Robert Keatinge– Chair Volume XVII, No. 1
Peter D. Hutcheon – Editor October 2000

FROM THE CHAIR

By: Robert Keatinge
Denver, Colorado

The Partnership Committee has concluded a very successful meeting in New York. As a result of several distractions, including the split venue of the New York/London meetings, the holding of the meeting much earlier in the summer than is usually the case, and the tremendous time pressure on our members, we were fortunate to have good turnouts for Ellisa Opstbaum Habbart’s program on Choice of Entity and reception by Christina Bank & Trust Company and our programs on "Hubs, Spokes and Junction Boxes, Entity Rationalization and Inter-Entity Mergers," "Partnerships and LLC's - Important Case Law Developments 2000," and "The Use of Single Member LLC's and Review of Prototype LLC's Operating Agreements for Single Member LLC's." In addition to Ellisa, the Lou's (Hering and Conti), Michael A. Bamberger, Bill Clark, George Coleman, Warren Kean, Chip Lion, Scott Ludwig, Beth Miller, Ann Stilson, and Jim Wheaton are to be congratulated for providing thoughtful and useful comments and valuable outlines. Those who were not able to get to the program should be aware that the materials are available to Business Law Section members on line at: http://www.abanet.org/buslaw/home.html.

I was recently asked by Section leadership to describe the activities and contributions of the Partnership Committee. My response was as follows:

- We are in the process of drafting model operating agreements for single-member and multiple-member LLCs and a limited liability partnership ("LLP") agreement under the Uniform Partnership Act (1997). These projects serve the dual purpose of: (1) creating usable documents that can serve as starting points for drafters of agreements, and (2) providing an opportunity for discussion of issues that come up in drafting.
- We provide a variety of programs on topics of interest to practitioners dealing with partnerships, LLCs and business trusts including a popular recurring program on current developments in partnership law, programs on drafting agreements and programs on the use of business trusts and other vehicles in financing and business transactions.
- For over a decade we have provided review and commentary on business organization statutes including: (1) the revision of the Uniform Partnership Act (which began with an article by committee leaders in the Business Lawyer), (2) the Uniform Limited Liability Company Act and other state limited liability company acts (which have been thoroughly discussed at our subcommittee on limited liability companies - discussions that have resulted in a prototype limited liability company act and many changes in state legislation), and, currently, (3) the revision to the Revised Uniform Limited Partnership Act, in which several committee members are involved, either as advisors or as members of an ad hoc committee to comment on the act.
- We work with other sections and committees to provide partnership and LLC law expertise. The committee has worked with the Taxation Committee and the Section on Taxation and Real Property Probate and Trust Law Section, we have worked with the Internal Revenue Service to develop rational tax policy with respect to partnership classification. The committee is currently working with the Committee on Negotiated Acquisitions to provide partnership commentary on the Model Joint Venture Agreement. Several members of the committee will be involved in the Symposium on the Future of the Practice on Business Law to be held in March of next year.
- As a result of the open discussion of business organizations in the committee, a joint subcommittee (with the Committee on Corporate Laws) on entity rationalization has been developed to identify inadvertent inconsistencies (i.e., inconsistencies that are not policy driven) among business organization statutes and seek to coordinate those statutes. In addition, the committee has been actively involved in the new National Conference of...
Commissioners on Uniform State Laws Drafting Committee on a Uniform Cross Entity Coordination Act with similar objectives.

I am sure that I have missed other important Committee activities, and I would appreciate any suggestions for inclusion in the report to the section.

Many of these projects will be continued at the Committee meeting in Washington, DC Wyndham City Center 1143 New Hampshire Avenue, Washington, DC 20037 (202) 775-0800 (phone) (202) 331-9491 (fax) 800-WYNDHAM (reservations) Washington, D.C. on Friday, November 10, 2000 from 8:00 am until 4:30 pm and Saturday, November 11, 2000 from 8:00 am until 2:00 pm. Among the topics that will be discussed on Friday are the current status of the revision of the Revised Uniform Limited Partnership Act, the new Uniform Cross-Entity Coordination Act being drafted by the National Conference of Commissioners on Uniform State Laws ("NCCUSL"), and current developments in unincorporated organization law and choice of entity. Attire at the meeting will be casual.

Agenda
Friday, November 10, 2000

8:00 am - 10:00 am ReRULPA Drafting Project - Lauris Rall, Business Law Section Advisor to Drafting Committee to Revise the Revised Uniform Limited Partnership Act

10:00 am - 11:30 am General Partnership Subcommittee, Business Trust Committee - Beth Miller, Ellisa Opstbaum Habbart

11:30 am - 12:00 pm Executive Subcommittee - Bob Keating, Beth Miller, Marty Lubaroff, Lauris Rall, Jim Wheaton, Ellisa Opstbaum Habbart, George Coleman, Peter Hutcheon, Tom Rutledge, Bill Clark.

12:00 pm - 2:00 pm Joint Luncheon with the NCCUSL Committee on a Uniform Cross-Entity Coordination Act- Harry Haysworth (Chair), Professor Ann Stilson (Reporter), Bill Clark (Business Law Section Advisor), George Coleman (ABA Advisor and Partnership Committee Chairman Has Been)

2:00 pm to 4:00 pm Limited Liability Committee Subcommittee, Jim Wheaton (including a discussion of choice of entity).

Saturday, November 11, 2000

9:30 am to 12:30 am Drafting Committee on Prototype LLC Agreement - Beth Miller "inch hitting" for Lou Conti.

12:30 am to 3:30 pm Drafting Committee on Prototype LLP Agreement - Scott Ludwig.

Over the coming months we will be following the NCCUSL drafting projects, preparing for the Spring and annual meetings of the section and continuing with our agreement drafting projects. I encourage members who have not gotten involved to contact me (perhaps most easily by e-mail at r or the appropriate subcommittee chairs with proposals for projects and activities. To the extent it is difficult participating in the meetings, consider signing up for the partnership committee List Serve. Either way, I hope to see or hear from you soon.

