allegedly granted Hunter Financial a mortgage,

the record is clear that the mortgagee in the mortgage allegedly granted by Mahn is Hunter Financial, not Woodard. And, the record does not establish whether Woodard transferred or assigned any of his interests to Hunter Financial after he registered the LLC and Woodard did not raise the question of mortgage ownership in the district court. As a general rule, we will not consider issues that were not argued and considered in the district court.

Minnesota Statutes, section 322B.88, provides that "a member of a limited liability company is not a proper party to a proceeding by or against a limited liability company," unless (1) the proceeding involves "member's right against, or liability to, the limited liability company"; or (2) "the proceeding involves a claim of personal liability or responsibility of that member and that claim has some basis other than the member's status as a member." Minn.Stat. § 322B.88 (2006). Because the case before us involves neither exception, we conclude that Woodard, as an individual, lacks standing as an individual to pursue this appeal.

Because Woodard's right to bring this appeal is precluded by Minn.Stat. § 322B.88, we need not consider the question of whether Woodard or his LLC had any legitimate rights in the foreclosed property. But because the parties may attempt to resolve this question with additional litigation, we find it in the interests of justice to address it here.

Woodard argues that the district court erred in determining, as a matter of law, that Hunter Financial had no interest in the property. Woodard bases much of his argument on his assertion that as a bona-fide purchaser under the Minnesota Recording Act, his interest in the property is superior to Lake State's interest. The Minnesota Recording Act provides that "[e]very conveyance of real estate ... [that is not] recorded shall be void as against any subsequent purchaser in good faith ... as against any attachment levied thereon ... of record prior to the recording of such conveyance." Minn.Stat. § 507.34 (2006). Woodard argues that he recorded Hunter Financial's mortgage against the property before Lake State recorded its mortgage and with no notice of Lake State's mortgage interest in the property. Thus, Woodard argues that he is a bona-fide purchaser with superior rights to the property.

But even assuming that Hunter Financial was a bona-fide purchaser under the Recording Act, neither Woodard nor Hunter Financial can claim any interest in the property because Hunter Financial was not a registered LLC when the mortgage was issued in Hunter Financial's name. *See Stone,* 733 N.W.2d at 486 (holding that deeds cannot be delivered to nonexistent entities, whether the entities are natural or legal, and that a deed conveying property to an unregistered LLC was void). The *Stone* court reasoned that because the LLC was a nonexistent entity, it could not accept delivery of the deed. *Id.* Although *Stone* concerned delivery requirements for deeds, a mortgage must also be delivered to a mortgagee to be valid. *Lee v. Fletcher,* 46 Minn. 49, 51, 48 N.W. 456, 457 (1891); *see also Tomlinson v. Kandiyohi County Bank,* 162 Minn. 230, 234, 202 N.W. 494, 496 (1925) ("It is elementary that delivery is essential to the validity of a deed or mortgage.").

The fact that Woodard registered Hunter Financial with the secretary of state after Mahn granted it the mortgage does not affect our analysis. In *Stone,* although the LLC was registered a year after the deed was delivered to one of its members, this court explicitly refused to recognize the LLC as a de facto entity. 733 N.W.2d at 487. "Allowing a form of future interest to vest in unorganized entities would be inconsistent with our public policy of encouraging legal organization." *Id.* We extend this conclusion to the case now before us and hold that because Hunter Financial was registered after the mortgage was granted to it, the mortgage allegedly conveying a property interest to it was void. We hold that neither Woodard nor Hunter Financial has any rights to the property. *See id.* (affirming a district court's finding that a deed conveying property to an unregistered LLC was void and awarding title to the property to the previous owner). We need not address the validity of the warranty deed nor Woodard's or Hunter Financial's alleged status as bona-fide purchasers. Similarly, we need not address what impact, if any, the voidness of the mortgage has on the debt associated with that mortgage. Affirmed.

The Power of Adoption and Ratification

The *Tretsven* case illustrates the dangers of pre-entity formation challenges that involve recorded real estate documents. The danger levels often drop in transactions that do involve recorded documents when the powers of adoption and ratification kick in. For example, In *02 Development, LLC v. 607 South Park,* LLC, 71 Cal.Rptr.3d 608 (Cal. App. 2 Dist. 2008), the court held that a limited liability company, the named buyer in a real estate purchase agreement, could enforce its rights under the agreement even though the LLC had not been formed at the time of the agreement. Referencing corporate law, the court stated:

> It is hornbook law that a corporation can enforce preincorporation contracts made in its behalf, as long as the corporation "has adopted the contract or otherwise succeeded to it." (1A Fletcher Cyclopedia of the Law of Private Corporations (2002 rev. vol.), § 214, pp. 448–450 ["Adoption or ratification may be express or implied. Indeed, one means of adopting a preincorporation contract is the corporation's institution of an action on it"].) California law does not deviate from that well-established norm. 607 South Park does not argue that limited liability companies should be treated differently from corporations in this respect, and we are aware of no authority that would support such a position. 607 South Park's first ground for its summary judgment motion—that there is no enforceable contract between 607 South Park and 02 Development because 02 Development did not exist when the assignment agreement was executed—therefore fails as a matter of law.
>
> 607 South Park's principal contention to the contrary is that a nonexistent business entity cannot be a party to a contract. The contention is true but irrelevant. When the assignment agreement was executed, 02 Development did not exist, so it was not then a party to the agreement. But once 02 Development came into existence, it could

enforce any pre-organization contract made in its behalf, such as the assignment agreement, if it adopted or ratified it.

D. THIRD PARTY CLAIMS

1. OWNER TORT EXPOSURES

HAIRE v. BONELLI

870 N.Y.S.2d 591 (N.Y.A.D. 2008)

KANE, J.

Defendant Robert Bonelli Jr. brought an assault rifle to defendant Hudson Valley Mall and began shooting indiscriminately. Of the nearly 60 rounds he fired, one hit plaintiff in the leg, injuring him severely. Plaintiff commenced this action against numerous individuals and entities associated with the mall (hereinafter collectively referred to as defendants) and Bonelli. As against defendants, plaintiff alleged causes of action sounding in negligence, gross negligence, public and private nuisance, common-law fraud and violations of General Business Law §§ 349 and 350. Defendants moved to dismiss the amended complaint. Supreme Court dismissed all causes of action against defendant PCK Development Company, and everything but the negligence cause of action against the remaining moving defendants.

Supreme Court correctly determined that plaintiff stated a negligence cause of action against the owners, operators and managers of the mall. Property owners and their agents have a duty to maintain the premises in a reasonably safe condition, which includes taking “minimal precautions to protect members of the public from the reasonably foreseeable criminal acts of third persons” (*Leyva v. Riverbay Corp.,* 620 N.Y.S.2d 333 [1994]. Plaintiff sufficiently alleged that inadequate security and warning and evacuation plans were in place to observe, detect or deter Bonelli or prevent him from injuring people in the mall.

Here, an attorney who is general counsel to one defendant provided information, from his own personal knowledge and his review of attached documents, regarding the corporate structure and relationships of the various defendants.

Plaintiff alleged that the individual defendants are officers or members of the defendant corporations or limited liability companies and participated in the commission of a tort in furtherance of company business or to benefit the business, namely reducing or eliminating mall security to maximize profits. These allegations, if proven, would be a sufficient basis to hold those individuals personally liable (*see Rothstein v. Equity Ventures, LLC,* 299 A.D.2d 472, 474, 750 N.Y.S.2d 625 [2002]. At this early stage of the action, and given defendants' failure to adequately explain the positions of the individual defendants and their roles in the business entities—let alone their roles in business decisions concerning mall security—we must accept the allegations as true. Thus, those individuals were not entitled to dismissal.

Failing to Perform and Fraud

Generally no personal liability will attach to a member of an LLC who fails to perform a contractual obligation on behalf of the LLC, even if the failure is the member's fault. In *American Realty Trust Inc. v. Matisse Capital Partners LLC*, 91 Fed.Appx. 904 (5th Cir. 2003), the court held that two individuals (Bagley and Takacs) were not personally liable for failing to provide adequate consulting services pursuant to a contract they signed on behalf of their LLC. The court stated;

> We believe that the district court was correct to reject the jury's verdict to the extent that the jury found that Bagley and Takacs individually, as opposed to Matisse Partners, LLC, had breached the Consulting Contract. The Consulting Contract states that it was "executed ... by and between MATISSE PARTNERS, LLC, a Colorado limited liability company" and the ART corporations. It was signed on Matisse's behalf by Takacs in his capacity as Matisse's managing director. It is of course true that a business entity can act only through its officers, employees, and other agents. If Matisse breached the contract, it would therefore necessarily be by virtue of acts taken by Bagley or Takacs. But that truism does *not* mean that any breach of the Consulting Contract, which breach could only happen through those two individuals' actions, creates individual liability on Bagley and Takacs. To so hold would ignore the fact that Matisse's principals were doing business as an LLC.

However, when the actions of the members acting on behalf of the LLC in a contractual context rise to the level of fraud, personal liability attaches. See, for example, *LJ Charter, L.L.C. v. Air America Jet Charter, Inc.*, 2009 WL 4794242 (Tex. App. 2009); Restatement (Third) of Agency § 7.01.

2. PIERCING THE VEIL

D.R. HORTON INC. - NEW JERSEY v. DYNASTAR DEVELOPMENT, L.L.C.

2005 WL 1939778 (N.J. Super. L. 2005)

OSTRER, J.

This lawsuit arises out of the construction of a planned residential retirement community on over 400 acres in West Windsor Township. Known as the Bear Creek Planned Development, the project was intended to satisfy part of the township's Mt. Laurel affordable housing obligation. The single-family development was ultimately named the Village Grande at Bear Creek. The townhome development was eventually called the Hamlet at Bear Creek.

Critical to the lawsuit is a contract dated April 26, 1996, entitled "PRRC Project Cooperation Agreement" ("PRRC Agreement"). In particular, the PRRC Agreement provided a formula for the parties to share the costs of improvements like roads, water line and sewer line extensions, which would be located outside each developer's respective property, but which would benefit that property. The PRRC Agreement stated that it was binding on the parties as well as their

successors and assigns.

Lehigh Corp. on the CRRC side agreed to convey its interests in the project to Esplanade L.L.C., then a newly formed New Jersey limited liability company located in Covington, Louisiana, under an agreement made February 20, 1998 ("Lehigh-Esplanade Agreement")…Although Esplanade L.L.C. lacked capital initially, and depended on Dynastar to finance its operations, it ultimately secured financing through the EDA for the initial stage of the project. On the other hand, the plaintiff was on notice that Esplanade L.L.C. lacked sufficient capital to complete other stages. Thus, plaintiff should have been aware that it might not have had sufficient capital to complete the initial stage if overruns, delays, or other setbacks were experienced.

Esplanade L.L.C. breached the PRRC Agreement and failed to reimburse Horton NJ for various offsite improvements that benefited its property… Based on the findings of fact, applied to the conclusions of law discussed below, only Esplanade L.L.C. is liable for breaching the PRRC Agreement. The breach consists of not paying for off-site improvements, delaying completion of affordable housing units, and failing to complete on-site improvements. Horton NJ may not pierce Esplanade L.L.C.'s veil and assign liability to its members Borne and Dynastar, or to Borne's related entity, Evangeline… Simply put, in this case, no party other than Esplanade L.L.C. was bound contractually to Horton NJ. The defendants on the contract claims, Dynastar and Evangeline, contracted directly neither with Horton NJ nor SGS Adult L.L.C.

The court rejects plaintiff's claim that Esplanade L.L.C.'s "corporate veil" should be pierced, so that Borne, or Dynastar may be held liable. Under the facts of this case, equity does not require permitting plaintiff to pierce Esplanade L.L.C.'s veil and assign liability for its breach of contract to Borne or to any of his related entities. In reaching this conclusion, the court concludes that the issue of piercing the veil in this case is governed by New Jersey law, even though Dynastar and Evangeline are Louisiana business entities. The court also concludes that the plaintiff need prove its case for piercing the corporate veil by clear and convincing evidence. Nonetheless, even under a preponderance of evidence standard, the court is not persuaded that an injustice would be done by maintaining limited liability, given the court's conclusion that Borne's alleged misuse of the limited liability company form did not proximately caused plaintiff harm. Even if not an essential element of a veil piercing claim, causation necessarily must be a factor in the court's analysis of this claim for equitable relief. The court also concludes that the traditional factors for piercing the veil of a corporation must be modified in a case involving a limited liability company, to account for the special characteristics of that business entity. Applying that test, the court concludes that Esplanade L.L.C.'s veil need not be pierced, to avoid injustice, or to remedy fraud.

The apparent weight of authority agrees that veil-piercing analysis is governed by the law of the state of formation. Although the court has found no New Jersey case directly on point, the Supreme Court has in another context adopted Restatement (Second) of Conflicts of Laws § 307, which states that the law of the state of incorporation governs shareholders' liability. That may suggest

a similar adoption of the incorporating state's law to a veil piercing claim.

An apparent minority of courts has suggested that the state with the most significant contacts would govern a veil-piercing dispute. Ultimately, the court need not resolve this issue, inasmuch as it concludes that the entity whose veil must be pierced as a threshold matter, Esplanade L.L.C., was both formed under New Jersey law, and maintained its most significant contacts here, and New Jersey certainly has the interest in this case to apply its veil-piercing law.

As discussed below, in order to obtain equity's aid in avoiding a duly executed contract, plaintiff needs to prove its claim by clear and convincing evidence. The court has found no New Jersey court decision that expressly addresses the standard of proof in veil-piercing claims. However, the court finds that this standard of proof is consistent with binding precedent establishing the same standard of proof in equitable and legal fraud claims. It is consistent with the public policy underlying that higher standard of proof in cases in which a party seeks to avoid a written contract. It is also supported by the public policy for limited liability for business entities, at least as it relates to contractual claims by voluntary creditors. Lastly, it is consistent with what this court finds is the better reasoned view of other courts.

Although limited liability is a statutory creation, the Legislature has not prescribed the standard of proof for piercing the veil. Indeed, piercing the veil is an equitable remedy, in derogation of the statute limiting liability. Thus, it is incumbent on this court to determine what our State's Supreme Court would deem the appropriate standard.

In choosing the standard of proof, the court must be mindful of the impact of a standard of proof in any proceeding. The preponderance standard imposes the risk of loss evenly between the two parties. In criminal cases, the defendant's liberty interest is so weighty that the beyond-a-reasonable-doubt standard of proof is designed to avoid as much as possible the risk of an erroneous judgment of conviction, even if means a guilty defendant may go free. The clear-and-convincing standard falls somewhere between the two extremes. Our Supreme Court has defined “clear and convincing” to mean evidence “so clear, direct and weighty and convincing as to enable either to come to a clear conviction, without hesitancy, of the truth of the precise facts in issue.” In re Seaman, 133 N.J. 67, 74, 627 A.2d 106 (1993).

Applying these considerations, the court concludes that a fact-finder should have a higher degree of confidence in a claim to pierce the veil on a private contract claim. The heightened standard apparently has its roots in equity and the desire to demand higher proof before setting aside written contracts.

The court concludes that the traditional standard for piercing a corporation's veil must be modified to accommodate the special characteristics of a limited liability company.

The Supreme Court described the standard for piercing a corporation's veil in State Dep't of Environ. Prot. v. Ventron Corp., 94 N.J. 473, 500, 468 A.2d 150 (1983). A corporation is a separate entity from its shareholders.. One of the primary reasons for incorporation is to insulate shareholders from the liabilities

of the corporate enterprise. Except in cases of fraud, injustice, or the like, courts will not pierce a corporate veil.

The Supreme Court established a two-part test to determine if the business entity has been used to defeat the ends of justice. First, the plaintiff must prove that the subsidiary was a mere instrumentality or alter ego of its owner. That is, that the parent or owner so dominated the subsidiary that it had no separate existence but "was merely a conduit for the parent." Id. at 500-01, 468 A.2d 150. Second, the plaintiff must prove that the parent or owner has abused the business form to perpetrate a fraud, injustice, or otherwise circumvent the law. "Even in the presence of dominance and control, liability will be imposed only where the parent has abused the privilege of incorporation by using the subsidiary to perpetrate a fraud or injustice, or otherwise to circumvent the law." State Dep't of Environ. Prot. v. Ventron Corp., supra, 94 N.J. at 501, 468 A.2d 150.

The first part of the test-pertaining to dominance and control-has been evidenced by facts that demonstrate the parent company's or owner's exercise of dominion and control over the subsidiary. In such instances, a subsidiary can properly be deemed an "alter ego" or "mere instrumentality" of the parent such that the entities operate as one. This requires proof of the complete domination and control of both the entity's policy and business practices. The alter ego or mere instrumentality factor is generally employed where two corporations or companies are realistically controlled as one entity because of common owners, officers, directors, members or lack of observance of corporate formalities between the two organizations. This test measures the separateness between the management of the corporation and its owners.

The second prong of the test-abuse of the privilege of incorporation consisting of fraud, injustice or circumvention of law-has been evidenced by facts that demonstrate some form of misrepresentation, deceit, undercapitalization, or other form of injustice. In determining whether a plaintiff has satisfied the second prong of the Ventron test, New Jersey courts have considered whether the defendant's use or misuse of the business entity's form caused harm. Several states hold that proof of injury or loss is an express prerequisite for veil-piercing. Including causation assures a proper balance between fulfilling the policy goals of limited liability, established by statute, and the policy goals of the veil-piercing doctrine, established in equity, to avoid injustice. Limited liability is said to promote investment, and allocate risk to more efficient risk-bearers.

Thus, to override a private bargain, the courts generally demand a showing of fraud, misrepresentation, or some violation of the express or implicit bargain of the parties.

[F]or close corporations, piercing the corporate veil is strongly rooted in the bargain setting. Because the market-related reasons for limited liability are absent in close corporations and corporate groups, the most important justification for limited liability is permitting parties in a consensual relationship to use the corporate form to allocate the risks of the transaction and the enterprise. Thus the presumption of limited liability is strongest when the outside party adversely

affected by the corporation's limited assets was aware of the corporation's separate existence at the time of the transaction. Conversely, courts will disregard limited liability for the same reasons that other bargains are not respected by courts. For example, misrepresentation is one of the most frequent factors listed by courts when they pierce the veil.

Absent the element of causation, a creditor would be granted a better bargain than it made for itself, simply because of the fortuity that the debtor, say, inadvertently commingled assets, ignored corporate formalities, or dominated the corporation. “Accordingly, absent very compelling equitable circumstances, courts should not rewrite contracts or disturb the allocation of risk the parties have themselves established.” 1 Fletcher Cyc. Of Private Corp. § 41.85 (2004).

While this court has found no New Jersey case expressly stating that proof of causation is an essential element of a veil-piercing claim, neither has the court found a case expressly stating that causation is irrelevant.

