American Bar Association
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Committee on Partnerships and Unincorporated Business Organizations

Pubogram Newsletter

George W. Coleman - Chair
Peter D. Hutcheon - Editor

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From the Chair

By George W. Coleman
Dallas, Texas

We made it this far! Its Annual Meeting time, August 2nd, 3rd and 4th, Toronto the place. The Committee has the following offerings:

Sunday August 2, 1998
8:00-12:00 p.m. PROTOTYPE OPERATING AGREEMENT
Louis T.M. Conti, Chair

2:00-3:00 p.m. SUBCOMMITTEE ON LIMITED LIABILITY COMPANIES
James J. Wheaton, Chair

3:30-5:00 p.m. COMMITTEE ON TAXATION
Robert R. Keatinge, Chair

Monday August 3, 1998
8:00-10:00 a.m. "PARTNERSHIPS AND LLC'S - IMPORTANT CASE LAW DEVELOPMENTS IN 1998"
Elizabeth S. Miller, Chair;
Other Panelists: Mike Bamberger, Bill Callison and Marty Lubaroff

8:30-11:00 a.m. JOINT MEETING - SUBCOMMITTEE ON LIMITED PARTNERSHIPS
Elizabeth G. Hester, Chair

11:00-12:00 p.m. SUBCOMMITTEE ON GENERAL PARTNERSHIPS AND JOINT VENTURES
Edward S. Merill, Chair

12:30-1:30 p.m. Committee Lunch
(together with COMMITTEE ON TAXATION)

2:30-4:30 p.m. "USES OF BUSINESS TRUSTS: CURRENT DEVELOPMENTS"
Ellisa O. Habbart, Chair;
Other Panelists: Thomas Mullen, Lisa Duda, Susan Boswell and Peter Partee

The schedule is overwhelming, what an effort the Committee is making. My thanks to all of you. I am looking forward to seeing each of you and to renew our friendships at the annual meeting and to work on projects for the greater good.
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TORONTO PROGRAMS

By James L. Jerue, Esq.
Chicago, Illinois

Our committee will continue its long, uninterrupted streak of outstanding programs with the two programs we'll be sponsoring in Toronto.

The first program, presented from 2:30 p.m. to 4:30 p.m. on Monday, August 3rd, is entitled "Uses of Business Trusts: Current Developments." Program Chair Ellisa Opstbaum Habbart will be joined by panelists Thomas Mullen (like Ellisa, from Pricket, Jones in Wilmington), Lisa Duda from Stradley, Ronon, Stevens & Young in Philadelphia, Susan Boswell of Streich Lang in Tucson and Peter Partee of Hunton & Williams in Richmond. The explosive growth in securitization and other financing transactions has created concomitant growth in the use of business trusts. The program will cover the critical legal characteristics of business trusts, address fiduciary duty issues and bankruptcy issues and compare and contrast business trusts with other entity forms.

On Tuesday, August 4th from 8:00 a.m. to 10:00 a.m., our committee will present "Partnerships and LLCs - Important Case Law Developments 1998." Chair Beth Miller of Baylor Law School and a panel of Mike Bamberger of Sonnenschein Nath & Rosenthal in New York, Bill Callison of Faegre & Benson in Denver and Marty Lubaroff of Richard, Layton & Finger in Wilmington will reprise the standing room only presentation they gave last year in San Francisco, supplemented by the important case law developments of the last year. We expect another packed house and excellent presentation.
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TASK FORCE ON DRAFTING A PROTOTYPE LLC OPERATING AGREEMENT MEETS

By Louis T.M. Conti
Orlando, Florida

The Task Force has met on two occasions at meetings of the Business Law Section, and additionally via conference calls and e-mail communications. The status of the committee's work is a current draft which will be the subject of discussion at the ABA Annual meeting in Toronto. The Task Force will meet from 8:00 a.m. to noon on Sunday, August 2nd. Hotel and room assignment for the Task Force have not been made available.

The current draft is awaiting revised "capital account provisions" from a committee member and then will be made available by e-mail to all Task Force members. Any member of the Committee on Partnerships and Unincorporated Business Organizations who would like to review a copy should send a request via e-mail to Lou Conti at lconti@hklaw.com. All comments are warmly welcomed.
The NASD’s listing rules do not presently address LLCs. Companies seeking NASD listings must satisfy both quantitative and qualitative criteria, and in both cases, LLCs seem to fall through the cracks.