PROTOTYPE LLC AGREEMENT DRAFTING TASK FORCE
STATUS REPORT AS OF SEPTEMBER 26, 2000

By Lou Conti
Orlando, Florida

The Prototype LLC Agreement Drafting Task Force under the inconsistent but dogged chairmanship of one whose body is giving in to the ravages of time; has nonetheless so far produced three (3) Prototype Single Member LLC Operating Agreements. These three prototypes are primarily the result of the efforts of an informal "subcommittee" of the Task Force, comprised of Lou Herring, Scott Ludwig, Marty Lubaroff and Beth Miller. These "Four Horsepersons" produced initial drafts which required but minor tinkering by the rest of the Task Force.

The three single member prototypes cover three distinct uses:

- An operating unit of a large parent holding company which wants to use the LLC to operate a trade or business;
- A "Bankruptcy Remote" special purpose entity (which the bankruptcy lawyers tell us is not really bankruptcy remote); and
- A prototype which could be used by an individual to hold real estate or operate a business.

Members of the Task Force put on a CLE program on the use of single member LLCs, and utilized the three prototypes as points of discussion, at this year's Annual Meeting in New York. Reaction to the prototypes, was mixed given the varying backgrounds and experience of lawyers in the audience. Members of the Task Force, however, were uniformly lavish in their praise of the prototypes.

The Task Force now returns to the time consuming task of seeking consensus on the Multi-Member, Manager Managed, Prototype Operating Agreements for use as an Operating Company, and another Multi-Member, Probably Manager Managed Prototype for use as a Real Estate development entity. In the drafting sessions to date, the Task Force has struggled mightily to break free from the constraints of the "Defined Terms" section of the multiple member prototypes. Like Jason's Argonauts however, the Task Force is inexorably drawn to return to the "Defined Terms" and the often unexplored mysteries hidden within those definitions.

At the drafting session in New York, the Task Force was finally able to move beyond the definitions to the sections on "Formation and Purpose", "Members Status Rights and Obligations", "Management of the Company" "Capital Contributions", until running out of time at Section 6 "Distributions Of Cash And Property"!

The Task Force, is primed and ready to complete Section 6 and proceed into "Allocations, Capital Accounts and Tax Matters", perhaps even getting to "Dissolution Of The Company" and "Transfers Of Membership Units" at the next meeting.

The Task will delve into the fray again at the Washington, DC meeting on Saturday, November 11th. Be There, and be a part of it.

1. Editor’s Note: Lou Conte has continued his dedicated leadership of this effort despite being "brought low" by his ailing back.

REPORT ON NCCUSL RERULPA PROGRESS:
RERULPA HAS FIRST READING AT NCCUSL ANNUAL MEETING!

By Lauris Rall
New York, New York

On August 2, 2000, Lauris Rall, as the Advisor from the ABA Section of Business Law, attended the Annual Meeting of the National Conference of Commissioners on Uniform State Laws in St. Augustine, Florida. On that date, the NCCUSL Drafting Committee which is working on a revision of the Uniform Limited Partnership Act (code name, "ReRULPA"), delivered the first reading of the draft statute to the assembled Commissioners. The Drafting Committee, the Reporter and Lauris sat on a stage while the Commissioners took turns reading line by line the current draft and entertained questions from the floor.

Howard Swibel, chair of the NCCUSL Drafting Committee, opened the reading by making some introductory remarks about the current draft of ReRULPA, and about the absence of the chief ABA representative, Marty Lubaroff, who is still recovering from serious illness. Howard extended his best wishes for Marty’s recovery and rapid return to the drafting process. Howard’s major points about the current draft were that the statute borrows heavily from RUPA and the Uniform LLC Act, including the rules regarding fiduciary duties, and that the mergers and conversions article is new.

In general, there were not extensive comments regarding the draft statute from the floor. Because there were other statutes being adopted or amended at the same time that the first reading of ReRULPA was taking place (the reading was interrupted during the day so that other statutes could be "finished"), there was a definite lack of continuity. Some of the comments from the floor were:

1. The definitions of business (for example, see the reference to "enterprise" in Section 306), entity and ownership interest are too vague and should be reconsidered.
2. Section 110(b)(4)(B), which permits the duty of loyalty to be modified by specifying the number or percentage of partners who can authorize a transaction which would otherwise violate the duty, should be revised to indicate the minimum percentage necessary to authorize.
3. Section 405 (b) and (c)(4) need to be revised to reflect the default status of a limited partnership as an LLLP - each suggests proceeding against the general partner’s assets if the "partner is personally liable for the claim under Section 404."
4. Consider whether a general partner of an LLLP should be personally liable for improper distributions under Section 509.

5. Consider how a general partner is to give notice of his dissociation from the partnership under Section 603 - delivery of notice to the registered agent?

6. Should transferees have voting rights under Section 801(3) in a decision to dissolve the partnership after the dissociation of a general partner (other than the last remaining general partner).

7. Should the liability to third parties of general partners of existing limited partnerships be altered by the adoption of ReRULPA and the passage of time as contemplated by the transition rules in Section 1205?

There were no comments from the floor regarding the radical change eliminating personal liability of general partners as a default rule or regarding the codification of fiduciary duties of general partners and limited partners in limited partnerships. In general, there were few comments and, as the afternoon reading wore on, few commissioners attending the first reading of ReRULPA. For example, Articles 3 and 4 were read in about one-half hour with very little commentary (perhaps because Commissioner Haynsworth read in a very authoritarian manner). The ABA representative was not requested to comment on any issue.

The Partnerships Committee Task Force on ReRULPA will meet in Washington DC to discuss the current draft of the statute. We anticipate the attendance of the Reporter for the NCCUSL Drafting Committee, Prof. Dan Kleinberger, who has been very receptive to input from the various advisors from the ABA and other groups. The Task Force’s discussion in November will probably center on certain issues which are not yet fully resolved, such as:

1. Does the existence of limited partner voting rights or management powers in the partnership agreement result in a fiduciary duty for the limited partner so that if he does not exercise those rights or powers, he could be found to have violated a duty?