This court has found no New Jersey case in which the court has expressly addressed whether the corporate veil-piercing doctrine should be applied without change to a limited liability company. Therefore, this court must consider whether it should modify the Ventron two-part test in view of a limited liability company's special attributes. The court concludes that an adjustment is appropriate. Lesser weight should be afforded the element of domination and control and adherence to corporate formalities, because the statute authorizing limited liability companies expressly authorizes managers and members to operate the firm.

New Jersey's limited liability statute does not apply corporate veil-piercing doctrine to limited liability companies. Rather, it appears to endorse the evolution of court-made rules. These in turn may address this business form's special attributes.

Although the limited liability of an L.L.C. is identical to a corporation's, the L.L.C. is significantly different…New Jersey enacted the Limited Liability Company Act (“N.J.Act”) to enable members and managers of a Limited Liability Company “to take advantage of both the limited liability afforded to shareholders and directors of corporations and the pass through tax advantages available to partnerships.” Senate Commerce Committee Statement, S. 890 (June 14, 1993), republished at N.J.S.A. § 42:2B-1.

New Jersey's Limited Liability Company statute is distinct from its corporate counterpart. The statute expressly authorizes L.L.C. managers to engage in financial transactions with the company, including lending and borrowing money, and assuming obligations of the company. N.J.S.A § 42:2B-9. As will be discussed below, this is significant, when considering the “dominion and control” factor under Ventron.

Other states' statutes variously treat corporate veil-piercing doctrine. Some states expressly adopt the corporate veil-piercing doctrine and others expressly reject it, at least in part. For example, the statutes of Colorado and Minnesota apply corporate veil-piercing common law to L.L.C.'s in their jurisdictions. On the other hand, some states have expressly distinguished L.L.C.s from

corporations, dispensing with the corporate formalities factor in a veil-piercing analysis involving a limited liability company.

Most states, however, do not explicitly and specifically address the issue of corporate veil-piercing doctrine by statute, and instead their laws only generally address member liability to third parties. See e.g., 6 Del.Code Ann. § 18-303 (Supp.1994) (stating that "no member or manager of a limited liability company shall be obligated personally for any ... debt, obligation or liability of the limited liability company solely by reason of being a member or acting as a manager."); Fla. Stat. Ann. § 608.436 (West 1996) (same).

Although the N.J. Act does not expressly address veil-piercing, an argument can be made the Legislature implicitly intended that courts not mechanically apply corporate veil-piercing law to limited liability companies. The original, introduced version of the limited liability legislation provided that case law on piercing the corporate veil would apply to a limited liability company. However, the Senate Committee Substitute that was ultimately passed and signed into law omitted that provision. See S. 890(SCS), 205th Leg. (1993), enacted as L. 1993, c. 210.

Indeed, rather than expressly address veil piercing doctrine, the Legislature apparently endorsed the continued evolution of the common law. "In any case not provided for in this act, the rules of law and equity, including the law merchant, shall govern." N.J.S.A. § 42:2B-67. This provision begs the question, what is the rule of law and equity on veil-piercing of a limited liability company. Apparently, it is for the courts to decide, grounded in the principles of equity, but mindful of the Legislature's expressed and implicit goals in creating this business form.

As discussed below, persuasive authorities indicate that corporate veil-piercing doctrine should not be mechanically applied to cases involving limited liability companies. In particular, a court should view in a different light the factors of adherence to corporate formalities, and scrutiny of owners' dominion and control.

Certainly, one may find cases in which courts have presumed that a plaintiff may pierce the veil of an L.L.C. just as it may pierce the veil of a corporation. However, courts that have expressly considered the differences between the two business forms have concluded that veil-piercing doctrine should be molded to accommodate the differences. In answering a certified question whether the veil-piercing remedy were available against a limited liability company, the Wyoming Supreme Court answered in the affirmative, but recognized that the applicable factors would differ from those applied to a corporate veil-piercing-in particular, adherence to corporate formalities should not weigh as much. The court also left for another day the identification of other differences.

Many commentators agree with the general principle that veil-piercing law for limited liability companies should be tailored to address that business form's special characteristics. As noted by the Wyoming Supreme Court, adherence to formalities is one factor that should weigh differently in the case of a limited liability company. First, a small-business owner's failure to adhere to formalities

may simply reflect disregard of formalities “irrelevant to their actual operation”, and lack of funds to hire lawyers and others to keep track of statutory obligations. None of that may evidence misuse of the statute. Second, “LLC's have relatively few statutorily mandated formalities and have a considerable amount of freedom and flexibility as to the management structure of the entity.” This informality, encouraged by statute, should not then be a basis to avoid statutory limited liability.

Reliance on dominance and control of the L.L.C. form also conflicts with the underlying policy of flexibility within the L.L.C. statute. LLC's are more often than not managed by the LLC members. In addition, generally speaking, members are normally authorized agents and/or managers of LLC's for the purpose of conducting its affairs. As such, it could be argued that the later ego factor is usually satisfied for LLC's. As one commentator noted, given the statutory authorization of flexible LLC management structures, domination of LLC management by members of the LLC, absent other equitable issues, would appear to be an ‘inappropriate’ factor for the courts to use to pierce the veil to the detriment of the interest holders. Thus, application of the alter ego factor to LLC's will often lead to ‘illogical’ results.

Undercapitalization is another factor that should be weighed carefully in the L.L.C. context, particularly involving a start-up. One court, addressing facts similar to those in this case, affirmed the trial court's refusal to pierce a limited liability company's veil. Advanced Telephone Systems, Inc. v. Com-Net Prof. Mobile Radio, LLC, 846 A.2d 1264, 1280-81 (Pa.Sup.Ct.2004). The court found no injustice in maintaining limited liability where the plaintiff knew it was dealing with a limited liability company that initially had no assets, but would only acquire those assets when a certain contract was entered and financing obtained; when that contract fell through the L.L.C. was undercapitalized. Ibid. Commentators agree that a limited liability company's undercapitalization-albeit still a highly relevant factor-should be considered in light of the circumstances. See D. Cohen, supra, 51 Okla. L.Rev. at 491 (suggesting that courts inquire whether the entity was formed with explicit intent of engaging in risky transactions and being undercapitalized given the risks, and then concluding that such facts would be evidence of unconscionable behavior toward involuntary creditors, but not toward voluntary creditors “unless the LLC's purpose was obscured or misrepresented.”).

In sum, out-of-state authority and commentators agree that the veil-piercing formula for limited liability companies should be molded to account for that business form's special attributes. As the Wyoming Supreme Court aptly suggested Kaycee Land and Livestock v. Flahive, supra, the particular standard should be developed over time, as courts address concrete cases. It is not for this court, solely on the facts presented to it in this case, to formulate a generally-applicable standard. It is sufficient for this court to conclude that in this case, Borne's failure to scrupulously identify the entity through which he was acting, his dominion and control of Esplanade L.L.C., and the entity's undercapitalization should not loom as large as it might were the entity a corporation.

As noted above, under the Ventron two-part test, Horton NJ must prove that (1) Esplanade L.L.C. was a mere instrumentality or alter ego of Borne; and (2) Borne abused the business form to perpetrate a fraud, injustice, or otherwise circumvent the law. Particularly given the lesser weight assigned to the formalities, and dominion-and-control factors, Horton NJ has failed to prove the first prong. Moreover, the court finds no injustice or circumvention of law, notwithstanding that Esplanade L.L.C. ultimately lacked sufficient capital to fulfill its obligations.

To prove the first prong of the Ventron test, Horton NJ relies on Borne's control of Esplanade L.L.C., and his failure to distinguish it from his Dynastar. As discussed above, there is no doubt that Borne failed to correct misimpressions of the entities' respective roles. He maintained control over all his entities, and used a central office, common employees, and common telephone lines. However, the separate entities served different functions. Borne did not intend to mislead. When entering formal contracts or obtaining payment, as opposed to informal correspondence, Borne was more careful to identify the correct entity. Finally, Borne's failure to correct Schoor's and Rothman's confusion did not cause Horton NJ to act to its detriment. Horton NJ would have made the same investments in off-site improvements even if Borne made it clear that Dynastar was performing services for Esplanade L.L.C., and Esplanade L.L.C. was the single purpose entity that owned the land.

Particularly given the lesser weight assigned to the formalities and dominion-and-control factors in an L.L.C. veil-piercing case, the court does not find that Borne's behavior justifies piercing Esplanade L.L.C.'s veil. Borne was a small-business owner. His lack of attention to detail-his misuse of stationery, for example-was not uncharacteristic of entrepreneurs and other L.L.C. owners. His operational efficiencies-in maintaining a central office for his various entities-was understandable. It presumably would have made little business sense for him to rent separate space, hire separate office-workers, and acquire separate phone lines for each of his related entities. To penalize him for rational economic behavior would be inconsistent with the business-promotion goals of the Limited Liability Act, and at odds with the specific provisions allowing member-management.

As for the second prong of the Ventron test, the court has found that Borne did not defraud in his use of the various entities. Nor did Borne use the limited liability form to perpetrate an injustice or a circumvention of the law. The court finds that Horton NJ has failed to establish by clear and convincing evidence-indeed, it has failed to establish by a preponderance of the evidence-that it has suffered an injustice by its failure to reach beyond the assets of Esplanade L.L.C. Esplanade L.L.C. disclosed its funding limitations. Horton NJ had no idea whether Dynastar was better capitalized than Esplanade L.L.C., or whether it was the other way around. To permit Horton NJ to reach beyond the parties who were liable under contract would not prevent an injustice, but create one. It would extend liability to parties with whom Horton NJ did not bargain and upon whose assets Horton NJ did not rely.

In sum, the court finds that Horton NJ has failed to establish a basis for

piercing Esplanade L.L.C.'s veil.

Corporate Piercing Claims

As the *D.R. Horton Inc*. case illustrates, the relationship between creditor piercing claims in an LLC context and a corporate context is evolving. Creditor piercing claims often are directed at the protective veil provided by a corporation. See section F. of Chapter 3 for cases involving such claims, where the creditor uses various factors to support an argument that the corporation and shareholders are one and the same and that it would be unjust or inequitable to allow the shareholders to escape personal liability. As such cases illustrate, it is never an easy burden of proof for the plaintiff-creditor, and there are a host of factors (all potentially relevant in an LLC or limited partnership context) that often come into play.

3. CHARGING ORDER REALITIES

WEDDELL v. H2O, INC.

271 P.3d 743 (Nev. 2012)

By the Court, CHERRY, J.:

In this appeal, we consider distinct issues arising from a fall-out between business partners. We first consider whether a judgment creditor divests a dual member and manager of a limited-liability company of his managerial duties. We conclude that a judgment creditor has only the rights of an assignee of the member's interest, receiving only a share of the economic interests in a limited-liability company, including profits, losses, and distributions of assets. Therefore, the judgment creditor and holder of a charging order against appellant Rolland P. Weddell's membership interests is simply entitled to Weddell's economic interest in appellant Granite Investment Group, LLC. For this reason, we reverse the district court's judgment relating to the scope of the charging order against Weddell's membership interests and remand this matter to the district court for further proceedings concerning Weddell's managerial interests in Granite…

Stewart and Weddell were both involved in some respect with Granite Investment Group and appellant High Rock Holding, LLC. In December 2004, Weddell was elected manager of Granite. Several months later in May 2005, Stewart and Weddell signed an amended and restated operating agreement (Granite operating agreement).

According to the Granite operating agreement, Stewart received 1.5 votes and Weddell received 1 vote. Several years later, in October 2007, Stewart used his majority voting power to allegedly remove Weddell as manager. Thereafter, Stewart ostensibly elected himself manager of Granite. However, pursuant to section 5.10 of the Granite operating agreement, a manager can only be removed by the unanimous affirmative vote of all of the members. Additionally, section 5.2 does not prohibit more than one manager at a time.

When Weddell was elected manager of the Granite Investment Group, he was also elected manager of High Rock Holding. To reflect the management

changes at High Rock, Stewart and Weddell entered into an amended and restated operating agreement whereby Stewart had 1.5 votes and Weddell had 1 vote (High Rock operating agreement). Likewise, in October 2007, Stewart used his superior voting power to remove Weddell as manager of High Rock. While the Granite operating agreement required a unanimous affirmative vote of the members, the similarly numbered section of the High Rock operating agreement only required an affirmative vote of the members.

In October 2008, in an unrelated matter, the district court granted an application by a creditor to charge Weddell's membership interest in Granite and High Rock, among other Weddell entities, for over $6 million. Pursuant to NRS 86.401, the charging order entitled the creditor to any and all disbursements and distributions, including interest, and all other rights of an assignee of the membership interest. Thereafter, Stewart purportedly purchased Weddell's remaining membership interest in Granite for $100 in accordance with section 10.2 of the Granite operating agreement.

The district court concluded that the charging order divested Weddell of *both* membership and managerial rights in Granite and High Rock upon the tender of purchase money made by Stewart. The district court also concluded that Stewart is the sole manager of Granite and High Rock.

To better understand the preeminent issue, we first review the general nature of limited liability companies, including the statutory framework pursuant to NRS Chapter 86. Next, we will present a historical overview of the charging order remedy. As part of this overview, we will analyze the rights of judgment creditors in the course of holding a charging order. Finally, we will explain the basis for our conclusion that, under Nevada law, judgment creditors have no right to participate in the management of the limited-liability company and only obtain the rights of an assignee of the member's interest—receiving only a share of the economic interests in a limited-liability company, including profits, losses, and distributions of assets. By limiting a creditor's right to exercise the debtor member's management rights, we ensure that creditors of a limited-liability company cannot disrupt and interfere with the management rights of other members. This conclusion rests on the uncontested right of a member to choose his or her associates and to encourage investing by enabling limited members to invest money and to share profits, but without risking more than the amount they contributed.

Limited-liability companies (LLCs) are business entities created "to provide a corporate-styled liability shield with pass-through tax benefits of a partnership." *White v. Longley,* 358 Mont. 268, 244 P.3d 753, 760 (2010); *Gottsacker v. Monnier,* 281 Wis.2d 361, 697 N.W.2d 436, 440 (2005) (stating that "[f]rom the partnership form, the LLC borrows characteristics of informality of organization and operation, internal governance by contract, direct participation by members in the company, and no taxation at the entity level. From the corporate form, the LLC borrows the characteristic of protection of members from investor-level liability."

In Nevada, an LLC is formed by signing and filing the articles of

organization, together with the applicable filing fees, with the Secretary of State. An LLC may, but is not required to, adopt an operating agreement, NRS 86.286, which is defined as "any valid written agreement of the members as to the affairs of a limited-liability company and the conduct of its business." NRS 86.101. Unless the articles of organization or operating agreement provide otherwise, management of a limited-liability company is vested in its members in proportion to their contribution to capital. NRS 86.291. A member is "the owner of a member's interest in a limited-liability company or a noneconomic member." NRS 86.081. The term "[m]ember's interest" is defined as "a share of the economic interests in a limited-liability company, including profits, losses and distributions of assets." NRS 86.091.

The collection rights and remedies against a member's interest in a limited-liability company are governed by NRS 86.401. This provision recognizes the charging order as a remedy by which a judgment creditor of a member can seek satisfaction by petitioning a court to charge the member's interest with the amount of the judgment. NRS 86.401(1); *see Brant v. Krilich,* 835 N.E.2d 582, 592 (Ind.Ct.App.2005) (holding "that a charging order is the only remedy for a judgment creditor against a member's interest in an LLC," after interpreting a similar Indiana statute). A charging order directs the LLC to make distributions to the creditor that it would have made to the member. As a result, a charging order affects only the debtor's partnership interest and does not permit a creditor to reach partnership assets.

"Charging orders originated as a statutory solution to cumbersome common law collection procedures 'that were ill-suited for reaching partnership interests.'" *Green v. Bellerive,* 135 Md.App. 563, 763 A.2d 252, 256 (Md.Ct.Spec.App.2000). The charging order concept was first established in the United States in the 1914 Uniform Partnership Act and has since been replicated in some degree in nearly every United States jurisdiction, including Nevada.

Charging orders have been described as "nothing more than a legislative means of providing a creditor some means of getting at a debtor's ill-defined interest in a statutory bastard, surnamed 'partnership,' but corporately protecting participants by limiting their liability as [ ] corporate shareholders." *Bank of Bethesda v. Koch,* 408 A.2d 767, 770 (Md.Ct.Spec.App.1979). In short, "[a] charging order gives the charging creditor only limited access to the partnership interest of the indebted partner." *Green,* 763 A.2d at 257. Consequently, the judgment creditor does not unequivocally step into the shoes of a limited-liability member. *Id.* at 259. The limited access of a judgment creditor includes "*only* the rights of an assignee of the member's interest." NRS 86.401(1) (emphasis added). A judgment creditor, or assignee, is only entitled to the judgment debtor's share of the profit and distributions, takes no interest in the LLC's assets, and is not entitled to participate in the management or administration of the business. After the entry of a charging order, the debtor member no longer has the right to future LLC distributions to the extent of the charging order, but retains all other rights that it had before the execution of the charging order, including managerial interests.

Here, the charging order levied by Weddell's creditor directed Granite to

divert Weddell's rights to LLC profits and distributions to the creditor. The charging order only divested Weddell of his economic opportunity to obtain profits and distributions from Granite—charging only his membership interest, not his managerial rights. *See* NRS 86.401. Prohibiting the creditor from exercising Weddell's management rights reflects the principle that LLC members should be able to choose those members with whom they associate.

We further conclude that the charging order triggered the involuntary transfer provision of the Granite operating agreement, section 10.4. Section 10.4 explicitly included charging orders in its purview. Therefore, we remand this case to the district court to resolve whether Stewart properly complied with section 10.4 and whether, as a result, Weddell was divested of his membership interest in Granite. In light of our conclusion, we direct the district court to determine whether Weddell has retained his managerial interests, and whether Stewart has elected himself co-manager pursuant to sections 5.2 and 5.10 of the Granite operating agreement. We also conclude that the district court did not err in finding that the April 2006 High Rock operating agreement signed by both parties controlled and that, under it, Weddell was voted out as manager of that LLC.

Pursuant to NRS 86.401, a judgment creditor may obtain the rights of an assignee of the member's interest, receiving only a share of the economic interests in a limited-liability company, including profits, losses, and distributions of assets. Thus, the charging order does not entitle the creditor to Weddell's managerial rights in Granite. Due to the district court's misinterpretation of NRS 86.401, we reverse the district court's judgment in part and remand this matter to the district court for further proceedings consistent with this opinion.

Example: Charging Order as Asset Protection Tool

George Judson is a surgeon. He has all the usual concerns. His malpractice rates have tripled over the last 10 years. He knows that there is a risk that 10 or 20 years down the road he might be held responsible for a surgical procedure that he performed today. He also knows that a damage suit could potentially produce a judgment that far exceeds the limits of his malpractice policy. George and his wife Betty have worked hard to build an estate valued at approximately $9 million.