Many of the non-quantitative criteria for Nasdaq National Market issuers involve corporate governance issues, and the NASD has two separate rules in this area that apply to limited partnerships and to all issuers other than limited partnerships. NASD Rule 4470 sets out the non-quantitative criteria for National Market companies that are limited partnerships. The rule requires the distribution of annual and quarterly reports, but does not require an annual meeting of limited partners unless such a meeting is required by the state of formation’s limited partnership statute or under the terms of the partnership agreement. A limited partnership issuer must also have a corporate general partner, and that corporate general partner must have at least two independent directors, as well as an audit committee the majority of which must be comprised of independent directors.

However, Rule 4470 applies only to limited partnership issuers, and not to entities like limited liability companies that should in many cases be treated like a limited partnership. For example, a manager-managed LLC with an operating agreement that is substantially the same as a public limited partnership’s partnership agreement would now be required to comply with the criteria found in Rule 4460. That rule technically applies to all non-limited partnership issuers, but is clearly geared toward corporate listings.

Rule 4460 contains many of the same provisions as the limited partnership rule, including requirements for annual and quarterly reports, independent directors and an audit committee, but also requires an annual meeting, and a variety of shareholder voting rights that go well beyond what a state LLC statute or operating agreement might otherwise require. These shareholder voting rights, which are deemed by the NASD to be conferred upon the owners of any non-limited partnership entity (whatever the owners are called) would require member approval of certain stock option or similar employee benefits for management, various change in control transactions, and merger, acquisition and other transactions where the voting stock being issued exceeds 20% or more of the existing voting power already outstanding. The NASD also imposes rules on non-limited partnership issuers that prevent various types of limitations or restrictions on shareholder voting power.
A separate issue involving the treatment of publicly-listed LLC interests arises under Rule 4420, which includes the quantitative designation criteria. That rule refers repeatedly to various "share" and "shareholder" requirements, and the NASD has been unclear whether an entity with "members" can use these criteria or would be relegated to a more restrictive rule that applies to "other securities."

Under the most likely models for public LLCs, it would seem that the NASD should take the approach of likening a manager-managed LLC to a limited partnership for purposes of both the qualitative and quantitative designation criteria. This position has been urged upon the NASD, but anyone with other views, or who has confronted this problem, should feel free to contact me so that I can bring you up to speed on the NASD contacts that have already been made.
FLORIDA JOINS THE UNION WITH RESPECT TO LLC'S

By Louis T. M. Conti
Orlando, Florida

On May 22, 1998, S.B. 704 became law in Florida without the Governor's signature. Although Florida was the second state to adopt legislation creating Limited Liability Companies ("LLC's") in 1982 and revised its LLC law in 1993, the use of LLC's in Florida had been substantially hampered because Florida taxed LLC's as corporations for purposes of Florida corporate income tax. Consequently, many lawyers advised their clients to use S corporations or partnerships to conduct business in the state. S.B. 704 is an important step in bringing Florida into the mainstream of state laws which govern LLC's. The bill provides that an LLC formed under Florida law or qualified to do business in Florida as a foreign LLC will not be subject to Florida's corporate income tax if the LLC is classified as a partnership for Federal income tax purposes.

S.B. 704 as originally drafted was limited in scope. It sought to have both domestic and foreign LLC's taxed for Florida corporate income tax purposes based on the Federal tax classification of the LLC. It did not anticipate single-member LLC's.

Prior to this legislative session, Florida chapter 608 did not permit single-member LLC's. Observers of this legislative session know that S.B. 704, as introduced, and throughout committee review, did not address single-member LLC status, except in remarks made as to the legislative intent of the House bill. While S.B. 704 was wending its way through the committee hearing process, another bill (H.B. 1657) was traveling through the legislative labyrinth. H.B. 1657 was primarily focused on permitting cross-entity mergers, but it also permitted single-member LLC's and provided for the use of the words "Limited Liability Company" or the abbreviation "L.L.C." in the name of the entity. Previously, Florida required that the words "Limited Company" or the abbreviation "L.C." be the last words of the name of every LLC formed in Florida.

However, in the final week of the legislative session, the sponsor of S.B. 704, moved the amendment of his bill to include provisions amending 608.405 to permit single-member LLC's. Shortly thereafter, provisions from H.B. 1657 (the single-member LLC, and entity merger bill) were added to S.B. 704. At about the same time, provisions from yet another bill (S.B. 608) were added to S.B. 704. Regrettably, as sometimes happens with last-minute amendments, the provisions added to S.B. 704 were not subject to careful review or analysis of construction, particularly with respect to single-member LLC's.