2. What should be the title of the new act and the new entity formed thereunder? If general partners have limited liability as a default rule, should the entity be known as a limited liability limited partnership (LLLP)?

3. Certain sections in the statute which are affected by the GP limited liability rule should be reviewed carefully to determine whether revisions are in order. Should alternative rules be adopted because of the possibility that a general partner could have general liability? Or should any rule which is internal to the partnership only be the default rule applicable to an LLLP?

4. What will be the effect of a new "junction box" statute - permitting mergers and conversions among all types of entities - be on Article 11 of ReRULPA.

Please join us for the discussion.

In the meantime, any member of the Task Force or the Partnerships Committee requesting additional information about the ReRULPA process is encouraged to contact Lauris Rall at lrall@thacherproffitt.com or by telephoning him at 212-912-7439.

"LLCS IN DISGUISE"

By Gerald V. Niesar
San Francisco, California

This article provides an overview of the increasingly popular hybrid that is a statutory Limited Liability Company whose operating agreement and other internal documents structure the entity to look and feel as much like a corporation as possible.

In each of the past two Spring Meetings of the Section, the Partnership and Tax Committees have presented a program on this subject entitled: The Unincorporation: or Ms. Doolittle, LLC Meets H. Higgins, Inc.-Why Can’t an LLC Be More like a Corporation? The materials from March 24, 2000 program should be available from the Section headquarters and on the Section website. What follows is a look at the major issues and concepts.

First, one might ask why business people might want to consider this hybrid. The answer is that the traditional partnership management and ownership allocation structure does not necessarily appeal to
business founders and their investors whose experience has been primarily in the corporate world. Thus, providing for a Board of Directors and typical corporate officers gives them a greater sense that entity will have an internal governance, and day-to-day management structure, that is essentially the same as what they are accustomed to seeing in early stage businesses which are incorporated. In addition, providing for founders holding "Common Stock" (often called "Common Units" in the LLC context), and investors having one or more series of "Preferred Stock" ("Units"), gives those with corporate investing experience a feeling of comfort that they are getting the same type of deal they are used to seeing in the traditional corporation model. Meanwhile, the investors can receive the benefit of pass through losses to shelter other passive income, and the entity preserves the option of an asset sale liquidity event without the double taxation that would be experienced if the corporate form had been used.

But, as the title of the Program implies, there remain differences between the LLC disguised to look like a corporation, and the true corporation. The most important of these differences, of course, is the pass-through tax treatment that is available to the LLC, assuming it has not checked the box to be treated as a corporation for tax purposes. Stemming from the partnership characterization of the LLC, however, are a number of problems that must be considered, mostly in the areas of "employee" compensation and incentives. A fundamental concept that applies in the tax arena has to do with the notion that no "partner" can be an "employee" of the partnership. This means that, if an employee obtains a membership interest in the LLC, for all purposes he or she must be treated as partner for tax purposes, and not as an employee. Thus, the "employee" will no longer have withholding taxes deducted from her paycheck but, instead, will receive an allocation of profit or loss on a K-1 Form at the end of the year. Other consequences of this non-employee status are inability to participate in a Section 125 Cafeteria Plan, the $10,000 limit on 401(k) Plan contributions applicable to partners, and a reduced ability to benefit from tax-free health insurance premiums.

Options are one area of great complexity and difficulty for LLCs desiring to provide equity-based compensation and incentives. First, it should be observed that Incentive Stock Options are not available to anyone other than employees of entities taxed as corporations. While "non-statutory" or "non-qualified" stock options can be used by LLCs, there are significant problems associated with this approach due to the fact that the "stock", when acquired on exercise of the options, is not the simple common stock acquired upon exercise of a stock option in a corporate entity. Theoretically, on exercise of the option, the LLC will have to determine the fair market value of its business, determine from that the fair market value of the "stock" issued (such amount being considered taxable income to the exercising option holder and a deductible expense to the LLC), and "book up" the assets of the LLC to account for the issuance of the stock at that, presumably, higher value than the book net asset value of the LLC. Because of these tax and accounting complications, generally speaking an LLC will almost always find that issuing "restricted stock" with a vesting requirement, coupled by a Section 83(b) election made by the recipient, will be the only practical way to use its equity as part of its compensation program.

While the tax and accounting hurdles of using an LLC like a corporation can be daunting, the management and administration aspects should be relatively easy to craft in the charter documents. The approach often used in "corporate LLC" entities is to provide a mostly generic Operating Agreement, but specify that the capital, profit/loss, and management characteristics will be as set forth in By-laws which are attached and incorporated as part of the Operating Agreement. These By-laws then will provide the capital structure, similar to the stock clauses in corporate Articles of Incorporation, governance by a Board of Directors to be elected by the members ("stockholders"), again tracking the type of language one would find in corporate By-laws on these subjects, and the titles and descriptions of duties of officers which are essentially the same as the provisions found in corporate By-laws. Because the LLC Act will not fill in the interstices that might exist in By-law provisions, reference may be made to a State corporate law, including cases construing such law, to be guidance for the implementation of the LLC’s By-laws in the event of ambiguity or dispute.

The California LLC form book published by Data Trace Publishing Company, of which this author is a co-author, contains forms which can be used as a basis for corporate model LLCs.

CASES INVOLVING LIMITED LIABILITY COMPANIES AND REGISTERED LIMITED LIABILITY PARTNERSHIPS - PART XI

By: Elizabeth S. Miller
Waco, Texas

LLC and LLP cases not identified in previous issues of the PUBOGRAM are noted below.
Limited Liability Companies:
Diversity Jurisdiction


Pro Se Representation

**Valentine L.L.C. v. Flexible Business Solutions, L.L.C.**, 27 Conn.L.Rptr. 378, 2000 WL 960901 (Conn. Super. June 22, 2000). The court held that an LLC may not appear pro se, relying on case law holding that corporations and partnerships may not appear pro se. The court found no basis to distinguish an LLC from either a corporation or partnership on this issue.