George and Betty would like to lock- up a portion of their assets that could not readily be confiscated by a judgment creditor in the future. In short, they want an asset protection strategy. They know that an asset protection strategy probably will not work if a claim has already been made. This type of planning should be done in calm waters. They figure that now is the time. George also understands that the strategy may not be completely fool-proof, and there may be some uncertainties. They figure that something is better than nothing. They know that some strategies are designed to make things difficult, unbearable and, hopefully in some cases, downright impossible for the judgment creditor who is going after the assets. Obstacles can be created. The hope is that most creditors, when they discover the obstacles and the potential legal implications, will conclude that the carrot isn't worth the fight.

George and Betty have decided to form a limited partnership to help protect certain commercial properties and investments that they own. Initially, they will own the limited partnership units and have a corporate entity be the general partner. Over time, they will transfer limited partnership units to other family members, including their children and trusts for grandchildren. Any such transfers will increase their protection from creditors. But for now, let's focus on the value of the limited partnership structure itself as an asset protection device, apart from any transfers that may be made to other family members.

The limited partnership, if properly structured and funded with assets, can itself become a nuisance for a judgment creditor. If George has a large malpractice judgment entered against him, in many states a judgment creditor is limited to obtaining a charging order against the partnership. This charging order gives the creditor the right to receive distributions from the partnership when and if distributions are made to George. The creditor gets no rights to control or gain access to the assets that are owned by the limited partnership. The creditor has no right to become a general partner, nor can the creditor remove the general partner, vote in the partnership, or have any say in the management. All the creditor has is the right to receive the income and any other amounts that may be distributed to George. In some states, the creditor may petition to have the charging order "liquidated," which has the effect of transferring to the creditor all rights of the partnership interest.

The obvious question is: Can the creditor require that the partnership make distributions with respect to the partnership interest? Generally, the creditor has no such power. In this regard, if asset protection is a priority, it is usually advisable to include a clause in the partnership agreement that allows the general partners to retain cash in the partnership for the future business needs of the partnership.

There is one additional aspect of the limited partnership device that makes it an even greater nuisance for the judgment creditor. It's a tax twist, and it can hurt. Based on Revenue Ruling 77–137,[150] many professionals believe that if a creditor secures a charging order against the partnership units and is entitled to receive all of the income distributed by the partnership, there is a possibility that the creditor will be taxed on its share of the partnership income as the owner of the units. If that income is retained in the partnership, the creditor may end up having to book phantom income for tax purposes. In effect, the charging order may become a poison tax pill for the creditor. If the creditor becomes a limited partner by having the charging order liquidated, there is little question that the income will be taxed to the creditor.

Once the limited partnership structure is in place, George and Betty can take other steps to strengthen their defense against a future judgment creditor. They can transfer units to their children, either outright or in trust. If the transfers are timely made and properly structured, the transferred units will be completely beyond the reach of the creditors. If a creditor obtains a malpractice judgment against George, the creditor can only seek a charging order against partnership

150. 1977–1 C.B. 178.

units owned by George, and cannot pursue the limited partnership units owned by the children. If George wants to add another layer of potential protection, he could consider the possibility of using a foreign trust to hold his limited partnership units or a trust established in a state with favorable asset protection laws. Although such a trust will provide another obstacle for the judgment creditor, it is far from bullet-proof and likely will trigger some tough legal challenges if attacked by a tenacious creditor.[151]

E. FIDUCIARY DUTIES AND RISKS

CASE PROBLEM 2-7

Refer to Case Problem 2-4 in which Son and Dad form a manager-managed LLC where Son is the manager. The LLC operating agreement states that "all fiduciary duties of care and loyalty that would otherwise exist between the members are hereby eliminated." Son causes the LLC to license all rights in Strategy long-term to a new corporation owned equally by Son and an unrelated deep-pocket investor. The royalties payable under the license are clearly on the low side of reasonable and do not reflect the potential value of Strategy. Dad is livid.

1. Does Dad have a cause of action against Son for breach of Son's fiduciary duties?

2. If Son has breached his fiduciary duties, can Dad have the license declared void?

3. Would Dad's cause of action have to be asserted as a direct or derivative claim? What difference would it make in this case? Does any such difference make sense under these circumstances?

CONNORS v. HOWE ELEGANT, LLC

2009 WL 242324 (Conn.Super. 2009)

BRUCE L. LEVIN, Judge.

This action arises out of the breakdown of the relationship between the principals, the plaintiff, Rosa Connors, and the defendant, Jennifer Kiman, who are the sole members of the defendant Howe Elegant, LLC (hereafter Howe), a beauty and hair salon. Connors (hereafter the plaintiff) alleges that in February 2005, she informed Kiman (hereafter the defendant) that she wanted to sell her interest in Howe or dissolve the business, but that she and Kiman were unable to come to terms about the business' future or the terms of dissolution. The plaintiff further alleges that on May 19, 2005, Kiman locked her out of the business' premises, subsequently closed the business' bank account and transferred those funds to another account, to which the plaintiff did not have access, and withdrew about $4,500 in operating cash.

The plaintiff brought this action on June 30, 2005.

151. See, generally, D. Osborne and M. Osborne "*Asset Protection: Trust Planning*," The American Law Institute (2010).

The plaintiff is a skin care specialist; the defendant is a hairdresser. In February 2001, both parties left their prior employment, taking with them their respective clients, and created Howe. Howe's business was hair styling, and nail and skin care. The plaintiff and the defendant obtained a $70,000 bank loan that was guaranteed by the United States Small Business Association (SBA), for which they were individually liable. Howe entered into a five-year lease on February 12, 2001 for the premises at 500 Howe Avenue in Shelton, Connecticut, which the plaintiff and defendant individually guaranteed.

By mutual agreement, the incomes that the plaintiff and the defendant derived from the business varied in a manner not prescribed by the LLC's operating agreement. Initially, the plaintiff and the defendant each put $700 back into the business each week, over and above what each party had earned from her respective customers. There was no evidence as to what the parties' arrangement was after this initial period, except that the plaintiff and the defendant took draws only out of what they respectively earned from their own clients, not from the revenue produced by anyone else in the shop.

In addition to the plaintiff and the defendant, the business had six employees. Employees were paid on a commission basis. The commission was not uniform for all employees, but varied from 25 percent to 50 percent. The balance was put back into the business. The employees had their own clients who they brought to the business. All the employees were employees at will, as were the plaintiff and the defendant. There were no employment contracts nor covenants not to compete.

For over three years, the plaintiff was the dominant member of Howe. Although Howe's operating agreement provided that each party was a member-manager, the plaintiff, with the defendant's acquiescence, was the de facto sole manager of the business. In the latter half of 2004, however, the defendant began to take a more assertive role in the business. On February 8, 2005, the plaintiff and the defendant had a telephone conversation about an issue that had arisen at work. An argument erupted at the end of which the plaintiff and the defendant agreed that they no longer would be partners and that their association would be terminated.

In the ensuing two and one-half months, the business continued. The atmosphere in the business was tense, but professional. The parties spoke little to each other; they generally only communicated through counsel. In March, the plaintiff, by her attorney, offered to sell her interest in Howe to the defendant "at a price to be determined by mutual agreement." In the alternative, the plaintiff suggested that they dissolve Howe. These offers failed to result in an agreement.

In March, the plaintiff informed the employees that she would be leaving Howe to start her own business. The employees made it clear to the plaintiff that they would be following her to that business. The defendant approached one employee, Heather Fernandez, informed her that she and the plaintiff would not be working together and encouraged Fernandez to stay with her. Fernandez was, at best, equivocal.

In March 2005, the plaintiff found a new location one-half mile away from Howe, obtained a building permit and began fitting up the building for her business, Sona Bella Salon and Spa, LLC (Sona Bella). Employees talked openly with their customers about their going to the plaintiff's new establishment, so much so that the defendant could overhear the remarks. The plaintiff took customer information from Howe's computer and used it to send a mailing to some of her customers, and to customers of the employees, announcing that Sona Bella would be opening and would employ Howe's soon-to-be former employees. She also took Howe's appointment book home and copied it and sold a gift certificate for her competing salon while she was still working at Howe. The plaintiff told the employees to tell their customers that the employees would be moving to Sona Bella soon, and the customers should make their next appointments there.

On Monday, May 9, 2005, the defendant called the plaintiff to discuss terms for dissolving the LLC. The parties did not reach an agreement on terms. During the week of May 9, 2005, the plaintiff was in and out of Howe, taking care of some of her customers, then leaving to tend to the fitting up of Sona Bella, where her work station was not yet ready. Although the fit up for Sona Bella was not complete, its new employees started seeing customers there on May 10, 2005. The plaintiff continued seeing her customers at Howe until May 18 or 19, 2005; she had nowhere else to service them.

On Thursday, May 19, 2005, the defendant changed the locks to the premises at 500 Howe Avenue. That evening, after business hours, the plaintiff tried to gain entry to the business, unsuccessfully, to retrieve a make-up unit she needed to service teenage customers who were attending a high school prom that weekend. The plaintiff's husband then telephoned the defendant's husband and asked him to open the door to the business that evening. The defendant's husband refused and also refused a request to provide the plaintiff with a new key to the premises. The plaintiff retrieved the make-up unit the following day, when she arrived at the business with a police officer. She never entered the premises again. She also made no payments on the lease to 500 Howe Avenue or on the SBA loan.

Thereafter, the defendant ceased doing business at 500 Howe Avenue under the name Howe Elegant LLC and did business under Jennifer Lee, LLC. She never again consulted with the plaintiff, and she assumed the lease and used the equipment and improvements that were made to the premises in 2001, when Howe first began operating. She also used the existing inventory of supplies. The defendant took charge of Howe's bank account, closed it with a balance of about $23,000, and transferred the money to a new account entitled Howe Elegant Old Money. She used that money, however, only to pay obligations of Howe or the SBA loan.

Although the issue of the plaintiff's standing has not been raised by the defendants, the court raises it sua sponte because it implicates the court's jurisdiction. *Smith v. Snyder,* 267 Conn. 456, 460 n. 5, 839 A.2d 589 (2004).

"Standing is established by showing that the party claiming it is authorized by statute to bring suit or is classically aggrieved ... The fundamental test for determining aggrievement encompasses a well-settled twofold determination: first, the party claiming aggrievement must successfully demonstrate a specific, personal and legal interest in [the subject matter of the challenged action], as distinguished from a general interest, such as is the concern of all members of the community as a whole. Second, the party claiming aggrievement must successfully establish that this specific personal and legal interest has been specially and injuriously affected by the [challenged action] ... Aggrievement is established if there is a possibility, as distinguished from a certainty, that some legally protected interest ... has been adversely affected ..." *AvalonBay Communities, Inc. v. Orange,* 256 Conn. 557, 567-68, 775 A.2d 284 (2001).

"Since at least the middle of the [nineteenth] century, it has been accepted in this country that the law should permit shareholders to sue derivatively on their corporation's behalf under appropriate conditions ... [I]t is axiomatic that a claim of injury, the basis of which is a wrong to the corporation, must be brought in a derivative suit, with the plaintiff proceeding secondarily, deriving his rights from the corporation which is alleged to have been wronged ... *Fink v. Golenbock,* 238 Conn. 183, 200, 680 A.2d 1243 (1996).

"[I]n order for a shareholder to bring a direct or personal action against the corporation or other shareholders, that shareholder must show an injury that is separate and distinct from that suffered by any other shareholder or by the corporation. It is commonly understood that [a] shareholder-even the sole shareholder-does not have standing to assert claims alleging wrongs to the corporation." *Smith v. Snyder, supra,* 267 Conn. at 460-62.

Fink v. Golenbock, 238 Conn. 183, 680 A.2d 1243 (1996), has some similarities to and differences with the instant case. In *Fink,* the named parties were each 50 percent owners of a professional corporation (the corporation) that became a successful pediatric practice. The plaintiff's wife sued him for divorce and told an employee of the corporation, Joan Magner, that the plaintiff had engaged in sexual conduct with his young adopted children. After learning this information, the defendant informed the plaintiff that he was no longer part of the medical practice, that he would not be allowed to see patients, and that if he attempted to do so, the defendant would have him arrested. Soon thereafter, the defendant and Magner formed a new professional corporation and operated a pediatric medical practice in the same building, which building was owned by the parties' corporation, used the same telephone number as the corporation and used the equipment that belonged to the corporation. Furthermore, the defendant took $10,000 from the corporation's checking account to establish the new corporation, and he did not pay the corporation either for the use of its equipment or for the use of its building.

The plaintiff brought a derivative action on behalf of the corporation alleging conversion, tortuous interference with business expectancies, an unjust enrichment. On appeal, the defendant argued that the plaintiff did not have standing to sue on behalf of the corporation because the plaintiff's injuries were personal, and not derivative. The Supreme Court disagreed. It also declined to

decide "whether the plaintiff could properly have brought a direct suit had he so chosen;" *id.,* at 200; although the court noted: "At least one authority has suggested that in the case of a closely held corporation, the court may choose to treat a derivative action as a direct action: 'In the case of a closely held corporation ... the court in its discretion may treat an action raising derivative claims as a direct action, exempt it from those restrictions and defenses applicable only to derivative actions, and order an individual recovery ...' 2 American Law Institute, Principles of Corporate Governance: Analysis and Recommendations (1994) § 7.01(d)." *Id.,* at 200 n. 14; see also *id.,* at 202 n. 17.

Subsequent cases have cast doubt on the current viability of this suggestion in *Fink.* In *Smith v. Snyder, supra,* 267 Conn. at 456, the plaintiffs, Patricia Smith, Carol Tartagnio and Lectron Labs, Inc., brought suit against the defendants, Bettina and Donald Snyder and CS Industries, alleging, *inter alia,* "that the named defendant, Charles Snyder, while serving as a director and officer of Lectron, breached a fiduciary duty that he owed to Lectron by engaging in a pattern of self dealing and other abuses of his position that were designed to destroy or devalue Lectron. On appeal, the Supreme Court addressed sua sponte the issue of the plaintiffs' standing; *id.,* at 460 n. 5; and concluded: that "Smith and Tartagni lacked standing to bring this action in their individual capacities because the allegations in the plaintiffs' complaint, if true, demonstrate that Lectron was harmed, but that no specific shareholder sustained an injury separate and distinct from that suffered by any other shareholder or by the corporation. Accordingly, the individual claims of Smith and Tartagni must be dismissed." *Id.,* at 462.

So too, here, the injuries that the defendant allegedly committed, transferring inventory, equipment and leasehold to Jennifer Lee, LLC, and even the "lock-out," were injuries to Howe, not to the plaintiff.

Based on *Smith v. Snyder,* the court holds that the plaintiff lacks standing to bring the tort claims in her individual capacity. Therefore, counts three through eighteen of the plaintiff's amended complaint are dismissed.

The defendants have filed a five-count counterclaim. In counts one and two of its counterclaim, Howe alleges that the plaintiff while she was a manager, member and employee of Howe, breached her fiduciary and statutory duties, pursuant to General Statutes § 34-141, in the following ways: "a. She obtained a location for a competing business within a short distance of the place of business of the defendant ... b. She recruited employees of the defendant ... for her competing salon; c. She and/or her recruited employees acting at her direction, compiled information relating to customers of Howe ... for the purpose of soliciting their business away from the defendant ... d. She and/or her recruited employees acting at her direction, communicated, directly or indirectly, to customers of Howe ... that the defendant ... was no longer going to be there; e. She and/or her recruited employees acting at her direction, sold gift certificates for her competing salon to customers of the defendant ... who came into the place of business of the defendant ... for the purpose of purchasing a gift certificate for the defendant ... and f. She, and/or her recruited employees acting at her

direction, sent mailings and other advertisements to customers of the defendant ... in order to solicit their business for the competing salon opened by the plaintiff."

Howe claims: "As a result of the breach of fiduciary duty by the plaintiff, the defendant ... lost customers, sales gift certificates and products and the opportunity to develop new customers, all to its financial detriment. As a further result of [the] breach of duty by the plaintiff, the defendant ... suffered damage to its business reputation."

Each protagonist, the plaintiff and the defendant, established her own LLC with the knowledge of the other. Under all the circumstances, it was reasonable for them not to wait until the dissolution of Howe to do so. Indeed, this would have been unrealistic. These are not wealthy people; they are beauticians servicing the lower Connecticut valley area who could not afford to suspend their livelihood while awaiting the outcome of litigation, now three and one-half years old. Furthermore, as observed above, the plaintiff and the defendant each knew the other would be plying her trade under the guise of a new corporate entity. Cf. *Ostrowski v. Avery,* 243 Conn. 355, 376, 703 A.2d 117 (1997) ("[A]dequate disclosure of a corporate opportunity is an absolute defense to fiduciary liability for alleged usurpation of ... a corporate opportunity.")

Moreover, comment (e) to § 393 of the Restatement (Second) of Agency, as well as 19 C.J.S., Corporations § 603 (2007), support a conclusion that a corporate officer should be allowed to make preparations for a competing business, prior to his or her resignation or termination, in the absence of a restrictive agreement stating otherwise.

As observed *supra,* the parties did not execute a restrictive covenant. Pursuant to the Restatement cited above, the plaintiff was permitted to make arrangements to compete with the defendant prior to her resignation. It is noteworthy that the plaintiff did not solicit customers for her rival business until the end of her employment. The court finds that the plaintiff merely informed Howe's employees that she would be leaving to start her own business, several employees announced that they would be following her, and the employees spoke openly to their customers about going to the plaintiff's new establishment. This conduct does not amount to solicitation under the circumstances.

Case law from other jurisdictions reflects that courts have found that, in the absence of a restrictive covenant, it is not a breach of fiduciary duty for an employee to prepare to compete with an employer prior to the employee's resignation or termination. The Court of Special Appeals in Maryland in *Dworkin v. Blumenthal,* 77 Md.App. 774, 782, 551 A.2d 947 (1989), held that two dentists, who were members of a professional association, did not actively compete with the association during their employment, although they did make arrangements to compete while they were still employees. In that case, the defendants began compiling a patient list from the association's records prior to their resignation. *Id.,* at 779. The court noted that the defendants only notified those patients that they, themselves, had treated, that they would be leaving the association and opening a new practice. *Id.,* at 780. Similarly, here, the court found that the plaintiff compiled customer information from Howe's computer

records and used it to notify her customers and her employee's customers that she would be opening a new salon. There is no evidence that the plaintiff solicited any of the defendant's customers prior to her departure from Howe.

By clear and convincing evidence, the court finds that the plaintiff did not breach any duty to Howe.