As to the single-member LLC provisions, the language of S.B. 704 provides that "any natural person who engages in a trade, business, or profession in this state under his or her own or any fictitious name, whether individually as a proprietor or in partnership with others, or as a member or manager of a Limited Liability Company classified as a partnership for federal income tax purposes will not be subject to corporate income tax." Under federal check-the-box regulations, a single-member LLC is not "classified as a partnership", but rather, the LLC is disregarded for federal tax purposes. Thus, the single-member LLC is a pure pass-through entity for federal tax purposes. Representative Lacasa, the House sponsor of the legislation, confirmed the House's intention to track...
federal classification of single-member LLC's. Consequently, one can take the position that a single-member LLC, whether or not using a fictitious name, would not be subject to the Florida corporate income tax (assuming the LLC did not elect to be taxed as a corporation under "check-the-box" regulations for federal income tax purposes).

This author believes firmly that the legislative intent is that if the LLC would not be taxed as an entity for federal income tax purposes, the LLC should not be taxed under chapter 220 of the Florida statutes. Regrettably, the language of the statute amending chapter 220 was not made clear with respect to single-member LLC's because the original focus was on two member LLC's and hence the analogy to partnership classification. Once the single-member provisions were added, the focus should have shifted from federal partnership classification to simply one of federal tax classification. One can only hope that the Florida Department of Revenue will look through to the intent of the various legislative proposals and classify the LLC's tax status for state income tax purposes identically to its classification for federal income tax purposes. Encouragingly, informal conversations with representatives of the Florida Department of Revenue have resulted in indications that the Department of Revenue will follow federal tax classification.
Doing Business in New York as an S Corporate Member of a Limited Liability Company

By Howard Lefkowitz
New York, New York

Doing business in New York as an S Corporate member of a limited liability company ("LLC") may, surprisingly perhaps, subject such member to New York corporate franchise tax. Under a recent advisory opinion from New York Department of Taxation and Finance the Advisory Opinion, TSB-A-97(26)C, Dec. 4, 1997, from the State of New York - Department of Taxation and Finance, when an LLC is doing business in New York State and such LLC is treated as a partnership for New York State tax purposes, a foreign (i.e., out-of-state) federal S Corporate member of the LLC is treated as a corporate partner of a partnership under the New York State Business Corporation Franchise Tax. If the S corporation's activities as a foreign corporate member of the LLC are like the activities of a general partner in a partnership, such corporate member is subject to New York corporate franchise tax under Article 9-A ("Article 9-A") of the New York State Tax Law (the "Tax Law"). However, if the S corporation's activities were like the activities of a limited partner, it would be subject to New York franchise tax under Article 9-A only if the LLC is doing business, employing capital, owning or leasing property or maintaining an office in New York State and the corporate member is engaged, directly or indirectly, in the participation in or the domination or control of all or any portion of the business activities or affairs of the LLC.

If such S corporation is subject to tax under Article 9-A, it would be treated as a C corporation for purposes of Article 9-A unless the S corporation has made the election under section 660(a) of the Tax Law to be treated as an S corporation.
Limited Liability Companies:

Limited Liability of Member

Page v. Roscoe, LLC, 497 S.E.2d 422 (N.C. Ct. App. 1998). In this case, the court found that the plaintiff’s naming of an individual member of an LLC in a nuisance suit was improper and was a basis for sanctions under Rule 11 of the North Carolina Rules of Civil Procedure. The plaintiffs brought a nuisance action against an LLC and a member of the LLC based upon the LLC’s plan to build a gas storage facility. The plaintiffs eventually dismissed all of their claims, and the LLC and its member sought Rule 11 sanctions. The court found that the plaintiffs’ allegations against the LLC were sufficient to avoid Rule 11 sanctions; however, the court found that the allegations against the individual member were not well-grounded in law and violated Rule 11. The court cited provisions of the North Carolina Limited Liability Company Act providing that an LLC member is not liable for the obligations of the LLC solely by reason of being a member and that a member is not a proper party to a proceeding against an LLC. Since the plaintiffs’ complaint did not allege any acts on the part of the member individually, the naming of the individual member was not well-grounded in law and violated Rule 11.

Personal Liability of Member Under Agency Principles

Water, Waste & Land, Inc. v. Lanham, 1998 WL 112869 (Colo. March 9, 1998). Two individuals who were members and managers of an LLC were held personally liable on a contract with a third party under the partially disclosed principal doctrine. Under well established common law agency principles, if an agent contracts for a partially disclosed principal (i.e., the third party knows of the existence of the principal but does not know the principal’s identity), the agent is personally liable on the contract as a general rule. In this case, Preferred Income Investors, L.L.C. was identified only as P.I.I. to the third party. The court rejected the argument that the constructive notice provisions of the Colorado Limited Liability Company Act protected the individuals from liability where they failed to adequately identify the LLC principal.