**Banco Popular North America v. Austin Bagel Company, L.L.C.**, No. 99 CIV. 11252 SAS, 2000 WL 669644 (S.D. N.Y. May 23, 2000). A default judgment was entered against a Texas LLC because it failed to appear with counsel. The LLC attempted to appear pro se, but the court stated that the rules do not permit a corporation to appear pro se.

Nature of LLC

**All Comp Construction Company, LLC v. Ford**, 999 P.2d 1122 (Okl. App. 2000). The court stated that an LLC is a fictional a person for legal purposes and, as such, is not entitled to recover damages for mental stress and anguish as a natural person would.

LLC as Indispensable Party in Suit Between Members;
Derivative Right in Absence of Statutory Authorization

**Weber v. King**, No. 00-CV-2815(JM), 2000 WL 1233047 (E.D. N.Y. July 10, 2000). Two members of Kathleen's Bake Shop, LLC sued the third member alleging various acts of past and ongoing breach of contract, unfair competition, and interference with the LLC's business. The court concluded that the LLC was a necessary and indispensable party whose joinder was not feasible because it would destroy diversity jurisdiction. Additionally, the court recognized a common law right to bring a derivative action even though the New York LLC law does not include provisions expressly permitting derivative lawsuits. The court then concluded that many of the plaintiffs' claims were more appropriately characterized as claims of the LLC that should be brought derivatively. In the course of its analysis, the court discussed the nature of an LLC as a separate entity and the analogies that should be made to partnerships and corporations.

Standing/Authority to Sue

**Industrial Electronics Corp. of Wisconsin v. Power Distribution Group, Inc.**, 215 F.3d 677 (7th Cir. 2000). The plaintiff and seven other companies, including the defendant Power Distribution Group, Inc. (Power), formed an LLC to develop an integrated marketing and distribution consortium using Power software. Once the LLC was formed, it entered a franchise agreement with Power to allow the LLC to purchase, install and use the Power software. The franchise agreement contained an arbitration clause, but the LLC agreement did not. When the plaintiff later sued Power alleging that Power had made material misrepresentations to induce the plaintiff to join the LLC, Power argued that the claim was subject to the arbitration clause in the franchise agreement. The court acknowledged that an LLC cannot bind its members or subject them to liability through contracts between the LLC and third parties but said that this principle did not resolve the case. The court explained that the plaintiff was like a corporate shareholder who would not have standing to sue or enforce a contract of the corporation; however, the court went on to address the possibility that the plaintiff was a third party beneficiary of the franchise agreement. The court did not have to resolve this issue because it determined that the injuries alleged did not arise under or relate to the franchise agreement. The alleged fraud related to the inducement of the plaintiff to join the LLC by entering the LLC agreement, and the arbitration provision in the franchise agreement did not affect disputes arising out of the LLC agreement.

Pre-formation Contracts

**P.D.2000, L.L.C. v. First Financial Planners, Inc.**, 998 S.W.2d 108 (Mo. App. 1999). The plaintiff LLC sought to bring suit on a contract entered on the LLC's behalf prior to the LLC's formation, and the defendant defended on the basis that the LLC lacked capacity to enter and enforce the contract. The contract was signed by the organizer as president of the LLC and, upon its formation, the LLC ratified
or adopted the organizer’s pre-formation activities. In the contract, the defendant acknowledged that the LLC was in the process of being formed as a Nevada LLC. The defendant argued that it was not bound because it withdrew prior to the LLC’s ratification of the contract. The court held, however, that under the circumstances in this case the defendant was estopped to deny the existence of the LLC.

Piercing LLC Veil

**Hollowell v. Orleans Regional Hospital LLC**, 217 F.3d 379 (5th Cir. 2000). The lower court’s opinion denying summary judgment in this case was reported in a previous issue of the PUBOGRAM. In this WARN Act case, the plaintiffs sued an LLC and various other individuals and entities seeking to pierce the veil of the LLC as well as two corporate members of the LLC on alter ego grounds. The plaintiffs also sought to establish that the LLC and various related entities constituted a single business enterprise. The jury found for the plaintiffs on both the alter ego and single business enterprise issues. On appeal, the defendants argued that there was insufficient evidence to support these findings. The court of appeals noted that neither party challenged the district court’s conclusion that Louisiana would treat an LLC in the same manner as a corporation for veil piercing purposes. (In an earlier footnote, the court described LLCs as essentially corporations which the Louisiana tax code taxes as partnerships.) The court rejected the defendants’ attack on the jury’s findings. With respect to the alter ego finding, the defendants’ challenged the jury’s findings of undercapitalization of the LLC and commingling of funds. The court stated that, even if the court were to accept the defendants’ arguments, the defendants had failed to present a challenge to the jury’s finding of alter ego based upon the totality of the circumstances. The court of appeals also rejected a challenge to the jury’s finding of single business enterprise, citing evidence of common ownership, common management, a unified employment policy, and disregard for corporate separateness of the entities.

**Oliver v. Boston University**, No. 16570, 2000 WL 1038197 (Del. Ch. July 18, 2000) (concluding LLC was Boston University’s alter ego for purposes of personal jurisdiction assuming truth of allegations that LLC was formed by BU solely to serve its interest and was completely dominated by BU).


Limited Liability of LLC Member; Personal Liability of Member Under Agency or Other Principles

**Whitmore v. Hawkins**, No. 99-1443, 2000 WL 828285 (4th Cir. June 27, 2000). Whitmore was employed to be the chief operating officer of an LLC. Hawkins, an individual, recruited Whitmore and signed the employment agreement on behalf of the LLC. Hawkins did not sign in an individual capacity, but the employment agreement’s initial paragraph recited that the parties were the LLC, Whitmore and Hawkins. When Whitmore was later terminated, he sought to hold Hawkins personally liable for the severance pay to which he was entitled under the contract. The court found that the agreement was ambiguous with respect to the liability of Hawkins since he did not sign in an individual capacity but was referred to as a party in the contract. The court examined the extrinsic evidence and concluded it was sufficient to create an issue for the jury as to personal liability of Hawkins under the contract. Thus, the court reversed the trial court’s dismissal of Hawkins from the case.