Derivative Action Obstacles

As the *Connors* case illustrates, often a member of an LLC will be denied the right to bring a direct action against other members for breach of fiduciary or contractual duties owed the LLC. The LLC statutes of many states require that such actions be brought as derivative actions on behalf of the LLC. Any recovery in a derivative suit against a wrongdoer goes to the LLC, not the member who prosecutes the lawsuit. Plus, before commencing the action, the plaintiff must make a demand on the LLC to prosecute or settle the charges or allege with particularity in the complaint that such a demand would be futile.[152] The demand requirement gives the LLC advance notice of the suit and, in theory, provides an opportunity for a pre-suit settlement and exhaustion of intra-LLC dispute resolution procedures. And it gives the LLC's management time to exercise its management prerogative in sizing up the situation and deciding whether the case should go forward. States that have adopted the latest version of the Revised Uniform Limited Liability Company Act statutorily permit the appointment of a special litigation committee composed of independent and disinterested members to represent the interests of the LLC in any derivative proceeding.[153]

See section C. of Chapter 9 for an extended discussion of derivative actions in the context of a corporation. The right of corporate shareholders to prosecute a derivative claim is an absolute necessity because it is the tool that reconciles the conflict between the fiduciary duties imposed on the officers and directors of a corporation and the board of directors' power to manage the enterprise. Without this right, the duties would mean little or nothing. A board is not going to authorize a suit against itself for its breach of the duties of care or loyalty. A shareholder, as an owner of the enterprise, must have the right to expose and prosecute the wrongdoing on behalf of the corporation. The lawsuit is labeled "derivative" because it is based on the rights of, and injuries to, the corporation. As discussed in Chapter 9, at times the line between direct and derivative actions is fuzzy. But, as illustrated by the *Connors* case, the line is important because often it is the difference between the case moving forward and being dismissed.

Many have claimed that the direct-derivative distinction often makes little sense in the context of a closely held corporation where some owners desire to bring an action against their co-owners, alleging breach of fiduciary duties.[154] These claims seek to distinguish the role of a derivative action in a publicly held company from the lack of a need for such a role in a closely held corporation. Thus, in limited situations involving closely held corporations, courts have

152. See RULLCA §§ 901 through 904.
153. See RULLCA §§ 901 through 905.
154. See, for example, *Crosby v. Beam*, 548 N.E.2d 217 (Ohio 1989), *Barth v. Barth*, 659 N.E.2d 559 (Ind. 1995), and ALI Principles § 7.01(d).

ignored derivative requirements and treated the conflict as the equivalent of a dispute among partners.[155] Any recovery flows to the prevailing party (not the corporation), there is no pre-suit demand requirement, and the parties can settle their dispute without court approval. As the *Connors* case illustrates, this movement to ignore derivative requirements has not caught on in the LLC context, and it's unlikely that it ever will in states that have specific LLC derivative statutes that are applicable to closely held enterprises.

AURIGA CAPITAL CORP. v. GATZ PROPERTIES

40 A.3d 839 (Del.Ch. 2012)

STRINE, Chancellor.

The manager of an LLC [Gatz] and his family acquired majority voting control over both classes of the LLC's equity during the course of its operations and thereby held a veto over any strategic option. The LLC was an unusual one that held a long-term lease on a valuable property owned by the manager and his family. The leasehold allowed the LLC to operate a golf course on the property.

The LLC intended to act as a passive operator by subleasing the golf course for operation by a large golf management corporation. A lucrative sublease to that effect was entered in 1998. The golf management corporation, however, was purchased early in the term of the sublease by owners that sought to consolidate its operations. Rather than invest in the leased property and put its full effort into making the course a success, the management corporation took short cuts, let maintenance slip, and evidenced a disinterest in the property. By as early as 2004, it was clear to the manager that the golf management corporation would not renew its lease.

This did not make the manager upset. The LLC and its investors had invested heavily in the property, building on it a first-rate Robert Trent Jones, Jr.—designed golf course and a clubhouse. If the manager and his family could get rid of the investors in the LLC, they would have an improved property, which they had reason to believe could be more valuable as a residential community. Knowing that the golf management corporation would likely not renew its sublease, the manager failed to take any steps at all to find a new strategic option for the LLC that would protect the LLC's investors. Thus, the manager did not search for a replacement management corporation, explore whether the LLC itself could manage the golf course profitably, or undertake to search for a buyer for the LLC. Indeed, when a credible buyer for the LLC came forward on its own and expressed a serious interest, the manager failed to provide that buyer with the due diligence that a motivated seller would typically provide to a possible buyer. Even worse, the manager did all it could to discourage a good bid, frustrating and misleading the interested buyer.

The manager then sought to exploit the opportunity provided by the buyer's emergence to make low-ball bids to the other investors in the LLC on the basis of materially misleading information. Among other failures, the manager made an offer at $5.6 million for the LLC without telling the investors that the buyer had

155. Id.

expressed a willingness to discuss a price north of $6 million. The minority investors refused the manager's offer. When the minority investors asked the manager to go back and negotiate a higher price with the potential buyer, the manager refused.

This refusal reflected the reality that the manager and his family were never willing to sell the LLC. Nor did they desire to find a strategic option for the LLC that would allow it to operate profitably for the benefit of the minority investors. The manager and his family wanted to be rid of the minority investors, whom they had come to regard as troublesome bothers.

Using the coming expiration of the golf management corporation's sublease as leverage, the manager eventually conducted a sham auction to sell the LLC. The auction had all the look and feel of a distress sale, but without any of the cheap nostalgic charm of the old unclaimed freight TV commercials. Ridiculous postage stamp-sized ads were published and unsolicited junk mail was sent out. Absent was any serious marketing to a targeted group of golf course operators by a responsible, mature, respected broker on the basis of solid due diligence materials. No effort was made to provide interested buyers with a basis to assume the existing debt position of the LLC if they met certain borrower responsibility criteria. Instead, interested buyers were told that they would have to secure the bank's consent but were given an unrealistic amount of time to do so. Worst of all, interested buyers could take no comfort in the fact that the manager—who controlled the majority of the voting power of the LLC—was committed to selling the LLC to the highest bidder, as the bidding materials made clear that the manager was also planning to bid and at the same time reserved the right to cancel the auction for any reason.

When the results of this incompetent marketing process were known and the auctioneer knew that no one other than the manager was going to bid, the auctioneer told the manager that fact. The manager then won with a bid of $50,000 in excess of the LLC's debt, on which the manager was already a guarantor. Only $22,777 of the bid went to the minority investors. For his services in running this ineffective process, the auctioneer received a fee of $80,000, which was greater than the cash component of the winning bid. Despite now claiming that the LLC could not run a golf course profitably and pay off the mortgage on the property, the manager has run the course himself since the auction and is paying the debt.

A group of minority investors have sued for damages, arguing the manager breached his contractual and fiduciary duties through this course of conduct. The manager, after originally disclaiming that he owed a fiduciary duty of loyalty to the minority, now rests his defense on two primary grounds. The first is that the manager and his family were able to veto any option for the LLC as their right as members. As a result, they could properly use a chokehold over the LLC to pursue their own interests and the minority would have to live with the consequences of their freedom of action. The second defense is that by the time of the auction, the LLC was valueless.

In this post-trial decision, I find for the plaintiffs. For reasons discussed in

the opinion, I explain that the LLC agreement here does not displace the traditional duties of loyalty and care that are owed by managers of Delaware LLCs to their investors in the absence of a contractual provision waiving or modifying those duties. The Delaware Limited Liability Company Act (the "LLC Act") explicitly applies equity as a default and our Supreme Court, and this court, have consistently held that default fiduciary duties apply to those managers of alternative entities who would qualify as fiduciaries under traditional equitable principles, including managers of LLCs. Here, the LLC agreement makes clear that the manager could only enter into a self-dealing transaction, such as its purchase of the LLC, if it proves that the terms were fair. In other words, the LLC agreement essentially incorporates a core element of the traditional fiduciary duty of loyalty. Not only that, the LLC agreement's exculpatory provision makes clear that the manager is not exculpated for bad faith action, willful misconduct, or even grossly negligent action, i.e., a breach of the duty of care.

The manager's course of conduct here breaches both his contractual and fiduciary duties. Using his control over the LLC, the manager took steps to deliver the LLC to himself and his family on unfair terms. With a minimally competent and loyal fiduciary at the helm, the LLC could have charted a course that would have delivered real value to its investors.

The manager's defense that his voting power gave him a license to exploit the minority fundamentally misunderstands Delaware law. The manager was free not to vote his membership interest for a sale. But he was not free to create a situation of distress by failing to cause the LLC to explore its market alternatives and then to buy the LLC for a nominal price. The purpose of the duty of loyalty is in large measure to prevent the exploitation by a fiduciary of his self-interest to the disadvantage of the minority. The fair price requirement of that duty, which is incorporated in the LLC agreement here, makes sure that if the conflicted fiduciary engages in self-dealing, he pays a price that is as much as an arms-length purchaser would pay.

The manager is in no position to take refuge in uncertainties he himself created by his own breaches of duty. He himself is responsible for the distress sale conducted in 2009. Had he acted properly, the LLC could have secured a strategic alternative in 2007, when it was in a stronger position and the economy was too. A transaction at that time would have likely yielded proceeds for the minority of a return of their invested capital plus a 10% total return, an amount which reflects the reality that the manager's desire to retain control of the LLC would have pushed up the pricing of the transaction due to his incentive to top any third-party bidder. I therefore enter a remedy to that effect, taking into account the distribution received by the plaintiffs at the auction, and add interest, compounded monthly at the legal rate, from that time period. Because the manager has made this litigation far more cumbersome and inefficient than it should have been by advancing certain frivolous arguments, I award the plaintiffs one-half of their reasonable attorneys' fees and costs. This award is justified under the bad faith exception to the American Rule, and also ensures that the disloyal manager is not rewarded for making it unduly expensive for the minority

investors to pursue their legitimate claims to redress his serious infidelity. I do not award full-fee shifting because I have not adopted all of the plaintiffs' arguments and because the manager's litigation conduct, while sanctionably disappointing, was not so egregious as to justify that result.

At points in this litigation, Gatz has argued that his actions were not subject to any fiduciary duty analysis because the LLC Agreement of Peconic Bay displaced any role for the use of equitable principles in constraining the LLC's Manager. As I next explain, that is not true.

The Delaware LLC Act starts with the explicit premise that "equity" governs any case not explicitly covered by the Act. But the Act lets contracting parties modify or even eliminate any equitable fiduciary duties, a more expansive constriction than is allowed in the case of corporations. For that reason, in the LLC context, it is typically the case that the evaluation of fiduciary duty claims cannot occur without a close examination of the LLC agreement itself, which often tailors the traditional fiduciary duties to address the specific relationship of the contracting parties.

It seems obvious that, under traditional principles of equity, a manager of an LLC would qualify as a fiduciary of that LLC and its members. Under Delaware law, "[a] fiduciary relationship is a situation where one person reposes special trust in and reliance on the judgment of another or where a special duty exists on the part of one person to protect the interests of another." other. *Metro Ambulance, Inc. v. E. Med. Billing, Inc.,* 1995 WL 409015, at 2 (Del.Ch. July 5, 1995). Corporate directors, general partners and trustees are analogous examples of those who Delaware law has determined owe a "special duty." *McMahon v. New Castle Assocs.,* 532 A.2d 601, 604–05 (Del.Ch.1987). Equity distinguishes fiduciary relationships from straightforward commercial arrangements where there is no expectation that one party will act in the interests of the other. *Wal–Mart Stores, Inc. v. AIG Life Ins. Co.,* 901 A.2d 106, 114 (Del.2006).

The manager of an LLC—which is in plain words a limited liability "company" having many of the features of a corporation—easily fits the definition of a fiduciary. The manager of an LLC has more than an arms-length, contractual relationship with the members of the LLC. Rather, the manager is vested with discretionary power to manage the business of the LLC.

Thus, because the LLC Act provides for principles of equity to apply, because LLC managers are clearly fiduciaries, and because fiduciaries owe the fiduciary duties of loyalty and care, the LLC Act starts with the default that managers of LLCs owe enforceable fiduciary duties.

The statute incorporates equitable principles. Those principles view the manager of an LLC as a fiduciary and subject the manager as a default principle to the core fiduciary duties of loyalty and care. But, the statute allows the parties to an LLC agreement to entirely supplant those default principles or to modify them in part. Where the parties have clearly supplanted default principles in full, we give effect to the parties' contract choice. Where the parties have clearly supplanted default principles in part, we give effect to their contract choice. But, where the core default fiduciary duties have not been supplanted by contract,

they exist as the LLC statute itself contemplates.

I note at the outset that the Peconic Bay LLC Agreement contains no general provision stating that the only duties owed by the manager to the LLC and its investors are set forth in the Agreement itself. Thus, before taking into account the existence of an exculpatory provision, the LLC Agreement does not displace the traditional fiduciary duties of loyalty and care owed to the Company and its members by Gatz Properties and by Gatz, in his capacity as the manager of Gatz Properties. And although LLC agreements may displace fiduciary duties altogether or tailor their application, by substituting a different form of review, here § 15 of the LLC Agreement contains a clause reaffirming that a form akin to entire fairness review will apply to "Agreements with Affiliates," a group which includes Gatz Properties, that are not approved by a majority of the unaffiliated members' vote. In relevant part, § 15 provides:

> 15. Neither the Manager nor any other Member shall be entitled to cause the Company to enter ... into any additional agreements with affiliates on terms and conditions which are less favorable to the Company than the terms and conditions of similar agreements which could be entered into with arms-length third parties, without the consent of a majority of the non-affiliated Members (such majority to be deemed to be the holders of 66–2/3% of all Interests which are not held by affiliates of the person or entity that would be a party to the proposed agreement).

This court has interpreted similar contractual language supplying an "arm's length terms and conditions" standard for reviewing self-dealing transactions, and has read it as imposing the equivalent of the substantive aspect of entire fairness review, commonly referred to as the "fair price" prong.

Importantly, however, entire fairness review's procedural inquiry into "fair dealing" does not completely fall away, because the extent to which the process leading to the self-dealing either replicated or deviated from the behavior one would expect in an arms-length deal bears importantly on the price determination. Where a self-dealing transaction does not result from real bargaining, where there has been no real market test, and where the self-interested party's own conduct may have compromised the value of the asset in question or the information available to assess that value, these factors bear directly on whether the interested party can show that it paid a fair price. Thus, as written, § 15 permits Affiliate Agreements without the approval of the majority of the Minority Members, subject to a proviso that places the burden on the Manager (here, Gatz) to show that the price term of the Affiliate Agreement was the equivalent of one in an agreement negotiated at arms-length. But, "[i]mplicit in this proviso is the requirement that the [defendants] undertake some effort to determine the price at which a transaction with [Gatz] could be effected through a deal with a third party." In other words, in order to take cover under the contractual safe harbor of § 15, Gatz bears the burden to show that he paid a fair price to acquire Peconic Bay, a conclusion that must be supported by a showing that he performed, in good faith, a responsible examination of what a third-party buyer would pay for the Company. The record convinces me that Gatz has failed

to meet the terms of this proviso.

The LLC Agreement does, however, contain an exculpatory provision, which is functionally akin to an exculpatory charter provision authorized by 8 Del. C. § 102(b)(7). In relevant part, § 16, governing "Exculpation and Indemnification," reads as follows:

> 16. No Covered Person [defined to include "the Members, Manager and the officers, equity holders, partners and employees of each of the foregoing"] shall be liable to the Company, [or] any other Covered Person or any other person or entity who has an interest in the Company for any loss, damage or claim incurred by reason of any act or omission performed or omitted by such Covered Person in good faith in connection with the formation of the Company or on behalf of the Company and in a manner reasonably believed to be within the scope of the authority conferred on such Covered Person by this Agreement, except that a Covered Person shall be liable for any such loss, damage or claim incurred by reason of such Covered Person's gross negligence, willful misconduct or willful misrepresentation.

Thus, by the terms of § 16, Gatz may escape monetary liability for a breach of his default fiduciary duties if he can prove that his fiduciary breach was not: (1) in bad faith, or the result of (2) gross negligence, (3) willful misconduct or (4) willful misrepresentation. Also, in order to fall within the terms of § 16, a Covered Person must first be acting "on behalf of the company" and "in a manner reasonably believed to be within the scope of authority conferred on [him] by [the LLC Agreement]." Thus, § 16 only insulates a Covered Person from liability for authorized actions; that is, actions taken in accordance with the other stand-alone provisions of the LLC Agreement. So, to the extent that the Auction and the follow-on Merger were effected in violation of the arms-length mandate set forth in § 15 (which they were), such a breach would not be exculpated by § 16. Moreover, even if I were to find that § 16 operated to limit Gatz's liability for actions taken in contravention of the terms of § 15, I find that his actions related to and in consummation of the Auction and follow-on Merger were taken in bad faith such that he would not be entitled to exculpation anyway.

Notably, the exculpation standard set forth in § 16 is both stronger and weaker than its corporate analogue in terms of limitation of liability. Whereas § 102(b)(7) authorizes a charter provision to exculpate a violation of the directors' duty of care (i.e., gross negligence), here § 16 does not exculpate for a breach of the duty of care. Gatz may still be liable for gross negligence. But, whereas § 102(b)(7) does not authorize exculpation for breaches of corporate directors' duty of loyalty, here § 16 does exculpate Gatz from liability for a breach of his fiduciary duty of loyalty (outside the context governed by § 15) to the extent he shows that the breach was not committed in bad faith or through willful misconduct.

The record convinces me that Gatz pursued a bad faith course of conduct to enrich himself and his family without any regard for the interests of Peconic Bay or its Minority Members. His breaches may be summarized as follows: (1) failing

to take any steps for five years to address in good faith the expected loss of American Golf as an operator; (2) turning away a responsible bidder which could have paid a price beneficial to the LLC and its investors in that capacity; (3) using the leverage obtained by his own loyalty breaches to play "hardball" with the Minority Members by making unfair offers on the basis of misleading disclosures; and (4) buying the LLC at an auction conducted on terms that were well-designed to deter any third-party buyer, and to deliver the LLC to Gatz at a distress sale price.

Despite this, Gatz argues that he and his fellow defendant should not be held liable because even if they breached their fiduciary duties, they did not cause any economic harm because Peconic Bay was insolvent as of the time of the Auction.

By the time of his post-trial briefs, Gatz's defense was really one based on minimizing the damages he would owe. That defense melds with his defense based on § 15 of the LLC Agreement, which is that regardless of his misconduct, Gatz Properties in fact paid a fair price for Peconic Bay at the Auction and thus complied with its core mandate that Affiliate Agreements be entered into on "arms-length" terms and conditions. In support of that argument, Gatz points to testimony of Carr of Auriga. In that testimony, which was in response to questions from the court itself, Carr admitted that he considered bidding at the Auction, but did not because he could not come up with a model predicting positive returns high enough to meet his personal requirements.