Veil Piercing

Marina, LLC v. Burton, No. CA 97-1013, 1998 WL 240364 (Ark. Ct. App. May 6, 1998). In this breach of contract action by Burton against an LLC and its sole member, the appeals court upheld the trial court’s refusal to pierce the LLC veil. The appeals court also found no error in the trial court’s refusal to hold the member liable for misrepresenting certain individuals as members of the LLC. Burton argued that the LLC’s veil should be pierced
because the LLC was undercapitalized and inadequately financed. However, the court noted that Burton was aware the LLC was a new entity and the financing of the project was to be accomplished through a bank loan. The court was not convinced under these facts that it should disturb the trial court's ruling. The court found that Burton's misrepresentation claim against the member failed because there was evidence to support the trial court's finding that Burton had not reasonably relied on the member's misrepresentations. In this regard, the court pointed out that Burton acknowledged he was aware that LLCs were designed to limit an investor's liability. Further, apparently satisfied with having a mortgage on the land that was the subject of the contract, Burton testified that the financial capability of the individuals listed as members was none of his business.

C & J Builders & Remodelers, LLC v. Geisenheimer, No. CV 97-0405555S, 1998 WL 203400 (Conn. Super. Ct. April 17, 1998). In this case, a construction contractor operating as a sole proprietor entered a construction contract with an arbitration clause. During the course of the construction work, the sole proprietor reorganized as an LLC. The contract contained a clause prohibiting assignment of any monies due under the contract without consent of the owner. The court held that the LLC could enforce the arbitration clause of the contract because the individual sole proprietor and the LLC were "practically identical." The court began its discussion of the "identity rule" with references to the concept of piercing the corporate veil. The court recognized that the rule "is more often applied in cases where an individual attempts to hide behind the corporate veil to avoid his legal obligations:" however, the court then stated that "there is no conceptual reason not to apply the rule to avoid injustice here."

Northern Tankers (Cyprus) Ltd. v. Backstrom, 967 F.Supp. 1391 (D.Conn. 1997). In this veil piercing case, the court pierced the veil of a number of entities, but it is unclear whether the LLCs mentioned in the case were among these entities. The plaintiff in this case sought to hold two individuals, Backstrom and Lindholm, and various related entities liable for a judgment the plaintiff had obtained against a shipping company controlled by Backstrom and Lindholm. The court identified "53 individual, corporate, partnership and trust defendants." In fact, two of the defendants were Colorado LLCs. The court applied federal common law to pierce the corporate veil of numerous shipping and real estate corporations, holding that these corporations were merely alter egos of Backstrom and Lindholm. Additionally, the court stated that it was piercing the "corporate veil of various other entities" that were fraudulently created for Lindholm personally. This is an apparent reference to part or all of a group of entities that owned substantial real and personal property in Colorado. This group consisted of a grantor trust, two corporations, a limited partnership and two LLCs. These entities were not directly part of the shipping and real estate enterprise operated by Backstrom and Lindholm but were personal investment vehicles of Lindholm. Although the two LLC defendants were identified by the court as part of this latter group of entities, it is unclear from the opinion whether the LLC veils were actually pierced. The court specifically found that the limited partnership and its corporate general partner were alter egos of Lindholm and expressly disregarded their "corporate" existence. The case does not indicate the basis for exercising jurisdiction over the LLCs, but it appears that jurisdiction may have been premised upon the fact that the LLCs were alter egos of Lindholm. The court noted that the LLCs were among defendants that had contested jurisdiction, but that the court had adopted a special master's recommended ruling. In an earlier reported decision, the court had postponed deciding whether the LLCs and certain other defendants were subject to jurisdiction based upon their alter ego status to provide the plaintiff an opportunity to engage in discovery on the alter ego issue. See Northern Tankers (Cyprus), Ltd. v. Backstrom, 901 F.Supp. 72 (D.Conn. 1995).