**Addy v. Myers**, No. 990387, 2000 WL 1231051 (N.D. Sup. Ct. Aug. 31, 2000). In this case, the court rejected the plaintiffs’ claim that a member of an LLC agreed to assume personal liability for the LLC’s debt. The LLC involved had four members, consisting of two individuals and two entities. Informally, the group consisted of four families. When the LLC experienced financial difficulties, two individuals in the group personally signed for several lines of credit over a period of months. These individuals argued that the defendant, a member of the LLC, and her husband agreed to assume personal liability for a portion of the debt. The court concluded that the defendant was not liable as a guarantor because she did not sign a written guaranty (as required by the North Dakota Statute of Frauds to enforce a guaranty). The plaintiffs argued that the defendant was liable as a member of the LLC because a majority of the members voted to borrow the funds for the LLC and to assume equally the debt. The court discussed the principle that an LLC is a separate legal entity whose members are not liable for its debts and obligations and concluded that the defendant member was not liable because she did not agree to be liable for any part of the loan. The court of appeals also upheld the trial court’s dismissal of the member’s husband because there was no evidence that he was a named owner or manager of the LLC or had done anything to personally obligate himself on the borrowing in issue.

Interpretation of Operating Agreement - Arbitration Clause

**Mid-America Surgery Center, L.L.C. v. Schooler**, 719 N.E.2d 1267 (Ind. App. 1999). Two former members of an LLC sued the LLC to enforce the terms of the operating agreement entitling them to be bought out after they resigned as members and the remaining members voted to continue the operation.
of the LLC. After the former members filed suit, the LLC sought to require the matter to be submitted to arbitration. The operating agreement had a clause requiring any dispute, controversy or claim arising out of or in connection with or relating to the operating agreement to be submitted to arbitration. The former members argued that the arbitration clause was unenforceable because of the LLC’s breach of the agreement or, alternatively, because the LLC had waived its right to arbitration. The court rejected both arguments and held that the trial court erred in denying the application for arbitration.

**Interpretation of Operating Agreement - Fiduciary Duties of Managers and Members**

*Suntech Processing Systems, L.L.C. v. Sun Communications, Inc.*, No. 05-99-00213-CV, 2000 WL 1052980 (Tex. App. B Dallas Aug. 1, 2000). The minority member of a Texas LLC claimed that the majority member owed it a fiduciary duty as a matter of law. The case does not state whether the LLC was member-managed or manager-managed, but the articles of organization provided as follows: Members of this Company have a duty of undivided loyalty to this Company in all matters affecting this Company’s interest. The Texas LLC act provides: To the extent that at law or in equity, a member, manager, officer, or other person has duties (including fiduciary duties) and liabilities relating thereto to a limited liability company or to another member or manager, such duties and liabilities may be expanded or restricted by provisions in the regulations. The court noted the absence of Texas case law on fiduciary duties of LLC members and looked to case law regarding fiduciary duties of shareholders of a closely held corporation. In prior cases, the court had held that co-shareholders of closely held corporations are not necessarily in a fiduciary relationship. Rather, the existence of a fiduciary relationship is a question of fact. The court applied the same reasoning and stated that it made no difference that the defendant was the majority member. The court pointed out the provision in the LLC’s articles provided for a duty of loyalty to the LLC rather than between the members. The court said that neither the statute nor the provision in the articles authorized the court to find that there was a fiduciary relationship between the members as a matter of law, and the issue was remanded for determination by the fact finder.

*Lynch Multimedia Corp. v. Carson Communications, L.L.C.*, 102 F.Supp.2d 1261 (D. Kan. 2000). One of the members of a Kansas LLC sued another member and the member’s owners and agent for breach of the operating agreement and breach of fiduciary duty when they acquired other cable franchises rather than securing them for the LLC. The LLC operated a television cable system, and the operating agreement specified that if an opportunity to purchase certain cable television systems came to the attention of a member, the opportunity must first be offered to the LLC. Another provision in the operating agreement stated that any member or manager was permitted to engage in other business ventures, and the LLC would have no rights in such regard. Robert Carson was trustee of the Robert Carson Trust, a 20% member of the LLC, as well as president and a manager of the LLC. In 1997, Carson informed representatives of Lynch Multimedia Corporation (Lynch), a 60% owner of the LLC, of the potential availability of certain cable systems. Lynch was receptive to exploring the opportunities. Over the next year, discussions and negotiations continued. At one point, a Lynch representative rejected the acquisition of the cable systems, but a couple of proposals were made a few months later in the fall of 1998. In the spring of 1999, Carson acquired the cable systems through his own entity. Lynch sued for breach of the operating agreement and breach of fiduciary duty. The court held that the operating agreement’s requirement that certain opportunities be offered to the LLC contemplated only that the LLC be made aware of such opportunities, not that a more formal offer, of the offer and acceptance variety, be presented. The court concluded that Carson satisfied this requirement by making Lynch aware of the opportunities. The court rejected Lynch’s claims that a formal meeting was required, noting that the LLC at all times operated on an informal basis with Lynch’s acquiescence. The court also stated that the operating agreement’s requirement that certain opportunities be offered to the LLC must be read in conjunction with the provision permitting members to engage in other ventures; therefore, it plainly was directed at permitting members to enter separate and additional business relations in the cable TV industry. The court thus granted summary judgment in favor of the defendants on both the breach of operating agreement and breach of fiduciary duty claims. The court said that Lynch had not articulated how the breach of fiduciary duty claims were distinguishable from the breach of operating agreement claims. The court cited the provision of the Kansas LLC Act that permits members of an LLC to expand or restrict their duties and liabilities by agreement. Lynch argued this provision did not apply because it was passed after the LLC in this case was formed, but the court held otherwise, citing the legislature’s intent that from January 1, 2000, the Act shall apply to all LLCs formed in Kansas, whether formed before or after that date.