Gatz himself is responsible for the evidentiary uncertainty caused by his own disloyalty. It was his own selfishly motivated acts of mismanagement that led to the distress sale. If he had acted properly, a liquidity event or some other sensible strategic alternative to the expiring American Golf Sublease would have been undertaken in 2007, when Galvin of RDC came on the scene. Gatz was the one who put Peconic Bay in a position of relative economic weakness by allowing the time on the Sublease to lapse and then choosing to put Peconic Bay on the auction block, and even then he chose an unduly rushed and compromised marketing process when there was time to do a professionally competent job. Given his own breaches of loyalty, the attendant uncertainties cut against Gatz, not against the victims of his infidelity.

In view of the persistent and serious nature of Gatz's breaches, and in view of his own 2008 claim that he was offering a deal that would have returned to the Minority Members their full initial capital contribution, I conclude that a remedy that awards the Minority Members their full capital contribution of $725,000 plus $72,500, is the equitable result. This is slightly less than the amount that would have been produced by a deal in 2007 of $6.5 million.

For all these reasons, I find for the Minority Members and will enter a final judgment for them.

The Value of Contractual Exculpation

Section 110(d) of the Revised Uniform Limited Liability Company Act authorizes liability exculpation provisions in an LLC operating agreement as

follows:

(d) If not manifestly unreasonable, the operating agreement may:

(1) restrict or eliminate the duty:

(A) to account to the limited liability company and to hold as trustee for it any property, profit, or benefit derived by the member in the conduct or winding up of the company's business, from a use by the member of the company's property, or from the appropriation of a limited liability company opportunity;

(B) to refrain from dealing with the company in the conduct or winding up of the company's business as or on behalf of a party having an interest adverse to the company; and

(C) to refrain from competing with the company in the conduct of the company's business before the dissolution of the company;

(2) identify specific types or categories of activities that do not violate the duty of loyalty;

(3) alter the duty of care, except to authorize intentional misconduct or knowing violation of law;

(4) alter any other fiduciary duty, including eliminating particular aspects of that duty; and

(5) prescribe the standards by which to measure the performance of the contractual obligation of good faith and fair dealing.

(e) The operating agreement may specify the method by which a specific act or transaction that would otherwise violate the duty of loyalty may be authorized or ratified by one or more disinterested and independent persons after full disclosure of all material facts.

(f) To the extent the operating agreement of a member-managed limited liability company expressly relieves a member of a responsibility that the member would otherwise have under this [act] and imposes the responsibility on one or more other members, the operating agreement may, to the benefit of the member that the operating agreement relieves of the responsibility, also eliminate or limit any fiduciary duty that would have pertained to the responsibility.

(g) The operating agreement may alter or eliminate the indemnification for a member or manager.. and may eliminate or limit a member or manager's liability to the limited liability company and members for money damages, except for:

(1) breach of the duty of loyalty;

(2) a financial benefit received by the member or manager to which the member or manager is not entitled;

(3) a breach of a duty [for improper distritions];

(4) intentional infliction of harm on the company or a member; or

(5) an intentional violation of criminal law.

The breadth of these provisions creates powerful planning opportunities in drafting an LLC operating agreement. You will discover when you study fiduciary duties in the context of a corporation (Chapter 10) that the scope of these exculpation provisions exceeds anything in the corporate world. Careful drafting of an LLC operating agreement can reduce and, in some instances, completely eliminate fiduciary liability exposure. The limiting factor under the Revised Act is that the exculpation provisions cannot be "manifestly unreasonable." In explaining the role of this limitation under subparagraph (d), the official comments to the Revised Act state:

> **Subsection (d)** -Delaware recently amended its LLC statute to permit an operating agreement to fully "eliminate" fiduciary duty within an LLC. This Act rejects the ultra-contractarian notion that fiduciary duty within a business organization is merely a set of default rule and seeks instead to balance the virtues of "freedom of contract" against the dangers that inescapably exist when some have power over the interests of others. As one source has explained:
>
> > The open-ended nature of fiduciary duty reflects the law's long-standing recognition that devious people can smell a loophole a mile away. For centuries, the law has assumed that (1) power creates opportunities for abuse and (2) the devious creativity of those in power may outstrip the prescience of those trying, through ex ante contract drafting, to constrain that combination of power and creativity.[156]

F. AUTHORITY AND MANAGEMENT DISPUTES

SYNECTIC VENTURES I, LLC v. EVI CORP.

251 P.3d 216 (Or.App. 2011)

SERCOMBE, P.J.

These consolidated appeals involve an action by three investment funds to collect on a promissory note and foreclose on a security interest against defendant EVI Corporation (EVI) pursuant to the terms of a loan agreement. The dispute between the parties turns on whether an amendment to the loan agreement is binding on plaintiffs. The dispositive issue on appeal is whether the trial court correctly determined that plaintiffs' manager, Craig Berkman, had the authority to bind plaintiffs to the amendment. We affirm.

Plaintiffs are three investment funds that were organized as limited liability companies and originally managed by Berkman. The operating agreement for each plaintiff designates a separate management firm controlled by Berkman as

156. Carter G. Bishop and Daniel S. Kleinberger, *Limited Liability Companies: Tax and Business Law*, ¶ 14.05[4][a][ii]

the manager for each fund. Berkman was also the board chairman and treasurer of EVI, and served as the main fundraiser for EVI. His involvement with EVI was allowed under the terms of the operating agreements. On appeal, plaintiffs argue that Berkman lacked authority to bind them to the amendment. Initially, they assert that, because Berkman breached multiple duties to plaintiffs by executing the amendment, he did not have authority to bind them. Alternatively, plaintiffs argue that they limited Berkman's authority to act without prior approval before he signed the amendment, and that EVI had knowledge, through Berkman and EVI's CEO, Thomas Wiita, that Berkman lacked authority to enter into the amendment. Accordingly, plaintiffs claim that the amendment is not binding.

EVI contends that the amendment was valid, given that plaintiffs' operating agreements vest Berkman with exclusive management authority, and that he was acting within his authority when he entered into the amendment on behalf of plaintiffs. In addition, EVI argues that the operating agreements granted third parties the right to rely, without further inquiry, on a certificate signed by Berkman as the managing member. EVI also maintains that plaintiffs' operating agreements authorized the types of conflicts of interest that plaintiffs assert exist in this case. Finally, EVI asserts that plaintiffs ratified the amendment because they did not object to it until seven months after they discovered it.

The basic facts are undisputed. Plaintiffs are venture capital funds that were formed to invest in emerging companies. Each plaintiff is a fund that consists of individual investors. All three are governed by substantially similar operating agreements. Berkman's management entities are named in each operating agreement as the manager, and those documents generally grant the manager the exclusive authority to manage and control the interests of plaintiffs. EVI is an Oregon corporation in the medical device field.

Plaintiffs, along with two other investment funds—defendants Synectic Ventures IV, LLC (Fund IV), and Synectic Ventures V, LLC (Fund V)—advanced over $3 million to EVI before March 2003. In March 2003, the parties documented the terms of the advances in the loan agreement, which required EVI to pay the debt by December 31, 2004. If the debt was not timely paid, plaintiffs were entitled to foreclose on EVI's assets. However, if EVI received additional investments of at least $1 million before the deadline, EVI could force a conversion of the debt to equity (in the form of EVI stock).

Around the time that the parties executed the agreement, some, but not all, of the individual investors in plaintiffs hired a Portland law firm to investigate Berkman's management of the funds. After some initial investigation and communications with Berkman, the concerned investors and Berkman entered into a letter agreement in September 2003. The terms of the letter agreement provided that Berkman would inform the concerned investors of certain activities taken on behalf of plaintiffs, and that Berkman would not take on additional obligations or increase existing obligations for plaintiffs, without advance approval of the concerned investors.

The terms agreed to in the September 2003 letter agreement were reiterated in another letter agreement in June 2004. The June 2004 letter agreement also contemplated winding up the funds. Further communications on behalf of the concerned investors in late 2004 informed Berkman that the concerned investors intended to remove him as manager as soon as a replacement could be found.

Although the exact date is disputed, in September 2004, Berkman executed an amendment to the agreement on plaintiffs' behalf that extended EVI's repayment deadline until December 31, 2005. He also executed a Unanimous Consent on behalf of EVI's board of directors, which allowed Wiita to execute the amendment for EVI. Plaintiffs assert that they were unaware of the amendment at the time it was made. Pursuant to the process outlined in the operating agreements, plaintiffs removed Berkman as manager in December 2004 and hired another management company.

EVI did not pay the debt and did not receive additional investments of $1 million before December 31, 2004. In early 2005, plaintiffs discovered the existence of the amendment. In late August 2005, plaintiffs notified EVI that the amendment was not authorized and that EVI was in default. Subsequently, another investment fund managed by Berkman—Synectic Asset Ventures LLC (SAV)—invested $1 million in EVI by December 31, 2005. EVI then purportedly converted the loans subject to the agreement into equity in satisfaction of its debt.

Plaintiffs consolidate their argument on appeal, and maintain that the amendment is not binding on them for alternative reasons. They claim that Berkman breached several fiduciary duties owed to plaintiffs at the time of the amendment, and that, because EVI had actual knowledge of his conduct, the amendment is not binding on plaintiffs. Alternatively, plaintiffs assert that, even if Berkman did not breach any fiduciary duties, he lacked the authority to execute the amendment on plaintiffs' behalf, and, because EVI knew that he lacked authority, the amendment cannot be enforced against plaintiffs.

EVI responds that the amendment is enforceable for any of three reasons. First, EVI contends that Berkman, through plaintiffs' operating agreements, had actual authority to enter into and bind plaintiffs to the amendment. Second, EVI argues that, regardless of Berkman's actual authority, EVI was entitled to rely on Berkman's apparent authority given that the operating agreements specifically authorized third parties to rely on Berkman's actions without further inquiry. Third, EVI asserts that plaintiffs ratified the amendment because they knowingly acquiesced to its terms for seven months before challenging it.

We begin our analysis with a key provision from the statutes governing limited liability companies. ORS 63.140(2)(a) provides, in part:

> "Each manager is an agent of the limited liability company for the purpose of its business, and an act of a manager, including the signing of an instrument in the limited liability company's name, for apparently carrying on in the ordinary course the business of the limited liability company, or business of the kind carried on by the limited liability company, binds the limited liability company unless the manager had

no authority to act for the limited liability company in the particular matter and the person with whom the manager was dealing knew or had notice that the manager lacked authority."

As such, ORS 63.140(2)(a) sets forth the statutory standard for determining if a manager's act in carrying on in the ordinary course the business of the limited liability company is binding on that company. If the manager had no authority in that particular matter and the third party knew or had notice of the manager's lack of authority, then the company is not bound.

Determining whether a manager has authority requires us to look to the law of agency. Generally, a principal is bound by its agent's acts if the acts are within the scope of the agent's actual or apparent authority.

Plaintiffs' operating agreements each contain identical statements about the management and control of the companies. The operating agreements gave Berkman authority to exclusively manage and control the business and affairs of plaintiffs. His actual authority, expressly granted in the operating agreements, encompassed the ability to take action on behalf of plaintiffs without the consent of the members. The operating agreements also granted any third party the right to rely on Berkman's authority to bind plaintiffs without further inquiry. As such, at first blush it would appear that Berkman's act of executing the amendment was within the express authority granted to him in the operating agreements.

Plaintiffs, however, assert that Berkman's actual authority was limited in one of two ways: either the "letter agreements" that Berkman entered into with the concerned investors limited his authority to further obligate plaintiffs without approval of the concerned investors, or his authority was limited by his acts of self-dealing and his breach of the fiduciary duties he owed to plaintiffs.

We first examine the effect of the letter agreements. Plaintiffs contend that the trial court erroneously relied only on the text of the operating agreements and failed to consider other circumstances that existed at the time that Berkman entered into the amendment. They maintain that, through the series of communications and letter agreements, Berkman agreed that his authority was limited, and that any new obligations required the approval of plaintiffs. From that, they conclude that Berkman lacked the authority to execute the amendment on plaintiffs' behalf.

We agree with the trial court that the letter agreements did not limit Berkman's authority to bind plaintiffs because Berkman did not enter into these agreements *with plaintiffs*. The letter agreements confirmed an understanding between Berkman and the concerned investors. However, the concerned investors were acting in their capacity as a group of individual investors, not as the funds. Under general principles of the law of agency, any agreement between Berkman and a subset of individual investors who were not acting as plaintiffs did not limit Berkman's actual authority. *Restatement (Third) of Agency* § 3.06 (2006) (noting that termination of an agent's authority may occur by agreement between the agent and the *principal* or a manifestation of revocation by the *principal* to the agent).

In fact, the September 2003 letter agreement eschews the legal effect that plaintiffs currently seek. It advises that "[Berkman] will remain responsible for the Funds to the same extent as in the past." Moreover, while the record shows that Berkman did at times comply with the letter agreements, it also demonstrates that the concerned investors and their attorneys understood and communicated to Berkman that the letter agreements did not limit Berkman's authority to act on behalf of plaintiffs. For example, e-mail communications between the concerned investors' attorney and a company in a separate investment deal state that:

> "the investors committee has no right to control the investment of Fund monies. That is the power, right, and responsibility of the Manager of the Funds. Even if the committee or individual investors whom we represent wanted to do so, they do not have the right to cause the Fund II Manager—[Berkman]—to invest or not invest further in [third party]. Moreover, there are other Fund II investors whose interests we do not represent. All of the Fund investors are free to express their preference to [Berkman], but he ultimately is the only one with responsibility for any Fund investment decisions."

Furthermore, the stated understanding of the concerned investors is consistent with the terms of the operating agreements, which set out a specific process for Berkman's removal as manager. Pursuant to the operating agreements, Berkman was removed in December 2004, but not before the amendment was executed.

Thus, the agreements purporting to limit Berkman's authority were ineffective to do so because they did not comply with the process set forth in the operating agreements. While the letter agreements may create an obligation that Berkman owed to the concerned investors, any breach of that obligation was between him and them, and it did not affect his authority to conduct business on plaintiffs' behalf.

Next, we address plaintiffs' contention that they were not bound by the amendment because Berkman breached his fiduciary duties to plaintiffs when he signed the amendment. Plaintiffs cite *Fine v. Harney Co. National Bank,* 181 Or. 411, 182 P.2d 379 (1947), and *Houck v. Feller Living Trust,* 191 Or.App. 39, 42–43, 79 P.3d 1140 (2003), for the proposition that an agent cannot bind the principal in a matter in which his own interest conflicts with the duty he owes to the principal—particularly when the third party with whom the agent is dealing knew that the agent was breaching his duties.

Plaintiffs maintain that ORS chapter 63 conferred duties of loyalty, care, and good faith and fair dealing on Berkman, and that the operating agreements contained a "standard of conduct" clause that explicitly required Berkman to act in accordance with those duties. Plaintiffs contend that Berkman breached the duties of loyalty, care, and good faith and fair dealing by executing the amendment without prior authorization from plaintiffs. Plaintiffs claim that, given Berkman's self-interest in the success of EVI, he was required by the operating agreements to seek plaintiffs' approval before executing the

amendment. Further, plaintiffs claim that, given Berkman's position with EVI, knowledge of Berkman's conflicts was imputed to EVI.

Before considering whether Berkman owed certain duties to plaintiffs, and whether he breached those duties, we must determine if the remedy sought by plaintiffs for any such breach is available. That is, even if Berkman breached a duty to plaintiffs, can plaintiffs void the amendment? While the legal proposition is well established that an agent who breaches a duty to the principal is liable to the principal for any damages arising from that breach, *Restatement (Second) of Agency* § 401 (1958), it is not so clear that an agent's action that involves such a breach does not bind the principal.

Plaintiffs contend that *Fine* and *Houck* establish the principle that allows them to void the amendment based on Berkman's breach. EVI, of course, counters that *Fine* and *Houck* are inapposite. In neither *Fine* nor *Houck* did the fact that the agent breached a duty to the principal act to sever or limit the agent's authority. In *Fine,* the employee simply had no authority to receive deposits of his own checks, and it would have been illegal for the bank to authorize such an action. In *Houck,* the power of attorney did not authorize the actions of the grandson, and thus he acted outside the scope of the express authority granted in the power of attorney. These cases stand for the unremarkable proposition that, if a third party is aware that the agent is engaged in self-dealing in the transaction, the party must inquire into the agent's actual authority.

That basic proposition of the law of agency is reflected in the relevant statutory standard in ORS 63.140(2)(a)—the act of a manager binds the limited liability company "unless the manager had no authority to act for the limited liability company in the particular matter and the person with whom the manager was dealing knew or had notice that the manager lacked authority."

Therefore, under ORS 63.140(2)(a), even if we assume that Berkman owed plaintiffs the duties that they list, and even if we assume that he breached those duties, the question is still whether Berkman had the authority to act for plaintiffs. As we determined, Berkman retained the express authority to enter into the amendment. Plaintiffs took no action to limit his authority, and there was no operation of law that stripped him of his authority to bind plaintiffs in the ordinary course of business. An extension of the terms of the loan agreement is within the ordinary course of business and was expressly contemplated by the terms of the loan agreement. So, even if knowledge of Berkman's alleged self-dealing was imputed to EVI, any inquiry by EVI could only lead to the conclusion that Berkman had authority to enter into the amendment on plaintiffs' behalf. Moreover, we also note that the operating agreements contained a provision that explicitly authorized third parties to rely on Berkman's authority without further inquiry.

Finally, we address the related, but distinct, conflict of interest issues raised by plaintiffs. As recounted above, plaintiffs alleged that Berkman had multiple conflicts of interest that limited his authority to act to amend the loan agreement.

ORS 63.130(2) to (4) set forth the general provisions governing conflict of interest situations in manager-managed limited liability companies.

> "(4) Unless otherwise provided in the * * * operating agreement, the following matters of a * * * manager-managed limited liability company require the consent of a majority of the members:
>
> "(h) A transaction involving an actual or a potential conflict of interest between a member or a manager and the limited liability company[.]"

As the statute makes clear, a majority approval of the conflict of interest is required unless the operating agreement provides otherwise. In this instance, the operating agreements recognized the conflicts of interest that are alleged by plaintiffs. Specifically, the operating agreements state:

> "Any Member or its Affiliates may engage independently or with others in other business and investment ventures of every nature and description and shall have no obligation to account to the Company for such business or investments or for business or investment opportunities. An 'Affiliate' shall mean any person or entity controlling, controlled by, or under common control with the person or entity in question, whether through beneficial ownership of securities, exercise of management control, or otherwise…

Accordingly, the type of conflict alleged here, where Berkman acted in his individual capacity as a board member and treasurer of a company in which plaintiffs invested, is authorized by the operating agreement, and ORS 63.130 does not apply. Affirmed.

G. DISSOLUTION CHALLENGES

HALEY v. TALCOTT

864 A.2d 86 (Del.Ch. 2004)

STRINE, Vice Chancellor.