**Dissolution**

Gee v. Bullock, 1996 R.I. Super 941, 1996 WL 937009 (R.I. Super. Nov. 16, 1996). Two members of an LLC sued the third member, Bullock, seeking injunctive relief barring Bullock from operating the LLC and permitting them to carry on the business. Bullock sought dissolution and an accounting. The court found that Bullock made fraudulent representations when she claimed to have sole ownership of an existing business into which she induced the plaintiffs to invest and when she promised to sign an operating agreement giving the plaintiffs a fifty-one percent controlling interest in their newly formed LLC. In fact, another individual had a substantial interest in the business Bullock claimed to own, and Bullock later refused to sign the operating agreement for the new LLC. Ultimately, Bullock locked the other two members out of the business premises and transferred the assets of the LLC to a new corporation formed by Bullock and yet another investor. The court concluded that the LLC dissolved when Bullock wrongfully
Cases Involving Limited Liability Companies and Registered Limited Liability Partnerships - Part IV

service in this case was ineffective under the New York Summit Bank v. Taylor, 1997 WL 811526 (S.D.N.Y. Nov. 12, 1997). The LLC issue

interests
court concluded
the instrument of conveyance
property. The court stated that there must
entirety. The court noted that an ownership interest in
claimed that his interest in an LLC was exempt because it was held in
In re Welty, 217 B.R. 907 (Bankr.D.Wyo. 1998). The debtor in this bankruptcy case

Limited Liability Company Property and Interest of Members

Graves v. Graves, 1998 WL 142005 (Mo. Ct. App. March 31, 1998). This divorce action included an issue as the propriety of the trial court's order that one spouse, who was awarded all interest in the couple's LLC, execute a lease on behalf of the LLC. Mr. and Mrs. Graves owned an LLC which operated on a tract of land it leased from the Graves. The trial court awarded Mr. Graves all right, title and interest in the LLC and awarded Mrs. Graves the land on which the LLC operated. The court also ordered Mr. and Mrs. Graves to sign a twelve month lease of the land to the LLC at a specified rent. The lease included a signature line for the LLC to be signed by Mr. Graves as president. Mr. Graves complained that the court did not have jurisdiction over the LLC and that the order to execute the lease was thus improper. The court acknowledged the difference between a member's interest in an LLC and property of the LLC itself, but analogized the situation to that of a sole shareholder corporation where a court may order the shareholder spouse to cause the corporation to undertake certain acts. The court concluded that the trial court was within its authority to cause the LLC to lease the property from Mrs. Graves since it did not order the LLC to distribute any property and did not directly order the LLC to sign the lease.

In re Welty, 217 B.R. 907 (Bankr.D.Wyo. 1998). The debtor in this bankruptcy case claimed that his interest in an LLC was exempt because it was held in a tenancy by the entirety. The court noted that an ownership interest in an LLC is intangible personal property. The court stated that there must be a clear manifestation of intent on the face of the instrument of conveyance to support the existence of a tenancy by the entirety. The court concluded that the articles of organization, the only evidence of the ownership interests of the debtor and his spouse, did not demonstrate an intent to hold ownership in the LLC in a tenancy by the entirety.

Service of Process

Summit Bank v. Taylor, 1997 WL 811526 (S.D.N.Y. Nov. 12, 1997). The LLC issue in this case was the effectiveness of an attempt to serve a subpoena on an LLC. The attempted service in this case was ineffective under the New York Limited Liability Company Act
because service was attempted by delivery of the subpoena to an individual who was neither a manager nor a registered agent of the LLC.

**Treatment of LLCs Under Other Statutes**

R & R Marketing, LLC v. Brown-Forman Corporation, 704 A.2d 1327 (N.J.Super.A.D. 1998). This case was ably summarized by Peter Hutcheon in the last issue of the PUBOGRAM. The case involved a determination of whether an LLC formed by two liquor distributors would retain the protection enjoyed by the distributors under New Jersey's wholesaler anti-discrimination statute. The court determined that the LLC was protected under the statute. Each of the distributor members of the LLC had been authorized to distribute distilled spirits for Brown-Forman prior to the formation of the LLC, but Brown-Forman refused to fill orders for the LLC. Brown-Forman argued that it never authorized the LLC to sell for it and that the distributor members lost the protection afforded by the anti-discrimination statute because they gave up their ability to act as independent wholesalers by forming the LLC. The court noted that the protection of the statute would have continued had the two distributors effectuated a corporate merger and concluded that affording the LLC the protection of the anti-discrimination statute would not defeat the purpose of that statute and would advance New Jersey's goal in promoting formation of LLCs.