*Froelich v. Erickson*, 96 F.Supp.2d 507 (D. Md. 2000). The factual background of this case is rather complicated, but the claims involved assertions of fraud, breach of fiduciary duty and breach of contract by Froelich, an ousted CEO and board member of a Maryland LLC. Froelich was also a member of the LLC who, along with other minority members, was cashed out in a squeeze-out merger following a reclassification of interests of the LLC approved by all members except Froelich. Two documents primarily governed the LLC’s operations as an LLC. These documents were an Operating Agreement, which the court characterized as the LLC equivalent of a corporate charter, and a Members Agreement, which the court described as the equivalent of a stockholders’ agreement. The
operating agreement defined classes of preferred and common interests, the role and responsibility of
the board, and the rights and duties of the members. The member agreement supplanted the
operating agreement by specifically defining rights of members and restrictions on alienation
of interests. The court summed up Froelich’s claims as a challenge to a handful of corporate actions
taken by [the LLC’s] Board and its Members. The court summed up the key issues in the case as
follows: (i) Did the corporate documents or Maryland corporate law authorize the Board to take the
actions that Froelich challenges? (ii) If the Board or the Members had the power to act, by what
standard (e.g., business judgment rule or fiduciary duty) should the Court review the Board’s exercise
of that power? and (iii) Did the Board meet the appropriate standard? The court characterized the case
as arising in the context of corporate decisions by the LLC’s board of directors and applied the
business judgment rule. The court noted that the LLC’s operating agreement stated that the LLC’s
directors are subject to the duties of a corporate fiduciary as defined by Maryland law, thus, the court
continued, the LLC board’s decisions are measured against the business judgment rule just as if [the
LLC] were a traditional corporation, rather than an LLC.@ The court found no evidence that the board
had acted in bad faith and concluded that the board’s actions were protected by the business judgment
rule. The court also concluded as follows: the LLC and majority member did not breach a duty of good
faith and fair dealing (noting uncertainty under Maryland law as to whether there is a separate cause
of action in this regard and stating that the duty in any event only prohibits a party from preventing the
other party from performing under the contract); the majority member did not breach a fiduciary duty to
Froelich by usurping a business opportunity (stating that a majority interest holder clearly owes the
minority a fiduciary duty but finding no breach in view of the board’s independent approval of the
transaction); the reclassification did not breach the operating agreement or the member agreement
(finding that the transaction fell outside a provision in the member agreement restricting redemptions
and was governed by the operating agreement, which was amended in accordance with its terms to
permit the reclassification). In Froelich’s favor, the court found that the LLC owed Froelich severance
pay under an employment agreement between the LLC and Froelich and that the reclassification and
squeeze out were related parts of a transaction in which Froelich had properly preserved his statutory
right to an appraisal. The court explained that the Maryland LLC statute grants a member the same
appraisal rights as an objecting stockholder under corporate law. Maryland corporate law provides
appraisal rights in connection with a parent-subsidiary merger, and Froelich properly objected to the
squeeze-out merger. The court viewed the reclassification and subsequent squeeze-out merger as a
single transaction rather than separate events such that Froelich was entitled to appraisal of his
interests immediately prior to the reclassification rather than appraisal of his reclassified interests
immediately prior to the merger that occurred five months later.

Interpretation of Operating Agreement - Withdrawal/Buy-Out

chief operating officer of an LLC that operated fast food restaurants. He also received a 5%
membership interest in the LLC and a 5% interest in a second LLC that was being formed to acquire
additional fast food franchises. When Whitmore’s employment was terminated, he claimed that he was
entitled to receive the value of his membership interests under provisions of the Maryland LLC Act in
effect at the time. The court pointed out that the statutory provisions relied upon by Whitmore were
default provisions and that the operating agreements of the two LLCs had provisions addressing
withdrawal and buy-out. The court concluded that the termination of Whitmore’s employment did not
amount to a withdrawal or entitle Whitmore to receive the value of his interest under either of the
operating agreements, thus Whitmore was not entitled to be bought out.

Dissolution/Winding Up

27, 2000). This case involved a dispute as to whether an LLC’s claim against a deceased member was
timely presented to the administratrix of the deceased member’s estate. In the course of the court’s
opinion, the court notes that, while the member’s death dissolved the LLC, the LLC had authority to
wind up its affairs, including the ability to make payments to creditors required by the deceased
member’s actions.

Charging Order; Receivership

2000). Baker obtained a judgment against David Dorfman for legal malpractice and fraud.
Subsequently, Dorfman formed a professional LLC and began to operate his law practice through
the PLLC. In this action, Baker sought to hold the PLLC liable on the judgment against Dorfman as a
successor in interest. The court concluded that the PLLC was liable as a successor in interest. Baker
also sought assignment of a 75% interest in the PLLC and appointment of himself as receiver for the
LLC. (The court explained that the request for assignment of a 75% interest was to permit Baker to
receive 75% of the profits of the PLLC while leaving Dorfman an incentive to generate future profits.)
The court relied upon the charging order provisions of the New York LLC Act to grant Baker’s request

http://apps.americanbar.org/abanet/common/login/securearea.cfm?areaType=committeee&role=CLS90000&url=/buslaw/committees/CL590000/newsletter/pub...
for assignment of an interest in the LLC. The court relied upon general receivership provisions to conclude that the circumstances warranted appointment of a receiver, and the court appointed Baker, through his attorney, receiver of the PLLC.