Plaintiff Matthew James Haley has moved for summary judgment of his claim seeking dissolution of Matt and Greg Real Estate, LLC ("the LLC"). Haley and defendant Gregory L. Talcott are the only members of the LLC, each owning a 50% interest in the LLC. Haley brings this action in reliance upon § 18-802 of the Delaware Limited Liability Company Act which permits this court to "decree dissolution of a limited liability company whenever it is not reasonably practicable to carry on the business in conformity with a limited liability company agreement." The question before the court is whether dissolution of the LLC should be granted, as Haley requests, or whether, as Talcott contends, Haley is limited to the contractually-provided exit mechanism in the LLC Agreement.

Haley and Talcott have suffered, to put it mildly, a falling out. There is no rational doubt that they cannot continue to do business as 50% members of an LLC. But the path to separating their interests is complicated by a second company, Delaware Seafood, also known as the Redfin Seafood Grill ("Redfin Grill"), a restaurant that, at the risk of slightly oversimplifying, was owned by Talcott and, before the falling out, operated by Haley under an employment contract that gave him a 50% share in the profits. The LLC owns the land that the

Redfin Grill occupies under an expired lease. The resolution of the current case and the ultimate fate of the LLC therefore critically affect the continued existence of a second business that one party owns and that the other bitterly contends, in other litigation pending before this court, wrongly terminated him.

The question before the court is essentially how the interests of the members of the LLC are to be separated. Haley asserts that summary judgment is appropriate because it is factually undisputed that it is not reasonably practicable for the LLC to carry on business in conformity with a limited liability company agreement (the “LLC Agreement”) that calls for the LLC to be governed by its two members, when those members are in deadlock. Therefore, urges Haley, the LLC should be judicially dissolved immediately. Such an end will force the sale of the LLC's real property, which is likely worth, at current market value, far more than the mortgage that the LLC must pay off if it sells.

In response, Talcott stresses that the LLC Agreement provides an alternative exit mechanism that allows the LLC to continue to exist, and argues that Haley should therefore be relegated to this provision if he is unhappy with the stalemate. In other words, Talcott argues that it is reasonably practicable for the LLC to continue to carry on business in conformity with its LLC Agreement because the exit mechanism creates a fair alternative that permits Haley to get out, receiving the fair market value of his share of the property as determined in accordance with procedures in the LLC Agreement, while allowing the LLC to continue. Critically, the exit provision would allow Talcott to buy Haley out with no need for the LLC's asset (i.e., the land) to be sold on the open market. The LLC could continue to exist and own the land (with its favorable mortgage arrangement) and Talcott, as owner of both entities, could continue to offer the Redfin Grill its favorable rent.

But the problem with Talcott's argument is that the exit mechanism is not a reasonable alternative. A principle attraction of the LLC form of entity is the statutory freedom granted to members to shape, by contract, their own approach to common business “relationship” problems. If an equitable alternative to continued deadlock had been specified in the LLC Agreement, arguably judicial dissolution under § 18-802 might not be warranted. In this case, however, Talcott admits that the exit mechanism provides no method to relieve Haley of his obligation as a personal guarantor for the LLC's mortgage. Haley signed an agreement with the lender personally guaranteeing the entire mortgage of the LLC (as did Talcott) in order to secure the loan. Without relief from the guaranty, Haley would remain personally liable for the mortgage debt of the LLC, even after his exit. Because Haley would be left liable for the debt of an entity over which he had no further control, I find that the exit provision specified in the LLC Agreement and urged by Talcott is not sufficient to provide an adequate remedy to Haley under these circumstances.

With no reasonable exit mechanism, I find that Haley is entitled to exercise the only practical deadlock-breaking remedy available to him, and one that is also alluded to in the LLC Agreement, the right to seek judicial dissolution. Haley argues, convincingly, that the analysis under § 18-802 for an evenly-split, two-owner LLC ordinarily should parallel the analysis under 8 *Del. C.* § 273,

which enables this court to order the judicial dissolution of a joint venture corporation owned by deadlocked 50% owners. Because Haley has demonstrated an indisputable deadlock between the two 50% members of the LLC, and that deadlock precludes the LLC from functioning as provided for in the LLC Agreement, I also grant Haley's motion for summary judgment and order dissolution of Matt and Greg Real Estate, LLC.

Haley and Talcott each have a 50% interest in Matt & Greg Real Estate, LLC, a Delaware limited liability company they formed in 2003. In 2003, the parties formed Matt & Greg Real Estate, LLC to take advantage of the option to purchase the Property that was the subject of the Real Estate Agreement. The option price was $720,000 and the new LLC took out a mortgage from County Bank in Rehoboth Beach, Delaware, for that amount, exercised the option, and obtained the deed to the Property on or about May 23, 2003. Importantly, both Haley and Talcott, individually, signed personal guaranties for the entire amount of the mortgage in order to secure the loan. The Redfin Grill continued to operate at the site, paying the LLC $6,000 per month in rent, a payment sufficient to cover the LLC's monthly obligation under the mortgage. Thus by mid-2003, the parties appeared poised to reap the fruits of their labors; unfortunately, at that point their personal relationship began to deteriorate.

Haley, having managed the restaurant from the time it opened in May 2001, and having formalized his management position in the Employment Contract, apparently believed that the relationship would be reformulated to provide him a direct stock ownership interest in the Redfin Grill at some point. The reasons underlying that belief are not important here, but in late October they caused a rift to develop between the parties. On or about October 27, 2003, the conflict that had been brewing between the parties led to some kind of confrontation. As a result, Talcott sent a letter of understanding to Haley dated October 27, 2003, purporting to accept his resignation and forbidding him to enter the premises of the Redfin Grill.

Haley responded on November 3, 2003 with two separate letters from his counsel to Talcott. In the first, Haley asserts that he did not resign, and that he regarded Talcott's October 27, 2003 letter of understanding as terminating him without cause in breach of the Employment Contract. Haley goes on to express his intent to pursue legal remedies, an intent that he acted upon in the related case in this court.

The Redfin Grill's lease has expired and, as a consequence, the Redfin Grill continues to pay $6,000 per month to the LLC in a month-to-month arrangement. The $6,000 rent exceeds the LLC's required mortgage payment by $800 per month, so the situation remains stable. With only a 50% ownership interest, Haley cannot force the termination of the Redfin Grill's lease and evict the Redfin Grill as a tenant; neither can he force the sale of the Property, land that was appraised as of June 14, 2004 at $1.8 million. In short, absent intervention by this court, Haley is stuck, unless he chooses to avail himself of the exit mechanism provided in the LLC Agreement.

That exit mechanism, like judicial dissolution, would provide Haley with his share of the fair market value of the LLC, including the Property. Section 18 of the LLC Agreement provides that upon written notice of election to "quit" the company, the remaining member may elect, in writing, to purchase the departing member's interest for fair market value. If the remaining member elects to purchase the departing member's interest, the parties may agree on fair value, or have the fair value determined by three arbitrators, one chosen by each member and a third chosen by the first two arbitrators. The departing member pays the reasonable expenses of the three arbitrators. Once a fair price is determined, it may be paid in cash, or over a term if secured by: 1) a note signed by the company and personally by the remaining member; 2) a security agreement; and 3) a recorded UCC lien. Only if the remaining member fails to elect to purchase the departing member's interest is the company to be liquidated.

But despite this level of detail, the exit provision does not expressly provide a release from the personal guaranties that both Haley and Talcott signed to secure the mortgage on the Property. Nor does the exit provision state that any member dissatisfied with the status quo must break an impasse by exit rather than a suit for dissolution.

Haley argues that dissolution is required because the two 50% managers cannot agree how to best utilize the sole asset of the LLC, the Property, because no provision exists for breaking a tie in the voting interests, and because the LLC cannot take any actions, such as entering contracts, borrowing or lending money, or buying or selling property, absent a majority vote of its members. Because this circumstance resembles corporate deadlock, Haley urges that 8 *Del. C.* § 273 provides a relevant parallel for analysis.

In examining the record, I must draw every rational inference in Talcott's favor. Here, even if I find that there are no facts under which the LLC could carry on business in conformity with the LLC Agreement, the remedy of dissolution, by analogy to 8 *Del. C.* § 273, remains discretionary.

Here, the key facts about the parties' ability to work together are not rationally disputable. Therefore, my decision on the motion largely turns on two legal issues: 1) if the doctrine of corporate deadlock is an appropriate analogy for the analysis of a § 18-802 claim on these facts; and 2) if so, and if action to break the stalemate is necessary to permit the LLC to function, whether, because of the contract-law foundations of the Delaware LLC Act, Haley should be relegated to the contractual exit mechanism provided in the LLC Agreement.

Section 18-802 of the Delaware LLC Act is a relatively recent addition to our law, and, as a result, there have been few decisions interpreting it. Nevertheless, § 18-802 has the obvious purpose of providing an avenue of relief when an LLC cannot continue to function in accordance with its chartering agreement…

The relationship between Haley and Talcott indicates active involvement by both parties in creating a restaurant for their mutual benefit and profit, and the Employment Contract shows that Haley was to be the "Operations Director" of the Redfin Grill, a position that, according to the Side Letter Agreement, would

only be terminated if the restaurant was sold. Haley was also entitled to a 50% share of the Redfin Grill's profits. In short, Haley and Talcott were in it together for as long as they owned the restaurant, equally sharing the profits as provided in the Employment Contract.

Most importantly, Haley never agreed to be a passive investor in the LLC who would be subject to Talcott's unilateral dominion. Instead, the LLC agreement provided that: “no member/managers may, *without the agreement of a majority vote of the managers' interest,* act on behalf of the company.” Under these terms, as a 50% member/manager, no major action of the LLC could be taken without Haley's approval. Thus, Haley is entitled to a continuing say in the operation of the LLC.

Finally, the evidence clearly supports a finding of deadlock between the parties about the business strategy and future of the LLC. The very fact that dissolution has not occurred, combined with Talcott's opposition in this lawsuit, leads inevitably to the conclusion that Talcott opposes such a disposition of the assets. Neither is Talcott's opposition surprising given his economic interest in the continued success of the Redfin Grill, success that one must assume relies, in part, on a continuing favorable lease arrangement with the LLC.

For all these reasons, if the LLC were a corporation, there would be no question that Haley's request to dissolve the entity would be granted. But this case regards an LLC, not a corporation, and more importantly, an LLC with a detailed exit provision. That distinguishing factor must and is considered next.

The Delaware LLC Act is grounded on principles of freedom of contract. For that reason, the presence of a reasonable exit mechanism bears on the propriety of ordering dissolution under 6 *Del. C.* § 18-802. When the agreement itself provides a fair opportunity for the dissenting member who disfavors the inertial status quo to exit and receive the fair market value of her interest, it is at least arguable that the limited liability company may still proceed to operate practicably under its contractual charter because the charter itself provides an equitable way to break the impasse.

Here, that reasoning might be thought apt because Haley has already “voted” as an LLC member to sell the LLC's only asset, the Property, presumably because he knew he could not secure sole control of both the LLC and the Redfin Grill. Given that reality, so long as Haley can actually extract himself fairly, it arguably makes sense for this court to stay its hand in an LLC case and allow the contract itself to solve the problem.

Notably, this court's authority to order dissolution remains discretionary and may be influenced by the particular circumstances. Talcott rightly argues that the situation here is somewhat analogous to that in *In re Delaware Bay Surgical Services*, C.A. No. 2121-S (Del.Ch. Jan. 28, 2002), where this court declined to dissolve a corporation under § 273 in part because a mechanism existed for the repurchase of the complaining member's 50% interest.

But, this matter differs from *Surgical Services* in two important respects. First, in *Surgical Services,* the respondent doctor had owned the company before admitting the petitioner to his practice as a 50% stakeholder. The court found that

both parties clearly intended, upon entering the contract, that if the parties ended their contractual relationship, the respondent would be the one permitted to keep the company. By contrast, no such obvious priority of interest exists here. Haley and Talcott created the LLC together and while the detailed exit provision provided in the formative LLC Agreement allows either party to leave voluntarily, it provides no insight on who should retain the LLC if both parties would prefer to buy the other out, and neither party desires to leave. In and of itself, however, this lack of priority might not be found sufficient to require dissolution, because of a case-specific fact; namely, that Haley has proposed-as a member of the LLC-that the LLC's sole asset be sold. But I need not-and do not-determine how truly distinguishing that fact is, because forcing Haley to exercise the contractual exit mechanism would not permit the LLC to proceed in a practicable way that accords with the LLC Agreement, but would instead permit Talcott to penalize Haley without express contractual authorization.

Why? Because the parties agree that exit mechanism in the LLC Agreement would not relieve Haley of his obligation under the personal guaranty that he signed to secure the mortgage from County Bank. If Haley is forced to use the exit mechanism, Talcott and he both believe that Haley would still be left holding the bag on the guaranty. It is therefore not equitable to force Haley to use the exit mechanism in this circumstance. While the exit mechanism may be workable in a friendly departure when both parties cooperate to reach an adequate alternative agreement with the bank, the bank cannot be compelled to accept the removal of Haley as a personal guarantor. Thus, the exit mechanism fails as an adequate remedy for Haley because it does not equitably effect the separation of the parties. Rather, it would leave Haley with no upside potential, and no protection over the considerable downside risk that he would have to make good on any future default by the LLC (over whose operations he would have no control) to its mortgage lender. Thus here, unlike in *Surgical Services,* the parties do not, in fact, "have at their disposal a far less drastic means to resolve their personal disagreement."

For the reasons discussed above, I find that it is not reasonably practicable for the LLC to continue to carry on business in conformity with the LLC Agreement. The parties shall confer and, within four weeks, submit a plan for the dissolution of the LLC. The plan shall include a procedure to sell the Property owned by the LLC within a commercially reasonable time frame. Either party may, of course, bid on the Property. IT IS SO ORDERED.

IN RE KECK, MAHIN & CATE

274 B.R. 740 (Bkrtcy.N.D.Ill. 2002)

CAROL A. DOYLE, Bankruptcy Judge.

This matter is before the court on plaintiff Jacob Brandzel's ("plaintiff") adversary complaint seeking a determination of defendants' liability under the Illinois Uniform Partnership Act ("IUPA"). The plaintiff is the plan administrator for the debtor Keck, Mahin & Cate ("Keck") pursuant to the chapter 11 plan ("Plan") confirmed by the bankruptcy court on December 16, 1999. The plaintiff seeks recovery for malpractice claims filed by Bank of Orange County and

Pacific Inland Bancorp (collectively, "Pacific Inland") and Wozniak Industries, Inc. ("Wozniak"), a claim filed by Citizens Commercial Leasing Corporation ("Citizens") and administrative claims allowed in the bankruptcy case as of December 16, 1999. Defendants Barbara P. Billauer and Thomas E. Ho'okano (collectively, "defendants") are former capital partners of Keck. Pursuant to the Plan, the plaintiff is the assignee of all allowed claims, and has the right to seek recovery from partners who did not participate in a settlement of partners' outstanding liabilities. Ms. Billauer and Mr. Ho'okano dispute any liability for allowed claims against Keck.

Keck was an Illinois partnership whose partners engaged in the practice of law. On December 16, 1997, some of Keck's creditors filed an involuntary chapter 7 bankruptcy petition against the partnership. On December 31, 1997, the bankruptcy court granted Keck's motion to convert the case to chapter 11 of the Bankruptcy Code. The Plan was confirmed on December 16, 1999. Under the confirmation order ("Order"), Jacob Brandzel was appointed plan administrator.

Ms. Billauer and Mr. Ho'okano are former capital partners of Keck. Ms. Billauer was a partner from July 2, 1990 until August 31, 1993. Mr. Ho'okano was a partner from June 24, 1991 until March 26, 1993. Pursuant to the Plan, all Keck partners had the option to pay a specified settlement amount for partnership liabilities and become "participating partners," or to decline to pay the settlement amount and become "non-participating partners." Non-participating partners potentially faced maximum liability for Keck's obligations. Ms. Billauer and Mr. Ho'okano chose not to participate in the settlement and are being sued for their liability with regard to the Pacific Inland, Wozniak, Citizens and administrative claims, totaling $5,483,189.96.

The plaintiff seeks to hold the defendants liable for administrative claims allowed in the bankruptcy case as of December 16, 1999, in the amount of approximately $2.1 million.

The plaintiff contends that the defendants are jointly and severally liable under section 13 of the IUPA, 805 ILCS 205/13, and the partnership agreement ("Agreement") for the Pacific Inland, Wozniak and Citizens claims. He asserts that each of these claims arose before or during the time the defendants were partners. Ms. Billauer and Mr. Ho'okano dispute any liability for the Pacific Inland, Wozniak and Citizens claims.

Ms. Billauer and Mr. Ho'okano first argue that no obligations to Wozniak or Pacific Inland existed at the time they left Keck. They assert that they are liable under paragraph 8(a) of the Agreement only for "Firm Obligations" that arose before they left the partnership. They further contend that the Wozniak and Pacific Inland malpractice claims did not become Firm Obligations until those claimants had a judgment entered against them or the malpractice claims were settled, which the defendants assert occurred after they left the partnership.

This argument is not persuasive. Sections 13 and 15 of the Illinois Uniform Partnership Act, 805 ILCS 205/13 & 15, determine the scope of Ms. Billauer's and Mr. Ho'okano's liability to third parties (which includes the plaintiff in this case). That liability is not limited to "Firm Obligations" as that phrase is used in

paragraph 8(a) of the Agreement. Section 13 of the Act provides that "[w]here, by any wrongful act or omission of any partner acting in the ordinary course of the business of the partnership, ... loss or injury is caused to any person, ... the partnership is liable therefore to the same extent as the partners so acting or omitting to act." 805 ILCS 205/13. Under the language of section 13, it is the "wrongful act or omission" of a partner that gives rise to the liability of all other partners. The only reasonable interpretation of this provision is that the liability of all partners arises at the time of "any wrongful act or omission" by any partner. *Cf. In re Keck, Mahin & Cate,* 241 B.R. 583, 595 (Bankr.N.D.Ill.1999) (Barliant, J.) ("[I]f a professional's negligent conduct causes an injury, that professional's liability arises from his or her conduct."); *Garcia v. Pinto,* 258 Ill.App.3d 22, 25, 195 Ill.Dec. 795, 629 N.E.2d 103, 105 (1993) ("Generally, a cause of action for legal malpractice arises at the time of the negligent act when the attorney breaches his duty to act skillfully and diligently in representing his client.").

A partner cannot escape liability simply by leaving the partnership after the malpractice is committed but before the client wins or settles a malpractice claim. Courts have consistently held that, within the context of partnership dissolution, withdrawing partners remain liable for matters pending at the time of dissolution. *See, e.g.,* (holding that "the dissolution of a partnership does not relieve a partnership member from liability on existing contracts"); *Redman v. Walters,* 88 Cal.App.3d 448, 152 Cal.Rptr. 42, 45 (1979) ("In general a dissolution operates only with respect to future transactions; as to everything past the partnership continues until all pre-existing matters are terminated."). These cases support the conclusion that liability under section 13 of the IUPA arises at the time of the offending conduct.