**Securities Law Issues**

People v. Riggle, 95CA1476 (Colo. Ct. App. Jan. 15, 1998) This case was not selected for publication and is not, at least at the time this summary is being written, available on Westlaw or Lexis. The following summary is based on information supplied by Bob Keatinge. The defendant in this case appealed a jury verdict finding him guilty of selling unregistered securities and employing unlicensed sales representatives under Colorado law for selling interests in a Nevada LLC (a wireless cable deal). The Colorado Court of Appeals held that the facts permitted the jury to find that the interests being sold in the Nevada manager-managed LLC were securities, but the appeals court reversed the verdict because the jury was not provided with a requested clarifying instruction regarding the definition of a security. The court appeared to acknowledge that the same presumption of non-security status applicable to general partners applies to members who have the right by a majority vote to remove the manager and assume management functions themselves. However, the court stated that a factfinder might find that (1) the number of members necessary to remove the manager would make removing the manager impractical, (2) the number of members would make management impractical, and (3) the business in which the LLC was to engage was very specialized and the operating agreement provided that it was in the members' best interest to engage a manager. On this basis, the court determined that there was sufficient evidence to support the jury's finding that the interests were investment contracts and therefore securities. The court of appeals reversed, however, because the trial court refused to respond to the jury's request for clarifying instructions on the definition of a security and the Howey test.

IBS Financial Corporation v. Seidman and Associates, LLC, 136 F.3d 940 (3rd Cir. 1998). In this case, a group that included LLCs filed a Schedule 13D with the SEC, and the court was called upon to interpret the "control" disclosure requirements as applied to the LLCs. The IBSF Committee to Maximize Shareholder Value (the "Committee"), a group of shareholders of IBS Financial Corporation ("IBSF"), filed a Schedule 13D which IBSF contended did not conform with the requirements of the Exchange Act and SEC regulations. With respect to the LLC members of the Committee, IBSF argued that the Schedule 13D did not report information regarding the persons "controlling" the LLCs. In general, the defendants argued that it was sufficient to provide information about certain managers of the LLCs whereas IBSF argued that information about certain members and others must also be included. For those LLCs in which a majority in interest of the members had the power to remove the manager, the court held that the majority member was a person "controlling" the LLCs. Thus, information regarding the majority member should have been included in the Schedule 13D. One of the LLCs had an investment manager and an administrative manager. The Committee argued that only the investment manager was a "controlling" person while IBSF argued that the administrative manager, the majority member and the majority member's general partner were all "controlling" persons of the LLC. The administrative manager had the power to remove the investment manager and to make management decisions. The court thus concluded that the administrative manager was a "controlling" person. However, since the operating agreement of this LLC made no provision for removal of the administrative manager, the court concluded that the Committee was not required to include information regarding the majority member or its general partner.
Registered Limited Liability Partnerships:

Sasaki v. McKinnon, 1997 WL 781769 (Ohio Ct. App. Dec. 18, 1997). This opinion addresses whether a shareholder derivative action that included claims against the corporation's outside auditor should be stayed based on an arbitration clause in a letter agreement between Ernst & Young, LLP and the corporation. In the course of its discussion, the court referred to Ernst & Young, LLP as Ernst & Young's "successor" and stated that "the two entities...are, but for the corporate change to a limited liability partnership designation, the same entities for all practical intents and purposes."

Howard v. Klynveld Peat Marwick Goerdeler, 977 F.Supp 654 (S.D. N.Y. 1997). In this employment discrimination case, the court noted in passing that the defendant KPMG Peat Marwick became a limited liability partnership and amended its Articles of Partnership to add the suffix "LLP" to its name in August 1994. The court explained that the partnership was not dissolved and continued without interruption with the same partners, principals, employees, assets, rights, obligations, liabilities and operations as maintained prior to the change." The court continued, "Peat Marwick LLP is in all respects the successor in interest to Peat Marwick."
A DELAWARE "WAKE-UP CALL" FOR GENERAL PARTNERS

By Vernon R. Proctor
Wilmington, Delaware

Does anyone remember the term contra proferentem from Contracts class in law school? (No, it does not have anything to do with the habits of Nicaraguan rebels.) Well, the Delaware Supreme Court recently applied that hoary principle in a lawsuit between some of the limited partners of a Delaware limited partnership and its general partner. On March 19, 1998, the Supreme Court affirmed a preliminary injunction entered by the Delaware Court of Chancery against a general partner's plan of withdrawal and dissolution ("Plan") on the ground that the Plan violated the limited partnership agreement ("Partnership Agreement"). SI Management L.P., et al. v. Wininger, Del., No. 457, 1997 (Mar. 19, 1998).

The plaintiffs in the case were two of approximately 1,850 limited partners in a Delaware entity called Synthetic Industries, L.P. (the "Partnership"). The principal asset of the Partnership was common stock of a Delaware corporation named Synthetic Industries, Inc. ("Synthetic"), a maker of polypropylene products. The general partner was another Delaware limited partnership called SI Management L.P. (the "General Partner"). Originally, the Partnership held 100 percent of the common stock of Synthetic. In November 1996, Synthetic made an initial public offering of new stock that diluted the Partnership's interest in Synthetic to approximately 67 percent. Disputes arose between the General Partner and certain limited partners concerning the IPO and broader issues of returning value to the limited partners for their interests in the Partnership, which interests had been illiquid since the Partnership's formation in 1987.