**Bankruptcy**

*In re Sandman Associates, L.L.C.*, 251 B.R. 473 (W.D. Va. 2000). The court held that an LLC’s letter agreement that it would grant a membership interest to a new member in exchange for a capital contribution was not an executory contract that could be rejected by the LLC. The agreement called for James Dye to make a $350,000 capital contribution in exchange for a 25% membership interest. Dye made the contribution and was treated as a member by the LLC, though Dye never signed the operating agreement as the letter agreement required. The court found that the failure to sign the operating agreement was not a material breach and that the agreement had been substantially performed. Thus, it was not an executory contract. The court also addressed Dye’s objections to the application for fees filed by the law firm for the LLC debtor. Dye objected on the grounds that the firm was representing the interests of the other members rather than the LLC in the dispute over Dye’s membership. The court upheld the bankruptcy court’s finding that the services of the law firm were rendered in an effort to clarify the debtor’s ability to reorganize and function as an ongoing entity.

*In re Forbes Property Management, L.L.C.*, No. 99-24812-SBB, 2000 WL 1175620 (Bankr. D. Colo. June 6, 2000). An LLC debtor filed an application for authority to hire counsel. The application was granted, but the LLC sought clarification regarding the procedures for payment since the funds to be used were not property of the estate. The $5,000 retained was paid by the general managing member of the LLC from personal funds, but the court’s original order required application for court approval of fees and set forth guidelines for compensation. In the course of modifying the original order, the court pointed out that the managing member and the LLC had a potential, though not actual, conflict of interest and cautioned counsel that he represented and served the interests of the debtor and not those of its managing member.

**Securities Laws**

*KFC Ventures, L.L.C. v. Metairie Medical Equipment Leasing Corp.*, No. CIV. A. 99-3765, 2000 WL 726877 (E.D. La. June 5, 2000). The issue in this case was whether the plaintiff’s LLC membership interest was a security under federal securities laws. In response to the defendants’ motion for failure to state a claim for securities fraud, the court held that it was possible that the plaintiff’s membership interest was a security. The focus was upon whether the investment involved an expectation of profits to be derived solely from the efforts of others. The LLC in question was manager-managed, and the operating agreement gave the manager full power and discretion to manage the affairs of the LLC. The operating agreement did not permit a member to act as the LLC’s agent and largely limited the member’s role to voting on extraordinary matters such as dissolution. The manager was also an 85% member of the LLC. Thus, the court concluded the membership interest might be a security. However, the plaintiff’s allegations of fraud lacked particularity, and the court dismissed the claims subject to fifteen days leave for the plaintiff to amend and plead with sufficient particularity.

*Great Lakes Chemical Corporation v. Monsanto Company*, 96 F.Supp.2d 376 (D. Del. 2000). The plaintiff purchased a Delaware LLC from the defendants and brought a securities fraud suit alleging that the defendants failed to disclose material information in connection with the sale. The defendants moved to dismiss for failure to state a claim, arguing that the interests sold to the plaintiff were not securities. The plaintiff argued that the LLC membership interests were either stock, an investment contract or any interest or instrument commonly known as a security. After reviewing various seminal cases in the securities area as well as recent decisions specifically addressing whether LLC membership interests constituted securities, the court addressed the plaintiff’s arguments that the membership interests in issue were securities. First, the court rejected the argument that the membership interests in issue were stock although the court acknowledged that the interests were stock-like in nature. To determine whether the membership interests were investment contracts, the court applied *Howey*. The court concluded that the plaintiff did not invest in a common enterprise because it bought 100% of the LLC membership interests from the defendants. The plaintiffs pointed out that when the LLC was formed it involved a pooling of contributions by the two defendants; however, the court focused on the challenged transaction, which was the sale of the defendants’ interests to the plaintiff, rather than the formation of the LLC. The court also concluded that the plaintiff’s expectation of profits did not depend solely on the efforts of others. While the LLC was manager-managed, the operating agreement gave members the power to remove managers, with or without cause, and to dissolve the LLC. The court pointed out that the plaintiff’s ownership of 100% of the LLC meant that its power to remove managers was not diluted by the presence of other ownership interests. Finally, although the purchase agreement referred to the interests as equity securities, the court rejected the argument that the membership interests were any interest or instrument commonly
known as a security because the interests did not satisfy the Howey test. Relying on Supreme Court and lower court cases, the court refused to distinguish between an investment contract and any interest or instrument commonly known as a security.

Successor Liability

**Baker v. David A. Dorfman, P.L.L.C.,** No. 99Civ.9385(DLC), 2000 WL 1010285 (S.D. N.Y. July 21, 2000). Baker obtained a judgment against David Dorfman for legal malpractice and fraud. Subsequently, Dorfman formed a professional LLC and began to operate his law practice through the PLLC. In this action, Baker sought to hold the PLLC liable on the judgment against Dorfman as a successor in interest. The court concluded that the PLLC was liable as a successor in interest. The court found no reason to doubt that the traditional rules of successor liability are applicable to limited liability companies. The court also commented that the facts of the case supported an inference that Dorfman formed the LLC as a fraudulent attempt to escape his obligation to Baker.

Inter-Entity Merger

**Cole v. Kershaw,** No. Civ.A. 13904, 2000 WL 1206672 (Del.Ch. Aug. 15, 2000). The plaintiff, a former partner in a Delaware general partnership, challenged the 1993 merger of the partnership into a Delaware LLC. The merger eliminated the plaintiff’s interest in cash. The plaintiff claimed the merger was invalid because it was not authorized under the Delaware Partnership Act or the partnership agreement and, even if otherwise valid, was invalid because it was unfair to the plaintiff. While neither the Delaware Partnership Act nor the partnership agreement authorized merger of the partnership, the court found that the merger was authorized under the Delaware LLC Act, which authorized LLCs to merge with other entities. According to the court, if this provision, explicitly authorizing LLCs to merge with general partnerships, is to have meaning, the General Assembly must have presumed to have intended that such a merger could go in either direction, i.e., that LLCs would be allowed to merge with general partnerships, or the reverse. Therefore, the fact that the general partnership statute was silent on the subject is of no moment. The court also found that the LLC statute was applicable even though the partnership was formed prior to the effective date of the LLC Act. The court concluded that the effect of the merger was to dissolve the partnership. The court agreed with the plaintiff’s claim that the merger did not meet the entire fairness test and that the plaintiff was entitled to an award of damages measured by his proportionate share of the fair value of the partnership as of the merger date.