[I]t is the act or omission by the attorney that gives rise to the partners' liability under the IUPA, not the subsequent liquidation of a client's damages. The court therefore finds that both the Wozniak and Pacific Inland claims arose before Ms. Billauer and Mr. Ho'okano left Keck in 1993, and they are both liable to the plaintiff for the full amount of each of those claims.

Ms. Billauer and Mr. Ho'okano argue that they are not liable for the Pacific Inland and Wozniak claims because the partnership dissolved when they withdrew from the firm and a new partnership was formed. They contend that the new partnership assumed any debts from the old partnership, and that therefore no liabilities against them now exist. However, whether the partnership dissolved and a new partnership was formed, or the old partnership continued by virtue of paragraph 15(b) of the Agreement without the defendants, the result is the same. The general rule under Illinois law is that "dissolution of the partnership does not of itself discharge the existing liability of any partners." 805 ILCS 205/36(1). As noted earlier, that liability can stem from prior contractual obligations, including those that give rise to malpractice claims.

In addition, partners cannot release one another from liability to third parties. *See Olin Corp. v. Fisons PLC,* No. Civil A. 93–11166–MLW, 1995 WL 811961, at 11 (D. Mass. Apr.24, 1995). Illinois law requires consent by the third party itself to release the liability of any partner. 805 ILCS 205/36(2). This

consent may be express or inferred based on the third party's course of conduct after it learned of the dissolution. *Id.* Without this consent, partners cannot shield themselves from the rights of creditors. There is no evidence that either Wozniak or Pacific Inland consented to releasing Ms. Billauer and Mr. Ho'okano of their liability. Therefore, whether the partnership dissolved or the old partnership continued without the defendants, they are liable for debts incurred to the third-party claimants before their departure dates.

Under Illinois law and the Agreement, Ms. Billauer and Mr. Ho'okano are liable for claims arising before or during the time they were partners. *See* 805 ILCS 205/13 (establishing the liability of co-partners for the acts or omissions of a partner); Agreement ¶ 8(a)(1) (providing for the assumption of pre-existing Firm Obligations by incoming partners); *Magrini,* 17 Ill.App.2d at 356, 150 N.E.2d at 392 (holding that an incoming partner can be held personally liable for pre-existing partnership debts where there is an express assumption of liability). Keck is a general partnership subject to Illinois law. Under Illinois law, partners are jointly and severally liable to creditors of the partnership. Illinois law does not limit this liability with respect to innocent co-partners. 205 ILCS 210/13 & 15; *In re Georgou,* 145 B.R. 36, 37 (Bankr.N.D.Ill.1992) (Barliant, J.). As noted above, partners cannot release their liability to third parties without their consent. There is no evidence of any such consent.

Both defendants argue that they should not be held liable for any partnership debts because the firm was solvent when they left in 1993. However, neither party cites any support for this argument. The solvency of a partnership at the time a claim arises is not a defense to an action under section 13 of the IUPA.

Ms. Billauer asserts that the Agreement is void as against public policy. She contends that an amendment to the Agreement passed on May 3, 1996 reflects an intent by the partners in 1996 to fraudulently shield themselves from joint and several liability. The amendment in question, paragraph 15(r), attempts to limit a third party's recovery for liabilities arising after May 1, 1996 to general partnership assets. *See* Amendments to Agreement ¶ 15(r) (May 3, 1996) ("Notwithstanding anything to the contrary herein set forth, any ... payment or other obligation provided for under this [Partnership] Agreement in connection with events that occur or liabilities that arise on or after May 1, 1996 shall be limited to the general partnership assets of the Firm and none of the Partners shall have any personal liability therefore.").

This argument fails for two reasons. First, the amendment would only limit liabilities arising after May 1, 1996. Therefore, it would have no effect on the liability of partners with regard to the Wozniak and Pacific Inland claims, both of which arose prior to the defendants' departures in 1993. Second, even if the partners intended to limit their personal liability with regard to those claims, the amendment is unenforceable under the IUPA. *See* 805 ILCS 205/13 & 15.

For the foregoing reasons, the court finds that Mr. Ho'okano and Ms. Billauer are jointly and severally liable to the plaintiff in the amount of $775,000.00 for the Wozniak claim, $825,000.00 for the Pacific Inland claim and $2,177,787.73 for the administrative claims.

H. OPERATING AGREEMENT DESIGN

1. SCOPE AND LAWYER'S ROLE

The primary planning challenge during the organization of a partnership or LLC is to prepare a comprehensive operating agreement that incorporates all of the essential deal points between the co-owners of the business. Often the parties are tempted to short-circuit the front-end planning effort. They perpetuate the common (but false) perception that there is a "normal" or "accepted" way of documenting issues between co-owners. The result is that, in far too many cases, the operating agreement effort is limited to filling in blanks on a stock form, and the dialogue is limited to descriptive pronouncements from the lawyers. The operating agreement looks complete and official, but does little or nothing to reflect thoughtful, negotiated deal points that the owners have resolved with the assistance of skilled planning advisors.

In nearly all situations, the planning lawyer must take the lead in defining the scope of the front-end planning effort. This is done by identifying key planning issues, explaining the significance of the issues, and then helping the client carefully evaluate his or her objectives or priority concerns with respect to each issue. Usually customization of the operating agreement increases as the planning effort improves. More customization leads to more complexity and, most importantly, to a better mutual understanding of the key deal points between the owners of the business.

The identity of the client affects how the potential deal points are discussed and analyzed in any given partnership or LLC situation. If the client will own the controlling vote in the entity, the preferred choice may be to refrain from initiating any dialogue on many deal points with the other owners. The client knows that he or she has the power to dictate the outcome of any dispute by virtue of the voting control. Typically, the burden is on the minority owners to raise any operational issues that may require special treatment in the operating agreement. So the lawyer who represents the minority owners usually has the toughest job. Key issues must be identified, discussed, and prioritized. A plan must be developed for creating minority rights for those issues that are of greatest concern. Then the plan must be sold and eventually incorporated into the operating agreement.

The lawyer who is engaged to organize and represent the partnership or LLC, not a particular owner of group of owners, must be sensitive to the conflicts that many of the key planning issues might create between the owners. In this situation, usually the best approach is for the entity's lawyer to initiate a dialogue with all the owners in a meeting or series of meetings that addresses the most important issues, with input from lawyers representing specific owners. The process requires a modest commitment of time and expense, but it will go a long way in identifying and resolving on the front-end any fundamental differences between the parties.

Following is a brief description of certain key provisions of an operating agreement and related options for customizing these provisions. Specific

references are to the LLC operating agreement in section B. of Chapter 17.

CASE PROBLEM 2-8

Refer to Case Problem 2-4 in which Son and Dad form a manager-managed LLC. Son lines up a deep-pocket investor ("Investor") who is willing to invest $1 million in the LLC if, and only if, the LLC operating agreement contains the following provisions:

1. Investor is the manager of the LLC and has the exclusive right to determine how Strategy is exploited, when it is sold, and the terms of any sale.

2. Investor is relieved of all liabilities to the LLC for any actions or omissions taken in good faith, even those that are determined to be grossly negligent or intentionally reckless.

3. All fiduciary duties of the Investor are eliminated.

4. The Investor is allocated 90 percent of the losses that are expected during the first three years of operation. This is regarded as a tax benefit for Investor.

5. Investor accrues an annual fee of $100,000 for management services, to be paid when the LLC has sufficient cash flow to pay this accrued compensation.

6. Investor is allocated 50 percent of all profits realized in any year or on the sale of Strategy.

7. Available cash flows from operations or the sale of Strategy are used: first, to pay any accrued management fees due Investor; second, to repay Investor's $1 million investment; and third, to pay Investor 50 percent of the excess and the other members the remaining 50 percent.

What problems, if any, will the parties encounter in designing the LLC operating agreement to meet these deal-braking demands of Investor?

2. AUTHORITY AND MANAGEMENT PROVISIONS

Purpose of the Company (Section 5). In a partnership or LLC, the preferred choice often is to use this provision to specifically define and limit the scope of the business activities of the entity. Partners and LLC members often want the comfort of knowing that their investment will not be diverted into activities that are outside the scope of what was originally discussed. Liability exposure may also be an issue, particularly where the managers of the venture have multiple business interests. Limiting the scope of the business activities may help eliminate the business entity's liability exposure for unrelated actions of its managers. A written activity limitation also may dash any expectations other owners may have relative to their other business activities by drawing an express, unequivocal line in the sand. Some partners and LLC member may object to a written limitation on the scope of the enterprise, arguing that it restricts flexibility, creates potential confusion for third parties, and fosters notions of "separateness" and "temporariness" between the owners.

Limits on Manager Authority. (Sections 11.1 and 11.6). Often the manager of the partnership or LLC is given broad authority to administer the business

affairs of the enterprise. The planning challenge is to define those situations where the manager must seek approval of the partners or LLC members before taking action and what level of approval is required. In some circumstances, majority approval may be adequate. In other situations, a unanimous or super-majority vote may be justified. It all turns on the nature and scope of the business and the expectations and goals of the partners or LLC members. These are the sections of the agreement that can be used to define and protect minority rights and often justify significant dialogue during the planning process. Provisions that often require special attention in these sections include: required cash distributions; the admission of new partners or LLC members; outside or competitive activities of partners or LLC members; related party transactions; material changes to the business plan; debt limitations; confidentially covenants of managers, partners or LLC members; tax elections; selection of professionals; and dispute resolutions procedures.

Limited Liability of Manager (Section 11.3). The key issue is whether the manager should be relieved of personal liability to the partnership or LLC for actions taken or omitted by the manager with a good faith belief that such actions or omissions were in the best interests of the entity. Resolution of the issue in the partnership or LLC operating agreement often turns on the level of culpability that partners or LLC members are willing to forgive. Ordinary negligence usually isn't enough to override a good faith exculpation provision, while willful misconduct and criminal acts often render provision moot and trigger liability. But what about grossly negligence or intentionally reckless conduct? These are tougher issues in the planning process. Managers often do not want any liability exposure absent a showing of bad faith, willful misconduct or criminal activity. They don't want to get tangled up in line drawing between ordinary and gross negligence. In constrast, many owners want protection against a manager's gross negligence or intentionally reckless activities.

Resignation, Removal and Replacement of Manager (Section 15). This provision raises a number of potential issues in the design of the operating agreement. If a manager resigns in violation of specified conditions in the operating agreement, does the manager have any liability exposure to the entity? Will the manager be subject to any non-competition restrictions? What ongoing confidentiality covenants, if any, will apply to the manager? What level of partner or LLC member vote (majority, super-majority, unanimous) is required to remove and replace a manager? Is there any requirement to show "cause"? Is the manager entitled to any severance benefit if removed for no cause? Does the resignation or removal of manager entitle the partnership or LLC to purchase the partnership or LLC interest of the member or give the manager a right to compel such a purchase?

Indemnification (Section 11.4). Will partners and managers who act on behalf of the partnership or LLC be protected against any personal loss, damage or liability they incur as a result of their activities on behalf of the entity? Usually an indemnification and hold harmless provision is included in the operating agreement to protect against such liabilities and any associated legal fees, but limitations often need to be worked out between the partners or LLC

members. The agreement may provide that the indemnification rights are limited to assets of the entity and are not obligations of the partners or LLC members. The owners may not want any personal exposure, and the primary assets of the business may have been pledged to secure financing. The net result is that the indemnification provision, as a practical matter, may mean little or nothing if the business fails. The indemnification provision may be limited to acts or omissions undertaken in good faith and with a belief that they were in the best interests of the entity, subject to exceptions for specified levels of culpability (see prior paragraph). The operating agreement also may condition any indemnification right on a tender of the defense or resolution of the claim to the partnership or LLC so that the entity can control expenses and dispose of the matter on its own terms. These indemnification limitations often create concerns for managers. A solution to ease these concerns may be an errors and omissions insurance policy for the managers that facilitates the agreed limitations while providing an additional level of protection for the managers of the enterprise.

Compensation of Managers (Section 11 Insertion). Often there is a need to specify how those partners or members who manage the enterprise are to be compensated for their services on behalf the partnership or LLC. Absent such an agreement, the statutory default rule usually will deny any compensation for services that are not related to dissolving and winding up the entity.

Time Devoted to Enterprise (Section 11.2). For partners or LLC members who manage the enterprise, key issues often include their service commitments and their right to be involved in other activities. Are they expected to devote all of their time and energies to the enterprise? Failure to adequately clarify this issue can lead to an early showdown when the investment partners or LLC members discover that the manager spends only a fraction of his or her time looking after the affairs of the enterprise and is heavily involved in other ventures. The stock language in many forms gives the manager significant flexibility to define the service level and pursue other ventures. This language won't do the job in many situations.

3. OWNER RIGHTS PROVISIONS

Owner Transfer Rights (Section 14). State statutes generally permit a partner or LLC member to transfer the economic (but not voting or management rights) rights of partnership or LLC interest to a third party transferee. Often, it is necessary and smart to prohibit any such voluntary or involuntary transfer unless specified conditions exist. These conditions usually include the death of a partner or LLC member or the approval by the managers or a designated percentage of the partners or LLC members. Absent such approval, partners are unable to transfer interests in the partnership or LLC. In many situations, the operating agreement also needs to specify the procedures and conditions that must be satisfied in order for a third party transferee to be admitted as an owner with all the rights and privileges of a partner or LLC member.

Buy-Sell Rights (Section 14 Insert). In many business enterprises, the operating agreement between the partners or LLC members needs to spell out buy-sell rights that are triggered when a partner or LLC member dies, becomes

disabled, just desires to cash out and move on, experiences a messy divorce or bankruptcy, or needs to be expelled. These buy-sell provisions and the associated planning may be used to accomplish various objectives, including to ensure that (1) ownership interests in the enterprise are never transferred or made available to third parties who are unacceptable to the owners, (2) there is a mechanism to fairly value and fund the equity interest of a departing owner, (3) control and ownership issues will be smoothly transitioned at appropriate times so as not to unduly interfere with and disrupt the operations of the business, (4) owners have a fair "market" for their shares at appropriate points of exit, (5) owners have the power to involuntarily terminate (expel) an owner who is no longer wanted, (6) the amount paid for the equity interest of a deceased owner determines the value of the deceased owner's equity interest for estate tax purposes, and (7) cash and funding challenges of owner departures are appropriately anticipated and covered. An extended discussion of this planning challenge is included in section C. of Chapter 13. The substance of that discussion, including certain of the common mistakes that are often made in the buy-sell planning process, is directly applicable to partnerships and LLCs.

Major Transaction Approval Rights (Section 11.6). The operating agreement usually requires partner or LLC member approval of transactions that involve a merger of the partnership or LLC, a combination with another entity, or a sale of all or substantially all of the entity's assets. Majority approval works for many partnerships and LLCs. In some situations, the parties desire to require a super-majority vote, such as two-thirds. Often it helps to clarify if the manager's approval also is a condition to the transaction. And sometimes the often-used "substantially all" standard for determining whether an asset sale triggers owner approval rights is perceived as being too undefined or capable of manipulation. In such situations, the operating agreement lowers the threshold by specifying objective criteria (a designated percentage of assets or revenues, or both) for determining whether owner approval rights are required for a sale of assets.

Inspection Rights. (Section 13.4) Some operating agreements provide partners and LLC members with broad document inspection rights, conditioned only on reasonable notice, inspection at the location where the documents are kept, and reimbursement of any reproduction costs. Often those who manage a limited partnership or a manager-managed LLC desire to limit the inspection rights of limited partners or LLC members who have no management rights. The rationale is that broad inspection rights for such investors will not benefit the entity in any way and may create opportunities for abuse that frustrate management efforts. When limited investor inspection rights are desired, the operating agreement often requires that the requesting partner or LLC member provide a written request that specifies the entity-related purpose for making the request, the particularized list of the documents requested, and how such documents relate to the stated purpose. The manager has the final say on whether the conditions of the request have been satisfied.

Fiduciary Exculpatory Provisions. (Section 11.5 and Section 12 Insertion). Statutory provisions impose fiduciary duties of care, loyalty, good faith, and fair dealing on those partners or LLC members who have the right to

participate in the management of the enterprise. As explained in section E. of this Chapter, the operating agreement usually may include provisions that substantially reduce any liability for fiduciary breaches that do not involve bad faith. The only limitation in many states is that the exculpatory provision may not be "manifestly unreasonable." This presents a planning opportunity for those enterprises that want to deemphasize restrictions that come with the duties of care and loyalty.

Amendment Rights (Section 18). The power to amend the operating agreement is always an important consideration. In many situations, nothing short of unanimous consent will work. The agreement is viewed as a contract that protects minority rights. In those circumstances where ownership and management interests are separated (limited partnerships and manager-managed LLCs), the operating agreement specifies what may be amended by the approval of partners or members who own a majority or designated super-majority of the entity's interests. Also, in such situations, often the manager is authorized to amend the agreement without partner or member approval to cure ambiguities or inconsistencies in the agreement.

Owner Confidentiality Covenants. (Section 12 Insertion). Sometimes it is necessary to extend confidentially covenants to partners and LLC members, particularly in those enterprises where the owners may have access to trade secrets or proprietary information critical to the success of the business. Some investors may resist any such agreements or any mechanism that limits other investment options or exposes them to any future claims relating to the use of proprietary information.

Dissolutions Rights (Section 16). The operating agreement should specify the conditions for dissolving the partnership or LLC, which often track the applicable statutory provisions. A primary consideration is the approval requirement of the partners or LLC members to force a dissolution and winding up. Many require unanimous approval, while others impose a super-majority requirement. In limited partnerships and manager-managed LLCs, a dissolution decision generally always requires the consent of those who manage the enterprise.

Life After Rights (Section 12 Insertion). In professional organizations and other partnerships and LLCs where revenues are generated from the personal services of the owners, often it is advisable to spell out the "going forward" rights that each owner will have in the event there is a falling out and the group fractures. Absent such an agreement, the owners may find themselves tangled up with dissolution and wind-up issues that may make it difficult to immediately shift gears and preserve the continuity of their business activities. Most professionals and service providers cannot afford a major disruption that stops their careers. Key issues include the right to engage in the same business as the fractured entity, to pursue and service clients of the entity, to hire employees of the entity, to deal with vendors and financial institutions used by the entity, to make copies of client documents, files and other important documents, to use the same personal business email addresses and phone numbers, and to disclose the prior affiliation with the entity.