In February 1997, plaintiff Wininger filed suit against the General Partner and its controlling persons, alleging breaches of their fiduciary duty to the limited partners for, among other things, the alleged failure to sell either the Partnership's holdings of Synthetic stock, or Synthetic as a whole, to a buyer for a control premium. After the lawsuit was filed, the General Partner announced its Plan, one that, if approved by the limited partners, would offer them the option of either (a) liquidating their interests in the Partnership for cash through another public offering or (b) maintaining their proportionate equity interests in Synthetic itself. In order to implement the Plan, the General Partner proposed certain amendments to the Partnership Agreement that were required "to eliminate restrictions concerning the withdrawal and distribution of partnership interests."

In September 1997, the General Partner and its affiliates filed their proxy statement with the SEC and began to solicit proxies in support of the Plan. Within a few days after the commencement of the solicitation, the plaintiffs amended their Delaware complaint to seek a preliminary injunction against both implementation of the Plan and the scheduled meeting of limited partners to consider the necessary amendments.

The plaintiffs alleged in the amended complaint that the proposed amendments to the Partnership Agreement violated that contract in several respects. Two of the alleged breaches are particularly pertinent to the Supreme Court's opinion. First, the limited partners contended that Section 12(d) of the Partnership Agreement -- requiring an opinion
of special counsel selected by the limited partners to approve certain aspects of the legality of the proposed transaction — was violated, even though the meeting was called by the General Partner and not at the request of 10 percent or more in interest of the limited partners. Second, the limited partners contended that the Plan violated Section 12(h)(ii) of the Partnership Agreement in that the proposed amendments allegedly altered or modified the rights of limited partners to receive a certain percentage of distributions without their specific consent. In that connection, the plaintiffs criticized the proposed amendments as discriminatory, because certain limited partners would receive distributions in cash while others would be forced to accept distributions of Synthetic stock on three distribution dates into the distant future at a time when the stock value was likely to be lower.

On October 23, 1997, after limited discovery was taken, the Court of Chancery heard the plaintiffs' preliminary injunction application on an expedited basis. At the conclusion of the hearing, the Vice Chancellor made an oral ruling enjoining implementation of the Plan but refusing to prevent the meeting of the limited partners. The Court of Chancery found that the plaintiffs' interpretation of the pertinent provisions of the Partnership Agreement had a reasonable probability of success on the merits at a final hearing. Specifically, the Vice Chancellor seemed to agree with the plaintiffs' position that an opinion of special counsel was required even where the General Partner, as opposed to the limited partners, proposed an amendment to the Partnership Agreement, and that the proposed amendments violated the provision preventing the adoption of amendments that altered certain rights of limited partners to receive distributions without their consent. (Ironically, at the scheduled meeting of limited partners, the limited partners voted overwhelmingly to accept the Plan proposed by the General Partner.)

The General Partner took an interlocutory appeal from the preliminary injunction order, which appeal was accepted by the Delaware Supreme Court because "the underlying question of contract interpretation presented here in the context of a limited partnership agreement is an important one of first impression in this jurisdiction." The appeal was likewise conducted on an expedited basis. On March 19, 1998, the Supreme Court (in an opinion written by Chief Justice Veasey) affirmed the injunction and remanded the case for further proceedings.

The Supreme Court framed the issue on appeal as follows: "The proper judicial approach to contract interpretation of a limited partnership agreement in a setting where the general partner solicits numerous investors who become limited partners by signing a comprehensive agreement." This case followed closely on the heels of two other Supreme Court decisions on contract interpretation in other contexts: Eagle Industries v. DeVilbiss Health Care, 702 A.2d 1228 (Del. 1997) (standard two-party indemnification contract), and Kaiser Aluminum Corp. v. Matheson, 681 A.2d 392 (Del. 1996) (involving an ambiguity in a certificate of designations relating to the conversion rights of preferred stockholders of a Delaware corporation). The Supreme Court was clearly interested in expanding the scope of its rulings on the proper use of extrinsic evidence to construe commercial contracts in a noncorporate setting.