Conversion

**Sinatra v. Edin,** No. 99-CA-1515, 2000 WL 1125864 (La.App. Aug. 2, 2000). Edin and Sinatra formed Nite Life, Inc. to operate a nightclub, and each contributed $50,000 to the corporation for a $100,000 security deposit required to lease certain premises. Later Sinatra and Edin formed an LLC to take over all assets of the corporation including the lease and the rights to the deposit. Edin, Sinatra and their bookkeeper proceeded as if the lease had been transferred, but the court stated that the lease was not effectively transferred because the lease and deposit constituted substantially all of the assets of Nite Life, Inc. and the technical requirements under the corporate statute were not followed. Sinatra ultimately withdrew from the LLC pursuant to an agreement whereby he received $50,000 and released the LLC from any liabilities. The corporation was dissolved by action of Edin and Sinatra. About the same time, the lease was canceled because Edin decided to purchase the property, and the $100,000 security deposit was returned to Edin or the LLC and used as a down payment on the property. Sinatra argued that he was entitled to a distribution of $50,000 because the lease was never effectively transferred and the deposit should have been returned to the corporation and distributed to the shareholders. The court rejected Sinatra's claim on the basis that he had failed to comply with a requirement under the corporate law that the claim be brought within 90 days of the attempted transfer of the lease. The court also rejected Sinatra's claim for breach of fiduciary duty inasmuch as Sinatra intended that, and gave instructions for, the lease to be transferred, and he proceeded as if the transfer had been accomplished.

Termination of Title Insurance on Transfer of Property to LLC

**Gebhardt Family Investment, L.L.C. v. Nations Title Insurance of New York, Inc.**, 752 A.2d 1222 (Md.App. 2000). The issue in this case was whether a title insurance policy continued in effect for property transferred by a husband and wife to their wholly owned LLC. The court held that the transfer terminated the policy. The Gebhardts conveyed the real property to a Virginia LLC of which they were the only members. The deed recited that the LLC paid $160,990 for the property, but Mr. Gebhardt testified that this recitation was for transfer tax purposes and that the LLC did not pay anything for the property. The Gebhardts argued that the conveyance was in effect a conveyance to themselves because they were the sole members of the LLC. The court, however, stressed that an LLC is a separate entity and that there was indeed a transfer from one entity or person to another. The court stated that there was a real conveyance even if no money changed hands because the Gebhardts obtained benefits conferred by a Virginia LLC, including limited liability and estate planning benefits.
Finally, the court rejected the argument that, because they had already reported the cloud on the title before the transfer to the LLC, the Gebhardts should be able to recover under the title policy. The court rejected this argument on the basis that any loss suffered by virtue of the cloud on the title would be suffered by the LLC, not the Gebhardts, because the Gebhardts successfully conveyed the entire property under a special warranty deed.

**Mortgage Registration Fee on Transfer of Property to LLC**

*GT, Kansas, L.L.C. v. Riley County Register of Deeds,* ___ P.2d ___, 2000 WL 966769 (Kan. App. July 14, 2000). In this case, the court interpreted a mortgage registration fee exemption that applies when the principal indebtedness is covered or included in a previously recorded mortgage or other instrument with the same lender or their assigns upon which the registration fee... has been paid. A mortgage registration tax was paid upon the filing of two real estate mortgages totaling $7,880,000 on two tracts of real estate owned by a two person partnership. Later, the partnership conveyed the property to its two partners, and the partners subsequently transferred the property to their LLC, which took title subject to the mortgage. A new mortgage listing the LLC as the borrower was presented for filing along with an affidavit that $7,880,000 of the mortgage was principal indebtedness included in a previously filed mortgage. The county required a fee on the entire amount of the new mortgage, and the LLC filed a protest. The Board of Tax Appeals found the ultimate issue to be whether the LLC was the same entity that originally mortgaged the subject property, and the Board therefore rejected the protest. The LLC appealed, and the district court found that the statute did not require that the borrower be the same entity. The court of appeals reversed the district court and followed the Board's interpretation. The court distinguished this case from another case in which a refinancing by the same borrower was held to be exempt. The court seemed to conclude that the result would have been different if the LLC had assumed liability for the mortgage when it took title to the property.

**Over Thirty**

"Survey" is a rather intriguing word. It conjures up images both of the landscape rolling on to a distant horizon and of the surveyor, perhaps atop a vantage point with telescope mounted on a tripod. So do we measure the Earth; not all that much different today than in the time of the *pater familias* of this nation. His name graces an often graceless urban center; his stature overwhelms the narcissists we have too often made his unworthy successors.

Early in November after the frightful exploits of *Walpurgisnacht* on October 31 (the eve of All Hallows Day) and the quadrennial cotillion we call Election Day, the Committee will meet in Washington. And countless unbilled hours of intellect and policy will be contributed to rationalization and clarification of abstract structures, structures so abstract they are without *corpus*. This life of the mind invest itself in unincorporated business organizations, not mere aggregates (we believe), but separate juridical entities whose "ness" would command even the attention of Mr. Justice Stephen Field.

Those efforts are but the present making of the very "landscape" that will someday be the subject of a surveyor's study. Lest you be incredulous, refer to the very first column from Chairman Keatinge, in which he cites his report to Section leadership. This is the prattling of a latter-day Ozynandias. It is merely a factual recounting of the "landscape" created by the several members of this Committee in their continuing search for a consensus that bespeaks the very partnership that is in its name.

Celebrate the past and the tasks already accomplished; nurture the present and the colloquy of law making; welcome the future with all its unexpected uncertainties, secure in knowledge that in the face of Chaos, we were yet *homo faber* in the realm of the intangibles.

See you inside The Beltway.

PdH

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