4. CAPITAL AND ALLOCATION PROVISIONS

Initial Capital Contributions (Sections 7.1 and 7.6). The operating agreement should describe the initial contribution obligations of the partners or LLC members. Most importantly, the value that is going to be assigned to non-cash contributions for capital account purposes should be specified in the agreement or an Exhibit. Such contributions may include tangible property (such as land or equipment), intellectual property rights, the business plan for the enterprise, past services rendered on behalf of the enterprise, future services to be rendered, and more. The planning challenge is to clarify the expectations of the parties with respect to any non-cash assets and properly value those assets that are going to be positive additions to the capital account of the contributing partner or LLC member. The agreement should authorize the partnership or LLC to take any action to enforce the contribution obligations of partners or LLC members, to recover any associated costs and attorney fees, and to settle any such disputes with a designated approval (usually majority) of the other partners or LLC members.

Future Contribution Obligations (Section 7.4). The issue of additional capital contribution obligations of the partners or LLC members should be documented in the operating agreement. Some owners, even those with deep pockets, may want to eliminate any expectations that they will provide additional capital to keep the venture afloat or fund growth. Others may be concerned with dilution; they do not want their equity interests reduced as those with greater means continually pony up more money and claim a bigger share of the enterprise. When this issue is a major concern (as it often is in start-up ventures), the owners need to talk through their concerns and, with the aid of counsel, reach an agreement that, to the fullest extent possible, addresses the objectives of the owners. One approach is to specify that each partner or LLC member must contribute his or her *pro rata* share of the capital needed to accomplish the purpose of the entity. Some owners may be unwilling to agree to an unlimited equity contribution requirement. In this situation, the agreement may have to place a cap on future required capital contributions. If there is no mandatory requirement for additional capital contributions, the operating agreement should spell out how future capital needs will be satisfied. Often this is done by specifying that owners may make additional contributions, as needed, and receive additional equity interests, while giving all partners or LLC members the right to participate in any such contributions on a *pro rata* basis.

Capital Account Maintenance (Section 7.5). The operating agreement must provide that a capital account will be maintained for each partner or member. This account ultimately determines what a partner or LLC member yields when the entity's business is sold or distributed and its affairs are wound up. The agreement should specify that each owner's account will be increased for capital contributions and allocations of income and will be decreased for distributions and loss allocations. It should also clarify the capital account impacts of contributions and distributions of non-cash assets and the rights of the partnership or LLC to restate and revalue capital account balances when a new owner is admitted and other designated conditions are satisfied. As section 7.5

illustrates, often this is accomplished by incorporating by reference the provisions of specific Treasury regulations to the Internal Revenue Code.

Allocations of Net Income and Net Loss (Section 8). The operating agreement should specify how the annual net income or net loss of the enterprise is going to be allocated to the partners or LLC members and reflected in their respective capital accounts. A benefit of partnerships and LLCs that are taxed as partnerships is that they have tremendous flexibility in structuring such allocations, far beyond that of a corporation. For example, one partner or LLC member may be allocated 60 percent of all income and 30 percent of all losses. A partnership allocation will be respected for tax purposes only if it has "substantial economic effect,"[157] three words that make section 704(b) of the Internal Revenue Code and its regulations one of the most complex subjects in the world of tax. Generally speaking (and I do mean generally), an allocation that does not produce a deficit capital account for a partner or LLC member will be deemed to have "economic effect" if capital accounts are maintained for all partners and, upon liquidation of the partnership, liquidating distributions are made in accordance with positive capital account balances.[158] In order for an allocation that produces a deficit capital account balance to have "economic effect," the partner or LLC member also must be unconditionally obligated to restore the deficit (i.e., pay cash to cover the shortfall) upon liquidation of the partnership,[159] or the partnership must have sufficient nonrecourse debt to assure that the partner's share of any minimum gain recognized on the discharge of the debt will eliminate the deficit.[160] An "economic effect," if present, will not be deemed "substantial" if it produces an after-tax benefit for one or more partners with no diminished after-tax consequences to other partners.[161] The most common examples of economic effects that are not deemed "substantial" are shifting allocations (allocations of different types of income and deductions among partners within a given year to reduce individual taxes without changing the partners' relative economic interests in the partnership) and transitory allocations (allocations in one year that are offset by allocations in later years).[162]

Required Cash Distributions (Section 10). The operating agreement should clarify how and when cash distributions are going to be made to the partners or LLC members. Some owners want to know that the plan includes regular distributions to the owners as the business ramps up and distributions that will cover the tax burden of partners or LLC members as the entity's income is allocated and taxed to them. Others may expect that all after-tax profits will be invested to finance growth or that cash distributions will be left to the discretion of the managers. This issue usually is tied to other key factors, including the growth rate of the business and the use of debt. Often the answer is to set guidelines regarding growth and debt that, once hit, will begin to trigger cash distributions to the owners. Typically, a provision is structured to ensure that

157. I.R.C. § 704(b).
158. Reg. §§ 1.704-1(b)(2)(ii) (b)(1), 1.704-(b)(2)(ii) (B)(2).
159. Reg. § 1.704-1(b)(2)(ii) (b)(3).
160. Reg. §§ 1.704-(2)(c), 1.704-(2)(f)(1), 1.704-(g)(1), 1.704-2(b)(1) & (e).
161. Reg. § 1.704-1(b)(2)(iii).
162. Reg. § 1.704-1(b)(2)(iii) (b) & (c).

cash is only distributed when all other cash needs of the business have been met, including ensuring appropriate reserves for working capital and targeted growth needs of the enterprise.

Cash Allocation Provisions. A related and equally important planning consideration is how cash distributions are allocated among the partners or LLC members. The most common and basic structure is to provide that any cash distributed will be allocated among the owners according to their respective percentage interests in the entity and then to insure, through forced allocations, that the respective capital account balances of the partners or LLC members at time of liquidation reflect these percentage interests. But there is flexibility in structuring the distribution provisions in the operating agreement. Consider the situation where there is a 50-50 ownership structure between two owners, one who puts up all the capital and one who provides services to the venture. The operating agreement might provide that cash distributions first will be allocated to the owner who provided the capital until that owner receives the equity contributed together with a specified preferred return equivalent to an interest rate. In addition, if the owner who put up the money also provided the personal guarantee that made outside institutional financing possible, the operating agreement may provide that owner an additional priority allocation of cash (e.g., two percent of the amount of the loan guaranteed) in consideration of providing the guarantee. Once these preferred distributions are made, all future cash distributions will be made to the owners according to their respective percentage interests. The important point is that, in partnerships and LLCs, there is flexibility in structuring cash rights among the owners, and preferences may be created in favor of certain owners.

Anti-Deficit Account Provisions (Section 8.3 through 8.8). Often the partners and LLC members want the operating agreement structured so that there is no risk that the capital account of a partner or member will have a negative balance when the affairs of the partnership or LLC are wound up. Such a negative balance would trigger an unwelcome contribution obligation to eliminate the negative balance. To protect against such a negative balance, the operating agreement often includes a number of relatively complicated provisions that limit net loss allocations, designate how net gains from non-recourse debt obligations ("Minimum Gain Chargebacks") are to be handled, force gross income allocations ("Qualified Income Offsets") in certain circumstances, authorize curative allocations and modifications, and clarify the overriding intention that no partner have a deficit capital account balance at liquidation. These provisions, illustrated by sections 8.3 through 8.8 of the form agreement, are a multifaceted attack on the risk of a negative capital account.

I. FAMILY PARTNERSHIPS AND LLCs

1. FLEXIBLE PLANNING TOOLS

Many business owners want financial plans that protect assets, preserve control, and save taxes. Perhaps no planning tools have been more effective in meeting these basic family objectives than the family partnership and the family

limited liability company (LLC). These are flexible tools that can be crafted to accomplish specific, targeted objectives, including shifting income to other family members, maximizing wealth scattering gifting opportunities, protecting assets from creditors, and creating tax-saving valuation discounts in the parents' estate by repackaging investment assets into discounted limited partnership interests.

The powerful tax planning benefits of family partnerships and LLCs have made them a popular target of the IRS. The heat has been turned up over the last 15 years as the Service has pulled out all the stops to shut down techniques that are designed to produce extreme tax savings. The thrust of the fighting has made everything harder. This is not to suggest that the family partnership or LLC is doomed as a planning tool or is only suited for those who have a cast iron stomach and the will to invite an encounter with the government. What it does confirm is the importance of careful attention to detail, reasonable expectations, and a willingness to not push the evolving limits.

Most investment assets offer three potential benefits: income, value growth, and control. Many mistakenly assume that these three components are tied together and must reside in the same individual. A partnership or LLC makes it possible to separate these benefits. Valuable economic benefits can be transferred to another and separated from the control element.

Following are brief descriptions of four strategies for using a limited partnership or LLC in a family planning context. Although the examples focus on a family partnership, the planning opportunities and issues are the same for any family LLC that is taxed as a partnership.

2. FOUR MINI–CASE STUDIES

a. The Shift. Roger and Denise Moore have two children, ages 24 and 26. They also have strong incomes. Roger is a successful architect, and Denise owns and manages a profitable desktop publishing firm. Their combined taxable incomes exceed $450,000 a year. Their assets include a securities portfolio and real estate investments that produce a steady stream of interest, rental, and dividend income.

Roger and Denise's primary concern is income taxes. They pay big income taxes now and know that they will likely pay more as budgetary pressures promise higher rates for high-income taxpayers. Although they know that they are building an estate that will likely trigger an estate tax exposure on the death of the survivor, the estate tax threat is not their major concern at this time. The real issue now is income taxes.

In contrast to the parents' situation, each of their children is in a 15 percent tax bracket and will likely remain in that bracket for a long time. Simple arithmetic confirms that substantial income taxes could be saved if income could be shifted from the parents to the children. Plus, Roger and Denise would like to have a mechanism for transferring a steady income stream to each of their children. Since both children are over the age of 19, the Kiddie tax is not an

issue.[163] The challenge is to figure out how to accomplish "The Shift."

After considering the alternatives, the Moores elect to use a family limited partnership to shift the income. A partnership is formed and funded with an income-producing securities portfolio and real estate investments. All of the general partner and limited partnership units initially are issued to Roger and Denise. Roger and Denise then embark on a program of gifting limited partnership units to each of their children. They initially make a gift of limited partnership units valued at $50,000 to each child. They use a portion of their combined unified credits to eliminate the gift tax impact of these initial transfers. They plan to gift to each child additional limited partnership units valued at $26,000 each year for the next five years. They will use their annual gift tax exclusions to shelter these gifts from gift taxes. They estimate that within five years, each child will have been given limited partnership units valued at approximately $180,000 for gift tax purposes. Appropriate minority interest and lack of marketability discounts will be used to maximize the value of the transfers to the children.

The income attributable to the gifted limited partnership units will be shifted and taxed to the children. This income will be used to help fund many of the children's financial needs down the road. The bottom line is that Roger and Denise have determined that a permanent shift of an income stream for the benefits of the children is a good idea. The family partnership accomplishes the shift.

b. The Scatter. Jim Bain is a 70-year-old, self-made real estate developer. He and his wife Lucy, age 66, have five children and 16 grandchildren. Jim's health is marginal; he has had some heart problems. Lucy's health is average. Jim and Lucy have a combined net worth of approximately $24 million. Most of their assets are illiquid real estate projects that Jim has developed over many years. Jim manages all of the assets. The couple's second son, Brandon, is the only child with any knowledge of the business. Brandon has worked with Jim for five years.

Jim and Lucy are concerned about their estate tax exposure. Although they have heard about estate taxes for many years, they've never really wanted to deal with the issue. Jim likes his real estate, and has never been able to get excited about the idea of transferring assets to his children and grandchildren. He has no intention of retiring and wants to keep developing. His desire to stay in the saddle is strengthened by the fact that Brandon is now involved in the business and wants to make real estate a career.

Jim and Lucy have determined that it's time to embark on a gifting program to save estate taxes. Income taxes have never been a serious issue; they have plenty of write-offs from their real estate projects. Their primary concern is estate taxes. They want to maximize the impact of the annual gift tax exclusion. They

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163. In 2007, the Kiddie tax age limit was raised to include children under age 19 and students under age 24. The tax requires that the unearned income of any such child be taxed at his or her parents' highest marginal rate. I.R.C. § 11(g).

have figured that they have 24 potential donees each year. These include their five children, the spouses of their five children, and their 14 grandchildren. Jim and Lucy want to embark on a program of scattering their wealth to these 24 donees each year. Jim designs a wealth-scattering program that can be implemented over a 10-year period. He estimates, based on reasonable appreciation scenarios, that the plan could reduce their future estate value by at least $13 million.

As Jim considered such a program, he had some initial reservations. First, he knew that he didn't have cash to make the gifts each year, and he felt that it would be extremely cumbersome to transfer interests in specific real estate investments to 24 different individuals each year. Transfers of undivided interests through deeds would be cumbersome, complicated, costly, and confusing. Second, he was concerned that he would lose control as these transfers were made. Finally, he was concerned that it would be complicated to transfer an interest in real estate to a minor grandchild who had no legal capacity to deal with property.

A limited partnership or LLC would eliminate these concerns and made it possible for Jim and Lucy to embark on their family-scattering gifting program. Jim and Brandon would each contribute real estate interests to a newly formed S corporation, which in turn would contribute the interests to a new limited partnership in exchange for general partnership interests. Jim and Lucy would contribute a substantial block of low-leveraged real estate investments to the limited partnership in exchange for limited partnership interests. Jim and Lucy would then embark on a program of transferring limited partnership units to each of the 24 donees (or trusts established for their benefit) each year. They would structure the program so that, in even years, the gifts are made at the end of the year and, in odd years, the gifts are made at the beginning of the year. This technique would eliminate the need for annual valuations; valuations every other year would do the job.

The S corporation general partner provided a means of transitioning control to Brandon or others without impacting the family partnership. The family limited partnership would make it possible for Jim and Lucy to save substantial estate taxes by scattering their wealth to a broad range of descendants over an extended period of time.

c. The Freeze. Sam and Joyce are both 65 years of age and looking forward to a long retirement. They have three children, and six grandchildren. Their estate is valued at approximately $25 million. A significant asset in their estate is an interest they hold in a bottling distribution LLC. They have owned this interest for about five years. This investment presently pays them an income of about $12,000 a month. They are looking forward to receiving this income for the rest of their lives.

They are concerned about estate taxes. They believe that their investment in the bottling distribution company will grow rapidly in value. It is postured to take off. Indeed, they anticipate that the value of the investment could increase eight to ten times over the next five to seven years. They are concerned that, as the

value of the investment grows, their estate tax exposure will balloon. They want to take steps to reduce their estate tax exposure, without jeopardizing their current income stream.

The answer for Sam and Joyce may be a freeze family limited partnership. They would form a limited partnership with an S corporation general partner and then transfer their interest in the bottling distribution company LLC to that partnership. The LLC interest presently has a value of approximately $1.5 million.

The partnership would issue two kinds of limited partnership units. The first would be limited partnership units ("Income Units") that allow the holders of the units to receive a fixed, guaranteed income from the partnership every year. This would be an ongoing, cumulative obligation of the partnership. The Income Units would be owned by Sam and Joyce, and would be structured to pay them a guaranteed income of 12,000 a month.

The remaining units would be growth limited partnership units ("Growth Units"). Unlike the Income Units, these units would not offer any guaranteed income rights. However, all appreciation in the value of the investment held by the partnership would be allocated to these units. Sam and Joyce would gift the Growth Units to their children.

This structure is called a "Freeze Limited Partnership" because it is designed to freeze the value of the investment in Sam and Joyce's estate, while at the same time preserving the income stream for them. All of the future growth in value is allocated to the children, who own the Growth Units.

Great care should be exercised by anyone who is considering a family partnership freeze transaction. The limitations of section 2701 of the Internal Revenue Code are an insurmountable barrier in most situations, but not all. In order for the interest retained by the parents to have any value for gift tax purposes (and thus reduce the value of the interests transferred to the children), the parents must be entitled to receive a fixed, cumulative income interest that is the equivalent of a cumulative preferred stock interest.[164] In many cases, the required yield to be paid to the parents will exceed the anticipated increase of the value of the asset. In such a situation, the freeze transaction will be of no value. For this reason, the freeze strategy is best used in those situations, such as that faced by Sam and Joyce, where there is a real expectation of huge future appreciation that will balloon an existing significant estate tax exposure. It is important to realize that, if the income interest of the parents is not properly structured, any transfer of an interest to the children may trigger an enormous gift tax. Great care needs to be taken in structuring the parents' income interest and valuing the interest transferred to the children.

d. The Disappearing Act. Rubin, age 75, is a widower with a $20 million estate that consists primarily of a large stock and bond portfolio, various real estate investments, investments in a handful of passive limited partnership ventures, and an expensive home. He has one son, Bruce, and three

164. I.R.C. § 2701(c)(3).

grandchildren. His health is marginal, but he knows of no life threatening condition. He is distressed over his estate tax exposure.

Rubin decides to "get aggressive." He forms a limited partnership. A subchapter S corporation owned by his son, Bruce, is the sole general partner. Bruce separately funds the general partner, which owns one percent of the partnership. Rubin owns the remaining 99 percent of the partnership through limited partnership interests that are issued to him in exchange for all his assets except his home and $1.5 million of cash. Rubin estimates that the retained cash should cover his spending needs for the rest of his life. Bruce has complete control of the assets, and Rubin is relieved of all management burdens.

From a tax perspective, what Rubin hopes to accomplish with this technique is a substantial reduction in estate taxes at his death. As an owner of a limited partnership interest that provides no control and is subject to substantial marketability limitations, Rubin's estate would claim substantial lack of control and lack of marketability discounts in valuing the limited partnership interests. These discounts could total as much as 30 to 40 percent of the value of the underlying partnership assets attributable to the limited partnership units.

This strategy requires careful planning and a willingness to take some tax risks. Claiming these types of discounts to save big estate taxes when there has been a "circuitous recycling of value" can trigger a fight with the IRS. The Service has successfully attacked the use of this strategy in a number of “bad fact” cases where the taxpayer was too aggressive in pushing the limits of the strategy.[165] Use of this technique, and those described above, require the assistance of a competent planning attorney.

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165. See, for example, *Estate of Rosen v. Commissioner*, T.C. Memo 2006–115, *Rector Estate v. Commissioner*, T.C. Memo 2007–367, *Estate of Erickson v. Commissioner*, T.C. Memo 2007–107, *Estate of Bigelow v. Commissioner*, 503 F.3d 955 (9th Cir. 2007); *Strangi v. Commissioner*, 417 F.3d 468 (5th Cir. 2005); *Estate of Hillgren v. Commissioner*, T.C. Memo 2004–46; *Kimbell v. United States*, 371 F.3d 257 (5th Cir. 2004); *Estate of Thompson v. Commissioner*, 382 F.3d 367 (3d Cir. 2004); *Estate of Bongard v. Commissioner*, 124 T.C. No. 8 (2005); *Estate of Jorgenson*, T.C. Memo 2009-66; *Estate of Malkin*, T.C. Memo 2009-212.