On the limited record before it, the Court examined the relevant provisions of the Partnership Agreement and determined that they were ambiguous. The Supreme Court's specific holding was that the Court of Chancery had not abused its discretion in entering the preliminary injunction against implementation of the Plan. However, the Court was somewhat sympathetic with the plaintiffs' construction of the key provisions of the Partnership Agreement regarding the required opinions of special counsel and the procedures whereby the limited partners could adopt amendments. The defendants had contended that the opinion of special counsel was required only where the amendment process was invoked by the limited partners pursuant to the "written request" procedure in the Partnership Agreement, as opposed to a competing procedure permitting amendments suggested by the General Partner. The defendants similarly contended that the restrictions on adoption of amendments with respect to distributions did not apply to amendments initiated by the General Partner. The General Partner offered extrinsic evidence to support its position from the original offering memorandum sent to prospective investors in the Partnership.

The Supreme Court's analysis began with established Delaware principles governing the construction of insurance contracts, which are usually not negotiated with policyholders. Such contracts, if ambiguous, are traditionally interpreted against the insurance companies drafting them under the principle of contra proferentem. In Kaiser Aluminum, the Court applied the same principle without extrinsic evidence in construing an ambiguous corporate charter provision against a public corporation in a class suit brought
by preferred stockholders. On the other hand, in Eagle, the Court held that extrinsic evidence was permissible in interpreting an ambiguous provision in a negotiated bilateral contract. In SI Management, the Supreme Court explicitly continued its decade-long effort "to cabin the use of extrinsic evidence" in contract cases.

Chief Justice Veasey found that the factual setting of SI Management was closer to Kaiser than to Eagle:

This was not a bilateral negotiated agreement. Rather, it appears that the General Partner solicited and signed on 1,850 investors to the Agreement that those investors had no hand in drafting. Based on that premise, the principle of contra proferentem applies. Accordingly, ambiguous terms in the Agreement should be construed against the General Partner as the entity solely responsible for the articulation of those terms. On remand and final hearing on a permanent injunction, the trial court should determine whether these plaintiffs actually did engage in negotiations with the General Partner on the issues in question here.

In a footnote, the Court rejected the General Partner's further argument that it should not be bound by contra proferentem because the ownership of the General Partner had changed since the time of drafting the Partnership Agreement.

The limited purpose of the remand was clear: to determine whether extrinsic evidence would be admissible on a final hearing. After remand, the General Partner informed the plaintiffs that it could not present evidence of any negotiations of the pertinent terms of the Partnership Agreement with the limited partners. Later, the Plan was withdrawn by the General Partner, which has now moved to dismiss the underlying litigation as moot. (The plaintiff limited partners dispute the mootness contentions in part, based on other allegations in their pleadings concerning alleged self-dealing acts of the General Partner and its affiliates.)

The implications of SI Management for practitioners are potentially significant. Most limited partnership syndications of any size involve partnership agreements drafted by the general partners/issuers or their affiliates, with the aid and assistance of underwriters in appropriate cases. In transactions involving a large number of investors, limited partners have no opportunity to "negotiate" with the General Partner in any meaningful sense regarding the specific terms of the partnership agreements. In effect, they are "contracts of adhesion." Should similar disputes arise in the future, the Supreme Court's opinion in SI Management clearly indicates that the burden will be on the general partners of Delaware limited partnerships to prove either (a) that the agreements should be construed unambiguously in their favor, or (b) that there were actual negotiations with investors sufficient to permit general partners to introduce extrinsic evidence in cases of ambiguity. Otherwise, the general partners will be forced to concede defeat in any contract-based case in which they can proffer no evidentiary support (in the form of negotiations) for their interpretation of the agreement. As in SI Management, potentially beneficial transactions may have to be withdrawn as a result of such problems. Of course, the broader moral of the story is to draft partnership agreements clearly, particularly those sections regarding dissolution or withdrawal options available to investors (in short, "exit strategies"). To the extent entities are formed in Delaware, serious business consequences may attach to the failure to do so.

(In the interest of full disclosure, the author's law firm represents a group of intervenor limited partners in SI Management who aligned themselves with the General Partner in defense of the Plan.)
American Bar Association
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OVER THIRTY

"Brevity is the soul of wit."

What strikes the unsuspecting mind, upon reflection is the notion of wit having a soul. First, the pointed satire - so (often) "rapier wit" - is too frequently a blade of dis-temper. Second, it seems a bit perverse (save for the fallen Michael and the powers of the Dark Side of the Force) to imbue wit (even in the abstract) with an esse. More astonishingly, one is to accept the presence of nothing - some reified photon doing the particular wave in the last days of this Millennium.

Nonetheless, in the North Country, we shall have passed over to a place where good souls will gather, albeit briefly. See You in Toronto.

PdH